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# ISS A/S: Focus on Global Contracts Builds Barriers to Entry

KEY INDICATORS – ISS A/S:

| | 9/30/2012(L) | 12/31/2011 | 12/31/2010 |
|---|---|---|---|
| Pretax Income (USD Million) | $156.9 | $108.0 | $158.5 |
| Revenue (USD Million) | $13,753.2 | $14,507.0 | $13,199.7 |
| RCF / Net Debt | 6.5% | 6.2% | 6.9% |
| FCF / Debt | 1.5% | 0.8% | 1.6% |
| (EBITDA-CapEx) / Interest Exp | 1.5x | 1.3x | 1.5x |
| Debt / EBITDA | 6.7x | 6.7x | 6.7x |

*Source: Moody's Financial Metrics*

RATINGS – ISS A/S:

| | |
|---|---|
| Outlook | Stable |
| Corporate Family Rating | B1 |
| Senior Subordinate | B3/LGD6 |

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## Summary

» **The proportion of revenues that ISS A/S (B1 stable) derives from Integrated Facility Services (IFS) continues to grow.** Against this background, ISS is gradually becoming less dependent upon cleaning services, its traditional business. Its solid global positioning as a provider of multi-services positions it as a leading player within the growing IFS segment. We believe this growth will enable the company to reap advantages of scale, and to gradually improve profitability through the longer duration of these contracts.

» **Industry fundamentals are positive.** In line with an increasing share of regional and global facility-services contracts, we expect IFS to represent a larger share of the global market.

» **Only a few facilities services companies are able to self-deliver an IFS product because of the scale required.** This creates barriers to entry in an industry that previously has been characterised by very weak entry barriers.

» **Large global contracts contribute to drive the company's organic growth and protect its profitability in an otherwise challenging economic environment.** ISS's organic growth has slowed recently due to economic downturns in some of its key markets, but we expect it to be boosted in the fourth quarter of 2012 and into 2013, supported by the positive impact from recent IFS contracts.

» **Large contracts increase business risk.** Failure to implement new contracts may expose the company to increased risk, including reputational damage and/or litigation.

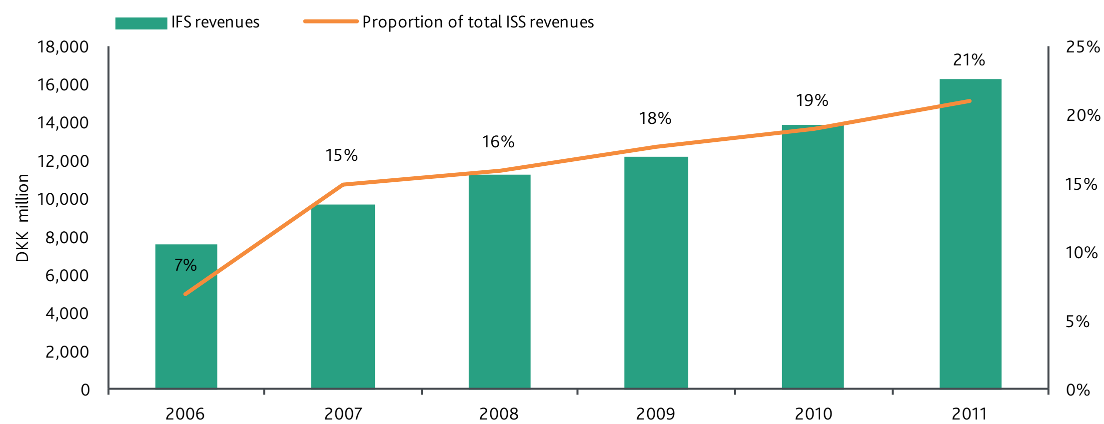
» **Rating remains constrained by high leverage.** Although we upgraded ISS's corporate family rating (CFR) in August 2012 to B1 from B2, reflecting the injection of €500 million of equity from new investors, the rating remains constrained by high leverage.

