# ISS Group

## Major Rating Factors

**Corporate Credit Rating**

B+/Stable/B

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*Strengths:*

- Leading player in most of its markets, and a well-known brand;
- Wide geographical and customer diversity;
- Resilient nature of basic services business; and
- Strong cash generation from business operations, with low asset intensity and capital expenditure needs.

*Weaknesses:*

- Very highly leveraged financial profile;
- Competitive industry with fairly weak margins;
- Few barriers to entry preventing local competition;
- Little price flexibility; and
- Growth-by-acquisition strategy.

## Rationale

The ratings on FS Funding A/S, ISS A/S, and ISS Global A/S, entities of Denmark-based facilities services provider ISS Group (ISS), reflect the group's very highly leveraged financial profile and weak credit measures. This is mitigated by the group's strong business profile, underpinned by its solid business position in an attractive—albeit fragmented and competitive—industry.

At end-December, 2006 adjusted debt was about Danish krone (DKK) 28.4 billion (€3.8 billion) including unfunded postretirement liabilities.

With sales of DKK55.8 billion in 2006, ISS benefits from a strong business position, particularly in Northern Europe, where it is a leader in most of its markets. The group benefits from good geographical diversity and a highly diversified customer base. Standard & Poor's Ratings Services considers ISS' business sector to be attractive, as it is resilient to recession and likely to benefit from increasing outsourcing. Although there are few barriers to entry and pricing is competitive within the sector, the group has a good record of contract retention, and is large enough to benefit from economies of scale.

Acquisitions have been and are likely to continue to be part of ISS' strategy to add competencies and build critical mass and geographical presence. Although this acquisition strategy adds some risk to the business, ISS' track record is good, with management successfully integrating acquired companies. As a result of the competitive nature of the facilities services business, ISS' operating profit margins are relatively low. Its EBITDA margin was about 7% (not adjusted for operating leases) in 2006.

The group is very highly leveraged following a buy-out in May 2005 by a private equity consortium consisting of funds advised by EQT Partners (EQT) and Goldman Sachs Capital Partners. As a consequence, its credit measures are weak. In 2006, adjusted debt to EBITDA was 7.3x (not lease adjusted), and EBITDA interest coverage was 1.8x. Standard & Poor's does not expect medium-term material improvements in these ratios, in view of the group's acquisitive growth strategy. Acquisition spending is flexible, however, and acquisitions are normally immediately cash flow enhancing. Although free operating cash flows are small, due to high interest expenses, the group's highly flexible cost base (primarily related to staff) and low capital expenditure needs are likely to provide some cushioning in the event of a downturn.

***Liquidity***

The group's liquidity resources are adequate, with modest expected annual debt maturities before 2010. At Dec. 31, 2006, short-term debt was DKK1.0 billion. DKK 0.6 billion of this was drawings under the group's major liquidity resource, a DKK2.4 billion committed revolving credit facility. In addition, the group has a letter of credit/guarantee facility of DKK500 million and separate acquisition facilities totaling DKK4.9 billion (of which DKK2.5 billion was drawn at Dec 31., 2006). Current drawings under the acquisition facilities are expected to be partly repaid with proceeds from new term loans raised in connection with an upcoming refinancing. All the group's current credit facilities mature in 2012 or 2013 and include financial covenants. Headroom under the covenants is expected to be sufficient. We also expect the group to continue to post positive free operating cash flow (before acquisitions, and adjusted for seasonal working-capital swings).

***Recovery analysis***

€1.3 billion in senior subordinated notes issued by FS Funding A/S have been rated two notches below the corporate credit rating as they are contractually and structurally subordinated to substantial priority liabilities within the group, including drawings under credit facilities and non-interest-bearing liabilities at operating subsidiary level. For similar reasons, two existing EMTNs totaling €1.35 billion, maturing in 2010 and 2014 and issued by ISS Global under the group's EMTN program, continue to be rated two notches below the corporate credit rating, although the €1.3 billion senior subordinated notes are structurally subordinated to the EMTNs. ISS plans to fully or partly refinance and repay €850 million in senior subordinated floating rate notes and make a tender offer to purchase part of the €500 million 2014 EMTN issue with proceeds from new term loans and second lien debt. This will not change the notching of remaining rated debt.

