Part 4 Case 2

KarstadtQuelle AG

Teaching Notes

# Introduction

The KarstadtQuelle case is a case about credit analysis. KarstadtQuelle is a German retail and tourism company that was in financial difficulties during the first half of the 2000s. The company underwent restructuring during 2005 and claimed to be almost debt-free after the first half year of 2006. The objective of the case is to teach students which factors a credit analyst should focus on when analyzing the creditworthiness of a company that is restructuring both its operations and its financial obligations.

# Questions for students

1. When preparing a report that summarizes the main factors affecting KarstadtQuelle’s creditworthiness, which factors should the credit analyst focus on? How do these factors affect KarstadtQuelle’s creditworthiness?
2. Assess whether KarstadtQuelle could bear the burden of another €500 million loan. If so, what would be the appropriate interest rate on this new loan?

# Case analysis

## Question 1

The factors that credit analysts typically focus on when analyzing the creditworthiness of a company are: (1) profitability; (2) leverage, (3) interest coverage, and (4) firm size. Leverage is negatively related to creditworthiness; the other three factors are positively related to creditworthiness.

Important in this particular case is that profitability and leverage have been and will continue to be affected by KarstadtQuelle’s financial and operational restructuring. Although the credit analyst typically would focus on KarstadtQuelle’s *current* financial performance and financial position, *near-term changes* that will almost certainly take place during the second half of 2006 are likely to affect the analysts’ assessment of the company’s ability to carry the burden of another loan. An important task of the credit analyst is therefore to find out:

1. Whether KarstadtQuelle’s financial statements accurately reflect the company’s financial position. (In other words, is the company really close to being debt-free?)
2. How KarstadtQuelle’s operational restructuring will affect near-term profitability;
3. How KarstadtQuelle’s financial restructuring will affect near-term leverage.

*Accounting choices*

KarstadtQuelle engages in a few financial transactions that need further attention.

*Receivables sold.* In 2005, KarstadtQuelle sold its shares in Karstadt Hypothekenbank to one of its own pension trusts in exchange for shares in finance company Quelle Neckermann Versand. Consequently, the company deconsolidated Karstadt Hypothekenbank from its financial statements. The company’s notes to the financial statements indicate that receivables sold to Karstadt Hypothekenbank can be derecognized (in accordance with IAS 39), whereas receivables sold to the company’s finance company cannot. Presumably, not all risks and rewards of the latter receivables were transferred.

In 2005, Karstadt Hypothekenbank purchased from KarstadtQuelle’s finance companies receivables (for an amount of €613 million) that these finance companies previously had purchased from KarstadtQuelle and had financed by issuing in asset-backed securities. Consequently, the company deconsolidated these receivables. KarstadtQuelle reports that it has set aside provisions for the collection risk of sold receivables that the company assumes. A point of attention for the analyst would be whether the provisions set aside are sufficient. Given that only a minor fraction of the sold receivables will still be outstanding at the end of fiscal 2006, the transaction with Karstadt Hypothekenbank is, however, not likely to have a significant impact on the analysts’ assessment of KarstadtQuelle’s creditworthiness.

*Operating leases.* KarstadtQuelle has purchased aircraft under operating lease agreements. The net present value of the contractual operating lease payments equals €1,749 million on December 31, 2005. An amount of €332 million is current; €1,417 million is non-current. The obligation arising from operating leases is not recognized on the company’s balance sheet but does represent a financial obligation. In addition, the distinction between operating and capital leases is somewhat arbitrary. When analyzing KarstadtQuelle’s creditworthiness it is therefore advisable that the net present value of operating leases is recognized on the company’s balance sheet as a lease liability (€1,417m non-current; €332m current) and that the same amount is recognized as a non-current tangible asset. The recognition of the operating lease obligation also affects KarstadtQuelle’s interest expense. Exhibit TN-1 shows that the interest rate that is implicit in KarstadtQuelle’s operating lease payments is approximately 6.6 percent. Using this interest rate, the interest expense from operating leases (if recognized) would be €104.6 million (6.6% x 1,417 + [343.4 – 332.3]). Note that earnings before interest would also increase by €104.6 million because the recognition of operating leases would reduce operating expenses (by an amount of – operating lease payments + depreciation on operating leases ≈ interest expense from operating leases).

Under the (simplifying) assumptions that (1) interest on lease obligations can be split evenly between the first and the second half of the year, (2) lease payments are made throughout the year, and (3) KarstadtQuelle does not engage in new operating leases in 2006, on June 30, 2006 the (operating) lease liability has a carrying value of €1,635 million (1,749 + (6.6% x 1,417)/2 + [343.4 – 332.3]/2 – 343.4/2), of which approximately €166 million (343.4/2 - [343.4 – 332.3]/2) is current (hence, €1,469 is non-current).

