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Criteria | Corporates | Industrials: Key Credit Factors: Criteria For Rating The Global Automaker Industry

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(Editor's Note: We originally published this criteria article on Oct. 1, 2010. We are republishing this article following our periodic review completed on Sept. 18, 2012. The sections in this article on liquidity are partially superseded by "[Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers](#)," published Sept. 28, 2011. The business risk/financial risk matrix referenced in this article has been superseded by table 1 in "[Methodology: Business Risk/Financial Risk Matrix Expanded](#)," published Sept. 18, 2012. The sections in this article on management and governance are partially superseded by "[Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers](#)," published Nov. 13, 2012.)

- Standard & Poor's Ratings Services is refining its methodology and assumptions for the automaker industry. We are publishing this article to help market participants better understand the key credit factors in this industry. This article is related to "[Criteria: Principles Of Corporate And Government Ratings](#)," published June 26, 2007, on RatingsDirect.

Key Factors

- We consider the credit risk profile of the global automaker industry to be high compared with other industries. We discuss industry risk factors pertinent to our ratings process in the Industry Risk section of this methodology article. The key credit factors are listed below, divided into three categories. Category one factors are, in our view, the most relevant rating factors. They ordinarily affect the rating outcome in a meaningful way, and are in several instances critical to our rating conclusions. We view category two factors as being of lesser relevance, but may in some instances still prove critical. Category three factors may be individually meaningful in a few instances, but ordinarily just shape the company's overall profile in conjunction with the other factors.

Category one factors

- Global production overcapacity;
- High operating leverage;
- Volatile end-market demand;
- Limited end-market pricing power;
- Labor intensity, with labor usually organized and powerful;
- The ability to extend or protect retail market share in key markets by offering high quality products desired by customers;
- The frequency of model replacement and ability to meet shifts, often rapid, in consumer preferences and perceptions, coupled with skills in reducing lead times to develop new vehicles;
- Complex and evolving regulatory and political environment because of increasingly stringent fuel economy and emissions standards (and costs), related shifts in power trains and automakers' importance to national economies;
- The ability to limit sales incentives because of brand loyalty and success in differentiating product on the basis of quality, style or other consumer-driven measures (e.g. infotainment, fuel economy, or safety);
- The ability to generate consistent profits in key portions of the product lineup (retail and fleet) under most volume scenarios, along with prospects for breakeven results or better during a significant market slump;
- The degree of demand volatility in the company's key markets;
- Production capacity utilization across the company's manufacturing footprint, in light of typically high industry operating leverage;
- The degree of operating efficiency, fixed or variable costs, and the ability to realize scale benefits in vehicle design, production, and purchasing (including ability to mitigate exposures to commodity and currency fluctuations);
- Labor relations, rigidity, or flexibility in labor force costs, and the extent of reliance on labor rather than automation;
- The extent of brand, geographic, and product line diversification; and
- The scale, profitability, and funding efficiency of vehicle finance capabilities, through a captive unit or partnerships because of significant reliance on financing availability for the vehicle distribution and sales process.

Category two factors

- Sensitivity to raw material and energy costs, and a limited ability to mitigate substantial exposures to commodity prices swings;
- The ability to manage an intertwined supplier system upon which production is heavily reliant and which is partly responsible for technologic innovation, but is often financially vulnerable; and
- The ability to efficiently manage distribution in developed and developing markets through often-powerful independent dealerships, and the ability to maintain a profitable dealer base.

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Category three factors

- Expansion of competitors into existing markets;
- Track record of operating in both low growth mature markets and faster growing, more fragmented markets often with different product offerings;
- In most developed markets, reliance on distribution through often-powerful independent dealerships which can be difficult to rationalize; and
- The ability to use the Internet and other nontraditional means of customer marketing.

Summary Of Criteria Update

3. This article supersedes the article titled "Key Credit Factors: Business And Financial Risks In The Automaker Industry," published Sept. 25, 2008. Notable changes from the prior article include increased transparency through the discussion and categorization of key credit factors; e.g., we now divide of our key credit factors into three categories of importance.

Effective Date And Transition

4. These criteria are effective immediately.

Methodology

5. Our analytic framework for industrial companies in all sectors, including the automaker industry, is divided into two major segments. The first is fundamental business risk analysis. This step forms the basis and provides the industry and business contexts for the second segment of the analysis, a financial risk analysis of the company.
6. Business and financial risk profiles are the two components that form a corporate rating. We employ a matrix approach to combine this into a rating outcome (see [Criteria Methodology: Business Risk/Financial Risk Matrix Expanded](#), published May 27, 2009).

