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Putting The Credit Quality Of Mid-Market Companies On The Radar

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Putting The Credit Quality Of Mid-Market Companies On The Radar

For investors, comparative data and independent research about the companies they are targeting is crucial. For that reason, transparency about credit risk holds the key to the development of debt markets—including alternative funding markets. However, for mid-market companies, an emerging market where credit risk is typically higher, less information is publicly available.

Here, Standard & Poor's Ratings Services intends to narrow the information gap about credit risk for the mid-market. We have assessed the credit quality of well over 500 mid-market companies in Europe, the Middle East, and Africa (EMEA). We looked at credit quality in terms of geographic spread, sector distribution, and whether the companies in question were owned by financial sponsors. What we consistently found across our EMEA mid-market universe is on average weaker business positions that companies tend to compensate for with more conservative balance sheet and cash management. Nevertheless, a non-negligible portion of these mid-market companies boast strong niche positions in specific sectors, which allow them, when combined with a conservative financial policy, to reach investment-grade-equivalent credit quality.

Overview

The main findings stemming from our research show that:

- Mid-market companies in Europe display a wide range of credit risk from mid to low investment grade down to speculative grade, though concentrated in the categories 'MM3' (cross-over), 'MM5', and 'MM6' (equivalent to an indicative 'B' rating).
- Midsize non-LBOs display on average more vulnerable business positions, all along the rating spectrum, resulting mainly from lower scale and relatively higher business concentration than for larger peers. However, as an offset, those midsize companies have a conservative financial profile, adequate liquidity cushions, and, in some sectors, effective niche positioning shielding them from the competition of larger players.
- In terms of industry, mid-market players in the higher credit category are operating mainly in the machine and equipment manufacturing, consumer goods, and specialized high-tech sectors, where they can more easily differentiate themselves and build strong niche positions through greater efficiency, technological expertise, or local brand recognition. In contrast, midsize companies with a 'MM5' credit profile mainly belong to sectors where scale plays an important role in building efficient competitive positions, such as commodity and oil, commodity product manufacturing, and construction.

The EMEA Mid-Market Universe: A Well-Diversified Set Of Companies

We analyzed a sample of 547 mid-market companies in EMEA, defined as companies that generate maximum revenues of €1.5 billion with maximum total debt of €500 million (€250 million for LBOs), whose creditworthiness we have assessed as part of our process for assigning corporate credit ratings* (256), credit estimates* (150), and for evaluating mid-market companies under our methodology* (144). Note that we mapped ratings and credit estimates

back to our Mid-Market Evaluation (MME) scale. (See the glossary in Appendix 1 for the terms marked with an asterisk). Although the sample is well spread across industries and even sectors, and in terms of revenue size, it is concentrated geographically (80%) in eurozone and the U.K. (see chart 1). Asset-light industries represent more than one-half of companies in the portfolio (54%), as opposed to asset-heavy industries that comprise the rest (46%). The asset-light companies in the sample fall into these segments: telecom, technology, and business services (21%); healthcare and consumer goods (19%); and retail, leisure, and media (14%). Asset-heavy industries are dominated by materials, construction, and transportation companies (25%), while real estate and utilities represent 7% and 3%, respectively (see chart 2). If we look at the sample by revenue, we see a fairly even distribution, with a 36% concentration of companies with revenues below €300 million (see chart 3). For the purpose of this research, we have defined a portfolio of large rated companies which per definition have revenues above €1.5 billion and debt above €500 million, and have an outstanding public rating.

