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Analysis

SWEDEN
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Investor AB

Corporate Profile

HIGH ASSET COVERAGE OF DEBT MITIGATES MODERATE PORTFOLIO TURNOVER

Investor AB ("Investor", rated A2) is the largest industrial holding company in the Nordic region. The company's business strategy is to create value by building companies in sectors where it is deemed to have a strong knowledge and networking advantage and thus to grow Investor's net asset value in excess of market cost of capital over a business cycle. Investor is a leading shareholder in a number of Swedish and multinational companies including Ericsson (17% of total assets), SEB (14%) and AstraZeneca (14%).¹ It manages total assets of about €13 billion.

Currently, 83% of the total assets consist of the 11 core holdings to which Investor acts as a committed shareholder, participating actively in their development. In addition, Investor is building a diversified portfolio of investments in small- and mid-sized companies (through its New Investments division) in technology, healthcare and other sectors, most of which are unlisted. With its 40% stake in Hi3G, Investor is also participating in the build-out of third-generation (3G) wireless networks in Sweden, Denmark, and Norway.

Key Rating Considerations

The experience of the past three years demonstrates the high volatility in Investor's leverage that can result from downcycles in the equity markets. Leverage had reached the limits of the 20-25% (Net Debt/Total Assets) comfort zone as at September 2002, and management has subsequently liquidated core holdings (0.5% of AstraZeneca for SEK3 billion) and non-core holdings (e.g. Syngenta, Volvo²) in order to gain flexibility.

As of June 2005, net leverage was back down to 3.9% following the monetisation of shares in AstraZeneca, SEB, ABB³ and Scania and exits from New Investments during the first half of 2005, which were aimed at realising gains and increasing financial flexibility for future investments. Another factor contributing to the reduction in on-balance sheet debt was the refinancing of shareholder loans for mobile broadband operator 3 Scandinavia (Hi3G) by means of a SEK10.5 billion secured external loan. This loan is initially guaranteed by the company's owners (Investor holds 40%), but the guarantee will be released upon Hi3G reaching certain financial milestones. Adjusted for this obligation, Investor's leverage would reach 7.5%.

1. AstraZeneca, rated Aa2/P-1; Ericsson, rated Baa3/P-3 and SEB, rated Aa3/P-1/B
2. Syngenta, rated A3/P-2; Volvo AB rated A3/P-2
3. ABB, rated Ba2/N-P



Moody's Investors Service
Global Credit Research

Figure 1 – Portfolio Trends and Leverage						
Portfolio in SEK million	Jun. 30, '05	Dec. 31, '04	Dec. 31, '03	Dec. 31, '02	Sep. 30, '02	Dec. 31, '01
Core Holdings	94,764	87,643	85,841	63,304	57,837	110,518
New Investments	18,384	10,820	12,745	12,860	13,163	12,410
Other	4,930	7,054	5,070	3,063	4,658	6,438
Total Assets*	118,078	105,517	103,656	79,103	75,658	129,366
Net Debt**	4,659	15,551	20,493	16,358	18,744	11,082
Net Debt/Total Assets %	3.9%	14.7%	19.8%	20.7%	24.8%	8.6%
* at market value						
** In addition, Investor has guaranteed a SEK10.5 billion loan to mobile broadband operator 3 Scandinavia pro-rata to its 40% shareholding, adjusted leverage is 7.5%						

Moody's analytical approach for Investor AB focuses on portfolio size, quality, volatility and liquidity relative to the company's debt level and debt service obligations. Recognising that the company's debt is not formally collateralised, we view management strategy and flexibility as key to future levels of asset coverage. As part of our analysis, Moody's has also tested the ratings against certain portfolio analysis techniques based on asset volatility and leverage over long time horizons. In these models, we used an asset volatility of about 29% – commensurate with the observed long-term volatility of the OMX stock index,⁴ on which all of Investor's core holdings are listed, and a leverage factor of 20% – which is in line with Investor's own leverage comfort zone of 20-25% (Net Debt/Total Assets).

