



# How does a rating actually work?

Although Knorr-Bremse is not listed on the stock exchange, it can still be rated, and there are good reasons why it should be. Without a rating, for example, unfavorable annual interest rates would have resulted in the loan taken out in 2002 costing an additional EUR 1.4 million per year. But a rating is about more than just saving money.

## Rating levels

There's no better rating than the "AAA" awarded by Standard & Poor's or the "Aaa" awarded by Moody's. By definition, anyone who lends money to a "triple A" company can virtually rest assured that there will be no risk of default. Companies that are rated AA+, AA, AA- or Aa1, Aa2, Aa3 offer a high likelihood of payment and only a low risk of insolvency. The next rating level is A+, A and A- or A1, A2 and A3, followed by BBB+ – or Baa1, which correspond to good credit quality and quite a low risk of insolvency. From BBB and Baa2, the risk gradually increases and credit for these companies becomes increasingly expensive. The next level down is BB and Ba2. From B+ and B2, financial security becomes less stable. The ratings continue down to levels C or D – insolvency.

Anyone who goes to the bank asking for a loan has to undergo thorough credit checks. Do they have a regular income? Have they paid back previous loans, and did they do so on time? If the answer to these and similar questions is "yes", there is a good chance they will be granted a loan under excellent terms and conditions. After all, this means there is a good likelihood of the bank getting its money back.

In principle, a company's rating is calculated in much the same way, with the borrower's creditworthiness also being linked to the risk of default. However, in this case, the rating is not assessed by a single bank employee but by rating agencies. These verify good or less favorable creditworthiness by awarding a financial reliability rating, according to which a company can be quickly and easily appraised. The world's two largest recognized rating agencies, Standard & Poor's and Moody's, are responsible for carrying out Knorr-Bremse's rating.

## Appraisal

A rating takes several months from start to finish and is based on a so-called rating book drawn up by Knorr-Bremse. This includes all financial data such as past performance and also an assessment of the current market situation. In brief: in the rating book, Knorr-Bremse describes why the company believes it is well positioned for the future.

For agencies, the rating book provides just a rough outline. They then compare the contents of this book with general sector analyses and also assess the company's competitive position. Internal factors, such as management and strategy, are just as crucial as the financial data. When they are assessing whether a company will be able to discharge its liabilities, the analysts, for example, compare cash flow within a specific period with borrowing. And when they are analyzing the capital structure, they compare borrowing with total capital.



A good rating also has a positive financial effect on profitability: The rating enables Knorr-Bremse to issue securities or guarantee itself; without such a rating, such a task is typically performed by a bank, which charges high fees for the service. For Knorr-Bremse, these would amount to some EUR 1 million per year. At a cost of EUR 75,000, the rating is therefore a very worthwhile investment.

However, the rating is not just about saving money: companies also benefit from a regular external check that forces them to ask critical questions about their strategic and financial position. Furthermore, during times of crisis, a rating boosts the confidence of customers and suppliers alike.

### Next level: A-rating

The next step is to set sights even higher to the A-rating level. However, this is by no means as easy as it sounds. To achieve this, Knorr-Bremse would, first and foremost, have to continue to grow because the larger the company, the greater its reserves for cushioning possible crises. In addition to a good global positioning and a broad product range, analysts regard this as a key criterion for attaining an A-rating. Innovative products in the fields of engine management, air-conditioning, power electronics or door systems all contribute towards this.

However, the very highest class still remains unattainable. As a rule, only states can achieve a "triple A" rating since it is virtually impossible for them to go bankrupt. The only exception in Germany is Deutsche Flugsicherung GmbH; this comes as no surprise, since the company enjoys a monopoly in the field of air traffic control and will be needed for as long as there are planes flying in the sky!

*Uwe Falk / Dr. Sigurd Dahrendorf* ■

This is not simply a theoretical process. During a half-day presentation, Knorr-Bremse also provides the rating agency with further detailed information. This openness is important, as it is the only way analysts can gain a realistic picture of the actual situation. Of course, no sensitive company data is published - only a summary.

### The rating takes shape

As soon as they have all the relevant information, analysts calculate Knorr-Bremse's creditworthiness and establish its rating - the risk of the company defaulting on a potential loan. Before this is reported back to the company, the results are first presented to the agency's own internal rating committee, which comprises experts from both within and outside the sector. This dual control minimizes the risk of error and ensures that the conclusions drawn are correct.

### Knorr-Bremse assessed as "investment grade"

Both agencies - Standard & Poor's and Moody's - currently assess Knorr-Bremse as so-called "investment grade"; at Standard & Poor's, this is BBB+ and, at Moody's, Baa1. This rating is very good by international comparison - after all, the company's two mainstays - the rail and truck sectors - are subject to economic cycles that result in fluctuations in business development. BBB+ or Baa1 places Knorr-Bremse in the top quarter in Germany and thus higher than some other companies that are much better known. At present, the company does not have any capital requirements, but, as was the case with the acquisition of Bendix, should it need EUR 500 million or even EUR 1 billion, this would only be possible by turning to the capital markets. In such a situation, the impact on the interest rate of the difference between investment grade and any lower rating can be significant.