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ISS A/S: Increasingly Conservative Financial Policies Strengthen Credit Profile

RATINGS

ISS A/S

Outlook	Positive
Corporate Family Rating	B1
Senior Secured	Ba3/ LGD3
Senior Subordinate	B3/LGD6

KEY INDICATORS

	9/30/2013 (L)	12/31/2012	12/31/2011
Pretax Income (USD Million)	$128.6	$139.4	$108.0
Revenue (USD Million)	$13,949.5	$13,723.6	$14,507.0
RCF / Net Debt	7.2%	6.7%	6.3%
FCF / Debt	2.7%	1.7%	0.8%
(EBITDA-CapEx) / Interest Exp	1.4x	1.4x	1.3x
Debt / EBITDA	6.3x	6.1x	6.7x

Source: Moody's Financial Metrics

Analyst Contacts:

PARIS +33.1.5330.1020

Knut Slatten +33.1.5330.1077
Assistant Vice President - Analyst
knut.slatten@moodys.com

Eric de Bodard +33.1.5330.1040
Managing Director - Corporate Finance
eric.debodard@moodys.com

LONDON +44.20.7772.5454

Elena Marcén Argilés +44.20.7772.5585
Associate Analyst
elena.marcenargiles@moodys.com

» **Scaling back of debt-funded acquisitions supports deleveraging**. Over the past two to three years, ISS A/S (B1 positive), one of the world's leading facilities services companies, has moved away from its previously aggressive acquisition strategy, under which the company's annual acquisition spend exceeded its free cash flows (FCF), thereby increasing leverage. While ISS is likely to continue to make smaller, bolt-on acquisitions, we believe these will be funded using FCF and therefore lead to further strengthening of credit metrics.

» **ISS's current focus is on utilising its existing platform to deliver profitable organic growth**. The organic growth is mainly driven by an increasing portion of Integrated Facility Services (IFS) in the company's business mix, as well as an increasing exposure to emerging markets, where fundamentals are stronger.

» **Divestment of non-core activities is credit enhancing**. ISS is currently in the process of divesting assets it considers to be non-core to the business. The streamlining of the portfolio is credit enhancing for ISS because it is using the proceeds from divestments to redeem outstanding debt. However, the divestment of higher-margin activities will lead to an erosion of profitability in the short term.

» **Capital injection supports the company's financial policies**. The introduction of new investors in the ultimate holding company has de-risked ISS's capital structure as the company has used the equity to repay debt. The equity injection is evidence that ISS's financial policies are currently oriented towards lower absolute levels of net debt, prior to an eventual IPO by the company.

» **Redemption of higher-yielding debt and recent refinancing improves liquidity**. The redemption of ISS's more expensive debt will strengthen its FCF as interest expenses decrease. ISS's recent refinancing has further improved its liquidity profile as debt maturities have been extended and headroom to financial covenants has increased.

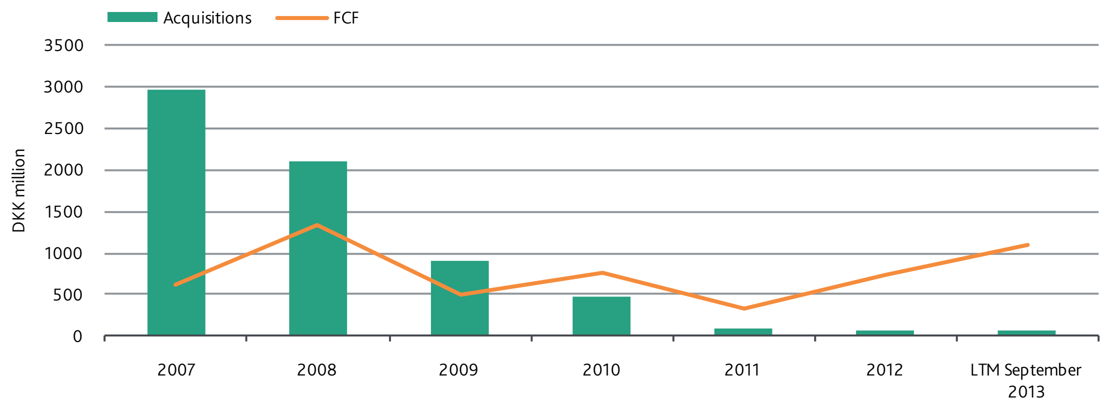
» **Further deleveraging expected, but could be hampered by restructuring costs**. While we expect ISS to continue on a path of deleveraging, high restructuring costs have adversely affected the company in 2013 and slowed down the pace of this deleveraging. Because challenging conditions are ongoing in a number of markets, we believe ISS will find it difficult to achieve EBITDA growth this year.