Part I--Business Risk Analysis

7. We subdivide business risk into four categories: country and macroeconomic risk, industry risk, competitive position (including management), and profitability/peer comparisons. We score overall business risk as Excellent, Strong, Satisfactory, Fair, Weak, or Vulnerable.

Country risk and macroeconomic factors (economic, political, and social environments)

8. Country risk plays a critical role in determining all ratings on companies in a given country. Country-related risk factors can have a substantial impact on company creditworthiness, both directly and indirectly.
9. While our credit rating on a sovereign suggests the general risk local entities face, it may not fully capture the risk applicable to the private sector. We look beyond the sovereign rating to evaluate the specific economic or other country risks that may affect the entity's creditworthiness. Such risks could arise, for example, from government policies, legal systems, security concerns, labor issues, and numerous environmental regulation factors (e.g., the requirement to reduce CO2 emissions), although there may be various strategies an entity can pursue to seek to insulate itself from some of these risks.
10. Because the automotive industry is a global business with export and foreign market growth opportunities, overseas market and country risk evaluations have become important elements of our credit analysis for automakers. For many vehicle producers, international markets provide opportunities for sales and profit growth beyond their home markets, which in developed countries are typically more mature. North America, Europe, and Japan are large, mature markets that are important sources of economies of scale for global automakers, but China has grown very rapidly and in 2009 surpassed the U.S. as the world's largest single market. India, Russia, Brazil, and Mexico are also projected to grow at substantially higher rates than developed markets during the next 20 years, but we also expect these markets likely will be more volatile than the more mature markets.

Industry risk and characteristics

11. In establishing a view of the degree of credit risk in a given industry for rating purposes, we find it useful to consider how its risk profile compares with that of other industries. Industry risk characteristic categories are broadly similar across industries, but the effect of these factors on credit risk can vary markedly among industries from a credit risk perspective (see chart). The key industry factors are scored High risk (H), medium/high risk (M/H), medium risk (M), low/medium risk (L/M), and low risk (L).

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Key Industry Characteristics And Drivers Of Credit Risk				
	Autos	Auto Suppliers	Airlines	Chemicals/ Commodity
Industry dynamics and competitive environment				
Industry cyclicality	H	H	H	H
Ease of entry	M/H	M	M/H	M/H
Product cycle/obsolescence	H	M	L	L
Product quality/pressure	H	H	M	M
Disintermediation/substitution	L/M	L/M	L	M
Competition/commoditization	H	H	H	H
Pricing inflexibility	H	H	H	H
Business model instability	L/M	L/M	M	L/M
Demographic trends	M	L/M	L	L/M
Growth and profitability				
Growth outlook	M/H	M	M	M
Profit margin pressure/outlook	M/H	H	H	H
Earnings volatility	H	H	H	H
Operating considerations and costs				
Technological risk/change	M	M	L/M	L
Cost rigidity/inflexibility	H	M	H	H
Operating leverage	H	H	H	H
Research and development costs	H	M	L	L
Energy cost sensitivity	H	H	H	H
Raw material cost sensitivity	H	H	L	H
Labor costs	H	M	H	L
Labor inflexibility/unrest	H	M	H	L
Pension costs/contingents	H	M	M/H	M
Environmental impact/costs	M	M	M/H	M
Marketing costs	H	L	L/M	L
Customer concentration	L	H	L	L
Supplier concentration	M	M	M	M
Risk management	M	M	M/H	M/H
Asset quality/plant upkeep and age	M	M	M/H	H
Event-risk sensitivity	M	M	H	L/M
Financial market volatility/sensitivity	H	M	M	M
Fashion/fad/design sensitivity	H	M	L/M	L
Capital and financing characteristics				
Capital intensity	H	M/H	H	H
Borrowing requirements	H	M	H	M/H
Interest-rate sensitivity	H	M	L/M	M
Government, regulatory, and legal environment				
Regulation/deregulation/patents	M/H	M	H	M
Government microeconomic and social policy	H	L	M/H	M/H
Litigiousness/ legal risk	M	M	M	M