## Share of revenues from Integrated Facility Services is growing

Originally a cleaning services company, ISS A/S now offers six broad types of services: property, cleaning, security, catering, support and facilities management. Cleaning remains an important activity (generating 51% of revenues); however, the company is increasingly offering packages of services bundled together. Under the IFS model, two or more services are delivered under one contract with a single point of contact on-site. The greater focus on IFS is becoming an increasingly important driver of growth for ISS, and it represented 21% of the company's revenues in FY2011, compared with 19% in 2010 (see Exhibit 1).

EXHIBIT 1

### IFS's Contribution to the Revenue Stream Is Increasing




*Source: ISS Annual Reports*

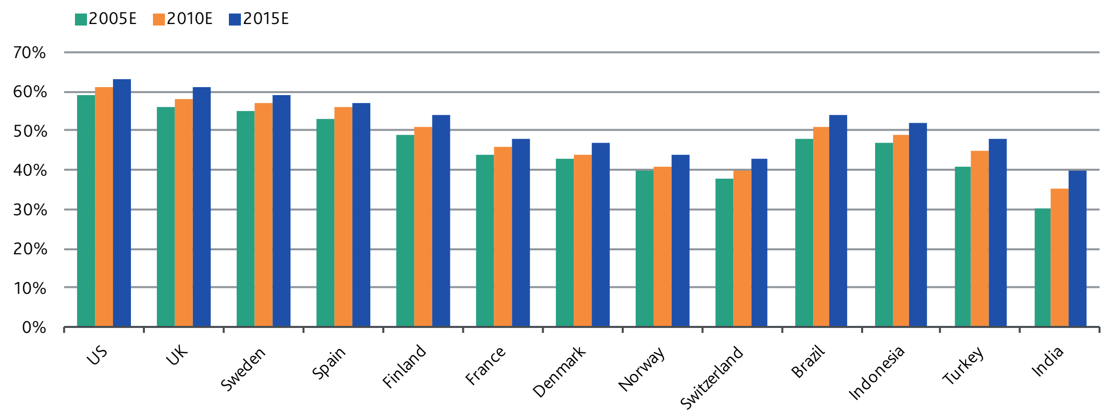
## IFS displays strong growth potential and may outpace growth in the facility services market

The development of facility management solutions through IFS, with a high degree of self-delivery, has been a focus area of the company over the past years. Against the background of increased globalisation, customers are increasingly requesting that facility-services providers are able to transfer their services with them as they expand internationally. This strategy requires a certain scale, and ISS is one of just a few companies able to offer such integrated services on a global or enlarged regional basis.

Growth in the overall business services market is correlated to underlying economic growth and structural changes such as the growing trend towards outsourcing. The degree of outsourcing varies from one country to another, but the overall trend is for the penetration rate to continue to increase – particularly in emerging markets. These underlying fundamentals are also reflected in ISS's results, in which emerging markets currently exhibit stronger organic growth than more mature Western markets. For example, in the nine months to September 2012, ISS's organic growth was much stronger in Asia (15%) and Latin America (7%) than in the company's more local markets in the Nordics (0%) or Western Europe (1%).

EXHIBIT 2

**Industry Outsourcing Penetration Rates Expected To Continue Increasing**




*Source: "ISS Estimates based on third-party data"*

Whilst an increased penetration rate is likely to benefit all types of facility-services outsourcing, we believe the IFS portion of the global facility-services market is likely to grow from a still relatively modest base as at year-end 2012. This growth will be fuelled by a combination of (1) international expansion of existing clients who want their service providers to follow them into new territories; and (2) an increased focus on consolidation/standardisation of procurement programmes – particularly at larger multinational companies – allowing for optimisation of costs. We believe that global companies will increasingly seek greater operational efficiency by sourcing services partners that are able to cover an enlarged geographical area rather than having in place a multitude of contracts country-by-country.

