Moody's Investors Service

Credit Opinion: ISS Holding A/S

Global Credit Research - 06 Jul 2009

Denmark

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	B2
Senior Subordinate	Caa1/LGD6

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Key Indicators

[1]**ISS Holding A/S**

	2008	2007	2006	2005
Pre-tax Income (DKK millions)	-569	-20	-750	1,398
(CFO-Div) / Net Debt	8.0%	6.3%	5.2%	-15.2%
FCF / Debt	3.1%	1.5%	0.1%	-19.9%
Debt / EBITDA	7.2x	7.1x	7.8x	6.8x
(EBITDA - Capex) / Interest Expense	1.3x	1.5x	1.2x	2.3x
ROA	-1.9%	-0.1%	-1.6%	2.1%

[1] All ratios adjusted according to "Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations - Part II" Rating Methodology located at www.moodys.com

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Company Profile

ISS A/S is the wholly owned subsidiary of ISS Holding A/S and one of the world's leading facility services providers. In 2008, the company reported around DKK68.8 billion (close to EUR 9.3 billion) in revenues and DKK4.1 billion (about EUR 550 million) in operating profit before other items and impairment. While the company continues to derive most of its revenues from the provision of cleaning services, the successful implementation of management's plan to broaden its revenue base and transform ISS into a truly integrated services provider has increased its revenue diversity.

Cleaning services represented 53% of 2008 revenues (down from 54% in 2007 and 65% in 2004), while acquisitions boosted the share from catering services (up to 8% in 2008, from 7% in 2007) and security (6%, from 5% in 2007).

Office support services and facility management delivered a stable contribution of a respective 6% and 4%. Property services represented 23% of 2008 sales, down 1% on 2007.

The company's model encompasses three delivery models: single services, multi services and integrated facility services (IFS): (i) under single service outsourcing, the company delivers a service solution based on a single service (45% of total 2008 revenues); (ii) under multi-services outsourcing (16% of total revenues), ISS offers to its customers two or more services but not a fully integrated solution and the client will benefit from service integration whenever possible; and (iii) those opting for full IFS will receive two or more services under a single contract through a single point of contact at the customer's premises. IFS offer the highest potential for cross-selling and represented around 16% of total sales in 2008. Key accounts made up the remaining 23% of the company's 2008 revenues.

FS Funding A/S, the predecessor of ISS Holding A/S, was incorporated in March 2005 in order to acquire ISS. It is 98% owned by funds advised by EQT Partners and Goldman Sachs Capital Partners. Management holds the remaining 2% of the shares.

Recent Developments

ISS recently published its results for Q1 2009. It reported more than a 7% drop in operating profit before other items (5% of which related to FX) on the back of a 0.4 percentage points decline in operating margins - and despite top-line growth of 2% (1.5% organic). The weaker results were mainly due to difficult economic conditions in France, Germany and Belgium, where the company is more exposed to the industry segment. At the beginning of 2009, ISS won two new IFS contracts, with a global IT company and with energy giant Shell.

On 24 June 2009, ISS disclosed its intention to seek consent from its senior priority lenders to amend certain items under the Senior Facilities Agreement. The amendments would be instrumental to the refinancing of the EUR 850 million EMTNs maturing in September 2010, with unsecured debt issued at ISS Global A/S. Moody's also understands that the company intends to fund the balance with the proceeds of the securitisation of certain companies' receivables.

Rating Rationale

ISS's corporate family rating remains B2, reflecting its strong Baa business profile but also its highly leveraged capital structure, particularly in a context characterised by increasing interest expenditure following refinancing and generally difficult market conditions. The assessment of ISS's business profile reflects its global presence and leadership in the facility services industry and the broad range of services it offers, which increases the opportunity for cost synergies, cross-selling and bundling. ISS's business profile is also characterised by low customer concentration, which, combined with the company's global penetration, reduces the impact of market volatility on its operating margins.

Current ratings also reflect: (i) the low barriers to entry and fragmentation of the facility services market, which increase the competitive pressure on the company; (ii) the ongoing integration risk linked to the company's strategy; (iii) the inherent risk in fixed-fee contracts; and (iv) the potentially negative margin effect from fixed-fee contracts, although this is partly mitigated by the company's relatively flexible cost base.