The group's unrated committed senior secured facilities consist of:

- DKK6.7 billion term facilities with final maturity in 2012 and 2013.
- A DKK2.4 billion revolving credit facility maturing in 2013.
- A DKK500 million letter of credit facility maturing in 2013.
- DKK4.9 billion acquisition facilities maturing in 2012 and 2013.
- The capital structure also includes a DKK100 million uncommitted revolving credit facility, maturing in 2012.

As part of the planned refinancing, ISS intends to add two new term loans totalling DKK8.5 billion to the existing senior secured facilities, maturing in 2013. In addition, the group's intends to add a €600 million second lien debt facility as part of its senior facility agreement. The proceeds from the new facilities will be used to repay a large part of the acquisition facilities, some or all of the €850 million senior subordinated floating rates notes, and part of the EMTN issue maturing in 2014.

The senior priority facilities are secured, inter alia, by a share pledge on shares in ISS A/S held by FS Funding. It is a condition of the senior facilities agreement that material subsidiaries guarantee the senior facilities and provide security pledges against their bank accounts, trade and intercompany receivables, and intellectual property and share pledges as far as legally possible, subject to agreed guarantee and security principles.

As is usual, there are limitations on the amounts certain subsidiaries can guarantee in accordance with local laws. Neither ISS A/S nor any of its subsidiaries has guaranteed or granted any security relating to the borrowings of FS Funding under the senior facilities. Moreover, ISS A/S will not pledge its shares in ISS Global A/S.

Despite being documented within the senior secured loan agreement, the second lien facility has a more limited security package than the senior priority secured facilities, in line with the security package available to the senior subordinated bondholders. The second lien facility is expected to be secured by the senior share pledge against the shares in ISS A/S, and the assignment of loans from FS Funding to various other ISS subsidiaries. There will be no guarantees or other security for the second lien facility. As the facility will be issued at the FS Funding level, it will be effectively structurally subordinated to the EMTNs (except to the extent of the €50 million intercompany loans to the ISS subsidiaries).

## Outlook

The stable outlook reflects our expectation that ISS' operating performance will remain steady, and is underpinned by the group's ability to generate strong cash flows. We do not incorporate material improvements in ISS' credit measures as we expect the group's acquisition strategy to continue. This limits upside potential for the ratings. Nor do we expect any material deterioration in the group's credit measures. If this were to occur, however, it could result in a negative rating action. Furthermore, Standard & Poor's does not incorporate any possible material near-term changes in ISS' financial risk profile as a result of proposed changes in Danish tax law.