*Sale and leaseback transaction.* In 2006, KarstadtQuelle entered into a sale and leaseback agreement with an entity that was jointly owned by the company (49%) and the Whitehall Fund (51%). This transaction involved the sale of property, plant and equipment for an amount of €4.5 billion. The first payment of €2.7 billion would be made on July 3, 2006. The first phase of the transaction (which included the first payment) had roughly the following effects on KarstadtQuelle’s balance sheet for the half year ending on June 30, 2006:

* The company recognized a receivable of €2.7 billion on its balance sheet;
* The company recognized non-operating gains on the disposal of non-current assets, amounting to approximately €900 million (which is, presumably, equal to 51 percent the difference between the book value of the assets sold and leaseback and the first payment; note that 49% of the profit on disposal is eliminated because KarstadtQuelle owns 49% of the joint venture’s equity).
* The company reduced the book value of non-current tangible assets by approximately €1 billion (2.7 – 0.9/0.51).

Management’s claim that KarstadtQuelle is almost debt-free suggests that it plans to use the proceeds from the transaction to pay-off (current) financial liabilities, thereby reducing net debt. (Note that it is possible for KarstadtQuelle to treat the lease as an operating lease because the real estate is likely to have a useful life than is substantially longer than the contractually agreed lease period.)

Implicit in the transaction is the company’s commitment to lease back the non-current tangible assets. To get a good view of KarstadtQuelle’s financial obligations it is therefore better to recognize the net present value of the real estate lease obligation as a lease liability on the balance sheet. Effectively, this would imply that (part of) the “purchase price receivable from real estate transaction” would be reclassified as non-current tangible assets and an equal amount of current liabilities would be reclassified as non-current (reflecting that KarstadtQuelle uses the proceeds to pay-off non-current obligations). Because the present value of the future real estate lease payments is not disclosed in KarstadtQuelle’s interim report, the credit analyst must make an assumption about the size of the lease obligation. Given that the company classifies the lease as an operating lease, the present value of the future lease payments is likely to be lower than the fair value of the real estate (which is assumed to be equal to the payment). However, for reasons of simplicity (and given that the present value of the minimum lease payments is likely to be at least close to the fair value of the real estate), we assume that the present value of the future lease payments is equal to the receivable of €2.7 billion.

*Pension obligations.* At the end of 2005, the present value of KarstadtQuelle’s future pension commitments equaled €2,585 million. The fair value of the company’s plan assets amounted to only €1,485. It is common for German companies that the fair value of their pension plan assets is substantially below the present value of future pension commitments. This is so because they typically do not fund all commitments but use a part of their pension obligation to finance operations. The difference between the present value of KarstadtQuelle’s pension commitments and the fair value of its plan asset represents the company’s pension liability (the amount that is still to be funded). However, at the end of 2005, only €909 million was recognized on the company’s balance sheet. An amount of €190 million remained off-balance (unrecognized actuarial gains/losses and unrecognized past service costs). When analyzing KarstadtQuelle’s creditworthiness it is advisable that the amount of €190 million is recognized on the company’s balance sheet as a pension liability. The recognition of this amount would not affect the company’s interest expense because the interest expense from pension obligation is already based on the present value of all future pension commitments.

Like most other European companies, KarstadtQuelle provides no detailed information about its pensions in its interim financial reports. At the end of the first half of 2006, the analyst can therefore only assume that the off-balance sheet liability has not changed since December 2005.

*Expected near-term changes in profitability*

* KarstadtQuelle’s sales decreased by 7.9 percent between 2004 and 2005 ([15,845m / 17,199m] – 1). Between the first half of 2005 and the first half of 2006 the company’s sales decreased by 9.7 percent ([6,474m / 7,166m] – 1). During 2005, KarstadtQuelle has undertaken several measures to improve its profitability. Part of the decrease in sales can be attributed to the company’s divestments of smaller department stores and specialty store chains and will, therefore, not sustain in the second half of 2006. If the company’s renewed focus in the mail order segment and reorientation of the group start to yield results in the second half of 2006, as management expects, the sales decline should come to a stop. If so, sales for the fiscal year 2006 would not be less than 90 percent of fiscal 2005 sales.
* The cash flow statement reveals that a substantial amount of non-operating gains is included in KarstadtQuelle’s net profits for 2005 and the first half of 2006. In particular, the company is able to boost net profits, especially in the first half of 2006, as a result of the profits it earns on the disposal of fixed assets (€900 million, see above). Since these gains are the result of a one-time event, they are not related to KarstadtQuelle’s future cash flow generating ability and should, therefore, be excluded from net profit when analyzing the company’s creditworthiness.

