Consumer Products Rating Methodology

Corporates

4 November 2022

Contacts

Henrik Blymke
Managing Director
+47 21 62 31 41
h.blymke@scoperatings.com

Eugenio Piliego
Director
+49 69 6677 38915
e.piliego@scoperatings.com

Barna Gáspár
Associate Director
+49 30 278 91325
b.gaspar@scoperatings.com

Table of Contents

1. Introduction ... 3
2. The consumer products industry ... 3
3. Rating drivers ... 5
3.1 Business risk profile ... 6
3.1.1 Industry-related drivers ... 6
3.1.2 Competitive positioning ... 7
3.2 Financial risk profile ... 9
3.2.1 Credit metrics ... 9
3.2.2 Liquidity ... 10
3.3 Supplementary rating drivers ... 10
3.3.1 Financial policy ... 10
3.3.2 Parent/government support ... 10
3.3.3 Peer context ... 10
3.3.4 Governance and structure ... 10
3.4 Environmental, social and governance assessment ... 10
4. Issuer rating ... 10
5. Additional methodology factors ... 10
6. Appendix ... 11
6.1 Related documents ... 11

1. Introduction

This methodology is the latest update of the Consumer Products Rating Methodology, which details Scope Ratings' approach to rating consumer products companies and complements the General Corporate Rating Methodology published on 15 July 2022. More specifically, it provides guidance on how we analyse business risks specific to consumer products companies, while the financial risk profile assessment remains largely based on the metrics set out in our Corporate Rating Methodology.

The update of the methodology comprises mainly editorial changes, aimed at providing further clarity on ESG, brand strength and ensuring consistent format with Scope's other corporate rating methodologies. It also includes extended guidance on the assessment of business risk profiles, including the 'A' and 'AA and above' categories, as well as 'B' and 'CCC and below' categories. Outstanding ratings are not affected by the changes.

We define consumer products corporates as those that generate the majority of their revenue and cash flow from the manufacture of consumer products, primarily by selling to wholesalers/retailers and in some instances directly to consumers[1]. Consumer products can be durable or non-durable. We define durable products as those consumed over time under normal circumstances (without requiring significant outlays for maintenance or repair) and non-durable products as those consumed over a short period (usually within a year) and normally used only once. Durable products may also be rented or leased, whereas non-durable products are generally not. If product demand is volatile and vulnerable to macroeconomic changes, we refer to it also as discretionary[2].

This methodology is applicably globally, but does not cover companies that primarily buy and sell finished products that they did not produce themselves (this is covered in Scope's Retail and Wholesale Methodology[2]).

2. The consumer products industry

The consumer products industry is a broad sector, including both durable and non-durable products[3]. These products are bought by individuals or households for personal use, and demand is affected by demographics, income development, consumer confidence and consumer preferences. The industry has changed dramatically over the last two decades, with the internet having a significant impact on the ways products are manufactured, marketed, distributed and sold. This is an ongoing adaptation with increasing consumer transparency. Given the broad nature of the products made and sold, careful attention must be given to company-specific factors in order to better understand individual issues during the rating process.

On the supply side, consumer products are offered by a broad spectrum of companies, ranging from niche players serving specific market segments with bespoke products to global players providing low-cost products with economies of scale. Typical sub-categories for durable consumer products are clothing and wearables (including jewellery), household products (appliances, furnishings, textiles, toys and electrical equipment), and sport/leisure equipment. Non-durable consumer products include food (including condiments), beverages (including alcoholic beverages), cigarettes and tobacco, and care products (including cosmetics, personal beaty and cleaning products). These products are purchased frequently, consumed rapidly and often sold in large quantities at lower prices.