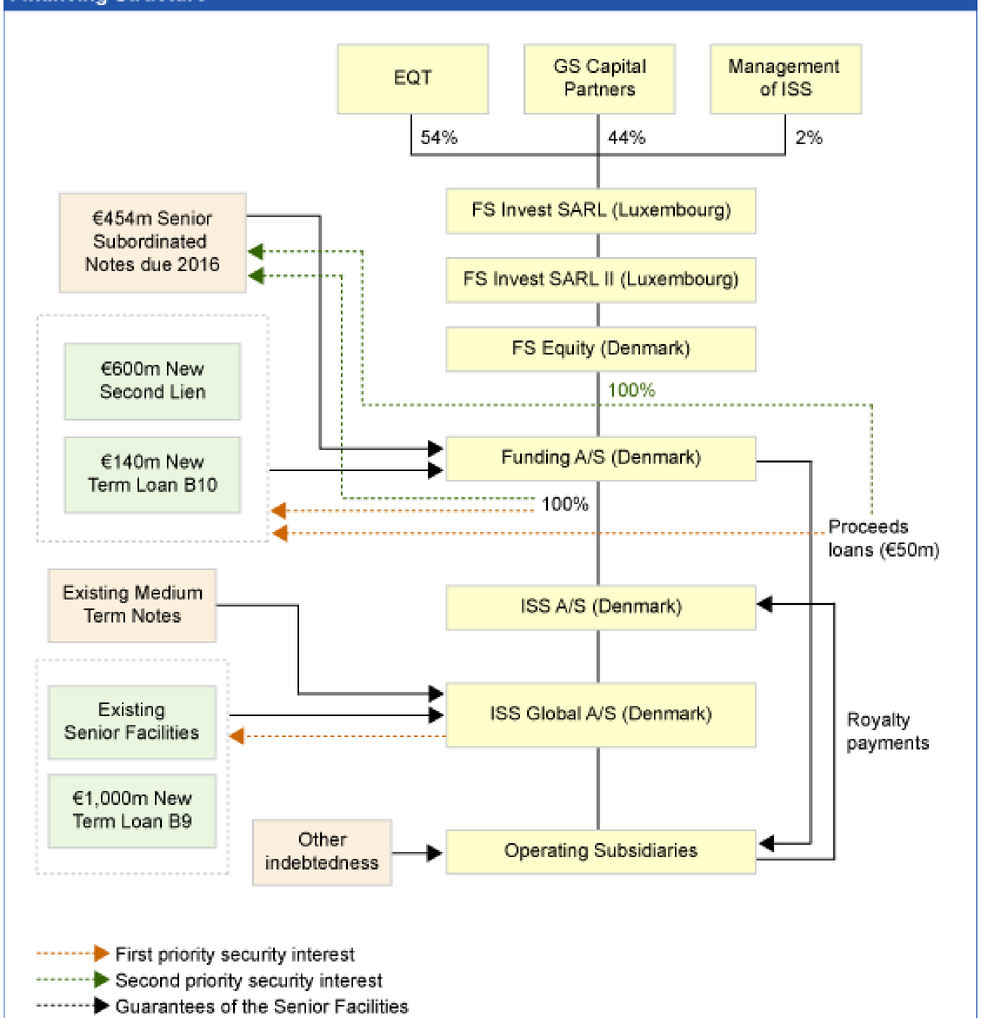
## Business Description: Established Facilities Services Group

ISS is a large and long-established facilities services group, with operations in 49 countries in Northern and Continental Europe, Asia, Latin America, and Australia. In 2006, the group had sales of DKK56 billion. The group provides general facilities services for private and public entities, such as:

- Cleaning services, (including washroom services), accounting for 57% of 2006 sales;
- Property services (including landscaping, pest control, damage control services, and maintenance and technical services), accounting for 22% of 2006 sales;
- Catering services, accounting for 6% of 2006 sales;
- Office support services (call centers, reception services, office logistics and access control), accounting for 8% of 2006 sales, and
- Integrated facility services (IFS; multiple facility services with on-site management and single-point contact for the customer), accounting for 7% of 2006 sales.
- From 2007, security services (manned guarding, access control) has been added as a fifth strategic service segment under the integrated facility service concept as a consequence of the group's increasing growth in this segment. (Security services have previously been incorporated under office support services).

In May 2005, ISS was 55% acquired by EQT and 45% by Goldman Sachs Capital Partners (see chart). It was subsequently de-listed from the Copenhagen Stock Exchange.

**Financing Structure**



## Business Risk Profile Based On Solid Position In Attractive Industry

ISS has a strong business risk profile, reflecting its size and market leadership in many of its countries of operation. The group benefits from good geographical diversity and a highly diversified customer base. It is acquisitive, but has a good track record of integrating its acquisitions. Standard & Poor's considers ISS' business sector attractive, as it is resilient to recession and is likely to benefit from increasing outsourcing. There are, however, few barriers to entry and pricing is competitive in the sector.

