Methodology

Rating Companies in the Merchandising Industry

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Scope and Limitations

This methodology represents the current DBRS approach for ratings in the merchandising products industry. It describes the DBRS approach to credit analysis, which includes consideration of historical and expected business and financial risk factors as well as industry-specific issues, regional nuances and other subjective factors and intangible considerations. Our approach incorporates a combination of both quantitative and qualitative factors. The methods described herein may not be applicable in all cases; the considerations outlined in DBRS methodologies are not exhaustive and the relative importance of any specific consideration can vary by issuer. In certain cases, a major strength can compensate for a weakness and, conversely, a single weakness can override major strengths of the issuer in other areas. DBRS may use, and appropriately weight, several methodologies when rating issuers that are involved in multiple business lines. Further, this methodology is meant to provide guidance regarding the DBRS methods used in the sector and should not be interpreted with formulaic inflexibility, but understood in the context of the dynamic environment in which it is intended to be applied.

Introduction to DBRS Methodologies

• DBRS publishes rating methodologies to give issuers and investors insight into the rationale behind DBRS's rating opinions.
• In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. DBRS ratings assess an issuer’s ability to make timely payments on outstanding obligations (whether principal, interest, preferred share dividends or distributions) with respect to the terms of an obligation. In some cases (e.g., non-investment grade corporate issuers), DBRS ratings may also address recovery prospects for a specific instrument given the assumption of an issuer default.
• DBRS rating methodologies include consideration of historical and expected business and financial risk factors as well as industry-specific issues, regional nuances and other subjective factors and intangible considerations. Our approach incorporates a combination of both quantitative and qualitative factors.
• The considerations outlined in DBRS methodologies are not exhaustive and the relative importance of any specific consideration can vary by issuer. In certain cases, a major strength can compensate for a weakness and, conversely, a single weakness can override major strengths of the issuer in other areas. DBRS may use, and appropriately weight, several methodologies when rating issuers that are involved in multiple business lines.
• DBRS operates with a stable rating philosophy; in other words, DBRS strives to factor the impact of a cyclical economic environment into its ratings wherever possible, which minimizes rating changes due to economic cycles. Rating revisions do occur, however, when more structural changes, either positive or negative, have occurred, or appear likely to occur in the near future.
• DBRS also publishes criteria which are an important part of the rating process. Criteria typically cover areas that apply to more than one industry. Both methodologies and criteria are publicly available on the DBRS website and many criteria are listed below under “Rating the Specific Instrument and Other Criteria.”
Overview of the DBRS Rating Process

- There are generally three components to the DBRS corporate rating process: (1) an industry risk rating (IRR); (2) an issuer rating; and (3) considerations for specific securities. The figure below outlines this process.

- An IRR is a relative ranking of most industries that have a DBRS methodology, typically using just three ranges of the DBRS long-term debt rating scale (i.e., “A,” BBB and BB), without making use of the “high” or “low” descriptors. The IRR is a general indication of credit risk in an industry and considers, among other things, an industry’s: (1) profitability and cash flow; (2) competitive landscape; (3) stability; (4) regulation; and (5) other factors. An “industry,” for the purposes of the IRR, is defined as those firms that are generally the larger, more established firms within the countries where the majority of DBRS’s rated issuers are based; this remains true for DBRS methodologies that are more global in nature. The industry risk rating helps DBRS set the BRR grid (see below) in that it positions, in an approximate way, an average firm in the industry onto the BRR grid. For firms in industries with low IRRs, the IRR can, in effect, act as a constraint or “cap” on the issuer’s rating.

- The issuer rating is DBRS’s assessment of the probability of default of a specific issuer. It is a function of: (1) the business risk rating (BRR), determined by assessing each of the primary and (where relevant) additional BRR factors in the BRR grid for a specific issuer; and (2) the financial risk rating (FRR), determined by assessing each of the primary and (where relevant) additional FRR metrics. The two components, BRR and FRR, are combined to determine the issuer rating; in most cases the BRR will have greater weight than the FRR in determining the issuer rating. Throughout the BRR and FRR determination process, DBRS performs a consistency check of the issuer on these factors against the issuer’s peers in the same industry.

- The issuer rating is then used as a basis for specific instrument ratings. DBRS assigns, for example, a recovery rating and notches up or down from the issuer rating to determine a specific instrument rating for instruments of non-investment grade corporate issuers. (See “Rating the Specific Instrument and Other Criteria” below.)
Merchandising Industry

• DBRS defines the merchandising industry as companies principally involved in the selling of any number and type of consumer products and services. This methodology also includes restaurant chains, wholesalers and distributors in these consumer segments.

