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Analysis

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Investor AB

Corporate Profile

Investor AB ("Investor", rated A2 with a positive rating outlook) is the largest industrial holding company in the Nordic region. The company's business strategy is to generate attractive long term returns on investment, 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. It manages total assets of about €16 billion.

Investor AB operates its holdings in four different segments, Core Investments, Private Equity Investments, Operating Investments and Financial Investments Core Investments have traditionally dominated Investor's activities and we expect these to continue to exceed 75% of total assets (85% as of 30 September 2006). Core Investments currently consist of 10 mostly Swedish-based, multinational companies to which Investor acts as a committed shareholder, participating actively in their development. The largest investments include SEB (rated Aa3, 16% of total assets), AstraZeneca (Aa2, 16%), Ericsson (Baa2, 14%), ABB (Baa3, 11%), and Atlas Copco (A3, 12%), together comprising 69% of total assets.

After many years of relative stability, this portfolio underwent significant change in 2006, reducing the number of Core Investments from 11 to 10 in the course of 2006. By June 2006, Investor in conjunction with its private equity partner EQT had taken the pharmaceutical company Gambro private, retaining a 49% direct stake, and reallocated the business from Core Investments to Operating Investments. Also in June, Electrolux (Baa1, under review for possible downgrade) spun-off its Outdoor Products business under the name Husqvarna and listed it on OMX. As a result, Investor has added a new Core Investment with its direct 10.7% stake in Husqvarna. In October 2006, Investor sold its 16.3% stake in WM-Data to LogicaCMG for a consideration of about SEK 2.0 billion paid to 80% in LogicaCMG shares, of which 63% are subject to a 12 months lock-up period and about SEK 400 million in cash. The shares in LogicaCMG are now held in Financial Investments

In addition, Investor is building a diversified portfolio of investments in small- and mid-sized companies (through its Private Equity Investments division) in technology, healthcare and other sectors, most of which are unlisted. Investor is also invested in the telecommunications business with a 40% stake in 3Scandinavia, the remainder being held by Hutchison Whampoa Ltd (rated A3), thereby participating in the build-out of third-generation (3G) wireless networks in Sweden and Denmark, and holds a licence in Norway. Together with Gambro and the Grand Hotel holding, this stake comprises Investor's Operating Investments.

The company was also approached with a plan for a merger of Scania with MAN and possibly Volkswagen's truck business. Management rejected the current proposal for the tie-up and the sales of its Scania shares, yet apparently more for price/value considerations than a lack of industrial logic, indicating that Investor may still be amenable to a sale of its stake.

Considering these transactions, Investor's Core Investments portfolio may well see more change in future and the percentage of unlisted investments may gradually increase. At the end of September 2006, i.e. before the WM-Data and a possible Scania transaction, the Core Investments still accounted for 85% of total assets and all Core Investments were listed at least on the Stockholm stock exchange.

Key Rating Considerations

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. The company's long, 90 years' track record and management's commitment to established policies, which have served to protect the company's financial flexibility through severe share price downcycles, are a major factor supporting the A2 rating.

As part of the analysis, Moody's has also tested the ratings against certain portfolio analysis techniques based on observed and assumed asset volatilities and leverage over long time horizons. We have derived the asset volatility from the OMX stock index,[1] on which all of Investor's Core Investments are listed and used a leverage factor of 20% – which is in line with Investor's own leverage comfort zone of 20-25% (Net Debt/Total Assets). The modelling results point to expected loss ratings of mid-Baa to low single-A for Investor AB.

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 SEK10 billion, seven-year syndicated credit facility due 2012, 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.

The A2 ratings for Investor AB have a positive outlook as rising market valuations of their equity investment have allowed management to realize holding gains and to reduce net leverage of the company to virtually zero. While management is not changing its strategic capital structure comfort zone of a 20-25% maximum net leverage, which it had actively protected by asset sales in the downcycle, the current asset composition and liquidity of its portfolio holdings still provide substantially increased asset coverage for debt and new financial flexibility. In addition, OMX-index stock prices (used as a proxy for Investor's portfolios) over the past two years have shown a trend of declining volatility, which provides additional comfort.

Moody's would consider a rating upgrade, if (i) Investor sustains its long-term oriented and conservative investment and funding strategy, if (ii) management keeps the level of listed investments above 75%, currently 85%, through the initiated portfolio changes, if (iii) Investor's portfolio of Core Investments shows an improved balance of company credit profiles and becomes more diversified, and if (iv) asset values continue on a high and less volatile level relative to the company's debt service obligations. Most of these criteria have been achieved to date, but with a relatively short track record for the high rating category so that sustainability still needs to be demonstrated.

