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## Research Update:

# Denmark-Based Facility Services Provider ISS Upgraded To 'BB' On Revised Corporate Criteria; Outlook Positive

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Research Update:

# Denmark-Based Facility Services Provider ISS Upgraded To 'BB' On Revised Corporate Criteria; Outlook Positive

## Overview

- Standard & Poor's Ratings Services published its revised corporate ratings criteria on Nov. 19, 2013.
- Under our new criteria, Denmark-based facility services provider ISS A/S' financial risk profile has improved to "aggressive" from "highly leveraged," and we assess ISS' business risk profile as "strong."
- We are raising our rating on ISS to 'BB' from 'BB-' and removing it from CreditWatch positive, where we placed it on Nov. 26, 2013, in conjunction with our criteria redesign.
- The positive outlook reflects our forecast of steady operating performance at ISS, as well as continued organic growth and ongoing deleveraging in the medium term.

## Rating Action

On Dec. 5, 2013, Standard & Poor's Ratings Services raised its rating on Denmark-based facility services provider ISS A/S to 'BB' from 'BB-'. The outlook is positive.

At the same time, we raised by one notch the issue rating on ISS' Danish krone (DKK) 17.3 billion senior secured facilities due 2018 to 'BB' from 'BB-'. The recovery rating on the senior secured credit facilities is unchanged at '3', indicating our expectation of meaningful (50%-70%) recovery for debt holders in the event of a payment default.

We also raised by one notch the issue rating on the €110.4 million 4.5% senior unsecured euro medium-term notes due 2014 and €349.5 million 8.875% subordinated notes due 2016, to 'B+' from 'B'. The recovery rating on these senior unsecured and subordinated notes remains unchanged at '6', indicating our expectation of negligible (0%-10%) recovery for debt holders in the event of a payment default.

In addition, we removed all the aforementioned ratings from CreditWatch, where we placed them with positive implications on Nov. 26, 2013, in conjunction with our criteria redesign.

## Rationale

We base our upgrade primarily on a reassessment of ISS' credit metrics following the implementation of our new corporate criteria. We now assess ISS' financial risk profile as "aggressive," instead of "highly leveraged" previously, given the improvement in ISS' credit metrics. Reported leverage is 4.5x as of the third quarter of 2013. This is a result of ISS' concentration on profitable organic growth, in contrast to the fairly acquisitive strategy it has deployed in the past. Historically, ISS had weaker financial metrics and is now divesting noncore operations, the proceeds of which it has used, and will continue to use, to repay debt and improve its capital structure. Our assessment of ISS' financial risk profile also incorporates its ability to generate positive free cash flow and its flexibility in terms of capital spending.

The corporate credit rating reflects the application of a one-notch negative adjustment for our "comparable ratings analysis," whereby we review an issuer's credit characteristics in aggregate. Our comparable ratings analysis is based on our forecast that ISS' funds from operations (FFO) to debt will remain at the weaker end of the 12%-20% range for the "aggressive" financial risk profile category in the medium term.

We continue to assess ISS' low volatility of earnings as positive for its business risk profile. The company's operating profitability (measured by the EBITDA margin) is less volatile than that of most of its peers, contributing to what we see as its "strong" competitive position. ISS has leading market positions across its main countries of operation. It benefits from operations in more than 50 countries, and a highly diverse customer base comprising thousands of private and public customers. Historically, ISS has had a strong track record of integrating its many acquisitions, which has produced a solid global service delivery platform with critical mass to support future organic growth opportunities. Our business risk assessment also incorporates our view of the global facilities services industry's "intermediate" risk and ISS' "low" country risk.

We assess ISS' management and governance practice as "strong" under our criteria. Our assessment takes into account our view of management's expertise and ability to maintain stable operations, even in difficult economic environments. Management has been consistently delivering its strategy, including a number of successfully undertaken acquisitions in the past. All of these factors result in the 'BB' corporate credit rating.

Our base-case operating scenario for ISS assumes:

- GDP growth of 0.9% in the eurozone and 2.5% in the U.S. in 2014.
- Constraints on growth from economic conditions in Europe, with stronger performance in the Asian market supporting the company's overall revenue growth at about 3.2% in 2014 and 4.0% in 2015.
- Improving credit metrics on the gradual reduction of debt, as well as the lack of sizable acquisitions and shareholder distributions.

Based on these assumptions, we arrive at the following credit measures:

- An improvement in cash flow due to lower interest costs owing to the early repayment of expensive debt tranches.
- FFO to debt of 11%-15% in 2013 and 2014, remaining under 20% in 2015, compared with 10.1% in 2012.
- Debt to EBITDA of 4.0x-4.5x this year, declining to 3.5x-4.0x in 2014 and 2015, compared with about 4.8x last year; and
- Free operating cash flow to debt in the 11%-13% range over the next two years.