• Per the three-tier IRR described on the previous page, the merchandising IRR is BBB.

• The merchandising industry is characterized by: (1) generally average industry stability, although different segments can have very different degrees of stability; (2) relatively high competition arising from low barriers to entry, although brand strength can be a significant barrier to entry; (3) sensitivity to changes in real estate conditions (i.e., property value if the issuer is a real estate owner, and rents if the issuer leases space); and (4) minimal regulation.

• Different segments of the merchandising industry show varying degrees of sensitivity to economic cycles. Retailers of consumer durables (such as appliances, building supplies, etc.) show greater sensitivity to economic cycles than do retailers of food staples and other non-discretionary items, although the latter may still show contraction of margins and earnings during low points in the cycle.

• Large volume retailers have distinct advantages in purchasing power, distribution efficiencies and the ability to negotiate favourable lease terms or better exploit real estate opportunities. In addition, companies that are dominant in their market segment can be price leaders and can influence market pricing to either increase revenues or create a barrier to new entrants.

• Working capital management, investment in new and existing stores and adapting to changing consumer trends as well as an ability to maximize inventory turns while minimizing discounting or markdown activities are all critical to achieving and maintaining profitability and long-term success in the merchandising industry.

• Diversification of product offering and geography provides access to growing rather than mature markets as well as an offset to seasonality inherent in certain product lines.

• Ownership of stores can provide greater operating flexibility in that expansion or contraction of stores does not involve the cash expense of lease termination. The leasing of stores, on the other hand, can be extremely advantageous in the case of low-rent, long-term leases, but store closure is more difficult and expensive. DBRS will adjust financial ratios to reflect off-balance-sheet lease obligations.

• Many retailers have also started to offer their customers credit cards and other financial services; these can support core retail operations and bolster performance but they also add another element of risk.
Merchandising Business Risk Rating

**PRIMARY BRR FACTORS**
- The BRR grid below shows the primary factors used by DBRS in determining the BRR. While these primary factors are shown in general order of importance, depending on a specific issuer’s business activities, this ranking can vary by issuer.

<table>
<thead>
<tr>
<th>Rating</th>
<th>Nature of Product Offering</th>
<th>Brand Name</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rating</strong></td>
<td><strong>AA</strong></td>
<td><strong>A</strong></td>
</tr>
<tr>
<td><strong>Nature of Product Offering</strong></td>
<td>Soft-line retailer with primarily non-discretionary and very diverse product offering.</td>
<td>Retailer offering primarily non-discretionary products with some diversity or primarily discretionary products with significant diversity.</td>
</tr>
<tr>
<td></td>
<td>Limited effects of seasonality and economic cycles, ensuring consistent cash flow.</td>
<td>Low to moderate relative risks related to seasonality and economic cycles.</td>
</tr>
<tr>
<td><strong>Brand Name</strong></td>
<td>Well-known brand name with significant levels of customer loyalty.</td>
<td>Known brand name, with some customer loyalty and an acceptable market share.</td>
</tr>
<tr>
<td></td>
<td>Relatively high market share.</td>
<td>Wide selection of products and solid overall perception of quality and value.</td>
</tr>
<tr>
<td></td>
<td>Diverse selections and perception of high levels of quality, service and value.</td>
<td>Long-term positive growth in same-store sales growth.</td>
</tr>
<tr>
<td></td>
<td>Consistent improvement in levels of same-store sales growth.</td>
<td>Moderate capital expenditure investment in store appearance and design.</td>
</tr>
<tr>
<td></td>
<td>Consistent capital expenditure investment in store appearance to remain fashionable and attractive to customers.</td>
<td></td>
</tr>
</tbody>
</table>