However, we also 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.

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

Analytical Criteria

MANAGEMENT STRATEGY: LONG-TERM ORIENTATION WAS CONFIRMED, BUT FURTHER TRANSACTIONS ARE NOT EXCLUDED.

Management has recently confirmed its basic strategy followed now for more than 9 decades: "to actively participate in developing businesses by being a leading shareholder that focuses on creating long-term value" (emphasis added). This applies particularly to the listed Core Investments, which we would expect to continue to make up the vast majority, or more than 75% of total assets. The commitment to these holdings and the extended support during turnaround situations (e.g. Ericsson or WM- Data) has helped Investor to outperform stock indices and, recently, to de-lever the company.

While shifts in the core portfolio composition were not uncommon in previous years, 2006 has seen significantly more change for the core, starting with the delisting of Gambro and probably not ending with the disposal of WM-Data. Also, management commented favourably about the benefits of private ownership ("in a private setting the board and management can exclusively focus on the business and value creation without the additional administrative burden of disclosure rules and different corporate governance codes."). A rising share of unlisted holdings would be negative for the ratings because one of Investor's strongest aspects, the liquidity of its portfolio, would be reduced, making a monetization of investments in a downside scenario more challenging and time consuming..

PORTFOLIO VALUE KEEPS RISING; LEVERAGE DOWN TO VIRTUALLY ZERO

Investor's portfolio values have been rising consistently from their September 2002 low point and net leverage has declined to virtually zero (0.4%) by September 2006. The net debt reduction was funded by the monetisation of shares (e.g. in AstraZeneca, SEB, ABB and Scania) and exits from Private Equity Investments, which were also realising gains and increasing financial flexibility for future investments. Another factor contributing to the reduction in on-balance sheet debt was the refinancing in 2005 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 still reach modest 3.1%.

1. Portfolio Trends and Leverage

Portfolio in SEK million	Sep 30, '06	Dec 31, '05	Dec. 31, '04	Dec. 31, '03	Dec 31, '02	Sep. 30, '02	Dec 31, '01
Core Holdings	126,642	115,419	87,643	85,841	63,304	57,837	110,518
Private Equity Investments*	14,892	16,858	10,820	12,745	12,860	13,163	12,410
Other Net Assets	8,028	2,126	7,054	5,070	3,063	4,658	6,438
Total Assets**	149,562	134,403	105,517	103,656	79,103	75,658	129,366
Net Debt***	653	1,442	15,551	20,493	16,358	18,744	11,082
Net Debt/Total Assets %	**0.4%**	**1.1%**	**14.7%**	**19.8%**	**20.7%**	**24.8%**	**8.6%**

** formerly: New Investments*
*** 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 (about: SEK4.3 bn), adjusted leverage is 3.1%*

While Investor's financial position is currently very strong, we also factor in the volatility of credit metrics and the experience in past stock price downcycles into the analysis and actually gear the rating level more to the issuer's resilience to adverse market trends or even economic shocks rather than to actual valuations. With hardly any debt, Investor would currently be very well positioned to face any abrupt value deterioration in its portfolio, but we expect management to continue to apply a moderate degree of leverage to develop the portfolio and take advantage of arising investment opportunities.

PORTFOLIO VOLATILITY IS HIGH FOR THE LONGER HORIZON

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). These two stocks together accounted for about 34% of the company's investment portfolio at market values in 1998, before the run-up in the share prices of the engineering and technology companies. During 1999, this segment generated total returns above 100% with Ericsson leading the race at

187%. As a result, the relative stable healthcare companies with returns of +12% (Astra Zeneca) and -12% (Gambro) declined in relative value to 22% going into the market downturn (i.e. 1999). The duo then peaked at about 40% in 2001 following the abrupt value declines of Ericsson and other shares. At the end of 2005, the two shares represent only 19% of total assets and may be less of a stabilising factor in the next downturn. In addition, Investor's stable core portfolio strategy and exposure concentration (5 stocks account for almost 70% of total assets) 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.

The experience of the 2002 severe stock market decline, when Investor's total assets declined by more than 40% in just 6 months (from SEK 130 billion at 31 March to SEK76 billion at the end of September) demonstrates the vulnerability of Investor's asset values to the stock market vagaries and the requirement for a fast response in such cases. In Q4, 2002, once the company's leverage had reached the corporate limit for net debt leverage of 25% (30 September actual: 24.8%), management indeed reacted decisively and liquidated core holdings (0.5% of AstraZeneca for SEK3 billion) and non-core holdings (e.g. Syngenta, Volvo[2]) in order to reduce leverage (20.5% by December 2002) and to gain flexibility. The expectation of a similar disciplined response to possible future leverage stress is factored into the A2 rating for Investor.