Figure 1 – Product examples with durable and non-durable consumer products

	Durable consumer products	Non-durable consumer products
Product examples (not limited to):	Clothing and wearables Household products (incl. electrical equipment) Sport/leisure equipment	Food (excl. agribusiness) and beverages Tobacco Care products

Business models in the consumer products industry vary widely, depending on the company's product portfolio, size, operational exposure to regulation (food, tobacco, alcoholic beverages in particular), horizontal and vertical integration, as well as the degree that business cycles affect both markets and the industry. Market participants range from very large multinationals with strong

[1] This could also include companies that outsource significant manufacturing activities but rely heavily on their branding and intellectual property for operations.
[2] The retail/wholesale methodology uses the terms discretionary/non-discretionary retail for its sub-categories – please refer to that methodology for detailed definitions
[3] For the purpose of this methodology, we use the terms products and goods interchangeably.

brands to sole-trader bespoke producers. While many participants limit themselves to national or local markets to use their comparative advantages, multinationals provide mass-market products, taking advantage of their economies of scale to establish pricing power and usage of its branding. The degree of industry fragmentation is often lower for durable products than for non-durable products. The latter segment particularly has many local SMEs, which face strong competitive pressures on pricing, product development, and consumer sentiment and preference. As a result, the sector must actively manage prices and costs, innovate, and create products that attract customers.

As with other broadly defined industries, cyclicality differs among sub-segments. Overall, non-durables are less cyclical than durables. In addition, some products could be seen as non-discretionary (e.g. packaged food) while others have a discretionary element (e.g. luxury items), which also affects cyclicality. Some parts of the industry are also subject to clear seasonal effects, which may need to be included in our assessment as well.

Branding is a key aspect of product differentiation and identification in the consumer products industry and hence an important component of our analysis. A company's ability to maintain commercial success hinges on its brand strength. At the individual company level, we monitor and assess intangible assets on the balance sheet to recognise a company's potential vulnerability to changes in brand perception and/or to the emergence of alternative brands and products that may better meet consumer needs.

Companies in the consumer goods sectors are heavy users of advertising to inform and capture consumers, helping them to set their products apart from others to gain market share or create new markets. The consumer goods sector is characterised by fierce competition for consumer spending, constantly shifting consumer preferences, and entries of alternative goods. Competition is on both price and quality, underscoring the importance of brand identification and clear product differentiation.

Generally, consumer products companies with strong market positions are more resilient during economic downturns. Such companies are not only large with high market shares but are also favourably positioned in supply and distribution chains, with a low dependence on any specific distribution channel or customer. This bolsters purchasing power with key suppliers and makes it easier to be a price-setter among competitors.

We recognise the constantly changing nature of the industry. We believe more consumer products manufacturers will expand their business-to-consumer sales where appropriate and/or increase their use of online channels (which are increasingly creating disruptive effects for many retailers). In addition, factory automation and integrated supply chains allow smaller company brands to be highly responsive to consumer demand and effectively provide bespoke products at mass-production prices.

Distribution channels and the position within supply chains are important aspects of company performance. Technological advances, such as additive manufacturing, 3-D printing and computerised bespoke manufacturing, have the potential to bring significant changes to consumer goods manufacturing as these technologies mature and become commercially feasible, providing high degrees of efficiency and a fast turn-around for mass production.

The sustainability of products and processes is gaining importance in the consumer products industry as well. This means tighter control of the value chain, from the procurements of raw materials to the final product. Brand building and communication with consumers are also increasingly being incorporated into social media channels. Companies must be able to use not only traditional distribution channels, but also social media to successfully engage with younger and more tech-savvy consumers.

While capex in the consumer goods sector is generally moderate, we recognise that some companies will require substantial operating expenses to maintain competitive positioning, increase product differentiation and expand product portfolios. Reported assets may be largely intangible (brand recognition, goodwill, trademarks), which means fair values could come under pressure in a stressed scenario, affecting expected recovery rates. We expect cash flow generation to be less volatile among producers of essential non-durable consumer goods as these products are always in demand, but more volatile among companies making more discretionary, durable consumer goods. With respect to the latter, inventory risk is high for products not meeting customer requirements or technological standards (consumer electronics products in particular).