***Industry characteristics: Resilient to recession, but fragmented and competitive***

The European facility services sector is a fragmented but mature industry, characterized by high-volume, low-value contracts. In most sectors of the market, there are few barriers to entry, but high margins are achievable, depending on the industry subsector. Consolidation is continuing at a fairly fast pace.

The trend in recent years has been toward outsourcing many of these mostly essential services. As a result, most segments of the industry are growing, and the sector is resilient to recession.

Keys to success in the industry include:

- Size, critical mass, and diversity in terms of geographical reach, service portfolio, and customer base;
- A presence in attractive service segments, with, for example, more stable demand and lower price competition than the industry average;
- The ability to provide a consistent high-quality service at a competitive price;
- Well-motivated staff with a professional attitude, and the ability to minimize turnover while controlling staff costs; and
- Good internal control systems, and the ability to integrate acquisitions.

***Competitive position: Diversified market leader with strong record of integrating acquisitions***

ISS is a strong player in the European facilities services business, with particular strength in the Nordic region (which accounts for about 28% of its sales). Cleaning services accounted for 57% of group turnover in 2006, and in most of the countries where it operates, ISS is one of the three largest players. As part of its long-term strategy ISS has in recent years increased its focus on broadening its service concept, and developing and offering integrated on-site facility service solutions (which can include a range of cleaning, property, canteen, office support services and security). Although this is leading to a gradual rebalancing of the current business mix, cleaning is often a starting point for developing integrated facility service contracts, and it is likely to remain a major activity for the group also in the future. One of ISS' major competitive advantages is its size, which also supports staff flexibility (for example, the same staff can provide different services within the same location). ISS is sizable and well known enough to be invited to tender for most large contracts in its areas of operation. Size and quality are the key barriers to entry in this fairly basic and competitive industry, as customers want good, reliable service at a competitive price.

ISS has a well-diversified and largely loyal customer base, with more than 200,000 business-to-business customers, which lends stability to the business. The 10 largest customers account for less than 5% of total turnover. Although the industry tends to renew contracts frequently, ISS' level of contract retention has remained stable for some years, at about 85%-90%. ISS benefits from its good geographical spread, reflecting the local nature of its markets. The group has a strong presence in a large number of European countries, and is gradually increasing its presence outside Western Europe, with a focus on the BRIC countries (Brazil, Russia, India, and China) as well as other growth markets in Eastern Europe, Latin America and Asia. In 2006, the group significantly increased its position in Australia through the acquisition of the remaining 51% in Tempo Services Ltd., resulting in 100% ownership. In 2006, sales from outside Europe increased to almost 12% of the total from 5% in 2005.

Acquisitions have been and are likely to remain an essential part of ISS' growth strategy. The risks associated with the acquisition strategy are mitigated by management's good track record in integrating the acquisitions and the fact that acquisitions are normally small in size (less than DKK100 million in sales). On the positive side, the acquisitions have contributed to building up ISS' strong market positions, and widen the service portfolio and geographical reach.

***Profitability low but margins are stable and the cost base highly flexible***

ISS has had reasonable operating profit margins for the sector, at about 7% (before depreciation and amortization, not lease adjusted, and about 9% lease-adjusted) over the past few years. Standard & Poor's expects margins to stay broadly flat in the coming years because continued cost efficiencies at ISS might be matched by continued price pressure. We would not expect significant margin deterioration in a downturn, (as demonstrated in the past), and ISS benefits from a highly flexible cost base, which could be quickly adjusted if necessary. Staff costs make up about 65% of total costs, and there are comparatively few fixed costs. Members of staff are mostly attached to specific contracts, meaning that ISS can slim down quickly if contracts are lost. Contracts also often include pass-through clauses for wage increases.