### Liquidity

We characterize ISS' liquidity as "adequate." We forecast that the company's sources of liquidity will exceed its uses by more than 2.5x over the next 18 months. We consider that ISS has sound relationships with its banks and prudent risk management.

We anticipate that ISS will benefit from large recurring cash balances, good free cash flow generation of about DKK2.7 billion in 2014, as well as more than DKK1 billion available under its revolving credit facility. With nearly DKK1.2 billion of debt maturities in 2014, we assume minor acquisition spending and capital expenditures of just over DKK1 billion.

## Outlook

The positive outlook reflects our forecast that ISS' operating performance will remain steady in the near term, thanks to the flexibility of its cost base and as a result of management's current deleveraging policy. The outlook also reflects our view that ISS could reach levels of debt to EBITDA commensurate with a "significant" financial risk profile--which would require debt to EBITDA to be between 3x and 4x--by the end of 2014.

### Upside scenario

We could raise the rating if ISS' capital structure evolves to be more consistent with that of a publicly listed company. This would mean metrics of debt to EBITDA of less than 4x and FFO to debt of more than 20%, among others.

### Downside scenario

Although we don't consider it likely, ratings downside could arise from a change in acquisition strategy toward debt-financed acquisitions or a tightening in operating profit margins, leading to weakened credit metrics, including debt to EBITDA of more than 5x.

## Ratings Score Snapshot

Corporate Credit Rating: BB/Positive/--
Business risk: Strong
- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: bb+

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Financial sponsor-5 (no impact)
- Management and governance: Strong (no impact)
- Comparable rating analysis: Negative (one notch down)

## Recovery Analysis

### Key analytical factors

The issue rating on ISS' DKK17.3 billion senior secured facilities due 2018 is 'BB', in line with our corporate credit rating on the company. The recovery rating on these senior secured credit facilities is '3', indicating our expectation of meaningful (50%-70%) recovery for debtholders in the event of a payment default. The recovery rating is underpinned by the company's good valuation, "strong" business risk profile, comprehensive security package, and the favorable jurisdiction of Denmark. The recovery rating is constrained, however, by the high levels of first-lien debt, which dilutes overall recovery prospects.

The issue rating on ISS' €110.4 million 4.5% senior unsecured euro medium-term notes due 2014 and €349.5 million 8.875% subordinated notes due 2016, is 'B+', two notches below the corporate credit rating. The recovery rating on these senior unsecured and subordinated notes remains unchanged at '6', indicating our expectation of negligible (0%-10%) recovery for debt holders in the event of a payment default. The recovery rating reflects their structural and contractual subordination to the senior facilities.

To calculate recoveries we simulate a hypothetical default scenario. Under this scenario, a default is triggered in 2017 by high leverage and significant debt maturities, an inability to manage the cost base, and reduced free cash flow as a result of deteriorating operating performance. In our opinion, the time lag between any decline in the company's revenues and an appropriate reduction in its cost base would hamper its profitability and ability to generate free cash flow.

### Simulated default assumptions

- Year of default: 2017
- EBITDA at default: About DKK2.7 billion
- Implied enterprise value multiple: 6.5x
- Jurisdiction: Denmark

### Simplified waterfall

- Net EV (after 9% admin costs):  About DKK16.1 billion
- Priority claims: About DKK4.0 billion

Senior secured credit facilities: about DKK23.7 billion*

- --Recovery expectation: 50%-70%

Senior unsecured notes claims: about DKK840 million*

- --Recovery expectation: 0%-10%

Subordinated notes claims: about DKK2.7 billion*

- --Recovery expectation: 0%-10%

*All debt amounts include six months of prepetition interest. EV--Enterprise value.

## Related Criteria And Research

- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Nov. 19, 2013
- Key Credit Factors For The Business And Consumer Services Industry, Nov. 19, 2013

## Ratings List

Upgraded; CreditWatch/Outlook Action

| | To | From |
|---|---|---|
| ISS A/S | | |
| ISS Global A/S | | |
| Corporate Credit Rating | BB/Positive/-- | BB-/Watch Pos/-- |
| | | |
| ISS A/S | | |
| Subordinated | | |
| Local Currency | B+ | B/Watch Pos |
| Recovery Rating | 6 | 6 |
| | | |
| ISS Global A/S | | |

| | | |
|---|---|---|
| Senior Secured | BB | BB-/Watch Pos |
| Recovery | 3 | 3 |
| Senior Unsecured | B+ | B/Watch Pos |
| Recovery | 6 | 6 |

Upgraded; CreditWatch/Outlook Action; Ratings Affirmed

| | To | From |
|---|---|---|
| ISS World Services A/S | | |
| Corporate Credit Rating | BB/Positive/B | BB-/Watch Pos/B |

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