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CreditStats:

2007 Adjusted Key U.S. Industrial And Utility Financial Ratios

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Table Of Contents

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(Editor's Note: This article, published on Aug. 28, 2008, contained incorrect data in charts 1 and 2. In addition, the subheadings in tables 1 through 4 were misleading and have been clarified to read: "Medians of three-year (2005-2007) average ratios." A corrected version follows.)

This statistical report by Standard & Poor's Ratings Services incorporates the median credit ratios by rating category for U.S. industrial and utility companies, based on 2007 reported financial information and our adjustments. These medians reflect credit quality measures that most closely resemble the data used by our credit analysts in their quantitative assessments of companies' financial performance. But these medians are not meant to be benchmarks for any rating category, if for no other reason than that the various ratios reflect the cyclicality of general economic conditions and of individual industry subsectors--not only in the U.S., but also internationally.

Nevertheless, these medians can help indicate the general credit quality of companies once their business risk profiles have been analyzed. Assessing the strength of their business risk profiles, ranging from vulnerable to excellent (for the strongest investment-grade categories), is the critical step in using the medians in a risk-adjusted approach.

In addition to our traditional median tables, which include three-year averages and annual data for 2003 to 2007, we have included annual ratio medians for the past 13 years for U.S. industrial companies in the more populated rating categories of 'B', 'BB', 'BBB', and 'A'. This additional data should be of interest to investors, as it shows the extent of fluctuations in certain key ratios over a longer time frame, which includes the downturn in the U.S. economy during 2000 and 2001.

With this longer time perspective, changes in our analytical methodologies may cause the ratios to move, as we do not recalculate previous years' results. The most significant change occurred in 2005, when we made the following adjustments:

- Included U.S. transportation companies;
- Refined our calculation of operating leases;
- More completely recognized unfunded pension and other postretirement obligations, especially in the debt amounts; and
- Simplified the net debt adjustment.

These adjustments resulted in credit quality measures in the 2006 report that showed meaningful differences from previously published data throughout the rating categories. Because these variations were not the result of criteria changes per se, we have not taken any rating actions solely because of these revisions.

The medians generated for this annual study are based on the statistics of the sectors we have traditionally included in our U.S. industrial universe, such as telecoms, aerospace & defense, chemicals, health care, metals & mining, auto parts, retail, consumer goods, paper & forest products, oil & gas, and technology, among other sectors. Regulation is now viewed as less of a factor for excluding transportation companies from the calculation of median ratios. Hence, beginning with 2005 data, we began incorporating financial statistics for railroads, airlines, trucking companies, and other transportation-related companies (see tables 1 and 3).

Table 1

Adjusted Key U.S. Industrial Financial Ratios, Long-Term Debt

Medians of three-year (2005 to 2007) average ratios

	AAA	AA	A	BBB	BB	B	CCC
Oper. income (bef. D&A)/revenues (%)	22.2	26.5	19.8	17.0	17.2	16.2	10.5
Return on capital (%)	27.0	28.4	21.8	15.2	12.4	8.7	2.7
EBIT interest coverage (x)	26.2	16.4	11.2	5.8	3.4	1.4	0.4
EBITDA interest coverage (x)	32.0	19.5	13.5	7.8	4.8	2.3	1.1
FFO/debt (%)	155.5	79.2	54.5	35.5	25.7	11.5	2.5
Free oper. cash flow/debt (%)	129.9	40.6	31.2	16.1	7.1	2.2	(3.6)
Disc. cash flow/debt (%)	84.4	23.3	19.9	10.3	5.5	0.7	(3.6)
Debt/EBITDA (x)	0.4	0.9	1.5	2.2	3.1	5.5	8.6
Debt/debt plus equity (%)	12.3	35.2	36.8	44.5	52.5	73.2	98.9
No. of companies	6	14	111	213	306	354	22