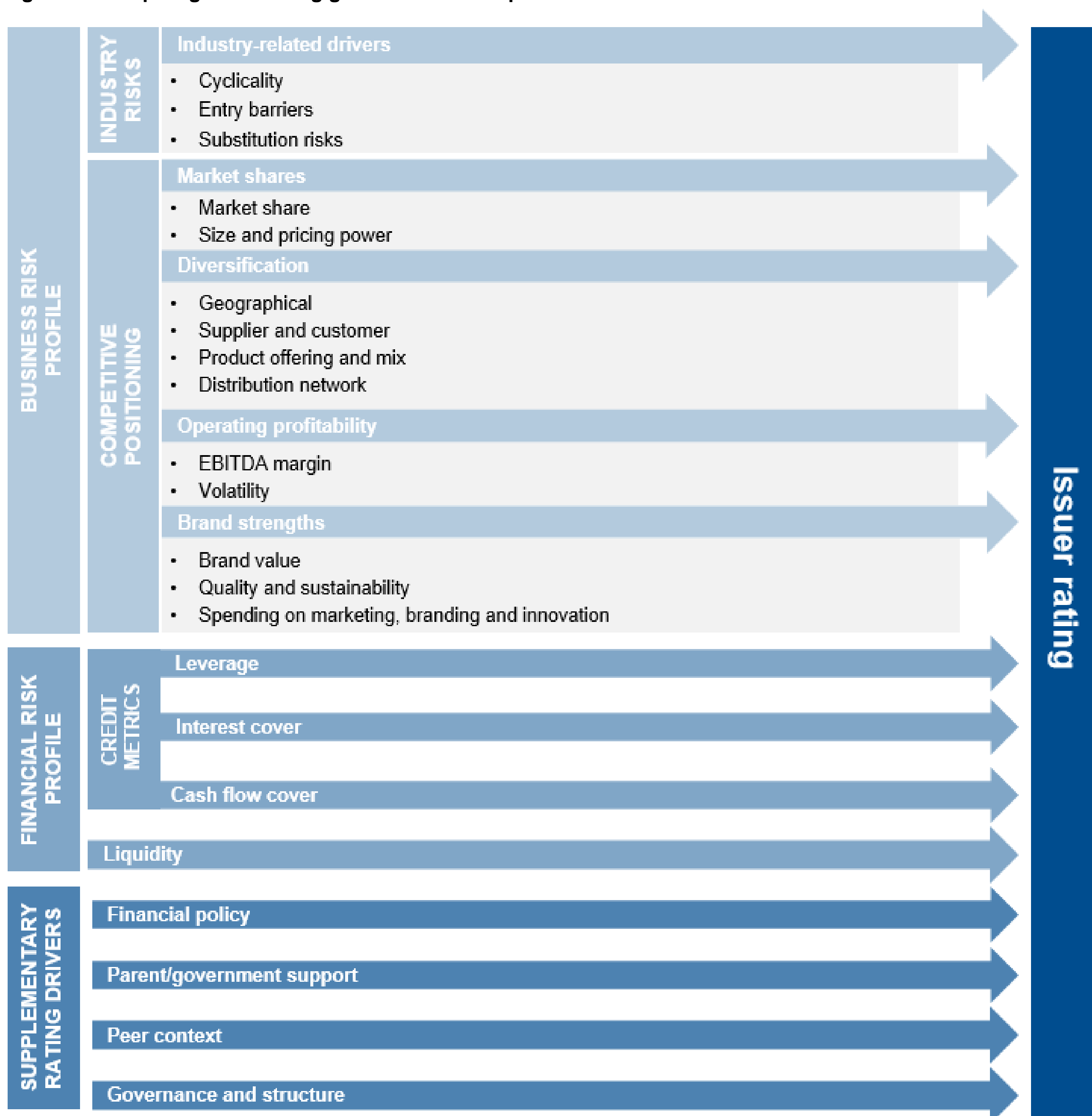
Size alone is not an absolute rating criterion. Small regional companies (or specialised niche producers with strong brands) with non-durable products, flexible and scalable cost structures, and low debt financing may receive a high rating, whereas larger companies lacking the above could see the opposite. Generally, parameters that would qualify a consumer products company for an investment grade rating are strong brand name(s) and sizeable market share, which translate into price-setting power that enables the company to generate sufficient profitability and cash flow with medium/low volatility. Further, investment grade companies should be broadly diversified in terms of geographies, distribution channels, product portfolios and customer bases, as well as reporting strong credit metrics over a sustained period. Companies with a non-investment grade rating will generally lack