Chart 1

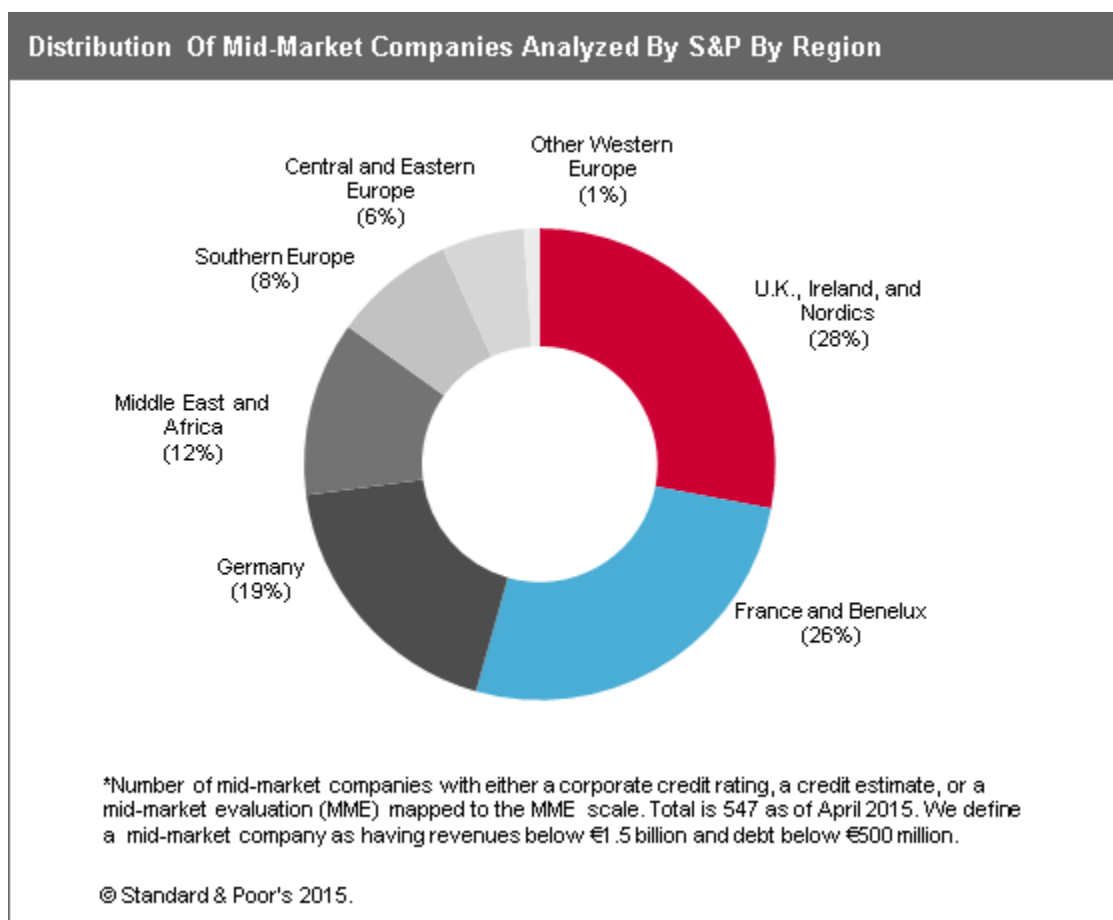


Chart 2