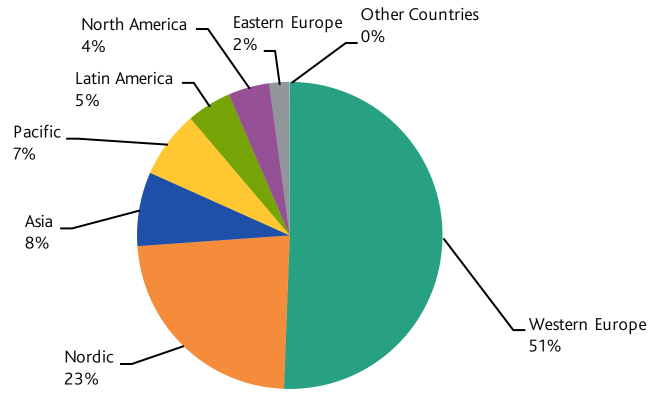
## Integrated solutions creates further barriers to entry

The overall facility-services market remains fragmented, with low barriers to entry as the more basic types of services – such as cleaning – can be delivered with few resources and is therefore largely commoditised. Although competition varies, in general the facility-services market in each country is restricted to only a handful of national players that have sufficient scale and scope to provide the six broad types of services.

As a result of the large scale needed in terms of geographic reach as well as the number of services provided, the focus on IFS enhances barriers to entry as only a limited number of companies are able to offer contracts on an enlarged regional or – in some cases – global scale. ISS had adopted an acquisitive strategy since it was taken private in 2006; however, the company has now scaled back its acquisition-related spending because it believes it has reached critical mass. In addition to creating further entry barriers, IFS contracts may contribute to geographic diversification.

EXHIBIT 3

### ISS's Global Footprint Enables it to Compete for Global Contracts




*Source: ISS FY2011 Annual Report*

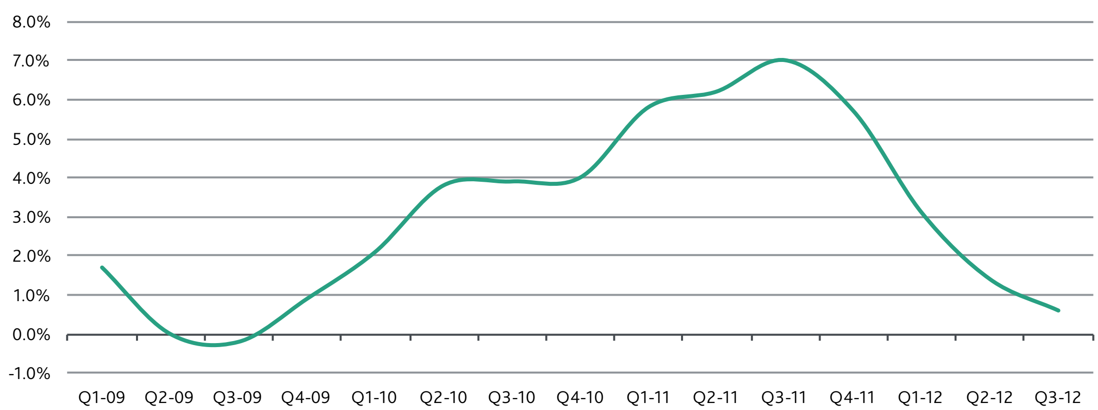
Given their longer duration, IFS contracts provide greater visibility on future revenues, as illustrated by the recent five-year contract with Barclays Bank. During the lifespan of an IFS contract, the company develops a deeper partnership with the client. The product offering includes a higher degree of personalisation of services in order to meet clients' needs across a wider geography. This offering may, in some cases, involve a deeper integration of certain processes and systems through back-office activities. Given its greater complexity and customisation, this approach also carries elements of execution risk because a successful long-term partnership is likely to increase the switching costs for the customer.

## IFS to drive organic growth and protect profits during periods of economic weakness

During the economic downturn in 2008-09, ISS fared better than many business services companies exposed to the economic cycle. However, the company is not immune to economic slowdown; its organic growth rate slowed to just 0.6% in the third quarter of 2012, compared with an organic growth rate of 7.0% in the same period in 2011.