adequate financial depth and have more volatile revenues and profitability, with balance sheets more exposed to negative developments.

3. Rating drivers

We apply our rating methodology for consumer products corporates as outlined in Figure 2. The rating analysis specific to this sector addresses factors common to all industries such as management, liquidity, legal structure, governance and country risks. The following business risk and financial risk indicators are non-exhaustive and may overlap. We may add issuer-specific rating factors, and a company's business model is decisive for the applicable indicators. No rating driver has a fixed weight in the assessment. Please refer to the General Corporate Rating Methodology for more detail.

Figure 2 – Scope's general rating grid for consumer products



3.1 Business risk profile

When evaluating a company's business risk profile, we analyse the industry dynamics and business drivers which are unique to consumer products companies. Our approach analyses the business risks for the industry and the competitive positioning of the company. For smaller companies, the overall industry rating is less important when assessing the business risk profile.

3.1.1 Industry-related drivers

Three elements constitute our assessment of the industry fundamentals of consumer products corporates:

- Cyclicality
- Entry barriers
- Substitution risks

Cyclicality

We consider the cyclicality of non-durable consumer products/goods demand to be low. This is based on historical sector trends and datasets including the global financial crisis in 2008/09. The average peak-to-trough cycle and observed volatility in revenue and profitability for non-durable goods companies are less than overall economic cyclicality. Further, we see consumer spending on essential food and beverages to be less susceptible to macroeconomic drivers and changes in consumer confidence.

For the durable consumer goods sector, we assess cyclicality as medium, due to the higher degree of discretionary spending on these products. During the 2008/09 global financial crisis, the peak-to-trough decline was close to that of the overall economic development and thus was more cyclical than for non-durable consumer goods.

Entry barriers

We view barriers to entry as medium for both durable and non-durable consumer products companies. While companies entering the consumer products industry can normally access markets with relative ease, government regulations for food, tobacco and alcohol, for instance, raise barriers. New entrants often lack pricing power, and manufacturing and distribution expertise, which limit their opportunities against established market participants, particularly the large incumbents. While there are few material barriers to market entry and capital investment is generally moderate, attaining the required economies of scale and establishing customer bases are more difficult.

Substitution risk

We assess substitution risk for the non-durable segment as low, reflecting the generally non-discretionary nature of its products and services. This is particularly true for food and beverages, despite large differences regarding quality, brand and price. For the durable segment, we assess substitution risk as medium as products are more discretionary in nature. We view substitution risk here to be tied to consumer choice regarding discretionary purchases: consumer preferences and a marginal inclination to purchase durable goods compete with substitute activities.

Figure 3 – Scope's industry risk assessment for consumer products companies

Cyclicality \ Entry barriers	Low	Medium	High
High	CCC/B	B/BB	BB/BBB
Medium	B/BB	BB/BBB	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Using the three industry drivers, our two main industry groups for consumer products are defined and rated as:

- **Durable consumer products industry**: medium cyclicality, medium entry barriers and medium substitution risk – leading to a BB industry rating
- **Non-durable consumer products industry**: low cyclicality, medium entry barriers and low substitution risk – leading to an A industry rating

We apply a blended industry risk rating when a consumer products company is exposed to several sectors. We usually calculate this rating based on the proportion contributed to EBITDA.