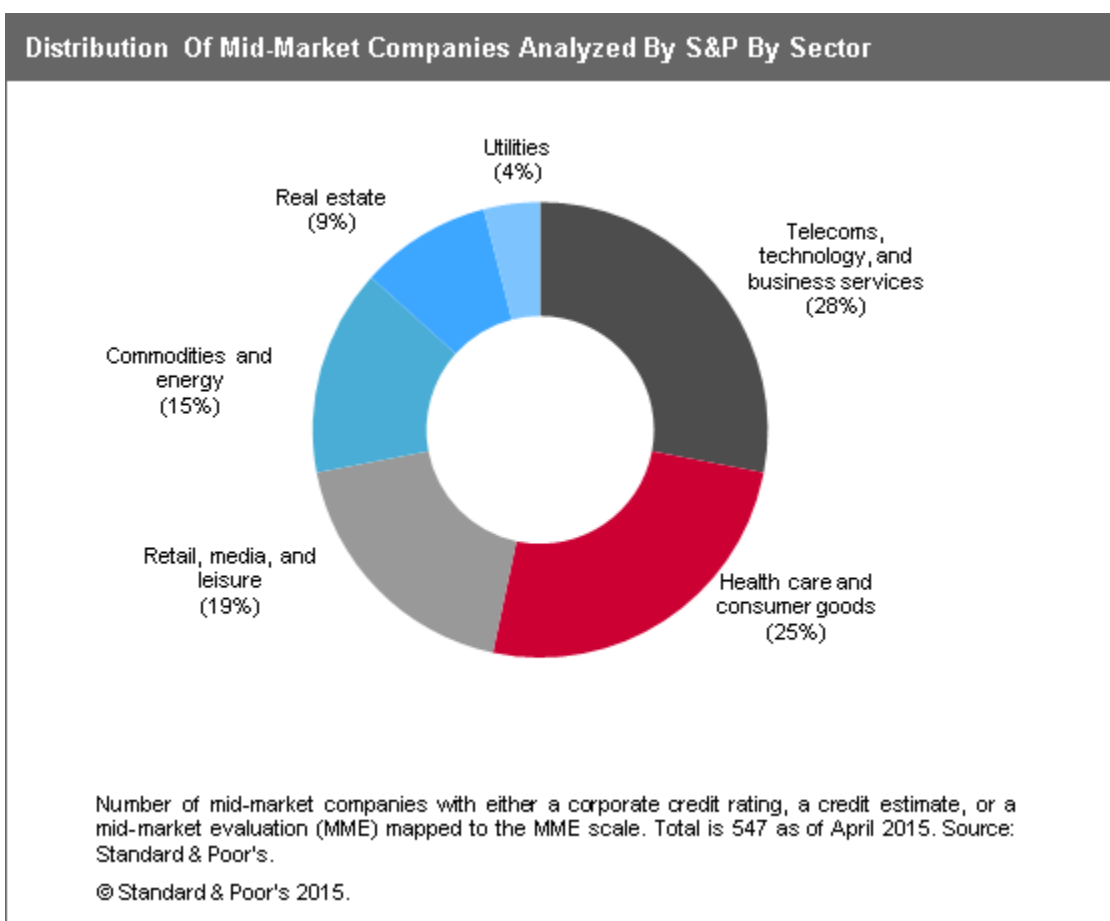
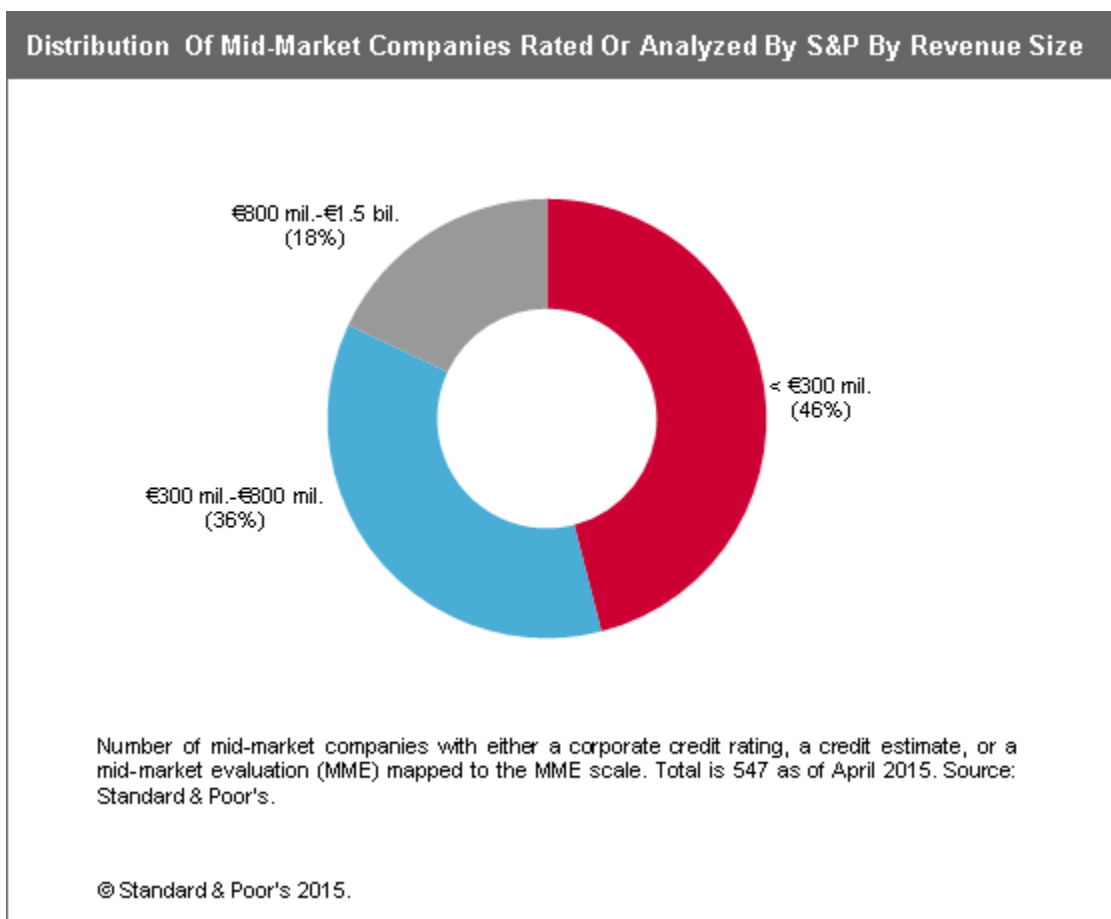