Table 2

Adjusted Key U.S. Utility Financial Ratios, Long-Term Debt

Medians of three-year (2005 to 2007) average ratios

	AA	A	BBB	BB	B
Oper. income (bef. D&A)/revenues (%)	15.8	22.7	25.2	20.8	15.6
Return on capital (%)	10.2	9.4	8.8	8.1	8.2
EBIT interest coverage (x)	4.3	3.4	3.1	2.2	1.1
EBITDA interest coverage (x)	6.2	4.8	4.3	3.0	1.5
FFO/debt (%)	22.8	20.0	17.2	14.6	12.5
Free oper. cash flow/debt (%)	5.5	(0.6)	(0.1)	(3.9)	3.9
Disc. cash flow/debt (%)	(1.4)	(7.7)	(5.7)	(6.2)	0.8
Debt/EBITDA (x)	2.9	3.6	3.8	4.6	5.7
Debt/debt plus equity (%)	49.9	53.0	56.8	57.9	60.2
No. of companies	6	51	105	15	9

(For a complete list of individual subsector tables, please search on RatingsDirect using "CreditStats" as the key word. You may also search using a specific subsector, with or without the region, i.e., "CreditStats: Commodity Chemicals" to see all the regions this subsector is covered in, or "CreditStats: Commodity Chemicals--U.S." to see only the U.S. tables.)

The differences in ratio medians throughout the spectrum of long-term debt and commercial paper ratings are generally quite pronounced. This median study covers 1,086 industrial and 213 utility companies with long-term debt ratings; the commercial paper ratings study covers 225 industrial and 108 utility companies. Special caution should be used when examining the 'AAA' and 'CCC' medians, both of which were derived from small samples of companies. There are only six industrial companies in the stellar 'AAA' category; the 'CCC' category contains 22 companies. For the utility sector, these ratings are absent. (Please see the separate articles titled "2007 Industrial Comparative Ratio Analysis" and "2007 Utility Comparative Ratio Analysis," both for U.S. long-term and short-term debt, published Aug. 28, 2008, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis.)

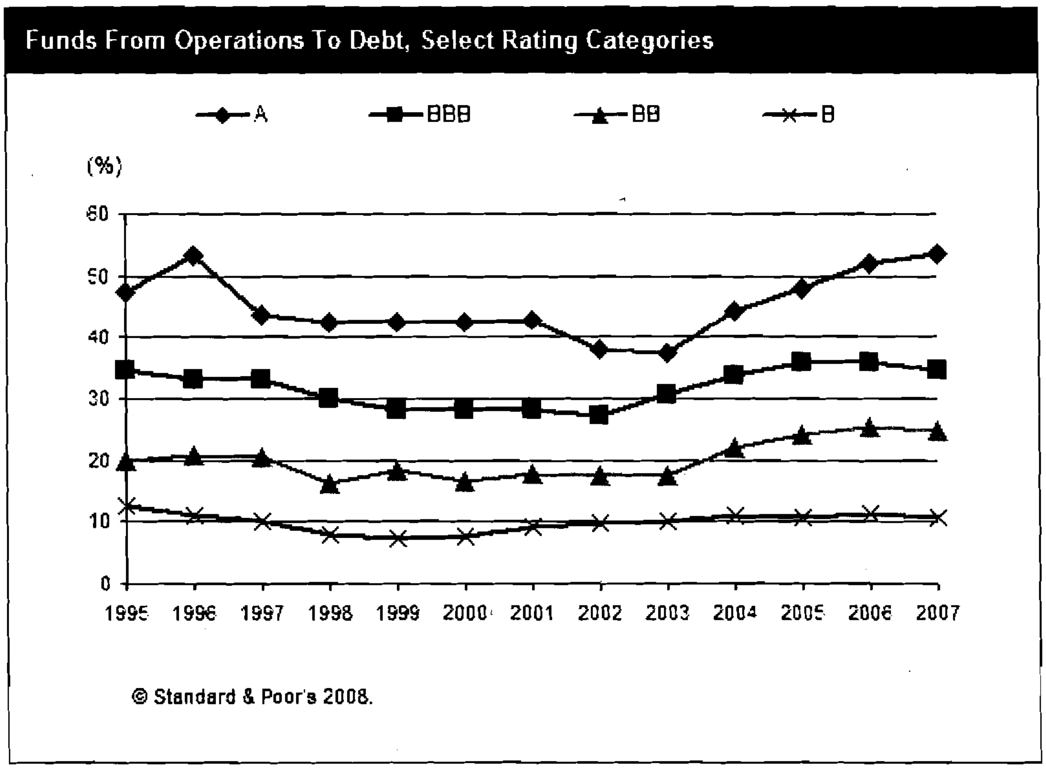
Differences Between Industrial And Utility Results