3.1.2 Competitive positioning

We assess the competitive positioning of consumer products corporates by examining the following risk drivers:

- Market shares
- Diversification
- Operating profitability
- Brand strength

For certain competitive positioning assessments, we provide a classification that spans over multiple rating categories. To position the issuer into a single rating category, we additionally apply a peer/relative analysis.

Market shares

We generally view strong market shares in a product category as positive but note that a large market share does not necessarily translate into price protection. Hence, we review market share and pricing power separately. Market leaders, for instance, may be challenged by smaller players taking advantage of new technologies or a higher flexibility in meeting market needs, putting pressure on market prices. Nonetheless, companies with large, stable market shares have advantage over smaller ones, as they have better control over distribution channels and volume effects, which generally creates more stable operational profitability. In addition, a company's size affects its purchasing power with key suppliers and negotiating position within various distribution channels. Smaller regional companies may have an acceptable market share and pricing power in a specific region that could mitigate to some extent concerns about its absolute size and diversification.

Figure 4 – Market shares by rating category

Market shares	AA and above	A	BBB	BB	B	CCC and below
Market shares	Global market leading positions	High international market shares (top three) in all product categories	Good international market shares (top 10) in most product categories	Moderate regional market shares in most product categories	Low market shares in most product categories	Very low market shares in all products
Size and pricing power	Dominant comparative size (revenue greater than EUR 25bn), very strong purchasing/ bargaining power and price-setting ability	Large comparative size (revenue EUR 5bn-25bn), strong purchasing/ bargaining power and price-setting ability	Medium-size company (revenue EUR 1bn-5bn), and/or good purchasing/ bargaining power	Below-average size (revenue EUR 250m-1bn), and/or adequate purchasing/ bargaining power	Small comparative size (revenue less than EUR 250m), somewhat weak purchasing/bargaining power and/or limited ability to set prices	

Diversification

We review four diversification categories: i) geographical; ii) supplier and customer; iii) product offering and mix; and iv) distribution networks. Strong geographical diversification can help to mitigate the impact from adverse regional economic conditions and is thus essential in our analysis. The degree of supplier and customer diversification helps to describe the vulnerability/strength of the business model or its operations. The company's distribution network is also linked to this assessment, as companies using multiple channels are more robust during downturns. Companies using e-commerce platforms in conjunction with more traditional marketing and distribution, for instance, will have significantly better and faster geographical access to customers than companies using primarily traditional retail distribution models.

Figure 5 – Diversification by rating category

Diversification	AA and above	A	BBB	BB	B	CCC and below
Geographical	Global presence; leading player in countries, regions and locations	Strong international presence; major player in many countries, regions and locations	Good international presence; operating in many countries, regions and locations	Moderate diversification by country, region and location	Low diversification by country, region and location and with low growth opportunities	Only single location with declining growth trend and opportunities
Supplier and customer	Broadly diversified regarding customers and suppliers		Adequately diversified regarding customers and suppliers	Some dependence on certain customers and/or suppliers	Heavy dependence on single customer and/or supplier	
Product offering and mix	Highly diversified product portfolio with many product types and/or high share of non-discretionary products		Diversified product portfolio and/or with mix of non-discretionary and discretionary products	Less diversified product offering and/or with predominately discretionary products	Highly concentrated product portfolio, and/or primarily based on a single discretionary product type	
Distribution network	Multiple well-established and robust distribution channels		Well-established and solid distribution channels	Concentrated distribution channels	Single distribution channel	

Diversification in terms of products is also essential in our risk assessment. Companies with a large product portfolio with many different product types (and/or a high share of non-discretionary products) tend to have more stable sales and profits over time, while highly concentrated product portfolios primarily based on a single discretionary product type are more vulnerable to downturns and changes in consumer preferences. Overall, diversification across product types reduces volatility and supports corporate profitability. Companies with only one brand can still be strongly diversified across geographies and product ranges.