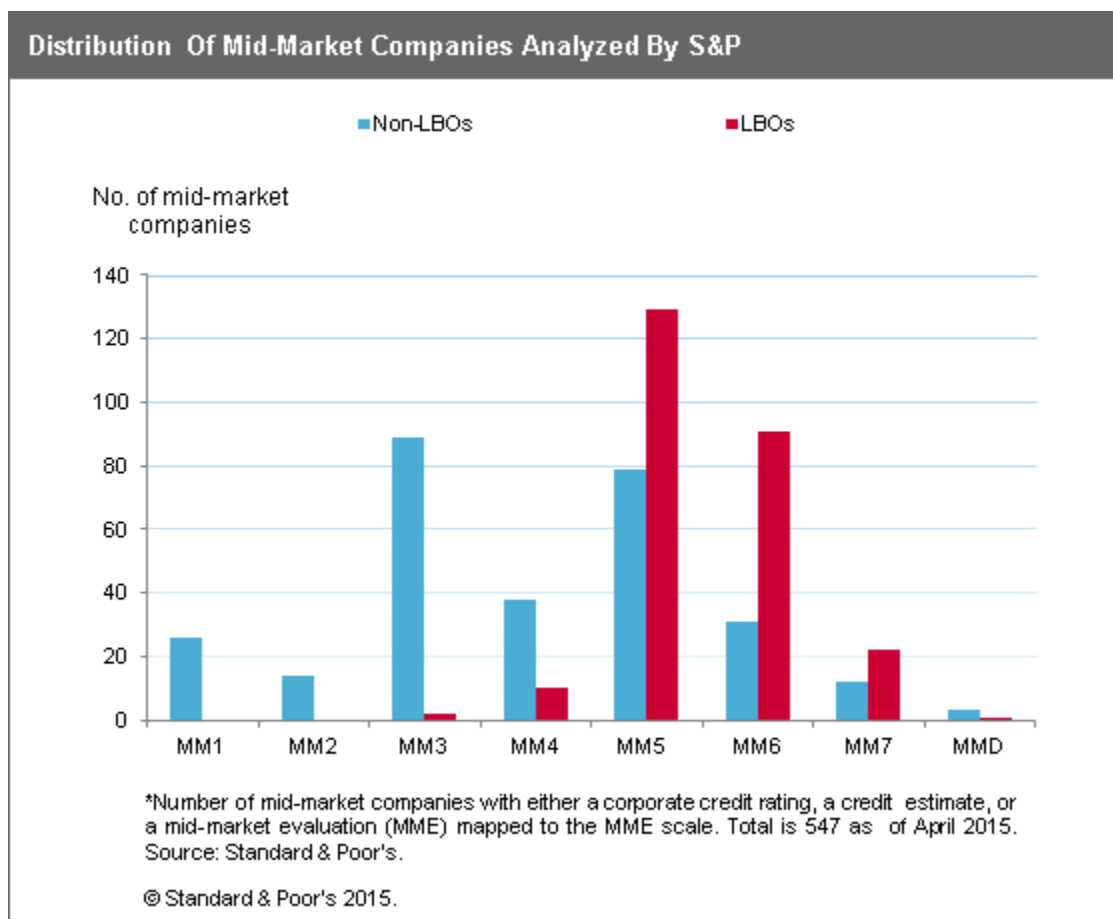
Chart 3



Credit Risk Is Skewed Toward Speculative Grade

In this research on mid-market companies, we have found that most of them do not carry very low default probabilities commensurate with investment-grade creditworthiness, but rather feature higher default probabilities covering the full spectrum of creditworthiness from cross-over to high-yield (see chart 4; with cross-over meaning credits that straddle investment-grade and speculative-grade). In fact, mid-market companies in the financial sponsor or leveraged buyout (LBO) segment typically show a credit risk of 'MM5' or 'MM6' on our mid-market scale (which indicatively maps to 'B' on our scale for long-term corporate credit ratings). On the other hand, non-LBO companies are spread out more evenly across the credit risk spectrum with a strong representation at 'MM3' and 'MM4' on our mid-market scale (which corresponds to the 'BB' category on the global rating scale).

Chart 4



Mid-Market Non-LBOs: Conservative Financial Policies Compensate For Weaker Business Positions

Midsized non-LBOs display a weaker business credit profile than larger corporates on average (see charts 5 and 6). However, they can achieve higher credit quality--that is, 'MM1', 'MM2', or 'MM3'--through conservative financial policies and in certain cases niche business positions.

Interestingly, 13% of non-LBO mid-market companies we assess fall in the higher credit quality categories, 'MM1' and 'MM2' (9% and 4%, respectively).

The companies reaching the highest rating on the scale, 'MM1', are mainly part of the regulated utilities sector (almost 50% of 'MM1' ratings, see chart 8) with an overall concentration in the U.K. This mirrors the sector's importance in the U.K. economy, and factors in our positive, "very low" risk assessment of this industry (see "Key Credit Factors For The Regulated Utilities Industry," published on Nov. 19, 2013). Midsized regulated utilities are shielded from direct competition in the same way that larger companies in the sector are, since they are granted exclusive franchises, licenses, or concessions, offering public services on a monopolistic basis.

Only 4% of the midsize companies in our sample have a 'MM2' profile. They operate in the high tech and capital goods sector, benefiting from a conservative financial profile, combined with niche market positioning. All companies in the 'MM2' risk category differentiate themselves from the ones in 'MM1' by displaying weaker business positions, somewhat offset by stronger financial risk profiles (see charts 5 and 6).

A large proportion of the non-LBO midsize companies (29%) fall in the 'MM3' risk category. Those companies carry out a wide range of activities, but mostly fall into the following sectors: capital goods and transportation, health care and consumer goods, as well as telecom and tech (see charts 7 and 8).

This upper-scale assessment ('MM1-MM3') is mainly reached by midsize companies with a conservative financial profile, including a prudent financial policy and adequate liquidity cushion. In addition to being conservative, some of those midsize companies (11% of the sample) attain the upper scale ('MM1-MM3') thanks to strong niche positions--mainly in machine and equipment manufacturing, consumer goods, and specialized high tech sectors. We believe that in these sectors, midsize companies are able to build stronger competitive positions thanks to their ability to differentiate themselves from larger players through technological know-how, efficient operating processes, and strong regional brand recognition.

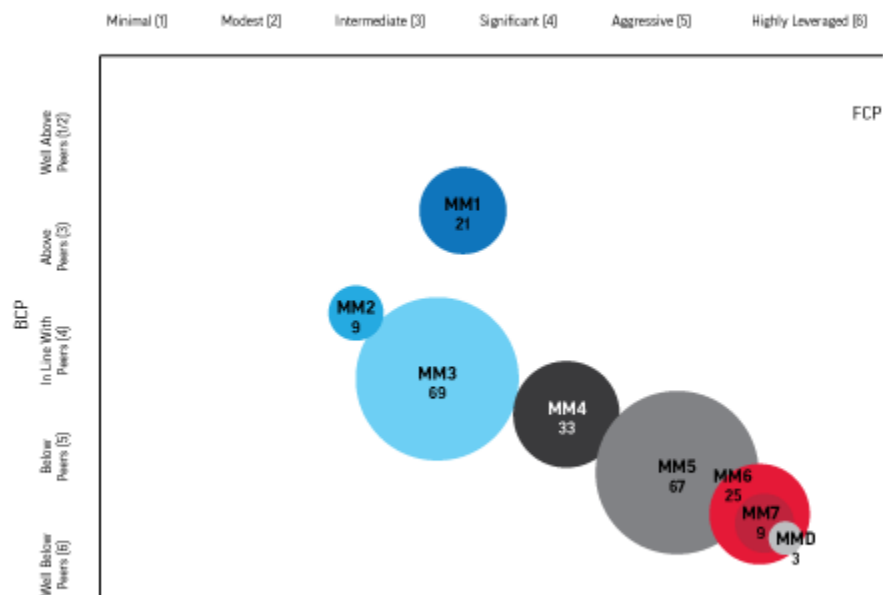
The second most-important concentration of midsize non-LBO companies falls into the 'MM5' credit risk category (see chart 4). These companies are mainly chemical and oil companies, commodity product manufacturers, and builders. For them, scale plays an important role in establishing effective competitive positions. Midsize companies with 'MM5/MM6' scores have similar business credit profiles (on the lower part of the scale), but different degrees of aggressive financial credit profiles. Indeed, 'MM6' midsize companies have higher leverage (debt/EBITDA of 6.4x on average and over our forecast period) and lower cash flow generation (FFO/debt of 12% on average and over the forecast period) than in the 'MM5' credit risk category (4.6x and 21% for the respective average and forecast ratios). (By "forecast period," we mean our average of the latest year when financial reports were published and our forecast for the two subsequent years.) Retail, media, and leisure is a sector where midsize companies display generally weaker creditworthiness than their larger corporate peers. That's because midsize retailers or hospitality businesses have weaker business positions, resulting most likely from high operating leverage and limited scale, which impedes adequate fixed-cost absorption, leading to weaker cash flow positions (see chart 8).