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12. Broadly speaking, the lower the industry risk, the higher the potential rating on companies in that sector. Industry risk identifies the range of business risk profile scores we generally expect to assign to an industry. We have found that those sectors with lower industry risk tend to have higher business risk profile scores than those sectors with higher industry risk. However, a high-industry-risk profile does not automatically limit our rating on a company. Companies can differentiate themselves regarding business risk, and may be able to mitigate certain business risks with cautious financial strategies.
13. Industry risk analysis sets the stage for company-specific analysis. Once key country risk and industry risk considerations are identified, our credit analysis process proceeds to a second phase—company-specific analysis. If, for example, we view technology as a critical competitive factor, our analysis typically places greater weight on a company's research and development (R&D) capabilities. If the industry produces a commodity, production cost is of major importance. The goal of our approach is to develop a robust understanding of the company's external operating environment when evaluating its overall business position. Industry analysis focuses on industry prospects, and identifying the competitive factors, risks, and challenges affecting participants in that industry. The degree of business risk facing a company almost always depends on the dynamics of the industry in which it participates. Different industries pose different risks and opportunities for the companies that operate in their sectors.
14. Our evaluation of an enterprise's competitive position identifies those entities we believe are best positioned to take advantage of these key industry drivers—or to mitigate associated risks more effectively. These entities should show a competitive advantage, and a stronger business risk profile compared with those companies lacking a strong value proposition or those more vulnerable to sector risks. When combined, our view of an enterprise's competitive position is shaped by the industry risk of the sector(s) in which it operates, thus establishing our overall view of the enterprise's business risk profile.
15. In our view, the following are among the major industry risks in the global automaker industry:

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- Global production overcapacity (high barriers to exit contribute to excess capacity);
- High operating leverage;
- Highly cyclical and volatile end-market demand;
- The industry produces expensive consumer products but has limited pricing power;
- Labor intensive, with usually organized and powerful labor;

16. Many of these risk factors are longstanding issues, while other factors, such as new and stricter environmental regulations, or shifts in power train choices, are more recent developments. Other business risks include shifting consumer preferences away from the most profitable vehicle segments such as large cars or SUVs, and the shortening product/model life cycle with related high R&D and marketing costs. We believe these factors and the overall high industry risk assessment constrain industry profitability and drive individual company business risk.

Company-specific analysis

17. Once key country and industry risk considerations have been identified, including industry-specific key credit factors, the credit analysis proceeds to company-specific analysis. The business risk part of this analysis is divided into three parts: Company competitive position (including market position, diversification, operating efficiency and technology/R&D); management assessment; and profitability (which incorporates industry peer group company comparisons.)

Competitive position

18. Many of the key credit factors outlined at the beginning of this report are a focus when evaluating the competitive position of automaker companies. They are discussed in detail below under market position, diversification, operating efficiency, management and strategy, and profitability analysis.

Market position

19. In analyzing an automaker's market position, we usually consider the following factors (from most to least important) as part of our ratings process:

- The ability to extend or protect retail market share in key markets by offering high quality products desired by customers (category 1);
- The frequency of model replacement and ability to meet (often rapid) shifts, in consumer preferences and perceptions, coupled with skills in reducing lead times to develop new vehicles (category 1);
- Complex and evolving regulatory and political environment because of increasingly stringent fuel economy and emissions standards (and costs), related shifts in power trains and automakers' importance to national economies(category 1);
- The ability to limit sales incentives because of brand loyalty and success in differentiating products on the basis of quality, style, or other consumer-driven measures (category 1);
- Scale, viability, and funding efficiency of vehicle finance capabilities through a captive unit or partnerships because of significant reliance on financing availability for the vehicle distribution and sales process (category 1);
- The ability to efficiently manage developed market distribution through often-powerful independent dealerships, and the viability of this dealer base (category 2);
- Expansion of competitors into existing markets (category 3);
- Track record of producing and selling in both low-growth, mature markets and faster-growing, more fragmented markets, often with different product offerings (category 3);
- In most developed markets, reliance on distribution through often-powerful independent dealerships which can be difficult to rationalize(category 3); and
- The ability to use Internet and other nontraditional means of customer marketing (category 3).

20. We view vehicle product quality--actual and perceived--as a significant determinant of market share. In turn high market shares generally allow for greater economies of scale. This is important in the mass-market, or volume, portion of the industry. Retail market share is almost always more profitable than fleet market share, but some fleet presence is typical for most automakers, so understanding the company's rationale for fleet sales is important. For lower-volume luxury automakers, overall market share is less of a focus, but share within the luxury segment is important and quality an even more relevant factor for market position than for volume manufacturers.