Operating profitability

We use EBITDA as a measure to assess profitability and operating efficiency. Successful companies have stronger and more stable margins. Volatility in raw material/input costs as well as currencies may affect margins. Our analysis takes into account hedging activities to mitigate some of this volatility. We also favour variable cost structures, the ability to reduce operating costs through productivity measures and the ability to adapt to market conditions during downturns.

Figure 6 – Profitability by rating category

Profitability	AA and above	A	BBB	BB	B	CCC and below
EBITDA margin	>30%	20%-30%	15%-20%	5%-15%	0%-5%	Negative
Volatility	Low to medium			Medium to high		

Brand strength

Brand strength is a key factor in our assessment of consumer products companies' competitive position. Companies with strong brands generally have greater customer loyalty, lower price-sensitivity, higher bargaining power and a greater ability to set prices, allowing them to charge at a premium. Consumer brands with a long successful history are usually associated with higher value, indicating customer loyalty, high-quality products, and strong operating performance. We also assess spending on advertising and investment in innovative research as we deem these essential for strengthening brands and products and growing or maintaining market shares.

Established brands also serve as an entry barrier, but their importance has declined of late as digital marketing opens new channels. Digital marketing has created new and easier connections between companies and consumers, with strong feedback channels for both established companies and new entrants. We believe that successful consumer products companies generally

have very good market intelligence, allowing them to understand consumers and their needs. Successful brands actively seek to influence the behaviour of customers and engage closely with them; customers in turn can have a strong influence on branding and demand. The perception of the value and sustainability[4] of a brand can change more rapidly today than in the past, reflecting the impact of digital marketing and communications. When a company has several brands, we look at the combined strength and value of the brand portfolio.

Our analysis also distinguishes between traditional brands and private-label (or white-label)[5] brands. Traditional brands include luxury brands, which we generally associate with higher value, especially established brands with a very long history. This is due to the strong loyalty for such brands among customers, the inelasticity of the brands' prices, and the higher investment needed to achieve such a status and ensure product quality. By contrast, private labels are usually coupled with lower value. This is because they charge lower prices (though partly justified by their low marketing spend) and tend to be less innovative, which could ultimately affect their competitiveness. Moreover, private labels have higher replacement risk as customer loyalty for them tends to be low. Still, some private-label producers can have long and important relations with their retailer customers, which indicate sustained quality. These brands could also be well-known in various markets.

We assess the strength of a brand by looking at a company's geographical presence, market shares and media/commercial footprint. We evaluate write-down risks by analysing the size of goodwill/intangible assets on the balance sheet and the company's dependence on a particular brand.

Figure 7 – Brand strength by rating category

Brand strength	AA and above	A	BBB	BB	B	CCC and below
Brand value	Globally well-known brand	Internationally well-known brand	Internationally/ domestically known brand	Domestic/regionally known brand	Regionally less well-known brand	
Quality and sustainability of brand	Premium-priced products with high-quality attributes and sustainability		Solid quality attributes and sustainability of products	Satisfactory quality attributes and product sustainability	Unsatisfactory quality attributes and sustainability of products	
Spending on marketing, branding and innovation	Very high amount (relative to sales) spent on marketing and innovative investments		Above-average amount (relative to sales) spent on marketing and innovative investments	Below-average amount (relative to sales) spent on marketing and innovative investments	Limited investments in brand development and marketing	No investment in brand and/or negative public perception

3.2 Financial risk profile

Our assessment of a consumer products company's financial risk profile follows the general guidance presented in the Corporate Rating Methodology. We focus on recent and forward-looking data including (but not limited to) key parameters like leverage, interest cover and cash flow. Liquidity is also assessed and is particularly important for non-investment grade issuers.

The financial risk profile indicates a company's financial flexibility and viability in the short to medium term. A company with a strong financial risk profile is more likely to be resilient to economic downturns, adverse industry dynamics, unfavourable regulation or an unexpected loss of a revenue source. The ability to retain financial flexibility during an economic downturn is a rating driver for Consumer Products companies as it indicates an ability to invest at all phases of the economic cycle.