### Merchandising — Primary BRR Factors

<table>
<thead>
<tr>
<th>Rating</th>
<th>AA</th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Operational Efficiency</strong></td>
<td>• Strong inventory management, with high product turnover and limited need for discounting and markdowns.</td>
<td>• Moderate to strong inventory management. Occasional use of discounting and markdowns to help turnover.</td>
<td>• Average inventory turnover with necessary use of discounts and markdowns.</td>
<td>• Low to moderate inventory turnover, requiring consistent use of discounting and markdowns, negatively affecting margins.</td>
<td>• Consistently low levels of inventory turnover, requiring heavy discounting and markdowns.</td>
</tr>
<tr>
<td></td>
<td>• High margins, relative to similar product types.</td>
<td>• Moderate to high margins relative to similar products.</td>
<td>• Overall margins remain adequate.</td>
<td>• Low to moderate comparative sales per square foot.</td>
<td>• Extremely small margins comparative to merchandisers with similar product offerings.</td>
</tr>
<tr>
<td></td>
<td>• Relatively high levels of sales per square foot.</td>
<td>• Relatively moderate to high levels of sales per square foot.</td>
<td>• Comparative moderate return on invested capital.</td>
<td>• Low to moderate comparative returns on invested capital.</td>
<td>• Consistently low comparative sales per square foot and return on invested capital.</td>
</tr>
<tr>
<td></td>
<td>• High levels of return on capital.</td>
<td></td>
<td></td>
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</tr>
<tr>
<td><strong>Relative Scale</strong></td>
<td>• Large comparative size, offering strong purchasing power.</td>
<td>• Moderately large comparative size, offering some influence over purchasing prices.</td>
<td>• Average size and therefore significant limitations on purchasing power influence.</td>
<td>• Small- to moderate-sized organization that has no influence on pricing and can only react to price changes on both the input and output sides.</td>
<td>• Small scale increases risks from pricing changes by larger competitors.</td>
</tr>
<tr>
<td></td>
<td>• Economies of scale sufficient to allow larger advertising and promotional campaigns, and the investment in and use of newer technologies to improve logistics, processes and efficiency.</td>
<td>• Size offers some economies of scale, offering certain benefits in advertising and promotion, and/or the investment in newer technologies.</td>
<td>• Average economies of scale, limiting advertising and promotional benefits, and potential beneficial investment in newer advantageous technologies.</td>
<td>• Use of only older technologies, with no economies of scale, affecting overall efficiency.</td>
<td>• Drastically behind on new and beneficial technologies that can provide larger competitors with enhanced margins and therefore the capability to lower prices and increase competitive pressures.</td>
</tr>
<tr>
<td></td>
<td>• Price leader, which can be used to drive revenue or act as a barrier to new entrants.</td>
<td>• One of few companies that can display some influence on prices.</td>
<td>• Moderate influence on product pricing, often simply a reaction to competitors and market conditions.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Merchandising — Primary BRR Factors

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<tbody>
<tr>
<td><strong>Geographic Diversification</strong></td>
<td>• Significant exposure to different countries, intensely accessing a limited number of different countries, regions or localities.</td>
<td>• Limited geographic diversification, offering decent exposure to significant markets.</td>
<td>• Average geographic spread, providing some performance risk based on regional conditions.</td>
<td>• Reliance on only a few geographic regions, further enhancing risks.</td>
<td>• Very heavy reliance on only a few geographic regions.</td>
</tr>
<tr>
<td></td>
<td>• Efficient use of strategic locations allowing access to more people per store.</td>
<td>• Adequate location selection offering adequate access to surrounding markets.</td>
<td>• Average locations that provide only adequate access to surrounding markets.</td>
<td>• Location selection offers no beneficial access to surrounding markets.</td>
<td>• Poor choice of locations for accessing surrounding markets.</td>
</tr>
<tr>
<td></td>
<td>• Excellent mix of access to developed and developing markets, offering continued growth opportunities.</td>
<td>• Adequate mix of developed and developing markets, offering some continued growth potential.</td>
<td>• Limited exposure to developing markets, potentially limiting future growth potential.</td>
<td>• Risk of market saturation is high.</td>
<td>• Very high levels of competition and limited potential for market development in the area.</td>
</tr>
</tbody>
</table>

| **Real Estate** | • Excellent relative locations in prime spaces offering direct access to target markets. | • Moderate to good selection of locations, appropriate to the target market. | • Average relative locations, with limitations related to target market access or with respect to the physical property. | • Below-average locations relative to competitors, presenting numerous challenges related to target market access or with respect to the physical property. | • Very questionable store locations, offering numerous challenges related to market access and physical storefronts. |
| | • Low rents in prime locations locked in with long-term leases. | • Positive rent pricing locked in long-term leases or low rents that are not locked up long term. | • Average or market-rate rents locked in for long periods of time. | • Below-average or above-market rents locked in long term, creating an unfavourable liability. | • Poorly negotiated lease agreements create rents locked in well above market values. |
| | • Desirable portfolio of owned properties offering stability and flexibility in relation to volatile market conditions. | • Some ownership of property to help stabilize business or relatively undesirable portfolio of owned properties. | • Limited long-term flexibility with respect to store changes and closures. | • Inflexible real estate lease portfolio makes store closures very expensive. | • Poor portfolio limits organizational changes due to high penalties related to lease terminations. |

The following BRR risk factors are relevant to issuers in all industries (although the relevance of sovereign risk can vary considerably):

**Sovereign Risk**

The issuer rating may, in some cases, be constrained by the credit risk of the sovereign; in other words, the rating of the country in which the issuer operates generally sets a maximum rating for the issuer. If the issuer operates in multiple countries and a material amount of its business is conducted in a lower-rated country, DBRS may reflect this risk by downwardly adjusting its issuer rating.