Non-LBOs midsize companies tend to compensate, on average, for their more vulnerable business positions--stemming from lower scale, higher business concentration, and often undiversified geographical footprints--with more disciplined balance sheet and cash management.

This is specifically visible for midsize companies reaching the 'MM2' and 'MM3' categories. Those companies display on average lower leverage and a higher coverage of debt by internal cash generation as do larger non-LBOs corporates of the similar rating category. Indeed, midsize companies have "historical" debt/EBITDA of 1.6x compared to 2.5x for larger companies of that same risk category and a forecast as well as historical FFO/debt ratio reaching 71% versus 68% on average for larger companies. (By "historical" we mean the average of the latest year for which financial reports were published and the two previous years.)

Chart 5

Distribution Of Mid-Sized Non-LBO Companies Analyzed By Standard & Poor's

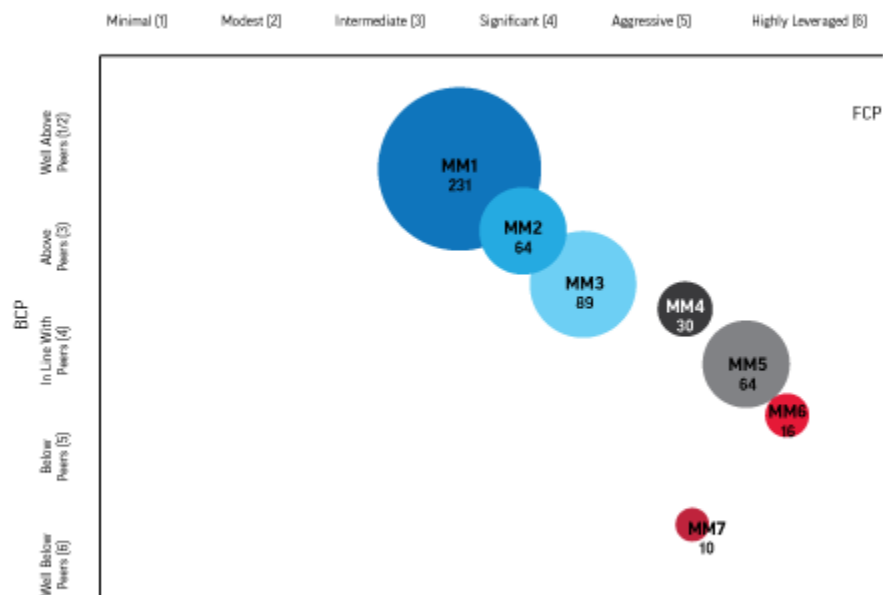


FCP—Financial credit profile. BCP—Business credit profile.
Average of BCP and FCP calculated on a total of 236 mid-sized non-LBO companies.
Source: Standard & Poor's

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Chart 6

Distribution Of Large Non-LBO Companies Analyzed By Standard & Poor's



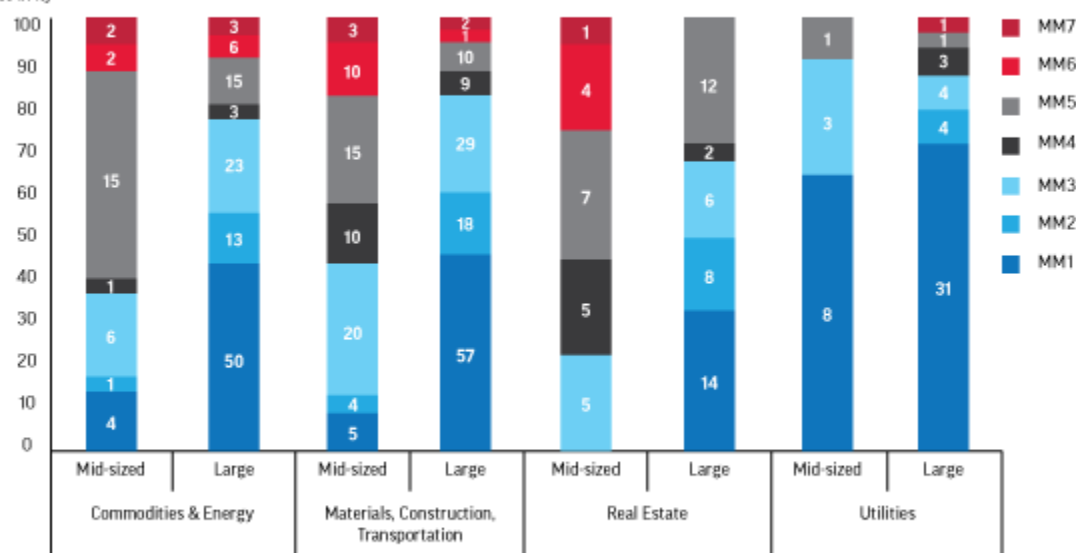
FCP—Financial credit profile. BCP—Business credit profile.
Total of 505 large non-LBO companies.
Source: Standard & Poor's