Scaling back of debt-funded acquisitions supports deleveraging

In the period between 2006 and 2010, ISS spent an aggregated amount of around DKK10 billion (€1.3 billion) on acquisitions. The annual acquisition spend largely surpassed the company's FCF, leading to an ever more aggressive capital structure, with leverage – measured as adjusted debt/ EBITDA – peaking at 7.4x in 2009. Since 2009, however, the company has significantly scaled back its acquisition activity, allowing for FCF to support deleveraging (see Exhibit 1). For example, in 2012, ISS spent only DKK60 million (€8 million) on acquisitions.

EXHIBIT 1

Acquisitions Are Currently Well Below FCF, Allowing for Net Debt Reduction



Source: ISS Annual Reports and Moody's Research

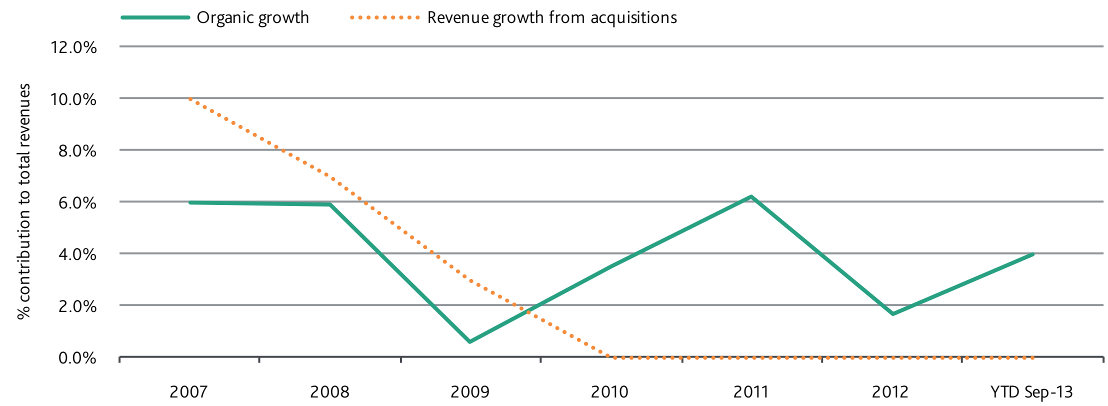
While we expect ISS to pursue a similar strategy going forward, we believe the company could yet consider smaller selected bolt-on acquisitions, notably to strengthen its existing service platform in emerging markets. However, we do not anticipate these acquisitions to represent significant amounts and we would expect the company to be able to comfortably finance such transactions – if they were to occur – with FCF. As such, ISS's credit metrics should continue to strengthen.

ISS's current focus is on utilising its existing platform to deliver profitable organic growth

While the acquisition spree undertaken by ISS in previous years contributed to a ramp-up in leverage, it did allow for the company to build a global service platform, which today plays a key role in supporting operating performance. With the contribution from acquisitions to ISS's revenues today being virtually non-existent (see Exhibit 2), the company is currently pursuing a strategy of profitable organic growth. This strategy is supported notably by ISS's strong performance in emerging markets and the further development of the company's Integrated Facility Services. ISS has also shown its willingness to focus on profitable organic growth by exiting – or not bidding for – contracts that do not correspond to the company's internal criteria of profitability.

EXHIBIT 2

The Contribution of Acquisitions to ISS's Revenue Growth Has Decreased Considerably