Aside from a smaller universe of companies, the utility results reflect the significant differences in business risk analysis for those firms. With a stringent, but far from uniform, regulatory environment across the 50 states, typical operating measures are not particularly revealing. Few differences are seen in operating income to revenue or return on capital for the different rating categories. In addition, these firms' voracious need for fixed-capital improvements and long-established practice of using dividends to return value to shareholders combine to drive free operating cash flow to debt and discretionary cash flow to debt to negative values across almost the entire rating spectrum. The remaining ratios are more reliable indicators of credit risk, although they are weaker than those for industrial companies, given utilities' exceptionally stable operating profiles.

Medians Compare Well With Ratio Guidelines

Note that a key cash flow protection measure, funds from operations to debt (FFO/debt), had a median ratio of 35.5% in the 'BBB' category for 2005-2007 (for 213 companies), essentially the same as the 35.9% median for 2004-2006. Those medians compare well with the guideline range of 30% to 45% that we characterize as "intermediate" financial risk. A U.S. industrial company with a "satisfactory" business risk profile and intermediate financial risk would normally receive a 'BBB' rating. During the past 13 years, the annual FFO/debt median ranged from 27.3% for 2002 to 36.0% for 2006 (see chart 1). That wide range reflects in part the downward pressure on the ratio caused by difficult economic times domestically.

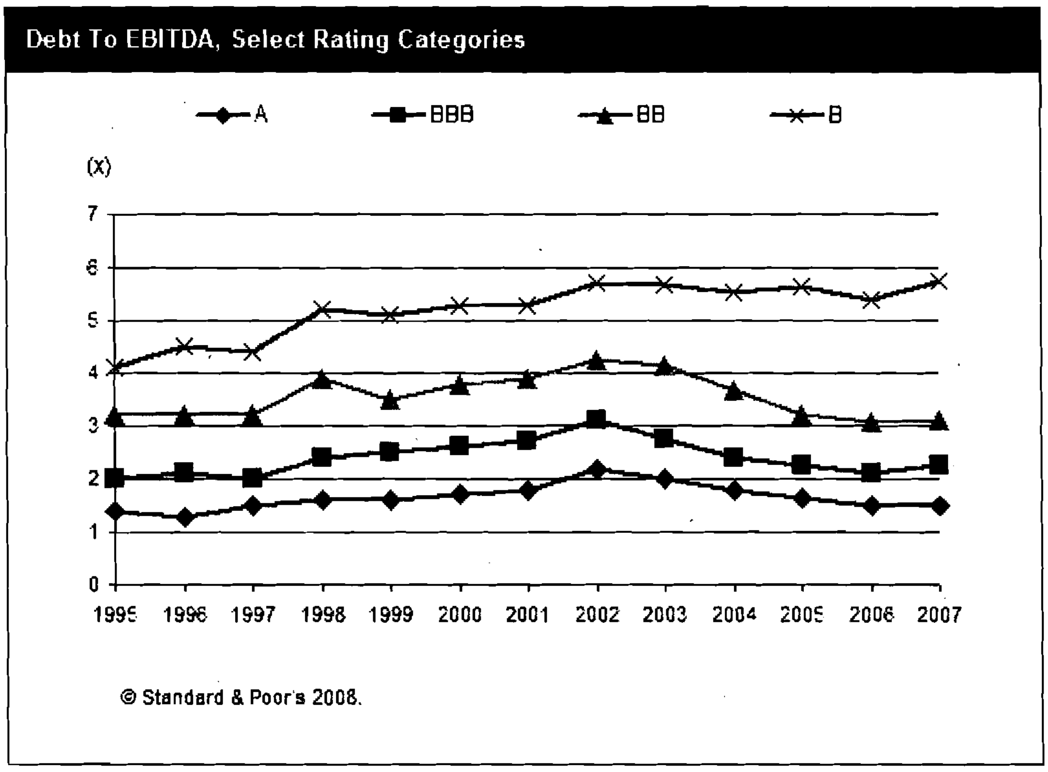
Chart 1



In the 'BB' category, which also has a large sampling of companies, the FFO/debt median for 2005-2007 was 25.7%. A company with a "weak" business risk profile, which we would characterize in the overall 'BB' category, would typically have cash flow coverage of 15% to 30%. During the past 13 years, that annual measure ranged from 16.3% in 1998, strengthening to 25.3% in 2006.