The quantitative analysis was complemented by a positive consideration of qualitative factors such as (i) the active portfolio management of Investor with a committed and proven leverage limit, (ii) the quality of its holdings, comprising stakes in large, international corporations, and (iii) the liquidity cushion provided by a committed US\$1.0 billion, five-year syndicated credit facility due February 2008, with neither financial covenants nor repeating MAC (material adverse change) clauses. Management is committed to extend or refinance the facility well ahead of its maturity and to keep the facility amount at a sizeable proportion of total assets.

We note that Investor would face downward rating pressure if management were to allow its asset leverage to leave the comfort zone and exceed 25%. In the statistical analysis, we have assumed a 20% adjusted leverage cap, because we would expect to see management addressing any material overshooting of that level, with the result that adjusted net leverage levels of above 20% would likely be only temporary in nature. However, Investor's flexibility to reverse a rapidly rising leverage trend in a falling equity price scenario may be limited, depending upon management's continued commitment to its core holdings and its liquidity cushions.

The possibility of capital increases at Investor is also considered unlikely at this stage, even though Investor has issued several convertibles in the past, which Moody's would consider debt-like until the bond is "deep-in-the-money" and close to maturity. Overall, the rating would benefit primarily from (i) any measures to reduce the volatility of asset values in the portfolio, or (ii) an even more conservative leverage strategy.

Analytical Criteria

PORTFOLIO VOLATILITY

Over the past 10 years, the annual changes in net asset value ranged between a positive 64% (in 1999) and a negative 47% (in 2002). In the previous downcycle, this high volatility was partially mitigated by the relative price resilience of the healthcare stocks (AstraZeneca and Gambro), which then accounted for almost 40% of the portfolio, but now represent only 21% and may be less of a stabilising factor in the next downturn. In addition, Investor's stable core portfolio strategy and exposure concentration contribute to the portfolio volatility. Even though a shift to cash-near investments at a stock market low point is not an attractive option, management showed during 2002 that it was willing to protect the comfort zone leverage by disposing of assets.

4. OMX: Integrated Nordic and Baltic marketplace, which includes the stock exchanges in Stockholm, Helsinki, Tallinn, Riga and Vilnius.

PORTFOLIO CONCENTRATION

The percentage of core holdings in total assets consistently ranges between 80% and 83% of the total portfolio. Three companies (SEB, Ericsson, AstraZeneca) account for about 45% of the total.

Figure 2 – Portfolio Concentration

Portfolio in SEK million	Jun. 30, '05	% total	Dec. 31, '04	% total	Dec. 31, '03	% total	Dec. 31, '02	% total
SEB	15,994	14%	17,768	17%	14,657	14%	10,126	13%
Ericsson	20,392	17%	17,437	17%	10,711	10%	5,840	7%
Astra Zeneca	16,714	14%	15,327	15%	29,675	29%	26,520	34%
Atlas Copco	11,654	10%	9,436	9%	8,100	8%	5,347	7%
ABB	8,441	7%	7,613	7%	7,368	7%	3,235	4%
Gambro	7,121	6%	6,487	6%	4,074	4%	3,329	4%
Scania*	6,113	5%	6,160	6%	3,672	4%	3,020	4%
Electrolux	3,064	3%	2,806	3%	2,980	3%	2,681	3%
Saab AB	2,734	2%	2,496	2%	2,356	2%	2,075	3%
WM-data	1,384	1%	1,012	1%	1,089	1%	534	1%
OMX	1,153	1%	1,101	1%	1,159	1%	597	1%
Total Core Holdings	94,764	80%	87,643	83%	85,841	83%	63,304	80%
Total Investment Assets	118,078	100%	105,517	100%	103,656	100%	79,103	100%
Co's of Swedish Origin %	94,764	80%	87,643	83%	85,841	83%	63,304	80%

*including Ainax

There is a similar concentration by industry, with technology comprising 27%, engineering 25%, healthcare 23% and financial services 18%. All core companies are of Swedish origin, but have long-established international operations and have sought listings on various stock exchanges; as a result, Investor's reliance on the Swedish economy or stock market has gradually diminished. Nonetheless, a higher level of diversification would render the portfolio more resilient and liquid.