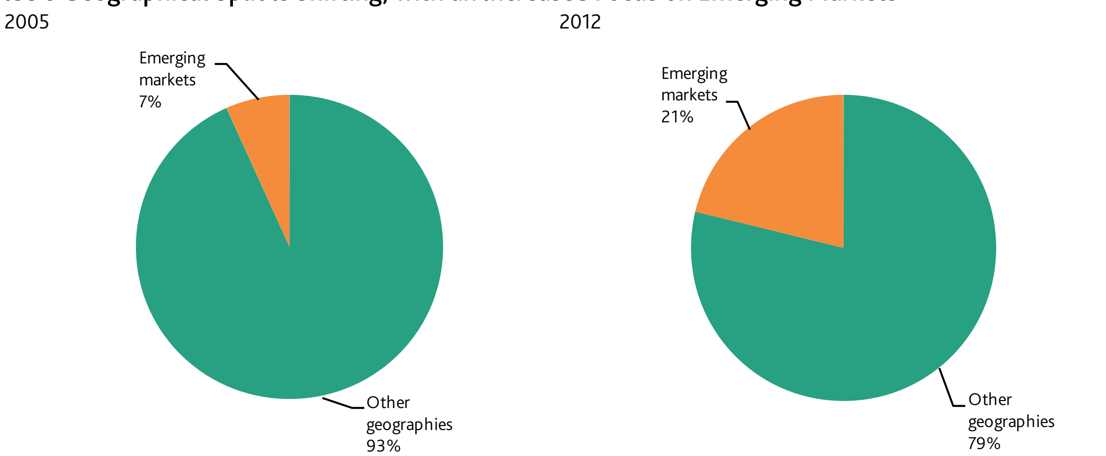


Source: ISS Annual and Quarterly Reports

In 2005, ISS generated only around 6% of its revenues from emerging markets (comprising Asia, Eastern Europe, Latin America, Israel, South Africa and Turkey). As of September 2013, the percentage had risen to 23% for the first nine months of the year (see Exhibit 3). On balance, emerging markets benefit from more favourable dynamics because of their higher GDP growth and lower outsourcing penetration rate. We expect these regions to continue to be among the main drivers of future revenue growth for ISS, as exemplified by the double-digit growth ISS recorded in countries such as China, India and Thailand (around 3% of total revenues) in 2012– well above the company's total organic growth (see Exhibit 4).

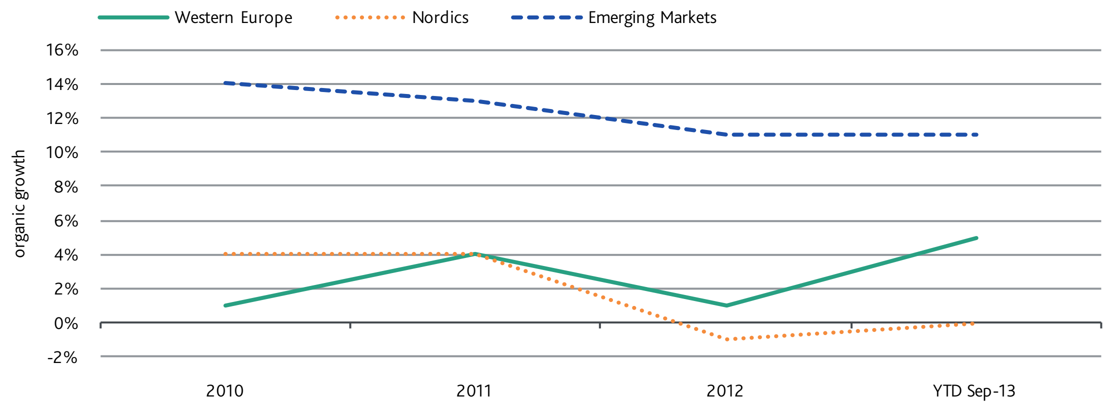
EXHIBIT 3

ISS's Geographical Split Is Shifting, with an Increased Focus on Emerging Markets*



*Emerging Markets include:
2005: Central and Eastern Europe, Asia, Latin America, Pacific
2012: Asia, Eastern Europe, Latin America, Israel, South Africa, Turkey
Source: ISS Annual Reports