**Corporate Governance**

Please refer to DBRS Criteria: Evaluating Corporate Governance for further information on how DBRS evaluates corporate governance and management.
ADDITIONAL BRR FACTORS

- The additional BRR factors discussed below may be very important for certain issuers, depending upon their activities, but they do not necessarily apply to all issuers in the industry.

Format/Banners
- Retail formats vary in terms of product positioning, physical size, location and level of services. DBRS assesses a company’s banner portfolio and format diversity to determine the level of competition the company faces, the nature of its cost structure, the level of profitability and the extent to which it depends on certain market segments or demographics.
- Discounters tend to favour large-scale, no-frills and low-service big-box formats, which will rarely be in direct competition with high-end retailers that generally have smaller, more refined spaces and high levels of service.
- Online sales or e-commerce has become increasingly common in certain product categories. Increasing online sales can pose significant levels of competition for traditional brick-and-mortar retailers by means of the same or similar products with a radically different cost structure. In many cases, traditional retailers must have an online offering to maintain their current customers. E-commerce has also offered traditional brick-and-mortar retailers significant opportunities to reach a greater number of customers than a traditional store base.

Understanding/Adapting to Consumer Trends
- Consumer preferences are constantly evolving, requiring retailers to adapt their product offerings.
- DBRS assesses the ability of retailers, particularly within riskier market segments, to predict and cater to changing demand, which is the key factor in remaining competitive over the long term. Riskier market segments are those most susceptible to changes in consumer trends (such as those that sell fashion-oriented apparel or merchandise).

Labour
- Non-unionized retailers generally have a significant advantage over unionized competitors because of the potential impact of work stoppages, higher labour costs and the general lack of flexibility in collective bargaining agreements.
- DBRS evaluates the historical relationship between management and labour in both environments and examines whether any labour issues are expected to arise. The impact of unsuccessful collective bargaining, potential labour disruptions and potential negative publicity is considered by DBRS.

Loyalty Programs, Credit Cards and Other Complementary Financial Businesses
- It is increasingly common for retailers to operate loyalty programs as well as proprietary credit card programs. Often the two are often linked together and provide the retailer with a closer relationship to its customer base. DBRS assesses the impact of the strength of a company’s loyalty program and/or credit card program on its business risk profile.
- Credit card and financial businesses can contribute to profit and add stability to earnings, but carry operating risks; if such risks are not managed properly, they can lead to higher write-offs of credit card loans. DBRS assesses the positive impact of credit card programs on a retailers’ earnings profile in relation to the risks posed.
- In evaluating the financial profile of the merchandising operations, the finance subsidiary is treated as an equity investment to remove the influence of high leverage associated with finance operations.
- In general, where such a business exists, DBRS will treat it as a deconsolidated entity and use the appropriate methodology to examine each business segment to ensure that the appropriate rating is assigned.
Restaurants
• In evaluating restaurants, which include a wide range of food service formats and banners, DBRS will evaluate the primary BRR factors noted above and consider the issuer’s operating model (i.e., franchise, owner operated or corporate operated).

Wholesalers and Distributors
• In evaluating wholesalers and distributors, including distributors of all types of food service products and pharmaceuticals, DBRS will evaluate the primary BRR factors noted above and consider the issuer’s distribution network and logistics management abilities, including trucking, fleet, systems and related resources.
Merchandising Financial Risk Rating

PRIMAR Y FRR METRICS

- The FRR grid below shows the primary FRR metrics used by DBRS to determine the FRR. While these primary FRR metrics are shown in general order of importance, depending upon an issuer’s activities, the ranking can vary by issuer.
- DBRS ratings are primarily based on future performance expectations, so while past metrics are important, any final rating will incorporate DBRS’s opinion on future metrics, a subjective but critical consideration.
- It is not unusual for a company’s metrics to move in and out of the ranges noted in the grid below, particularly for cyclical industries. In the application of this matrix, DBRS looks beyond the point-in-time ratio.
- Financial metrics depend on accounting data whose governing principles vary by jurisdiction and, in some cases, industry. DBRS may adjust financial statements to permit comparisons with issuers using different accounting principles.
- Please refer to DBRS Criteria: Financial Ratios and Accounting Treatments – Non Financial Companies for definitions of, and common adjustments to, these ratios in the FRR grid below.
- Liquidity can be a material risk factor, especially for lower-rated non-investment grade issuers. DBRS will consider available sources of liquidity including cash on hand, cash flow, access to bank lines, etc., as well as uses of liquidity such as operations, capital expenditures, share buybacks and dividends for every issuer.
- DBRS considers an issuer’s financial policy including factors such as its targeted financial leverage, its dividend policy and the likelihood of share buybacks or other management actions that may favour equity holders over bondholders.
- While market pricing information (such as market capitalization or credit spreads) may on occasion be of interest to DBRS, particularly where it suggests that an issuer may have difficulty in raising capital, this information does not usually play a material role in DBRS’s more fundamental approach to assessing credit risk.