EXHIBIT 4

### Organic Growth is Decreasing Amidst a Challenging Economic Environment




*Source: ISS Interim Reports*

The currently challenging economic environment is mitigated by IFS's contracts that have recently come on-stream or will come on-stream at the beginning of 2013. In particular, we would expect the company's IFS contract with Barclays Bank – ISS's largest-ever contract – to provide a boost to organic growth in the fourth quarter of 2012 (ISS reported a YTD September 2012 organic growth of 1.7%, but guided towards full-year organic growth of around 2%). Similarly, we expect the company to benefit from the award of a recent IFS contract with Novartis (covering Switzerland, Austria, Germany and Slovenia), which will start at the beginning of 2013. These contracts follow a number of other important contracts that have been signed over the past few years.

EXHIBIT 5

### Selected IFS Contracts Signed by ISS Since 2010

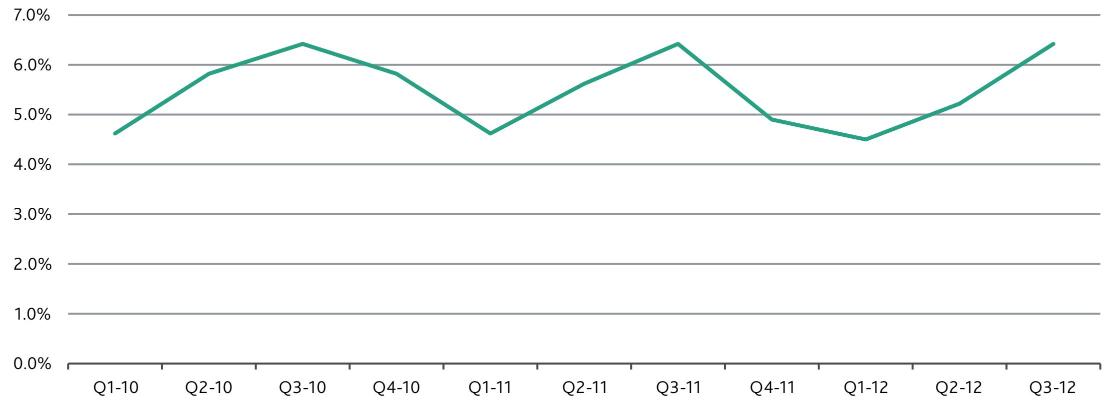
| Year | Company | Regions covered |
|---|---|---|
| 2012 | Barclays | UK, Europe, the Americas, Asia Pacific and the Middle East |
| 2012 | Novartis | Switzerland, Austria, Germany and Slovenia |
| 2011 | Tesco | Czech Repuplic |
| 2011 | Czech National Bank | Czech Repuplic |
| 2011 | Exxon | France |
| 2011 | Deutsche Bank | Italy and Iberia |
| 2011 | Statoil | Norway |
| 2010 | UK Foreign Commonwealth Office | 14 countries across Asia Pacific Japan region |
| 2010 | Hewlett-Packard | 13 countries across North America and Latin America 42 countries in EMEA and APJ regions |
| 2010 | Citi | 26 countries across Europe and the EMEA region |
| 2010 | Nordea | Denmark, Finland, Sweden and Norway |
| 2010 | UBS | Indonesia, Philippines, Taiwan and Switzerland |
| 2010 | Sony Ericsson Mobile Communication | 9 countries in the EMEA region, APJ region and in North America |
| 2010 | Nokia Siemens Network | Brazil, Argentina, Chile, and Mexico |
| 2010 | Falck | 4 countries in the EMEA region |

*Source: ISS Interim and Annual Reports*

The IFS contracts may also help protect the company's profitability. A ramp-up period may initially have an adverse affect on margins during the infrastructure development phase, such as installation of equipment or back-office systems. However, the economies of scale associated with this type of contract, as well as its longer duration, enable ISS to gradually improve its profitability throughout the lifecycle of the contracts. In particular, we see upside potential as processes and operations are standardised and procurement is optimised. Synergies may also be achieved as implementation costs are lowered and employee resources leveraged (the same personnel may be deployed for several types of activities, thus reducing duplication and maintaining staff efficiencies).