21. We do not have absolute levels we regard as acceptable for market share. We often measure market share in several ways, because a 15% market share in a segment with three larger competitors may not be sufficient to gain any meaningful market leadership, but a 15% share in a segment with 15 lesser competitors could indicate a strong competitive position. We measure market share by country, by main product segments (e.g., by vehicle size or purpose), and by retail sales compared with total sales (including daily rental and corporate and government fleet sales). In the U.S., we track market shares monthly. We monitor longer-term trends in market share--up or down--which may indicate increasing consumer acceptance or an unfavorable product mix compared to current marketplace demand. We also review the cause and benefit or damage of more sudden shifts in market share. These shifts often are event-driven (e.g., the General Motors Corp. bankruptcy leading to brand closures, or Toyota's well-publicized recalls).

22. The degree to which consumers are interested in buying from a company's product lineup (excluding sales incentives) is an important factor in our analysis. We examine a company's track record in aligning its product lineup with current market demand--or not. This can indicate a company's ability to anticipate and meet shifting consumer tastes. We measure this by looking at the market mix compared with the company's own market segmentation. If the company is overweighted (or underweighted) in an important vehicle segment relative to the market, it could be an area of vulnerability if the segment is declining (e.g., full-sized SUVs), or a source of strength if it is a nascent and growing segment (e.g., cross-over utility vehicles or hybrids in the past few years in the U.S.). Even the most nimble automaker needs at least a few years to bring a new product to market, so a company could be disproportionately affected if that overweighted segment becomes less popular with consumers. We believe there is a tradeoff between product lineup diversification and the attempt to be consistently positioned in the latest popular segment, because it is not feasible to shift quickly with changing markets. It is unusual for automakers to bring new vehicles from early stage development to launch in less than two years.

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23. Various factors influence a company's ability to limit sales incentives, which can help spur sales, but often do so at the expense of higher profitability. Two key aspects are brand loyalty and success in differentiating product on the basis of quality, style or other consumer-driven measures. Loyalty and differentiation can translate into favorable vehicle pricing and result in higher average transaction prices per vehicle. To measure a company's ability to manage incentives, we look at average incentive level data from company reports and third parties, and average vehicle transaction price data, usually in conjunction with monthly sales reports or in quarterly earnings calls. We also look at dealer inventory levels, because well-matched supply and demand helps keep incentives in check.
24. Quality levels are important for our analysis because they resonate with consumers, and lower warranty reserves and costs can be significant enough to affect earnings if they are better or worse than management's expectations.
25. We look at brand loyalty levels through third-party, short- and long-term data, and at dependability and quality surveys. We assume new and repeat buyers take resale value into consideration in making purchasing decisions. Higher used-car prices on trade-ins support lower discounting (incentives) at the time of new vehicle sale (the reverse is also true: Lower discounts support higher used prices). Consistent and predictable residual values can translate into premium pricing for the luxury manufacturers and pricing flexibility for the volume automakers.
26. We view a company's prospective model replacement plans and capabilities as an increasingly important business factor, because the industry's current model lineup is relatively young in many major markets. We believe auto manufacturers' success is highly correlated with their ability to maintain an appealing, profitable, updated vehicle mix. Judging the freshness of a model lineup includes average showroom age across the product lineup or for specific segments, or percentage of the total lineup renewed in a specific period.
27. We analyze a company's ability to provide competitive financing to consumers (retail) and dealers (wholesale financing for inventory held for sale by the dealers), most commonly through a captive finance unit, but also with third-party financial institutions. Financing dealers' inventory is a crucial aspect of the sales process for all automakers, because most dealers are not liquid enough to purchase their vehicle inventory outright. Repaying this "floorplan" financing usually is tied to the sale of the vehicle. Automakers provide sales incentives to dealers along with wholesale financing. For consumers, the finance companies (captive or third-party) provide loans and leases. We look at captive finance funding sources and requirements, costs, liquidity levels, the breadth of funding alternatives, and the ability to provide the full range of financing economically. Under our criteria, a captive finance unit generally receives the same rating as its parent, because of the strong economic links between the two entities and the parent's control over the captive. There are exceptions to our equalized ratings approach when the finance unit is highly regulated, which under certain circumstances can result in a slightly higher rating for the finance unit.
28. An automaker without a captive finance unit would be an exception to the norm; in those cases, we consider any operating agreement with third-party finance providers, including how committed and secure the financing availability is for retail and wholesale customers.
29. We draw conclusions about a company's ability to effectively navigate the political, regulatory, and technological environment, partly by looking at the likely costs of meeting upcoming environmental or safety rule requirements. However, these costs generally are company or trade-group estimates, and often subject to change, especially if effective dates and/or requirements are long-term and subject to revision. We also consider research and development costs as a percentage of revenues. This measure relates to both regulatory requirements and new technology developments that are not externally mandated. We expect most large global automakers would avoid damaging their product lineup with widespread lack of compliance. But companies can gain an advantage by staying a generation or more ahead of competitors in technologies popular with consumers: Toyota's growth in hybrid technology is an example.
30. In our view, the dealer base is critical in the vehicle distribution and sales process. Financially healthy dealers are an advantage in the assessment of market position. Strong dealer networks generally provide a good buying experience, customer-service satisfaction, and have good access to financing for retail customers. Dealers in many, but not all, countries are independent of the automaker, and their collective financial health and support can fluctuate with the automaker's prospects. Broad dealership geographic coverage is critical to distribution, sales, and service and repair. But cutting excess dealers can be a lengthy process in some regions (e.g., the U.S.) because of state franchise laws.
31. We evaluate an automaker's track record of operating results in both low-growth mature markets and in faster-growing, more fragmented markets. If available, we review regional profit margins. Sales strategies, capital spending requirements and cost structures are often different in these two types of end markets. We examine the company's approach in light of typical risks in emerging, high-growth markets, such as demand volatility and overcapacity.
32. Automakers can gain customers by using the Internet and other nontraditional means of pre-purchase research. We believe the Internet has changed the way many buyers research and shop for new and used vehicles. The rapid rise of Internet use to find features and pricing information means buyers have more information before going to a dealership. The automakers' challenge is to ensure that Web sites are competitive, and that Web site visits translate into showroom visits. We believe most global automakers have a sophisticated approach to their own and third-party Web sites, and to nontraditional media sites. These sites also give automakers insight about customer purchasing behavior.