ISS has about 390,000 employees. Staff turnover is high, at about 50%, although this is a common industry characteristic. High staff turnover imposes replacement costs, and can affect the quality of service. At the same time, high employee turnover makes it easier for ISS to adapt staff levels to any temporary weaknesses in market conditions. Reflecting local markets, retention of good local on-site management is therefore more important to ISS.

***Peer comparison: Lower rating than peers owing to higher financial risk***

Reflecting the fragmented nature of the industry, competitors tend to differ from country to country. Major rated competitors include Sodexho Alliance S.A. (BBB+/Stable/A-2), Compass Group PLC (BBB+/Stable/—), and Rentokil Initial PLC (BBB/Stable/—). These companies are leading market players like ISS and benefit from diversified customer bases and geographical spreads. While Sodexho's and Compass' margins are similar to those of ISS (see table 1), Rentokil Initial has the highest margins in the peer group, largely reflecting its business mix (with a large share of high-margin businesses such as washroom services and pest control). The three peers all have stronger financial profiles than ISS, as a result of the increase in ISS' leverage in 2005 following the buy-out..

## Financial Risk Profile: Very High Leverage Limits Free Cash Flow Generation

The group is highly leveraged following the buy-out in May 2005 by EQT and Goldman Sachs Capital Partners. As a consequence, its credit measures are weak. The company's operating cash flows benefit from low capital expenditure needs, but high interest expenses put pressure on free cash flow generation, and the group's acquisitive growth strategy is likely to prevent material improvements in its credit measures.

### *Accounting*

Since Jan. 1, 2005, ISS has reported according to IFRS, having previously reported according to the Danish Financial Statements Act, including Danish Accounting Standards. Standard & Poor's makes a number of adjustments to ISS'reported figures (see table 1).

The group's reported debt is adjusted to reflect the principal amounts of the group's €850 million and €500 million EMTN issues. These notes were recognised in the balance sheet at the market price as of the date of FS Funding's acquisition of ISS A/S. The difference (DKK1.1 billion at year-end 2006) has been added to ISS's adjusted debt (included under 'Other' in table 1).

Table 1

**Reconciliation Of FS Funding A/S Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. DKK)***

| | —Fiscal year ended Dec. 31, 2006— | | | | | | |
|---|---|---|---|---|---|---|---|
| *ISS A/S reported amounts* | | | | | | | |
| | Debt | Shareholders' equity | Operating income (before D&A) | Operating income (before D&A) | Interest expense | Cash flow from operations | Capital expenditures |
| Reported | 28,640.0 | 5,917.0 | 3,764.0 | 3,764.0 | 2,152.0 | 3,195.0 | 843.0 |
| *Standard & Poor's adjustments* | | | | | | | |
| Operating leases | 3,286.7 | — | 1,110.5 | 149.9 | 149.9 | 960.6 | 1,536.0 |
| Postretirement benefit obligations | 604.8 | 32.4 | (83.0) | (83.0) | 16.0 | 42.5 | — |
| Surplus cash and near cash investments | (2,275.0) | — | — | — | — | — | — |
| Reclassification of nonoperating income (expenses) | — | — | — | — | — | — | — |
| Reclassification of interest, dividend, and tax cash flows | — | — | — | — | — | (2,330.0) | — |
| Reclassification of working-capital cash flow changes | — | — | — | — | — | (50.0) | — |
| Minority interests | — | 63.0 | — | — | — | — | — |
| Other | 1,492.0 | — | 215.0 | 215.0 | — | 25.0 | — |
| Total adjustments | 3,108.5 | 95.4 | 1,242.5 | 281.9 | 165.9 | (1,352.0) | 1,536.0 |
| *Standard & Poor's adjusted amounts* | | | | | | | |
| | Debt | Equity | Operating income (before D&A) | EBITDA | Interest expense | Funds from operations | Capital expenditures |
| Adjusted | 31,748.5 | 6,012.4 | 5,006.5 | 4,045.9 | 2,317.9 | 1,843.0 | 2,379.0 |

* Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts.