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Chart 7

Heavy Industries: Distribution Of Mid-Sized And Large Companies Analyzed By Standard & Poor's In EMEA

(By number of companies in %)



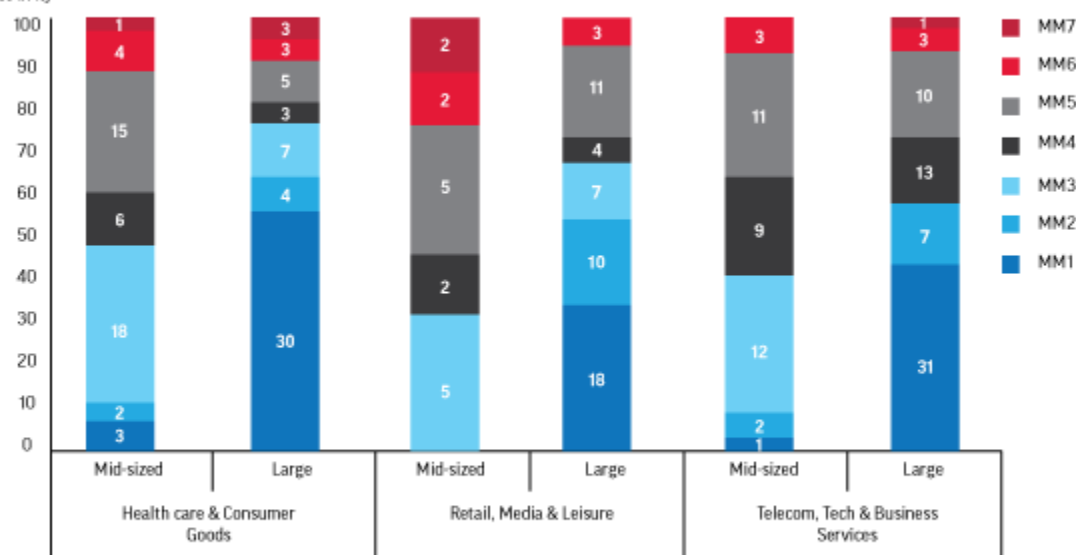
On equivalent MME rating scale.
Total of 167 mid-sized and 355 large companies in the asset-heavy industries.
Source: Standard & Poor's

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Chart 8

Light Industries: Distribution Of Mid-Sized And Large Companies Analyzed By Standard & Poor's In EMEA

(By number of companies in %)



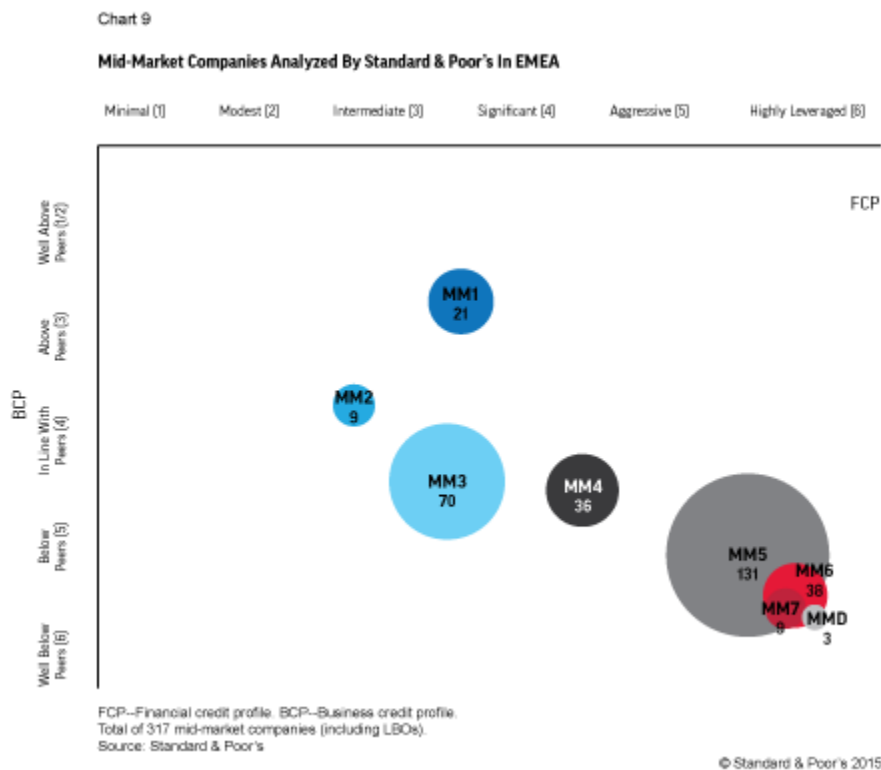
On equivalent MME rating scale.
Total of 147 mid-sized and 252 large companies in the asset-light industries.
Source: Standard & Poor's