Diversification

33. Most global automakers have little diversity in business lines, and are highly focused on passenger vehicles. For a few others, the combination of commercial truck and passenger vehicle businesses provides some degree of end-market diversity. However, we also review the extent of an automaker's brand, geographic, and product-line diversification (category 1).
34. We view diversity among segments—mass market or luxury cars—as less beneficial than a fairly broad product lineup. Hence, within their typically narrow line of selling vehicles, we examine a company's product breadth (small car to luxury lines and light trucks) and geographic market mix. We then consider the competitive conditions of the national markets in which a company operates. This is important to our analysis because of the cyclical and differing growth prospects of various regional markets, even though downturns can be correlated globally, as in 2008 and early 2009.

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Operating efficiency

35. In analyzing an automaker company's operating position, we usually consider the following factors (from most to least important) as part of our ratings process:
- Production capacity utilization across the company's manufacturing footprint in light of typically high industry operating leverage (category 1);
 - The degree of operating efficiency, fixed compared with variable costs, and the ability to realize scale benefits in vehicle design, production, and purchasing, including the ability to mitigate exposures to commodity and currency fluctuations (category 1);
 - Labor relations, the degree of rigidity or flexibility in the labor force costs, and the extent of reliance on labor rather than automation (category 1);
 - Sensitivity to raw material and energy costs, and a limited ability to mitigate substantial exposures to commodity prices swings (category 2); and
 - The ability to manage an intertwined supplier system that is partly responsible for technologic innovation, but also often financially vulnerable (category 2).
36. Capital intensity is characteristic of all automakers, because of the scale necessary for production facilities and the long lead times necessary to develop high quality plants. We review the company's production capacity across its manufacturing footprint. This information may be provided at a high level in public filings or investor presentations, but we typically seek more granular data from the company directly. This information is important because we view a high level of capacity utilization (close to 100%, two shifts per day) as a good indication of a company's ability to maintain profitability. Of course, utilization for some plants may be running at more than 100% to produce popular models, while others may be well below 100%. In addition, a company's ability to efficiently manufacture more than one vehicle type in a plant can influence capacity utilization measures. We consider the direction of a company's capacity utilization in light of our unit sales expectations, rather than a plant-by-plant review. We also review research data from third parties on manufacturing cost efficiency, such as labor hours per vehicle produced, when available.
37. Cost efficiency is a critical factor in our analysis of auto manufacturing. We examine a company's fixed, semi-fixed, and variable costs mix. One assumption we make is that all automakers have a high degree of largely fixed costs, especially in the short run. We review the company's ability to realize scale benefits in vehicle design, production and purchasing (and their ability to mitigate exposures to commodity and currency fluctuations).
38. We look at the extent of global platform use, and commonality between platforms. We examine actual results at different levels of sales over time to help gain insight into operating leverage. Manufacturing capacity, unionized labor, financial obligations (including pension and healthcare obligations) are all fairly fixed. We also consider variable costs--such as raw materials--that may not be recouped through higher selling prices.
39. Labor relations remain an important focus in our analysis of operating efficiency. Often a company's labor cost structure is driven by its history of contractual negotiations and specific country locations. We examine a company's degree of rigidity or flexibility in the labor force costs and the extent of reliance on labor rather than automation. We assume the hourly labor force for automakers is characterized by a more rigid set of work rules and higher all-in costs than most nonmanufacturing sectors, and even some other manufacturing sectors. We analyze labor cost structure by assessing the extent of union representation, wage and benefit costs as a part of cost of goods sold (when available), and by our opinion on the balance of capital equipment use and labor input into the manufacturing process. We also incorporate trends in a company's movement of labor costs between high-cost and low-cost regions. This information can be partly estimated if the company reports manufacturing assets by region.