Similarly, the company’s operating expenses in fiscal 2005 include restructuring expenses. The cash flow statement indicates, however, that during the first half of 2006, the company decreased its restructuring provision.

* In fiscal years 2004 and 2005, KarstadtQuelle reported pre-tax losses of -€1.433 billion and -€314 million, respectively. The effective tax rates in these two years were only 12.4 and 20.5 percent, respectively—much less than the company’s statutory tax rate of 39 percent. The most obvious explanation for the relatively low effective tax rates during these two loss years is that KarstadtQuelle’s management expected that the company would not be able to make use of the full amount of its tax loss carryforwards. The IFRS require KarstadtQuelle to recognize deferred tax assets only for the realizable portion of its tax loss carryforwards. In the first half year of 2006, KarstadtQuelle reported a pre-tax profit of €365,463, primarily because of the profit on the sale of the company’s real estate. Despite being profitable during this period, KarstadtQuelle recognized a tax benefit of €194,500. This was because the profit on the sale of the real estate helped management to realize tax loss carryforwards that it previously considered unrealizable. In its interim statement, KarstadtQuelle reported:

“Because of the real estate transaction the assessment changes with regard to the recoverability of deferred tax assets on tax loss carry-forwards. As a result allowances for deferred tax assets amounting to €290 million were released.”

Hence, €290 million of KarstadtQuelle’s net profit for the first half of 2006 is incidental/temporary. In addition, it is likely that in the coming periods, if the company becomes profitable again, its tax expense will increase (i.e., move towards 39 percent of pre-tax profits (statutory tax rate)).

* In 2005, KarstadtQuelle’s management announced that they expected to realize cost savings of €360 million in 2006. Assuming that these cost savings are gradually realized throughout the year, operating expenses as a percentage of sales in the first half of 2006 should already include these savings and, consequently, be predictive of the percentage in the second half.
* KarstadtQuelle’s management expects to be able to reduce cost of sales because of the cooperation with Li and Fung. The size of such a reduction is unknown.

*Expected near-term changes in leverage*

* KarstadtQuelle’s balance sheet for the half year ending on June 30, 2006, reports assets classified as held for sale for an amount of €482 million and liabilities from assets classified as held for sale for an amount of €31 million. If the company sells these assets, it can further reduce its financial obligations. For example, if the assets are sold for an amount that is equal to the assets’ current book value, the company receives €482 million, with which it can reduce current financial liabilities by €451 million (482 – 31). Given the current situation, it is likely that KarstadtQuelle will choose to use the proceeds to reduce debt; however, the value of the proceeds is uncertain.
* KarstadtQuelle’s management expects to be able to reduce working capital by an amount of 500 million because of the cooperation with Li and Fung. This reduction in working capital would result in a reduction in net capital and, possibly, a reduction in net debt. Note, however, that this predicted reduction in working capital is still uncertain and will unlikely be incorporated in the analyst’s assessment of KarstadtQuelle’s creditworthiness.
* As explained above, the receipt of the second payment from the real estate transaction will *not* change the company’s leverage (if the credit analyst recognizes a lease liability for the real estate operating lease).

*Summary*

In summary, the analyst’s report should pay attention to the following issues:

1. Creditworthiness is typically determined by (1) profitability, (2) leverage, (3) interest coverage, and (4) firm size.
2. The following accounting adjustments need to be made to the balance sheet of KarstadtQuelle on June 30, 2006:
   1. *Operating leases.* Increase non-current liabilities by an amount of €1,469 million, current liabilities by €166 million and non-current assets by €1,635 million.
   2. *Sale and leaseback.* Increase non-current debt and non-current assets by an amount of €2,700 million. Decrease current debt and current assets by the same amount.
   3. *Pensions.* Increase non-current liabilities and decrease equity by an amount of €190 million.
3. The following accounting adjustments need to be made to the income statement of KarstadtQuelle on June 30, 2006:
   1. *Operating leases.* Increase the interest expense and decrease operating expenses by an amount of €52.3 million.
4. Expected near-term changes to earnings performance are:
   1. Sales for the fiscal year 2006 will probably not be less than 90 percent of sales in 2005.
   2. Non-operating gains of €900 million that were recognized during the first half of 2006 were one-time gains.
   3. The tax expense will revert to a normal level (effective tax rate will move towards the statutory tax rate of 39 percent)
   4. Operating expenses as a percentage of sales in the first half of 2006 are probably predictive of the percentage in the second half (after the adjustment for non-operating gains of €900 million).
   5. The effects of the cooperation with Li & Fung are unknown and uncertain. It is better not to take these into account when predicting near-term profits.
5. Expected near-term changes to leverage are:
   1. Leverage will decrease if management uses the proceeds from the sale of assets (approximately €450 million) to reduce debt.