EXHIBIT 4
Emerging Markets Are Largely Outpacing Growth in ISS's Core Markets



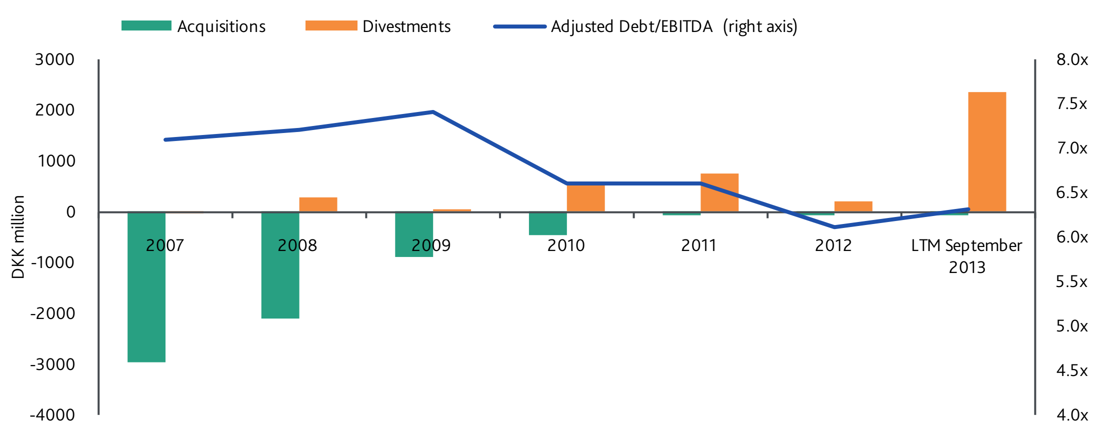
Source: ISS Annual Reports

IFS is another pillar driving organic growth for ISS. The company offers packages of services bundled together on a global or enlarged basis; the service continues to grow in importance, representing 23% of revenues in the 2012 fiscal year (to December). The start-up of several large IFS contracts contributed strongly to ISS's solid growth rates in Western Europe, where, for the first nine months of 2013, it recorded organic growth of 5%. We expect IFS to be a driver of organic growth for the foreseeable future. We also note favourably that the activity enhances barriers to entry to the market as only a few players have the capabilities and geographic reach to take on such large-scale contracts.

Divestment of non-core activities is credit enhancing

During the past 18 months, ISS has increasingly focused on streamlining its portfolio by divesting itself of activities it considers non-core to the business (see Exhibit 5). In May 2013, ISS completed the sale of its pest -control business in several countries[1] for an enterprise value of approximately DKK2 billion (c €270 million), an amount which by itself was close to the company's targeted amount of divestments for 2013. The company also sold off its Nordic damage control activities as well as some other minor activities during the first nine months of 2013.

EXHIBIT 5
Acquisitions Have Been Replaced by Divestments



Source: ISS Annual Reports and Moody's Financial Metrics

[1] Australia, Austria, Belgium, Denmark, Germany, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain and Switzerland.

We consider the divestment of non-core activities to be credit enhancing for ISS as it is using the funds generated to redeem debt, particularly the most costly of its debt obligations. For example, the divestment of its pest control activities allowed the company to redeem around €232 million (approximately DKK1.7 billion) of its 8.875% subordinated notes. We expect the company to continue pursuing a similar strategy going forward: as of 30 September 2013, ISS had a total of five business units comprising net assets of around DKK1.2 billion (€160 million) classified as held for sale.

On the other hand, the company's divestments will adversely affect its operating performance in 2013 and the effects will continue to be felt into 2014. For the first nine months of 2013, divestments had an unfavourable impact of 1.8% on the company's revenues. Furthermore, according to ISS, the divestment of the pest control segment, which was one of the group's higher-yielding businesses, had a negative impact of DKK21 million (€3 million) and led to a fall in operating margin of 21 basis points. On an annualised basis, ISS expects its operating margin to decrease by around 20 basis points and the company has indicated that its 2013 margin will be slightly below the previous year's as a result.

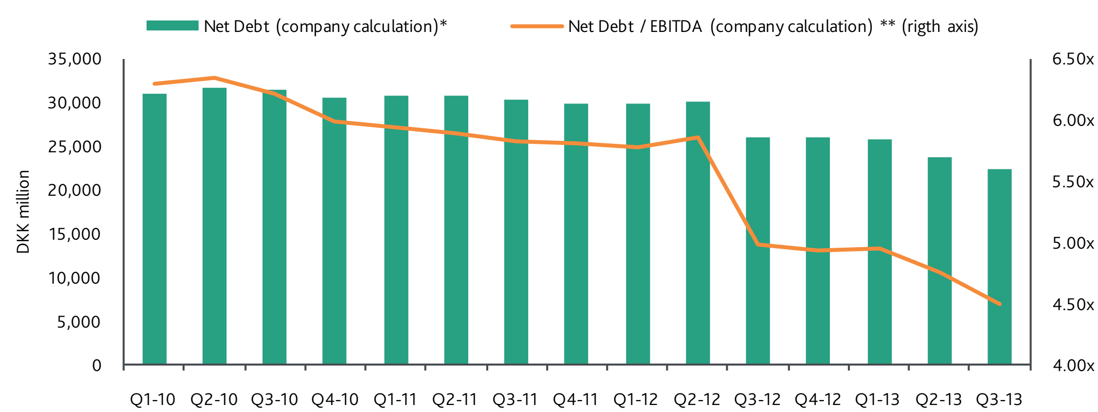
Capital injection supports the company's financial policies