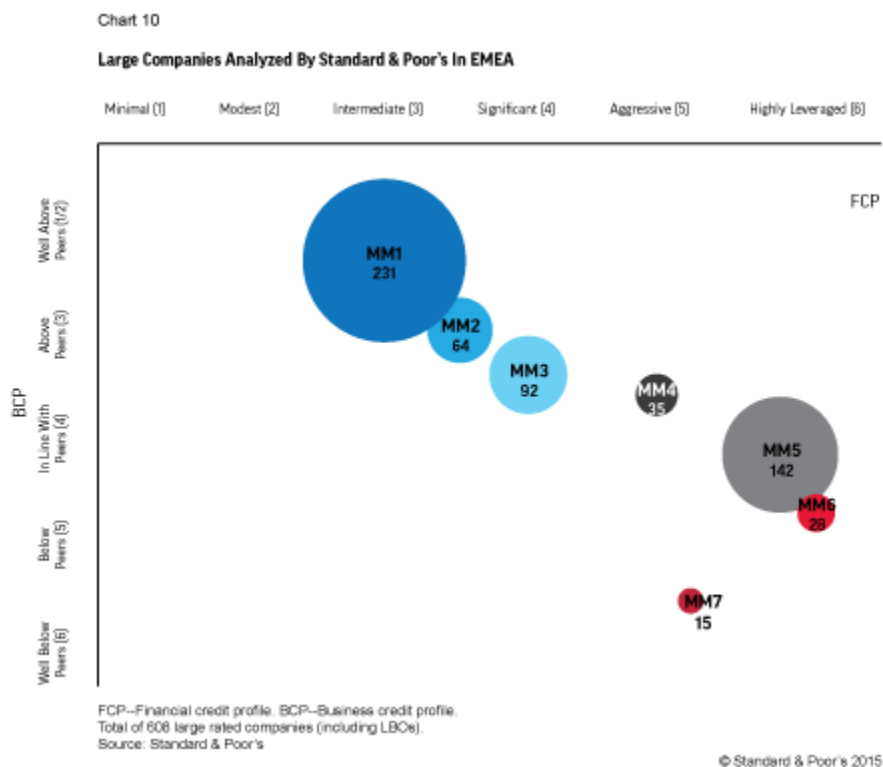
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Mid-Market LBOs: Less Aggressive Financial Policies Than Their Larger Peers

Mid-market LBOs in the study mainly fall in the 'MM5' and 'MM6' categories (analogous to the 'B' category), in line with larger leveraged companies, due to our assessment that financial sponsor ownership increases the aggressiveness of financial policy and therefore caps the overall financial credit profile (see "Corporate Methodology," published on Nov. 19, 2013). This is reflected in the charts below (9 and 10), which compare both mid-market and larger companies. The 'MM5' rating category is proportionally larger in both portfolios due to the inclusion of financial-owned companies.

In the LBO space, mid-market companies tend to be slightly less aggressive than larger LBOs. Indeed, they are aiming to compensate for their weaker business positions with lower leverage (on average 6.8x versus 8.3x historically) and slightly better cash flow generation. This is highlighted by ratios of funds from operations (FFO) for mid-market LBOs of 10.6% over the past three years, versus 7.3% for larger LBOs (see charts 11 and 12). This is particularly visible in the U.K. over the past three years, where mid-market LBOs have exhibited on average higher ratios of FFO-to-debt (10.6%) and lower leverage ratios (7.7x) than large LBOs (4.4% and 10.0x, respectively).