*Analysis of profitability and leverage*

Chapter 10 of the text book describes four variables that are indicative of a firm’s creditworthiness:

* NOPAT to net capital
* Pretax interest coverage
* Cash flow from operations to total debt
* Net debt to net capital

Exhibit TN-2 displays the values of these four indicators for KarstadtQuelle for the fiscal years 2004 and 2005 as well as the first half year of 2006. The implied debt rating (per indicator) is based on the values reported in table 10-3 in Chapter 10 of the textbook.

The analysis of KarstadtQuelle’s creditworthiness using unadjusted financial statement data suggests that KarstadtQuelle’s creditworthiness has, indeed, improved over the past two years. In particular, NOPAT to net capital has increased to 22.6 percent (annualized), which is the typical value for companies with AAA debt ratings. Pre-tax interest coverage has increased to 2.12, which is the typical value for companies with BB debt ratings. In addition, leverage—measured as net debt to net capital—has decreased from 91.4 percent to 77.7 percent. Some students may argue that leverage will further decrease when KarstadtQuelle uses the proceeds from the sale and leaseback transaction to pay off debt. More specifically, if net debt and net assets would be reduced by €2.7 billion, the net debt to net capital ratio would decrease to 58.7 percent, which is the typical value for companies with B ratings but fairly close to the typical values of companies with ratings of BB (54.9 percent).

This rather positive view of KarstadtQuelle’s creditworthiness is similar to the view that the company’s management is trying to articulate. However, this analysis does not take the results of the accounting analysis into account. When we do make the above-described accounting adjustments, a different picture arises.

*Profitability.* Profitability is an indicator of creditworthiness, primarily because current profits are predictive of future operating cash flows (which should cover future interest expenses). The predictive value of current profits is, however, negatively influenced by the degree to which profits include non-operating/one-time gains and losses. Before analyzing KarstadtQuelle’s profitability, the analyst should, therefore, remove such gains and/or losses from earnings.

The above discussion emphasized that KarstadtQuelle’s profitability improved primarily because of temporary gains, such as the profit on the sale of real estate and the release of deferred tax asset valuation allowances. If net profit is adjusted for these temporary gains, KarstadtQuelle appears to be loss making also in the first half of 2006. The company’s operating profit also becomes negative if the profit on the sale of real estate is deducted from the company’s “operating expense, net of operating income”. Based on these observations, one can conclude that in the near-term KarstadtQuelle will not able to cover its current interest expense unless the company can improve its operating performance. At the end of the first half of 2006, it is still uncertain whether and how the company can achieve such an improvement, especially since we concluded that:

* operating performance in the first half of 2006 should already include (part of) the effect of KarstadtQuelle’s expected costs savings in the department store business and the universal mail order business and
* the effects of the cooperation with Li & Fung are unknown and uncertain.

Exhibit TN-3 displays KarstadtQuelle’s income statement (for the first half of 2006) after accounting adjustments. The company’s adjusted net profit is almost zero. Note, however, that the adjusted income statement still includes a tax benefit because of the release of deferred tax allowances. Because adjusted profit before tax is negative, net profit would also be negative if the incidental tax benefit would be excluded from the income statement.

*Leverage.* Exhibit TN-4 displays KarstadtQuelle’s (condensed) balance sheet after the proposed adjustments for operating leases, sale and leaseback, pensions, and assets/liabilities held for sale. The adjusted net debt to net capital ratio is much closer to the ratio’s historical values (Note, however, that these historical values have not been adjusted for operating leases and pensions).

*Conclusion.* After removing transitory items from KarstadtQuelle’s profit and making adjustments to its balance sheet it becomes obvious that the company’s creditworthiness has not significantly improved.

Question 2

The previous analysis shows—after making the necessary accounting adjustments—that KarstadtQuelle is still highly leveraged and does not generate enough profit to cover its interest expense. Based on these findings, one could conclude that the company cannot bear the burden of another loan. Lenders may, of course, be willing to extend a loan based on the company’s anticipated performance improvements. In that case, the interest rate charged on the loan would include a premium for the additional risk that the lender incurs.