In August 2012, the Ontario Teachers' Pension Plan and KIRKBI Invest A/S announced its investment of €500 million of equity into the ultimate holding company of ISS A/S. The investment corresponded to an ISS A/S share price of DKK105 and gave the two new investors a combined ownership stake of 26%. In December 2012, ISS used the proceeds of the equity injection to prepay €525 million of its 11% senior notes due 2014.

We believe the equity injection, which led to a decrease in net leverage of around 0.7x, confirms ISS's organic growth and deleveraging-orientated strategies and financial policies. The funds received from the new shareholders have contributed to a de-risking of the capital structure (see Exhibit 6) and we consider the equity injection to represent the first step towards an IPO that is likely to take place within the next one to two years.

EXHIBIT 6

Equity Injection Reduced Net Debt and Contributed to Further Deleveraging

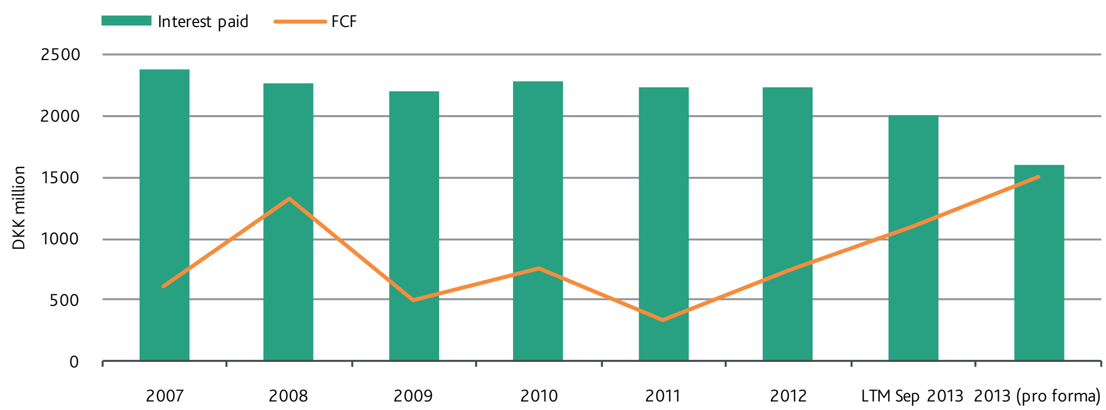


*Seasonality adjusted carrying amount of Net Debt
**Seasonality adjusted carrying amount of Net Debt measured to Pro Forma adjusted EBITDA
Source: ISS Results Presentations

Redemption of higher-yielding debt and recent refinancing improves liquidity

In tandem with ISS's deleveraging, we expect interest costs to significantly abate, thereby strengthening the company's FCF. During the first nine months of 2013, the company's interest expenses were down by DKK230 million (EUR31 million), reflecting in particular the fact that it has not had to pay interest on the notes it redeemed last year, which carried an interest rate of 11%. In addition, ISS expects to realise annualised benefits equivalent to approximately €20 million following the €232 million redemption the company made on its 8.875% subordinated notes in July 2013. On 18 November 2013, ISS announced its intention to reduce the outstanding subordinated notes by a further €94.5 million. This should lead to a reduction in interests of a further €8 million on an annualised basis. As a consequence, we would expect ISS's interest costs to decrease by around €86 million (approximately DKK640 million) on an annualised basis. This represents a reduction of 27% on the DKK2.373 billion (around €320 million) ISS paid in interest expenses in the 2012 fiscal year (see Exhibit 7).