40. Another factor in operating efficiently is a company's capability at managing a massive base of suppliers, because the supply base is a major factor in vehicle quality--an important source of technology development, but also the source of potential recalls. Certain large portions of the supply base have been financially vulnerable because of historic ties to weak automakers, the volatile nature of production, requirements to reduce prices to the automakers and leveraged capital structures. Suppliers may experience difficulties managing working capital, leading to liquidity issues when production is volatile or raw material costs spike. We monitor how much assistance (sometimes called accommodation agreements) automakers are providing to key suppliers.
41. We review the automaker's stated approach to the supply base (philosophy on sharing cost reductions or degree of scheduled contractual price reductions). Many global automakers have moved toward increasing use of common parts or components. This is an effective way of controlling costs, but it increases the risk that a larger number of vehicles will be affected by a defective part or component. Still, we believe using common parts across multiple vehicle platforms, when properly managed, is likely more efficient than the alternative.
42. The following measures may provide further insights into an automaker's operating efficiency:
- Manufacturing capacity utilization;
 - Fixed compared with variable costs;
 - Fixed costs to cost of goods sold (COGS);
 - Raw materials as a percentage of COGS;
 - Contribution margin per vehicle;
 - Return on assets; and
 - Dealer stock (days-on-hand) of all vehicles, and stock per category and per vehicle model as an indicator of future production and profitability.

Profitability analysis

43. In analyzing an automaker company's profitability, we usually consider the following factors (from most to least important) as part of our ratings process:
- The ability to generate consistent profits in key portions of the product lineup (retail and fleet) under most volume scenarios, along with prospects for breakeven results or better during a significant market slump (category 1);
 - Degree of volatility of demand in the company's key markets (category 1); and

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- Peer comparisons, e.g., automaker peers or rated companies outside of the industry that have similar ratings.
44. Within this context, we analyze margin levels and return on capital. But we also analyze the sources of profitability, considering whether profits are broad-based or concentrated in certain vehicle models or regions, and profitability volatility. Demand is closely linked to economic conditions, but is perhaps even more volatile, so automakers may report wide variations in operating performance during a normal business cycle.
 45. Understanding whether profits will be generated in the primary portions of the product lineup (retail and fleet) under most volume scenarios is a key factor in our analysis of profitability. But also important are prospects for breakeven or better results during a significant market slump. We take into account that smaller vehicles generally are less profitable (both in margin and absolute terms) than larger ones. Consumer shifts away from larger vehicles recently reduced profits in certain markets, and the opposite has been true in markets where larger, well-equipped vehicles are more popular. For example, we believe luxury automakers have been benefiting from high selling prices of large vehicles in China.
 46. We analyze trends in auto pricing. We focus on actual transaction prices net of the various forms of dealer and retail incentives--rebates, fleet discounts, low-interest-rate financing, and lease subsidies. Sales incentives or discounting are common, and in our view, effective, ways to move vehicle inventories at the end of a model year or when new replacement models are introduced, but repeated discounting often has been a sign of major competitive weakness.
 47. We review demand volatility in a company's key product and geographic markets, e.g., as measured by percentage change in peak to trough demand or the trend of decline or increase in demand in a key product segment. This is important to our analysis because complex manufacturing operations with high fixed costs typically perform poorly financially when production is volatile. Vehicles largely are produced where they are sold, lowering a company's ability to shift inventory between geographic markets. Volatility of demand and production also affects suppliers: Keeping finished vehicle inventories balanced with demand and keeping sales incentives in check is more challenging when end-market demand is volatile.