ISS has material commitments under operating lease agreements, primarily relating to properties and vehicles. Adjusting for these off-balance-sheet commitments, debt in 2006 increased by about DKK3.3 billion on a net present value basis, using a 5% discount rate. The debt to EBITDA ratio increases by about 0.5x. The negative impact in credit terms from these obligations are, however, mitigated by the fact that the lease contracts are mostly short-term, at three years or less, which means that ISS can relatively quickly adjust its needs to changes in the operating environment. In addition, leasing contracts for vehicles are flexible, and allow for the return of vehicles before the contract expires (although all vehicles in a particular country would need to be returned).

***Corporate governance/ Risk tolerance/Financial Policy***

Following the buy-out by EQT and Goldman Sachs Capital Partners in May 2005, ISS is highly leveraged, with an adjusted debt-to-EBITDA rate of about 7.3x (including postretirement liabilities, but not lease-adjusted) at year-end 2006. As bolt-on acquisitions are likely to remain a tool for growth, and will probably be financed with internal cash flow and additional debt, Standard & Poor's does not expect material improvements in credit measures over the medium term. Furthermore, as the bolt-on acquisitions normally enhance cash flow immediately, we do not expect any material deterioration in credit measures. In addition, any potential major acquisition is expected to be financed in such a way that credit measures do not weaken. Dividend pay-out is highly restricted, and the company is expected to dedicate free cash flows to growth investments.

***Cash flow adequacy good, but debt levels are high and credit measures weak***

Although operating margins are relatively low, ISS' free operating cash flow generation benefits from the low capital intensity of the business. Gross capital expenditure in relation to sales has been less than 2% over the past few years. The significantly increased debt levels following the buy-out have, however, resulted in high interest expenses, which have lowered free cash flows, and resulted in weak cash flow protection measures. Over the near to medium term, EBITDA cash interest coverage is expected to be about 2x, and adjusted FFO to debt about 5%-6% (not lease-adjusted). ISS is, however, even at this high leverage, expected to continue to post positive free operating cash flows. Although free cash flows are expected to be consumed for acquisitions rather than debt reduction, acquisition spending is discretionary and flexible, and can be cut back if needed. Also, when evaluating credit measures on a yearly basis, we take into account the fact that operating cash flows are slightly understated, as they do not show full-year cash flows from acquisitions made during the year.

***Capital structure weak, but near-term mandatory repayments small***

The high debt levels result in a weak capital structure for the ratings, with adjusted debt to capital of 83% at year-end 2006 (excluding operating leases).

ISS' EMTNs, totaling DKK10.1 billion, carry low interest rates, as they were issued before the buyout (when the capital structure was much stronger), and do not include any change of control clauses. This means that the average cost of debt for ISS is relatively low for the current ratings. Although ISS is considering repaying part of the 2014 EMTN issue, the group's average interest rate is expected to fall as it also intends to repay high yield floating rate notes with new senior secured borrowings. This means that the debt maturity profile will shorten slightly, although the group has only small mandatory annual repayments before 2010, when the €850 million EMTNs mature.

The balance sheet is heavily oriented toward the short term, with fixed assets comprising about 13% of ISS' DKK16 billion total tangible assets. ISS also has about DKK36 billion of intangible goodwill, brands, and customer contracts resulting from acquisitions in its DKK52 billion of total assets.