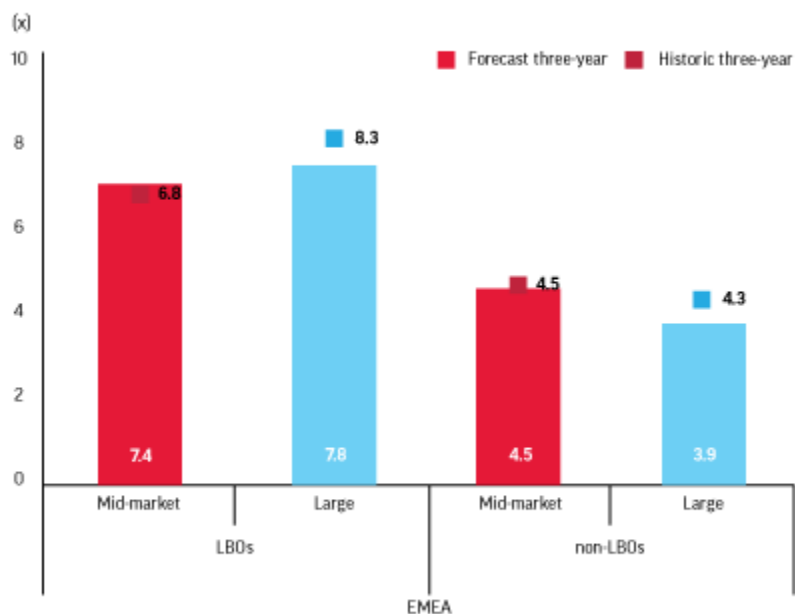


Appendixes

Appendix 1: Financial Ratio Trends For The EMEA Mid-Market

Chart 11

Standard & Poor's Adjusted Debt/EBITDA, EMEA

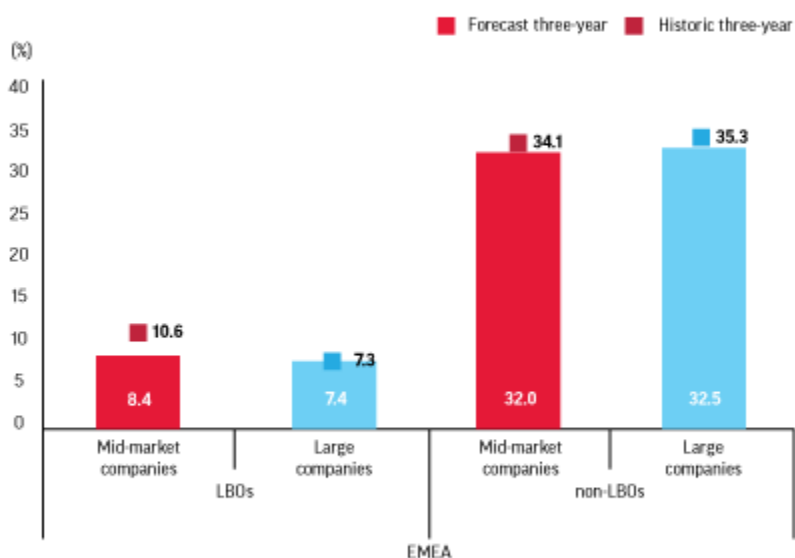


Average data on a total of 79 mid-market and 103 large LBOs, 120 mid-market and 490 large non-LBOs.
Historic three-year: average of latest published year and two previous.
Source: Standard & Poor's

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Chart 12

Standard & Poor's Adjusted FFO/Debt, EMEA



Average data on a total of 79 mid-market and 103 large LBOs, 120 mid-market and 490 large non-LBOs.
Historic three-year: average of latest published year and two previous; forecast three-year: average of latest published year and two subsequent forecasted years.
Source: Standard & Poor's

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Appendix 2: Determining A Company's Financial Credit Profile

Standard & Poor's determines the financial credit profile of a company by assessing its cash flow and leverage metrics. Benchmark ranges for various cash flow ratios we associate with different cash flow/leverage assessments for standard volatility are presented in the table below, which is table 17 in "Corporate Methodology," published Nov. 29, 2013. The relevant benchmark table for a given company is based on our assessment of the company's associated industry and country risk volatility.

Table 1

Cash Flow/Leverage Analysis Ratios--Standard Volatility							
	--Core ratios--		--Supplementary coverage ratios--		--Supplementary payback ratios--		
	FFO/debt (%)	Debt/EBITDA (x)	FFO/cash interest(x)	EBITDA/interest (x)	CFO/debt (%)	FOCF/debt (%)	DCF/debt (%)
Minimal	60+	Less than 1.5	More than 13	More than 15	More than 50	40+	25+
Modest	45-60	1.5-2	9-13	10-15	35-50	25-40	15-25
Intermediate	30-45	2-3	6-9	6-10	25-35	15-25	10-15
Significant	20-30	3-4	4-6	3-6	15-25	10-15	5-10
Aggressive	12-20	4-5	2-4	2-3	10-15	5-10	2-5
Highly leveraged	Less than 12	Greater than 5	Less than 2	Less than 2	Less than 10	Less than 5	Less than 2

Appendix 3: Glossary

(These definitions are taken from "Standard & Poor's Ratings Definitions," published on Nov. 20, 2014, on RatingsDirect.)

A General-Purpose Credit Rating covers the broadest set of credit risk factors, not limited in scope. An issuer credit rating is a forward-looking opinion about an obligor's overall creditworthiness. This opinion focuses on the obligor's capacity and willingness to meet its financial commitments as they come due. It does not apply to any specific financial obligation, as it does not take into account the nature of and provisions of the obligation, its standing in bankruptcy or liquidation, statutory preferences, or the legality and enforceability of the obligation.

A Credit Estimate is an indication, provided to a third party, of the likely Standard & Poor's issue or issuer credit rating on an unrated obligation or obligor. The estimate is based on input from a variety of sources including quantitative models, where applicable, and draws on analytical experience and sector knowledge of Standard & Poor's analysts. It is generally confidential.

A Mid-Market Evaluation rating (MME rating) is Standard & Poor's forward-looking opinion about the creditworthiness of a mid-market company relative to other mid-market companies. It assesses a mid-market company's relative capacity and willingness to meet its financial commitments as they come due.

Related Criteria And Research

Related Criteria

- Mid-Market Evaluation Rating Methodology, Nov. 20, 2014
- Corporate Methodology, Nov. 19, 2013
- Credit FAQ: Standard & Poor's Mid-Market Evaluation Ratings Explained, Nov. 20, 2014

Related Research

- S&P's First European Private-Placement League Table Shows €6.4 Billion In Transactions In 2014, June 8, 2015
- Sustainable Growth: Towards A Capital Markets Union In Europe, May 13, 2015
- Alternative Lending Markets In Europe Are Increasingly Open To Mid-Market Companies, Jan. 26, 2015

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