The assessment of the company's single B financial profile mainly reflects its highly leveraged capital structure, with a stable debt/EBITDA ratio of over 7.0x since the LBO resulting in a high interest burden and negative pre-tax income at the end of 2008. The rating assessment also reflects the company's limited post-acquisition cash flow generation, with FCF/debt of 3.1%, only moderately up from 2007 (1.5%), despite the company's generally successful efforts to maintain its cash conversion ratio above 100%.

ISS's performance to date has been in line with Moody's expectations and consistent with the B2 rating category.

Key Rating Drivers

According to Moody's Global Business & Consumer Service Industry Methodology (published in August 2007), the main credit drivers are as follows:

Factor 1: Size and Profitability

With a presence in 50 countries, ISS is one of the largest facilities services providers in the world. The company's turnover increased from about DKK63.9 billion to over DKK68.8 billion in 2008, the result of 5.3% organic growth and a 6% contribution from acquisitions. Currency adjustments negatively affected sales by around 3%.

ISS has enjoyed relatively stable profitability for the past three years, with an operating margin before other items of 5.9% in 2008, down from 6.0% in 2007 and up from 5.8% in 2006. In Q1 2009, the company reported a margin of 4.3% (4.7% in Q1 2008). However, we expect tight cost control and a flexible cost base to, at least partly, cushion the pressure from the negative economic cycle, which is likely to affect the company's performance. Moody's therefore expects ISS's 2009 margins to be only moderately below those in 2008, but to remain in any case above 5.5% and recover to previous levels in 2010.

In this regard, Moody's warns that the company's flexibility to reallocate resources to different projects is limited to instances where the full contract is cancelled. A simple reduction of the contract's scope would still require staff to be allocated to service it with lower cover to costs. Further negative margin pressure is likely from: (i) the loss of one-off projects, which represent around 21% of the company's revenues and typically carry higher margins than recurring business; and (ii) the relatively high elasticity of customer demand to pricing, which is favoured by the highly fragmented services business and by low barriers to entry.

Factor 2: Financial Strength

Given its highly acquisitive nature and sizeable interest burden, ISS's cash flow generation has remained weak since the company was taken into private ownership in 2005. However, Moody's notes that its 2008 cash flow-related ratios showed a moderate improvement thanks to reduced acquisitions (DKK2.1 billion versus DKK3.0 billion in 2007) combined with low capital expenditure (historically between 1.0% and 1.4% of revenues) and working capital requirements. The FFO/debt ratio increased from 7.1% in 2007 to 7.7% in 2008 and the CFO less dividends as a percentage of net debt increased from 6.4% to 8%. FCF measures also improved, with FCF/debt up from 1.5% to 3.1%.

Despite ISS's announced intention to slow down the pace of acquisitions, Moody's expects all cash flow measures to continue to position it weakly within the B rating category: the benefit of reduced acquisitions on its cash flow is likely only to mitigate the negative margin performance due to short-term market conditions. Current ratings therefore assume a leverage ratio in line with/slightly above that in 2008, with positive free cash flow generation and coverage (measured as EBITDA-capex/interest expenses) close to 1.5x. These metrics are expected to improve from 2010 onwards.

Factor 3: Business Profile

The company scores Baa in this category, thanks to its good geographic and business line diversity, low customer concentration and good customer retention rates.

ISS's global presence reduces its vulnerability to regional variation and changes in regulation, while the broad range of its services increases its cross-selling opportunities. In 2008, ISS continued to strengthen its market position in specific market segments and to increase its penetration in specific geographic areas in line with its strategy, which also improved its business profile. However, the company still generates around 82% of total revenues in Northern and Western Europe (95% in 2005). It also benefits from some economies of scale, with potential for cost savings, especially in the purchasing and marketing corporate functions.