PORTFOLIO LIQUIDITY

The liquidity of the company's investments has improved over the past few years as major holdings have been listed on international exchanges (NASDAQ, NYSE, LSE) in addition to their traditional presence on the Swedish Stock Exchange. Although Investor is committed to its core holdings, there has been a fair amount of turnover; average disposals in the Core Holdings have been in excess of SEK8 billion (about 7% of March 2005 portfolio value) during the past eight years. Over the same eight-year period from 1997, Investor has also shifted out of several sectors such as aviation (SAS), media (TV4), automotive (Saab) and pulp and paper (Stora Enso).

Given that Investor typically holds controlling stakes, its shareholdings are often subject to trading restrictions, and larger trades in a downcycle could affect market sentiment, thus limiting disposal flexibility. Apart from strategic decisions to shift core holdings, the portfolio liquidity rests primarily on companies in the New Investments division, many of which are unlisted, and on other non-core holdings and dividends received from the investees. The last eight-year average turnover for the total portfolio has been approximately 20% p.a.

Statistical Portfolio Analysis

In light of the relatively static nature of Investor's portfolio-mix as regards the core holdings and given that all core holdings are listed, analysis of the company's default risk lends itself well to the application of advanced techniques of portfolio analysis.

We have used three different models to test our fundamentals analysis against the more objective statistical methods. All three models are based on option-pricing concepts developed by Merton and derive their respective default probability or expected losses from estimates of leverage at default and the volatility of market prices of the assets, i.e. the probability of the portfolio value falling below the total of Investor's liabilities or the corresponding expected losses for debt holders in such events. The default probabilities or expected losses are then converted to a quantitative rating in line with Moody's rating definition. Certain qualitative factors are additionally considered to support the overall assessment. The rating outcomes from this process are broadly in line with Investor's current A2 rating. Moody's recognises that statistical modelling techniques can be inherently more volatile relative to our long-term ratings and, as such, we monitor the outcomes in the context of a cycle.

The first model replicates Merton's initial approach where a company defaults if the value of its assets no longer covers the level of its debt. For a long-term time horizon that was taken at five years, we have used a 29% asset volatility assumption as derived from the long-term performance of the Investor's domestic stock exchange, the OMX, and a 20% leverage expectation. The leverage level reflects Moody's expectation that Investor will continue to manage debt levels prudently, even though short-term deviations up to 25% are possible. On the basis of these parameters, the default probability and expected loss rating would emerge in the high Baa rating category. With the inclusion of qualitative characteristics, such as management's commitment to manage leverage levels prudently, and the extra liquidity provided by the firmly committed credit line, the rating would support an A2 category.

The second model observes the Dow Jones Industrial Average, which is the longest tracking stock index, with 108 years of history and experience of periods of extreme volatility, such as the Great Depression. From this experience, probabilities can be derived for the occurrence of certain stock price decline scenarios, including those that would render Investor insolvent. Applying this probability and the same 20% leverage assumption returns a high Baa rating on a combined default probability and expected loss basis. Upon consideration of qualitative factors as discussed in the previous method, the outcome would similarly support an A2 rating for Investor's senior unsecured debt. This second alternative approach was developed in order to minimise the significant reliance of rating outputs on the asset volatility assumption that was observed under the first model mentioned above.

The third model adds to these approaches an evaluation of the uncertainty about the issuer's capital structure at a potential default. Based on historic leverage patterns rather than a leverage assumption, the process determines default probabilities. However, the model requires input of a capital structure at the start of the analysis. Again we have used the 20% leverage assumption and the output of the model was in line with the previous approaches, i.e. an estimated A2 rating including the qualitative factors.

Moody's notes that the models depend critically on the input assumptions, notably volatility and leverage. However, in the case of Investor AB – with its long track record of portfolio management – certain key factors are unlikely to change materially over the medium term. The volatility measures are based on very long histories of experience, and Investor has kept its leverage comfort zone stable for many years. Any impetus for potential rating upgrades in the short-to-medium term would thus have to be derived primarily from qualitative factors, such as reducing portfolio concentration, increasing its turnover, or adding liquidity support.

Related Research

Special Comment:

[Default and Recovery Rates of European Corporate Bond Issuers, March 2005 \(91623\)](#)

Analyses:

[SEB AB, April 2005 \(92215\)](#)

[Telefonaktiebolaget LM Ericsson, May 2005 \(92817\)](#)

[ABB Ltd., June 2005 \(92986\)](#)

[Electrolux, June 2005 \(93095\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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