3.2.1 Credit metrics

We assess the financial risk profile of consumer products companies using the same four credit metrics in the Corporate Rating Methodology. For further information and definitions, see Scope's Corporate Rating Methodology.

---

[4] Regarding branding, we use the word 'sustainability' to indicate qualities associated with permanence and continuity and not in the ESG sense.
[5] Private labeling is when a product line is sold exclusively through one retailer. White labeling is the process of selling a generic product to multiple retailers, who can brand and price the product for their target market.

3.2.2 Liquidity

We assess liquidity separately from credit metrics, reflecting its different nature. We classify liquidity as either adequate or inadequate. Its implication for the ratings is ultimately subject to the rating committee's decision, as we believe liquidity can only be partially expressed by coverage ratios. For further explanation and definitions, please refer to page 10 of the Corporate Rating Methodology.

3.3 Supplementary rating drivers

3.3.1 Financial policy

Our assessment of supplementary rating drivers is described in the General Corporate Rating Methodology.

3.3.2 Parent/government support

Our assessment of parent support is described in the General Corporate Rating Methodology. When assessing the credit quality of consumer products companies that may benefit from government support, we incorporate the sovereign's or sub-sovereign's capacity and willingness to bail out a consumer product company in financial distress, as laid out in Scope's rating methodology for Government Related Entities.

3.3.3 Peer context

Our assessment of supplementary rating drivers is described in the General Corporate Rating Methodology.

3.3.4 Governance and structure

Our assessment of supplementary rating drivers is described in the General Corporate Rating Methodology.

3.4 Environmental, social and governance assessment

During the corporate rating process, we implicitly capture environmental, social and governance (ESG) factors that have a material credit impact. Consumer sentiment and ESG awareness are increasingly affecting the entire consumer products industry and exposing companies to ESG risks, not only directly but also indirectly through the value chain. Consumer companies are increasingly focused on environmental factors such as optimising the use of natural resources in production (including of water, raw materials and energy) and reducing product waste, with an increasing trend towards the circular economy.

The main social factors for the consumer industry include oversight of the supply chain and relationships with local communities, especially in emerging countries. Consumer companies are under increasing scrutiny to ensure human rights are respected and local resources not exploited. A failure to incorporate ESG aspects in strategy could expose a company to reputational risks that have severe consequences for brand value.

The General Corporate Rating Methodology provides further detail on how ESG factors and supplementary rating drivers are incorporated in the credit analysis.

4. Issuer rating

The final issuer rating is based on our analysis of the business risk profile, financial risk profile and supplementary rating drivers. The rating committee decides the relative importance of each rating driver. The business risk profile and financial risk profile are generally weighted equally for BB/BBB rated companies. The business risk profile is emphasised for investment grade companies (rated BBB- or above), while the financial risk profile is the focus for ratings assigned at B or below. A company's size, outreach, cash flow volatility and vulnerability determine which of the risk profiles will be weighted more in the analysis. The weighting between the business risk and financial risk profiles may be adjusted for specific business models and markets.

5. Additional methodology factors

Refer to the General Corporate Rating Methodology for more detail on our rating Outlooks for corporate debt ratings, short-term ratings, the recovery analysis, instrument ratings and rating categories.

6. Appendix

6.1 Related documents

For more information, please refer to the following documents:

- General Corporate Rating Methodology
- Government Related Entities Rating Methodology
- Rating Definitions
- Retail and Wholesale Rating Methodology

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
10 avenue de Messine
FR-75008 Paris

Phone +33 6 6289 3512

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

Madrid
Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer

© 2022 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings GmbH, Scope Ratings UK Limited, Scope Fund Analysis GmbH, Scope Innovation Lab GmbH, Scope ESG Analysis GmbH and Scope Hamburg GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided 'as is' without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or other damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party as, opinions on relative credit risk and not a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings GmbH at Lennéstraße 5 D-10785 Berlin.