PORTFOLIO CONCENTRATION

The percentage of Core Investments in total assets consistently ranges between 80% and 86% of the total portfolio. Five companies (SEB, Ericsson, AstraZeneca, ABB, Atlas Copco) account for almost 70% of total assets.

Figure 2 – Portfolio Concentration

Portfolio in SEK million	Sep 30, '06	% total	2005	2004	2003	2002
SEB	24,236	16%	15%	17%	14%	13%
Ericsson	20,543	14%	16%	17%	10%	7%
Astra Zeneca	23,524	16%	15%	15%	29%	34%
Atlas Copco	18,103	12%	12%	9%	8%	7%
ABB	16,009	11%	9%	7%	7%	4%
Gambro	0	0%	4%	6%	4%	4%
Scania*	9,855	7%	5%	6%	4%	4%
Electrolux**	6,789	5%	4%	3%	3%	3%
Saab AB	3,966	3%	3%	2%	2%	3%
WM-data	1,785	1%	1%	1%	1%	1%
OMX	1,832	1%	1%	1%	1%	1%
Total Core Holdings	126,642	85%	86%	83%	83%	80%
Total Investment Assets	149,562	100%	100%	100%	100%	100%
Co's of Swedish Origin %	126,642	85%	86%	83%	83%	80%

**including Ainax*
*** including Husqvarna*

There is a similar concentration by industry, with engineering comprising 35%, technology 24%, healthcare 22% and financial services 19% of total assets. 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 and support higher ratings.

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 Investments, there has been a fair amount of turnover; average annual disposals in the Core Holdings have been in excess of SEK8 billion (about 6% of 30 September 2006 portfolio value) during the past 10 years. Over the same ten-year period from 1996, 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. In addition to the

2. *Syngenta, rated A3/P-2; Volvo AB rated A3/P-2*

listed Core Investments, the portfolio liquidity rests on liquid, but non-strategic Financial Investments (1% of total assets), Operating Investments (e.g the privatized Gambro, 3 Scandinavia and the Grand Hotel together accounting for 4% of total assets) and dividends received from the investees. Private Equity Investments include holdings in 8 EQT funds, unlisted but held by institutional investors, as well as about SEK530 million listed investments. This segment has seen substantial trading activity in recent years, but unlisted holdings generally require substantial preparation for exits and may not be suitable for a quick monetization in stress periods.

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. Critical assumptions are the asset volatility (from OMX-index) and asset leverage at the start of the analysis. The OMX-volatility had spiked up during 2000-2005 from the 21% average of the nineties and is now gradually falling back. It had reached peaks of 29%, 27%, and 25% for the 6, 8 and 10 year horizons respectively and the longer time horizons are now stabilizing around 25%. Because of the high concentration in cyclical companies for the OMX index as apparent from the wide range of volatility figures, we have opted to continue to apply the higher volatilities in the 27-29% range to our portfolio models. However, a longer track record of lower volatility measures at the OMX through market cycles would likely drive the model ratings up.

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 at the cusp of the Baa and A rating categories. 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 or slightly higher rating.

The second model observes the Dow Jones Industrial Average, which is the longest tracking stock index, with 109 years of history and experience of periods of extreme volatility, such as the Great Depression or the stock market crash in 1987. 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. In addition to Investor's historic leverage pattern, the model requires input of a capital structure at the start of the analysis, for which again we have used the 20% leverage assumption. By the model workings, Investor's deleveraging of recent years, adds to the volatility pattern and keeps pressure on the mid-Baa model output. When adding in the qualitative factors, however, this model could also support a mid-A overall rating.

Moody's notes that the models depend critically on the input assumptions, notably volatility and leverage. If for instance, we were to run the first, Merton-based model, with a 10% leverage assumption, which equates Investor's average leverage of the last 8 years including the downcycle years, the calculation would return an Aa-level expected loss rating. However, in the case of Investor AB – with its long track record of portfolio management and the experience of a not too distant pressure period – we overweight the stress scenarios of peak volatility and align them with management long term strategy, notably the leverage comfort zone..

Related Research

Analyses:

ABB Ltd., July 2006 (98131)

AstraZeneca PLC, October 2006 (99835)

Electrolux AB, May 2006 (97675)

Telefonaktiebolaget LM Ericsson, July 2006 (98430)

Special Comments:

Default and Recovery Rates of Corporate Bond Issuers, 1920-2005, January 2006 (96546)

Default and Recovery Rates of European Corporate Bond Issuers: 1985-2005, March 2006 (97015)

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