With regard to the debt-to-EBITDA ratio for the various rating categories, we have established 3.0x to 4.5x as the appropriate range for the overall 'BB' category; the latest three-year 'BB' median was 3.1x, down slightly from 3.2x for 2004-2006. For 1995 to 2007, that measure ranged from 3.1x in 2007 to a more aggressive 4.3x in 2002 (see chart 2).

Chart 2



Moving up the rating scale, the debt-to-EBITDA target for "intermediate," or 'BBB', financial risk is 2.0x to 3.0x; the 2005-2007 median generated for the 'BBB' category was 2.2x. The annual median during the past 13 years fluctuated between 2.0x and 3.1x. (For a description of the relationship of business risk and financial risk using our matrix, please see "Industrials' Business Risk/Financial Risk Matrix--A Fundamental Perspective On Corporate Ratings," published April 7, 2005, on RatingsDirect.)

Meaningful Differences In Financial Ratios For Commercial Paper Ratings

Because commercial paper ratings are linked to long-term ratings, it is not surprising that the 'A-1+' category has robust three-year medians (based on just over 20 companies), as demonstrated by EBIT interest coverage of 20.5x, free operating cash flow to debt of 55.8%, and debt to debt plus equity at a very conservative 22.0%. As expected, measures of credit quality differ in strength when comparing those of the other commercial paper ratings of 'A-1', 'A-2', and 'A-3'. The variations in certain ratios are quite pronounced. For 'A-1' ratings, EBIT interest coverage was 11.5x, free operating cash flow to debt was 31.3%, and debt to debt plus equity was 37.1%, versus 'A-2' medians of 7.2x, 16.7%, and 55.1%, respectively (see tables 3 and 4).

Table 3

Adjusted Key U.S. Industrial Financial Ratios, Short-Term Debt

Medians of three-year (2005 to 2007) average ratios

	A-1+	A-1	A-2	A-3
Oper. income (bef. D&A)/revenues (%)	25.8	19.7	18.2	18.3
Return on capital (%)	26.3	22.8	16.6	12.7
EBIT interest coverage (x)	20.5	11.5	7.2	4.5
EBITDA interest coverage (x)	21.6	13.7	9.0	6.7
FFO/debt (%)	99.5	54.4	36.8	27.7
Free oper. cash flow/debt (%)	55.8	31.3	16.7	7.8
Disc. cash flow/debt (%)	33.0	19.9	11.1	4.4
Debt/EBITDA (x)	0.7	1.5	2.2	2.8
Debt/debt plus equity (%)	22.0	37.1	45.1	50.8
No. of companies	21	68	86	16

Table 4

Adjusted Key U.S. Utility Financial Ratios, Short-Term Debt

Medians of three-year (2005 to 2007) average ratios

	A-1+	A-1	A-2	A-3
Oper. income (bef. D&A)/revenues (%)	17.1	22.4	23.4	29.6
Return on capital (%)	9.4	10.5	8.8	7.9
EBIT interest coverage (x)	3.8	4.4	3.1	2.5
EBITDA interest coverage (x)	5.9	6.1	4.5	3.9
FFO/debt (%)	20.9	23.8	19.0	16.1
Free oper. cash flow/debt (%)	5.5	0.1	(0.2)	(4.4)
Disc. cash flow/debt (%)	(0.3)	(9.3)	(5.8)	(8.2)
Debt/EBITDA (x)	3.1	2.9	3.6	4.3
Debt/debt plus equity (%)	48.9	52.1	54.9	56.4
No. of companies	4	14	61	12

Ongoing Data Adjustments

The CreditStats study includes most, but not all, of the adjustments described in "Corporate Ratings Criteria" updated April 15, 2008. As noted in that article, some of the more sector-specific adjustments have yet to be added to our software, while others do not lend themselves to standardized approaches. Adjustments that have particular application to utility companies are described in detail in "Financial Adjustments Give A Clearer Picture Of Credit Quality For U.S. Utility and Infrastructure Companies" published on Aug. 13, 2008.