Merchandising — Primary FRR Metrics

<table>
<thead>
<tr>
<th>Primary Metric</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow-to-debt</td>
<td>&gt; 60%</td>
<td>30% to 60%</td>
<td>20% to 30%</td>
<td>10% to 20%</td>
<td>&lt; 10%</td>
</tr>
<tr>
<td>Debt-to-EBITDA</td>
<td>&lt; 1.0x</td>
<td>1.0x to 2.0x</td>
<td>2.0x to 3.0x</td>
<td>3.0x to 5.0x</td>
<td>&gt; 5.0x</td>
</tr>
<tr>
<td>EBITDA-to-interest</td>
<td>&gt; 12.0x</td>
<td>8.0x to 12.0x</td>
<td>5.0x to 8.0x</td>
<td>3.0x to 5.0x</td>
<td>&lt; 3.0x</td>
</tr>
<tr>
<td>Debt-to-capital</td>
<td>&lt; 25%</td>
<td>25% to 40%</td>
<td>40% to 60%</td>
<td>60% to 75%</td>
<td>&gt; 75%</td>
</tr>
</tbody>
</table>

ADDITIONAL FRR METRICS

- While the primary FRR metrics above will be the most important metrics that DBRS will use in determining the FRR of an issuer, other metrics may be used, depending upon an issuer’s activities, capital structure, pension liabilities and off-balance-sheet obligations.
- Profitability, particularly in the medium term, can be an important differentiator of credit risk. DBRS may assess profitability through a variety of metrics, including return on capital.
- While free cash flow (i.e., net of changes in working capital, dividends and capital expenditures, etc.) can be volatile and, on occasion, negative, DBRS may use this and/or other cash flow metrics to assess a company’s ability to generate cash to repay debt.
- Given the importance of real estate to the merchandising sector, issuers in this sector are likely to have material levels of off-balance-sheet lease obligations for which DBRS will adjust when determining debt, capital, EBITDA and cash flow in the metrics above.
Blending the BRR and FRR into an Issuer Rating

• The final issuer rating is a blend of the BRR and FRR. In most cases, the BRR will have greater weight than the FRR in determining the issuer rating.
• At the low end of the rating scale, however, particularly in the B range and below, the FRR and liquidity factors play a much larger role and the BRR would, therefore, typically receive a lower weighting than it would at higher rating levels.

Rating the Specific Instrument and Other Criteria

• For non-investment-grade corporate issuers, DBRS assigns a recovery rating and reflects the seniority and the expected recovery of a specific instrument, under an assumed event of default scenario, by notching up or down from the issuer rating in accordance with the principles outlined in the criteria DBRS Recovery Ratings for Non-Investment Grade Corporate Issuers.
• Preferred share and hybrid considerations are discussed under Preferred Share and Hybrid Criteria for Corporate Issuers.
• The issuer rating (which is an indicator of the probability of default of an issuer’s debt) is the basis for rating specific instruments of an issuer, where applicable. DBRS uses a hierarchy in rating long-term debt that affects issuers that have classes of debt that do not rank equally. In most cases, lower-ranking classes would receive a lower DBRS rating. For more detail on this subject, please refer to the general rating information contained in the DBRS rating policy Underlying Principles.
• For a discussion on the relationship between short- and long-term ratings and more detail on liquidity factors, please refer to the DBRS policy Short-Term and Long-Term Rating Relationships and the criteria Commercial Paper Liquidity Support Criteria for Non-Bank Issuers.
• The existence of holding companies can have a meaningful impact on individual security ratings. For more detail on this subject, please refer to the criteria Rating Holding Companies and Their Subsidiaries.
• Guarantees and other types of support are discussed in DBRS Criteria: Guarantees and Other Forms of Explicit Support.
• For further information on how DBRS evaluates corporate governance, please refer to DBRS Criteria: Evaluating Corporate Governance.
• Please refer to DBRS Criteria: Financial Ratios and Accounting Treatments – Non Financial Companies for definitions of, and common adjustments to, these ratios.