The company's ratings are also sustained by its diversified customer base, limited bargaining power and a certain degree of revenue predictability. ISS has over 200,000 customers, with the top ten accounting for less than 10% of 2008 revenues. Churn rates are relatively low, with clients usually remaining with ISS for 8-10 years or more.

Liquidity

The company's cash flow generation has historically been underpinned by its limited capex requirements, typically 1.0% to 1.4% of turnover, and a relatively low level of debtor days. While revenues are usually stable over the year and profitability shows some degree of seasonality in the summer months (mostly thanks to lower salaries for temporary workers), working capital tends to fluctuate. It tends to undergo negative swings in the first quarter, when expenses - such as pension contributions, insurance premium payments and bonuses - are paid, and positive variations in the second half of the fiscal year, when most revenues are collected.

For the year ending December 2008, ISS reported cash on the balance sheet of close to DKK3.0 billion, up from DKK2.6 billion in 2007. In Q1 2009, the cash balance decreased to close to DKK2 billion, mainly due to customary working capital requirements in the first quarter. The company also benefits from a committed revolving credit facility of around DKK2.4 billion (of which around DKK901 million was drawn at the end of Q1 2009), an uncommitted facility of DKK100 million and a letter of credit facility of DKK500 million. The company's Acquisition Facility A was fully drawn at 31 March 2009. Availability of Acquisition Facility B expired in May 2009. At that date, ISS had drawn a total of DKK2.1 billion.

Moody's understands ISS is considering entering into a securitisation programme to fund part of the refinancing of the EUR 850 million EMTNs maturing in September 2010, with the remaining funds to be provided by the unsecured loan to be issued at ISS Global level. Moody's also understands that the unsecured loan would replace the EMTNs expiring in 2010 in the capital structure, with effective subordination to the senior priority facilities but ranking structurally senior to the second-lien facility and high yield notes. Like the EMTNs expiring in 2014, the unsecured loan will not be guaranteed from ISS's operating subsidiary and will therefore rank "pari passu" with them.

Moody's understands that ISS has not yet signed an agreement with the parties involved in the refinancing and therefore warns that, at this stage, some execution risk remains. However, Moody's believes that the successful refinancing of the 2010 EMTNs, under the terms presented to us, would address the company's liquidity needs over the next three years, the indicated maturity of the securitisation programme.

Rating Outlook

The rating outlook remains stable, reflecting ISS's strong business profile and the expectation that the company will address liquidity concerns related to the refinancing of the EMTNs in coming weeks. However, in Moody's opinion, the company's credit metrics are likely to remain weak for the rating category in the medium term.

What Could Change the Rating - Up

An upgrade appears unlikely in the short term, particularly in light of difficult market conditions and the company's weak financial profile and liquidity concerns. The rating could be positively affected by de-leveraging close to 6.5x on a pro forma basis, coupled with an improvement in current levels of profitability due to long-term cost savings and rising cash flow from operations (ex dividend) as a percentage of net debt, which is currently slightly above 8%. An upgrade would also require an improvement in interest coverage (EBITDA-capex/interest expenses) to at least above 2.0x.

What Could Change the Rating - Down

Failure to address its liquidity needs in a timely fashion would probably prompt us to downgrade the company's ratings. There could also be negative pressure on the rating or outlook if the decline in operating profitability is more pronounced than expected, leading to operating margins before other items below 5.5%, debt/EBITDA trending towards 8.0x and interest cover closer to 1.0x.

Rating Factors

ISS Holding A/S

Global Business & Consumer Services Industry	Aaa	Aa	A	Baa	Ba	B	Caa-C
Factor 1: Size and Profitability (30%)							
a) ROA (NPATBUI / Avg. Assets)							-1.9%
b) Pretax Income (USD)							-107.8 mln
Factor 2: Financial Strength (50%)							
a) (CFO-Dividends) / Net Debt						8.0%	
b) FCF / Debt						3.1%	
c) (EBITDA-CapEx) / Interest Expense						1.3x	
d) Debt / EBITDA							7.2x
Factor 3: Business Profile (20%)							
a) Business Profile				X			
Rating:							
a) Indicated Rating from Methodology						B2	
b) Actual Rating Assigned						B2	

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