Table 10-2 in the text book displays companies’ average interest expenses by debt rating category. The previous analysis showed that KarstadtQuelle’s debt could be rated B or even lower than B. In fiscal 2005, the average interest expense paid by companies with B ratings was 7.5 percent. The interest rate that lenders would charge KarstadtQuelle is likely to exceed this percentage.

**Exhibit TN-1** Calculating the interest rate implicit in operating leases (implicit rate = 6.6%)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Year** | **Reported Payment operating leases** | **Assumed payment operating leases** | **Discount rate at 6.6%** | **Present value** |
| 2006 | 343359 | 343,359 | 0.9685 | 332,559.86 |
| 2007 | 919,291 in 5 y. | 183,858.2 | 0.9086 | 167,050.28 |
| 2008 | 919,291 in 5 y. | 183,858.2 | 0.8523 | 156,707.58 |
| 2009 | 919,291 in 5 y. | 183,858.2 | 0.7996 | 147,005.23 |
| 2010 | 919,291 in 5 y. | 183,858.2 | 0.7501 | 137,903.59 |
| 2011 | 919,291 in 5 y. | 183,858.2 | 0.7036 | 129,365.47 |
| 2012 and subsequent | 1,221,619 in 6.6 y. | 183,858.2 | 0.6601 | 121,355.98 |
|  | 1,221,619 in 6.6 y. | 183,858.2 | 0.6192 | 113,842.38 |
|  | 1,221,619 in 6.6 y. | 183,858.2 | 0.5808 | 106,793.98 |
|  | 1,221,619 in 6.6 y. | 183,858.2 | 0.5449 | 100,181.97 |
|  | 1,221,619 in 6.6 y. | 183,858.2 | 0.5112 | 93,979.332 |
|  | 1,221,619 in 6.6 y. | 183,858.2 | 0.4795 | 88,160.724 |
|  | 1,221,619 in 6.6 y. | 118,469.8 | 0.4498 | 53,289.617 |
|  |  |  |  | 1,748,196 |

**Exhibit TN-2** Analysis of KarstadtQuelle’s creditworthiness using unadjusted financial statement data

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **1st half 2006** | **FY 2005** | **1st half 2005** | **FY 2004** |
| NOPAT to net capital (annualized) | 22.6% | -3.2% | -5.3% | -20.1% |
| Implied debt rating | AAA | <B | <B | <B |
| Pretax interest coverage | 2.12 | -1.43 | -2.33 | -3.66 |
| Implied debt rating | BB | <B | <B | <B |
| Cash flow from operations to total debt (annualized) | -4.8% | 19.6% | -6.7% | 6.5% |
| Implied debt rating | <B | BBB | <B | BB |
| Net debt to net capital | 77.7% | 94.1% | 95.1% | 91.4% |
| Implied debt rating | <B | <B | <B | <B |

**Exhibit TN-3** Adjustments to KarstadtQuelle’s income statement

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **1st half 2006** | **Adjustments for interest on the (operating) lease liability** | **Adjustments for one-time gains/losses** | **Tax effect of adjustments** | **1st half 2006 Adjusted** |
| Sales | 6,474,551 |  |  |  | 6,474,551 |
| Operating expenses, net of operating income | (5,943,666) | +52,300 | (906,419) |  | (6,797,785) |
| Net Interest Expense or Income | (172,421) | (52,300) |  |  | (224,721) |
| Investment Income | 6,999 |  |  |  | 6,999 |
| Other Income | 0 |  |  |  | 0 |
| Other Expense | 0 |  |  |  | 0 |
| Profit before tax | 365,463 |  |  |  | (540,956) |
|  |  |  |  |  |  |
| Tax Expense | 194,500 |  |  | 353,503 | 548,003 |
| Minority Interest | (1,847) |  |  |  | (1,847) |
| Net Profit/Loss | **558,116** |  |  |  | **5,200** |

**Exhibit TN-4** Adjustments to KarstadtQuelle’s income statements

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **1st half 2006** | **Operating leases** | **Sale and leaseback** | **Pensions** | **Assets held for sale** | **1st half 2006 Adjusted** |
| Operating working capital | 2,747,837 | (166,000) | (2,700,000) |  |  | (118,163) |
| Net non-current assets | 3,111,200 | 1,635,000 | 2,700,000 |  | (482,000) | 6,964,200 |
| Net debt | 4,553,782 | 1,469,000 |  | 190,000 | (482,000) | 5,730,782 |
| Net assets | 5,859,037 |  |  |  |  | 5,859,037 |
|  |  |  |  |  |  |  |
| Net debt to net capital | 77.7% |  |  |  |  | 97.8% |