Among the adjustments we continue to make is the capitalizing of operating leases. (By making this adjustment, the financials of companies that lease part or all of their operating assets are more comparable with those of firms that buy all their plant and equipment.) The adjusted median ratios generated for this statistical article reflect application of the operating lease methodology whenever a company has reported the data required to perform the adjustment. We use the issuer's average interest rate from the most recent full-year statements, unless better information is available, such as industry-specific leasing practices or rates incurred on other secured borrowings. In the statistical studies of past years, the medians generated used 10% as a default discount rate for the present-value calculation. The low interest rates of the past few years have resulted in serious overstatement of the debt equivalent compared with that in previous periods.

Medians for cash flow protection, capitalization, and other measures have been adjusted to fully reflect unfunded liabilities relating to defined benefit pension plans and retiree medical plans, which we view as debt-like in nature. This adjustment has affected the credit ratios of U.S. industrial companies in this median study to varying degrees. In at least one instance, these debt-like liabilities exceeded reported debt outstanding. Notably, this statistical revision to the data brings the depiction of our medians into line with our analytical perspective.

With regard to the net debt adjustment, which is used mainly for U.S. pharmaceutical companies and a wide range of European firms, our analysts make a specific, justifiable determination of the availability of a large cash position to repay debt. Elements to consider in the determination of credit quality include the U.S.-specific issues such as investments in tax-advantaged locations with associated tax penalties for "repatriating" these funds to the U.S., as well as the nature of the investments and the need for a company to maintain some cash to operate efficiently. The borrower's direct control over this cash, immediate cash availability, and the currency of funds remain important considerations.

Cash Availability Gauge

Even with our elimination in recent years of some of the ratios included in previous median studies, investors should note that discretionary cash flow as a percentage of debt remains an effective ratio. It broadly measures the amount of cash generation--after capital expenditures and common dividends--available for acquisitions, common share buybacks, and debt reduction. Thus, a stronger discretionary-cash-flow-to-debt ratio should suggest stronger credit and a higher rating. In this regard, that 2005-2007 measure, which was a lofty 84.4% for the 'AAA' category, decreases as one proceeds down the rating scale. The differences in medians among the various rating categories are meaningful, as expected. For example, discretionary cash flow to debt for 'BBB' long-term debt was 10.3% for 2005-2007, above the 5.5% median for the 'BB' category. That measure was a mere 0.7% for the 'B' category. But this ratio will also vary meaningfully by industry, reflecting in part varying degrees of capital spending intensity.

Return On Capital Is Also Important

Another credit measure that helps assess credit quality is return on capital. Our population of 'A' rated entities generated a median for 2005-2007 of 21.8%, up meaningfully from the 2004-2006 median of 19.7%. Still, during the past 13 years, annual return on capital was 15% to 16% for a couple of years, a level also generated by the 'BBB' category. The overlapping of this ratio (although in different years) between these two rating categories highlights the importance of using a meaningful number of financial measures, along with historical performance, to aid in the determination of credit quality.

Operating Margins Are A Specific Industry Assessment Tool

Investors should continue to note that the strength of operating income (before D&A) as a percentage of revenues, also known as operating margin, is not indicative of a particular rating category and is best used when analyzing specific industries. This view is reinforced by the latest medians of the well-populated rating categories. In particular, the 2005-2007 operating margins for the 'BBB' median were 17.0%, lower than the 'BB' median of 17.2% and only slightly higher than the 'B' operating margin median of 16.2%. On the other hand, the operating margin medians for the 'A' and 'AA' categories were significantly stronger, at 19.8% and 26.5%, respectively, than any of the previously mentioned margin medians.

Chart 3