EXHIBIT 7
Interest Paid Has Decreased, Allowing for Higher Free Cash Flow

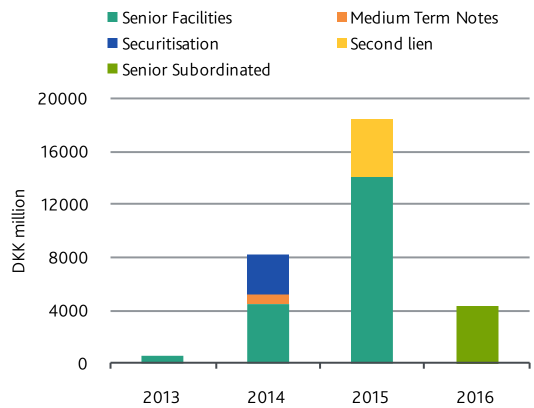


In April 2013, ISS went through an amend and extend operation, which saw the company replacing its €600 million second lien loan with a newly raised senior secured facility of an equal amount. Positively, the refinancing extended a significant portion of the company's debt for three years, thereby significantly reducing its refinancing risk (see Exhibit 8). Following the refinancing, we also expect ISS to continue to maintain ample headroom under its financial covenants. This had not always been the case, with the company's liquidity profile dented by limited headroom in the past.

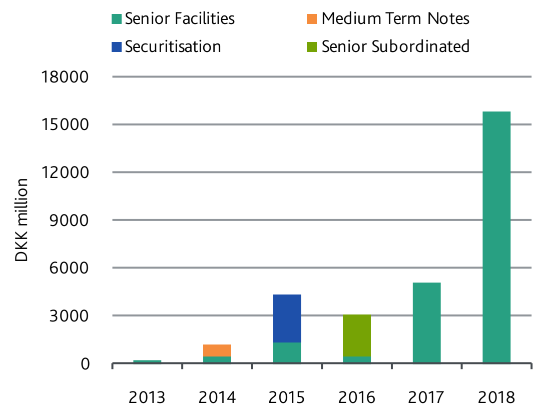
EXHIBIT 8

Refinancing Risk Has Diminished Significantly

Maturity profile prior to refinancing



Current Maturity profile



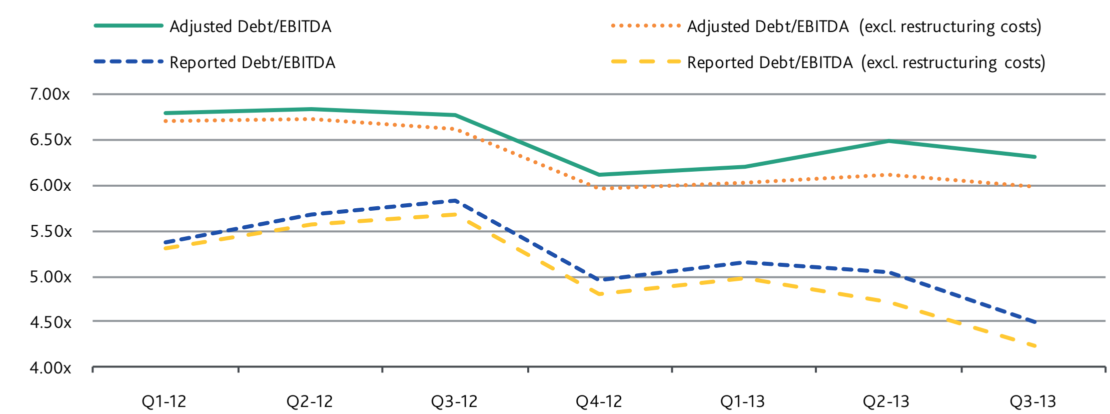
Source: ISS Results Presentations

Further deleveraging expected, but could be hampered by restructuring costs

ISS's high leverage (defined as adjusted debt/EBITDA) of around 6.3x continues to constrain its credit. In many ways, 2013 has been a challenging year in a number of the company's markets, negatively impacting EBITDA, which has been further affected by the DKK296 million (€40 million) of restructuring costs ISS has incurred this year to date. As such, we do not expect that ISS will have achieved growth in EBITDA in 2013 and deleveraging will therefore essentially materialise through the reduction of absolute debt levels. However, we note positively that ISS's financial policies are more conservative than in the past and we would expect the company to continue on its path of deleveraging, given that it is using FCF and funds from divestments to reduce its debt.

EXHIBIT 9

Leverage Is Likely to Continue Trending Downwards



Source: Moody's Financial Metrics

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Authors
Knut Slatten
Elena Marcén Argilés

Editor
Simon Culshaw

Production Associate
Vinod Muniappan

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