Part II--Financial Risk Analysis

48. Having evaluated an automaker's business risk, we next look at several financial categories. The company's business risk profile helps determine the financial risk appropriate for any rating category. We assess financial risk largely through quantitative means, particularly by using financial ratios.
49. We analyze five risk categories: accounting characteristics; financial governance/policies and risk tolerance; cash flow adequacy; capital structure and leverage; and liquidity/short-term factors. We then determine a score for overall financial risk: Minimal, Modest, Intermediate, Significant, Aggressive, or Highly Leveraged (see "[Criteria Methodology: Business Risk/Financial Risk Matrix Expanded](#)", May 27, 2009). We comment below on financial risk criteria specific to the global automaker industry.

Accounting characteristics

50. Overall, our adjustments of financial ratios for the automaker sector mainly relate to our key adjustments for postretirement obligations, operating leases, and captive finance operations. Some important accounting practices for automakers include:
 - Revenues are generated and recorded from the sale of vehicles to the dealer distribution channel (typically financed by the captive finance unit), rather than to the ultimate consumer, so production levels, rather than retail sales, are the direct link to cash generation for the automaker parent company.
 - Pensions (generally underfunded for most automakers as of early 2010) and other postretirement obligations have been issues mainly for U.S.-based automakers. In 2010, a substantial portion of postretirement health care liabilities, along with a large pool of assets, was transferred to trusts managed by the United Auto Workers union. These trusts, rather than the U.S. automakers, are now responsible for funding postretirement health care benefits. In other countries, government-sponsored health care or pension plans relieve the automakers of some, or all, of this cost. Our methodology for adjusting financial ratios incorporates these debt-like liabilities into automakers' credit ratios. As important as these long-term accrual concepts are, the near-term cash requirements to fund pensions are also important in our analysis. We consider them to be similar to debt maturities. Deferral is possible, but can be onerous.
 - Warranty accounting can have an impact on reported results if product quality is much better or worse than that for which the company reserved. We generally believe most automakers recently have improved product quality, so we expect warranty expenses to be less volatile than in past years.
 - Operating leases and similar off-balance-sheet obligations generally are not a large portion of automakers' total fixed financial obligations. We use a discounted present value model to adjust credit ratios for these obligations.
 - For automakers with captive finance companies, we use our captive finance methodology to adjust for their finance activities, for which we allow a higher leverage and different credit drivers than for the industrial businesses (see "[Captive Finance Operations](#)," Sept. 5, 2006).

Financial governance/policies and risk tolerance

51. We evaluate whether an automaker tends to eschew high financial leverage because of the inherent high operating leverage in their businesses or not, and whether an automaker ends up adding debt over time to fund cash operating losses, to fund dividends, or to reduce the underfunded status of their pension or other postretirement liabilities.
52. While most automakers focus on financial policies consistent with investment-grade ratings, the widespread challenges of the industry, including intense competition, often preclude them from achieving this goal. We also evaluate the degree of aggressiveness in their business strategies. For example, we examine a company's balance between partnerships that allow for sharing of research and/or product development costs between or among automakers, and outright mergers and acquisitions, which have had a poor track record in the industry.
53. The extent of derivatives use is a component of the risk tolerance assessment. Because currency fluctuations, raw material costs, and, to a lesser extent, energy costs, are often key influences on profitability and cash flows in the automaker sector, we analyze risk management practices including hedging policies and positions. The captive finance companies often use derivatives to manage interest rate, currency, or other risks that arise in their funding strategies.

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