During economic downturns, pricing pressure may increase on certain types of contracts, thus causing margin pressure to develop. ISS generates around 20%-25% of its revenues through one-off contracts, which are more vulnerable to the economic environment. Against this backdrop, we believe that IFS contracts could cushion pressure on margins. For the first nine months of 2012, ISS's operating margin decreased by 10 basis points (bps) compared with the same period in 2011, mainly due to austerity measures in certain mature markets. Nevertheless, ISS guided towards full-year 2012 margins in line with those of 2011.

EXHIBIT 6
**Operating Margins Have Held Up Well**




*Source: Company Interim Reports*

## Large-scale contracts increase business risk profile

In our opinion, the implementation of large-scale contracts carries certain types of execution risks, which somewhat increase ISS's business risk profile. In particular, we note the execution of IFS contracts includes a wide range of operations from back-office & internal software systems via potential differences in legal environment, to maintaining control of eventual subcontractors. Furthermore, customisation of services, which may require a change of existing organisational framework, could increase with ISS's exposure to large-scale contracts and expose it to a higher level of business risk.

ISS is expanding geographically. In combination with the award of some high-profile contracts, we believe the higher proportion of IFS contracts may expose the company's corporate image to risk should execution fail. However, such threats are mitigated by the company's track record of administering IFS contracts.

## Despite ISS's increased share of IFS revenues, high leverage continues to constrain the rating

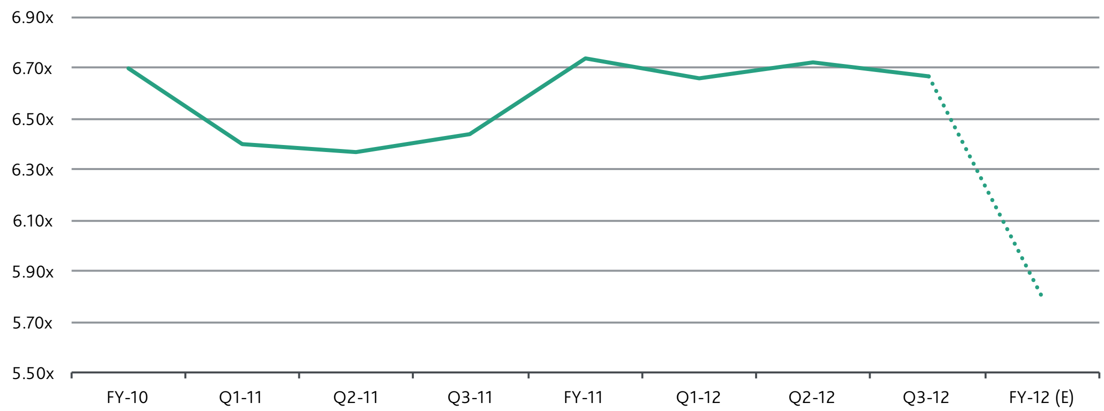
We upgraded ISS's CFR to B1 from B2 in August 2012 following an injection of equity capital (€500 million) from new investors. ISS will use these funds to repay the 11% senior notes, due 2014, after the notes 'call date' in December 2012.

The capital injection enhances ISS's credit profile given that it will (1) reduce the company's leverage; (2) strengthen its free cash flows in 2013 and 2014 as a result of saved interest costs on the 11% notes; (3) improve the company's liquidity profile overall through increased room under financial covenants; and (4) reduce refinancing risk for the company's 2014 maturities.

Whilst the increasing proportion of ISS's revenues that stems from IFS is ratings-positive, the company's leverage remains high. We anticipate that the company's leverage – measured as adjusted debt/EBITDA – will be approximately 5.8x by the end of 2012.

EXHIBIT 7

**Leverage Expected to Decrease Following Reimbursement of Notes in December**




*Source: Moody's Financial Metrics*

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