Table 2

**FS Funding A/S—Peer Comparison***

| | Fiscal year ended Dec. 31, 2006 | Fiscal year ended Dec. 31, 2006 | Fiscal year ended Aug. 31, 2006 | Fiscal year ended Sept. 30, 2006 |
|---|---|---|---|---|
| | **FS Funding A/S** | **Rentokil Initial PLC** | **Sodexho Alliance S.A.** | **Compass Group PLC** |
| Rating as of May 14, 2007 | B+/Stable/B | BBB/Stable | BBB+/Stable/A-2 | BBB+/Stable |
| Business risk profile | Strong | Satisfactory | Strong | Strong |
| Financial risk profile | Highly leveraged | Intermediate | Intermediate | Intermediate |
| *(Mil. €)* | | | | |
| Revenues | 7,480.9 | 3,154.3 | 12,798.0 | 15,927.3 |
| EBITDA | 542.7 | 615.4 | 814.9 | 1,157.0 |
| *Adjusted ratios* | | | | |
| EBITDA interest coverage (x) | 1.7 | 5.6 | 4.4 | 4.0 |
| FFO/debt (%) | 5.8 | 24.2 | 37.8 | 35.1 |
| Free operating cash flow/debt (%) | (1.5) | 7.5 | 19.6 | 24.7 |
| Debt/EBITDA (x) | 7.8 | 3.1 | 1.7 | 2.1 |

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt.

Table 3

**FS Funding A/S—Financial Summary***

| | —Fiscal year ended Dec. 31— | | |
|---|---|---|---|
| | **2006** | **2005§** | **2004§** |
| Rating history | B+/Stable/B | B+/Stable/B | BBB+/Stable/A-2 |
| *(Mil. DKK)* | | | |
| Revenues | 55,772.0 | 46,440.0 | 40,355.0 |
| Operating income (bef. D&A) | 5,006.5 | 4,262.0 | 3,747.0 |
| Net income from continuing operations | (827.0) | 935.0 | 817.0 |
| Funds from operations (FFO) | 1,843.0 | 2,960.7 | 2,536.2 |
| Capital expenditures | 2,379.0 | 1,545.6 | 1,828.2 |
| Debt | 31,748.5 | 19,397.5 | 11,225.9 |
| Common equity | 5,949.4 | 2,231.4 | 8,723.4 |
| Total assets | 52,253.0 | 31,865.0 | 30,805.0 |
| *Adjusted ratios* | | | |
| Oper. income/sales (bef. D&A) (%) | 9.0 | 9.2 | 9.3 |
| EBITDA interest coverage (x) | 1.7 | 4.1 | 5.3 |
| Return on capital (%) | 6.4 | 11.6 | 13.2 |
| FFO/debt (%) | 5.8 | 15.3 | 22.6 |
| Free operating cash flow/debt (%) | (1.5) | 6.1 | 8.0 |
| Debt/total capital (%) | 84.1 | 89.5 | 56.0 |

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt. § 2005 and 2004 refer to ISS A/S only. Credit measures for 2005 do note include the impact of about Dkr 6.8 billion of additional net debt at FS Funding. DKK—Danish krone

| Ratings Detail (As Of 14-May-2007)* | |
|---|---|
| **ISS A/S** | |
| Corporate Credit Rating | B+/Stable/B |
| **Corporate Credit Ratings History** | |
| 07-Nov-2005 | B+/Stable/B |
| 17-May-2005 | B+/Watch Neg/B |
| 12-May-2005 | BB+/Watch Neg/B |
| 29-Mar-2005 | BBB+/Watch Neg/A-2 |
| **Business Risk Profile** | Strong |
| **Financial Risk Profile** | Highly leveraged |
| **Debt Maturities** | |
| At Dec. 31, 2006*:<br>Within one year: DKK 1.0 billion<br>Between 1-5 years: DKK 8.3 billion<br>Thereafter: DKK 20.8 billion<br>*Principal amounts, not reported market value of debt | |
| **Related Entities** | |
| **FS Funding A/S** | |
| Issuer Credit Rating | B+/Stable/— |
| Subordinated | |
| *Foreign Currency* | B- |
| **ISS Global A/S** | |
| Issuer Credit Rating | B+/Stable/— |
| Senior Unsecured | |
| *Foreign Currency* | B- |

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.