Corporate Rating Methodology

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1. ABOUT THIS METHODOLOGY

The Corporate Rating Methodology describes the analytical framework and criteria that Capital Intelligence Ratings (hereinafter CI Ratings or CI) uses when it rates non-financial corporate issuers.

The methodology is applicable to non-financial corporates operating in a broad range of sectors, from heavy industry to asset-light services. Although focused on issuer ratings, the methodology is also used as part of the process for determining the ratings of financial instruments issued by corporates.

The Corporate Rating Methodology is a base methodology which – while sufficient to rate the companies currently covered by CI – may be enhanced in the future with the publication of supplementary criteria papers that are more geared to the specificities of a particular industry or sub-sector.

Structure of this Methodology Report

The remainder of this methodology paper is organised as follows:

- Section 2 contains an overview of our analytical approach for determining the ratings of corporates.
- In Section 3 we explain the rationale for each of the four analytical pillars of the Entity Standalone Assessment and outline the criteria used to assess the underlying key rating factors.
- In Section 4 we describe our approach to assessing extraordinary support and group factors.
- In Section 5 we summarise our approach to rating above the sovereign.
- Section 6 contains some additional factors we consider when rating real estate companies.
- Annex 1 contains our rating scales for issuer credit ratings, while the guidelines we use for mapping long- and short-term ratings are presented in Annex 2.

2. SUMMARY OF OUR ANALYTICAL APPROACH

Overview and Framework

CI Ratings assigns two main types of issuer credit ratings (ICR) to corporates: long-term international ICRs (LT ICRs) and short-term international ICRs (ST ICRs). These ICRs encapsulate CI's opinion of the overall creditworthiness of rated corporates and indicate the general likelihood of default on senior financial obligations denominated either in foreign currency (foreign currency issuer ratings), or in the currency of the jurisdiction in which the firm is domiciled (local currency issuer ratings).

When we rate a company, we consider both its standalone credit profile and the likelihood of it receiving extraordinary external support from owners or, less commonly, the government should such assistance be required in order to avoid default. (Ongoing or 'ordinary' support from owners, for example to facilitate business growth or meet changes in regulatory requirements, is factored into our assessment of the standalone credit profile.)

Where the company is a member of a corporate group, we apply the criteria contained in Parent-Subsidiary Considerations in the Determination of Corporate and NBFI Credit Ratings (issue date: April 2022) to determine the likelihood of extraordinary support. We also use this criteria to assess any potential rating constraints associated with the company's membership of a corporate group and to determine the distance – in terms of notches on the rating scale – between the ICRs of a parent and its subsidiaries.

When we rate a company, we also take into account the potential impact on its ICRs of sovereign risk factors, including the risk of transfer and convertibility restrictions and other state-imposed controls that could impede the entity's ability to meet its financial obligations in a timely manner.

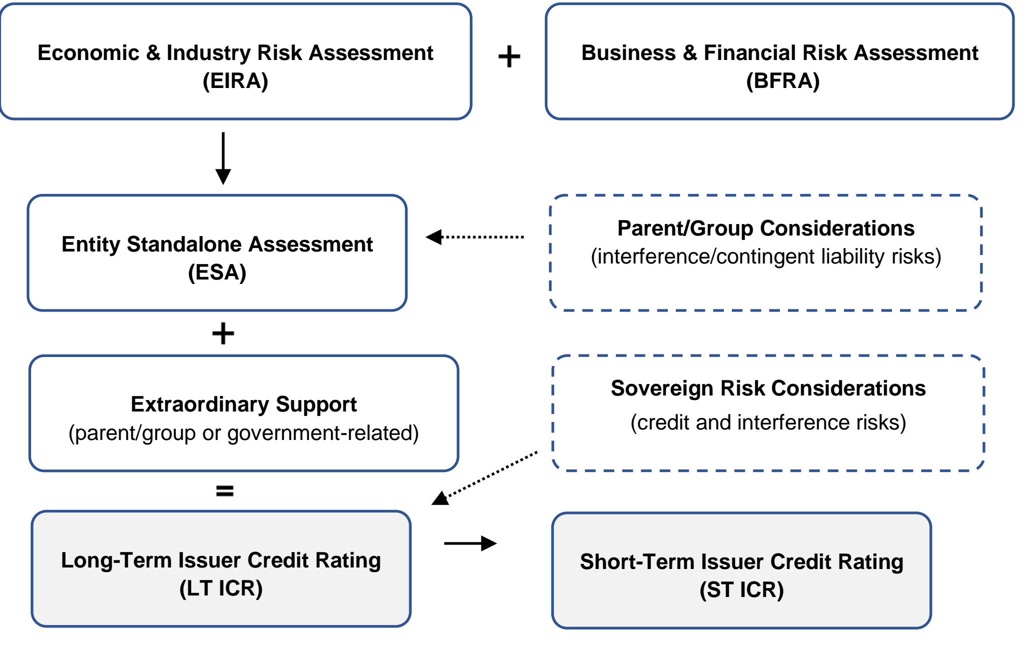
Determining International Issuer Credit Ratings

The framework for determining international ICRs for corporates is summarised in Box 1, while the methodological process we follow is outlined in the following sections.

Our evaluation of a company's fundamental credit strength is based on an assessment of four analytical pillars:

1. Economic Environment and Industry Risk
2. Business Risk
3. Financial Risk
4. Governance and Management

BOX 1: CORPORATE ISSUER RATING FRAMEWORK (SIMPLIFIED)



Economic and Industry Risk Assessment

Economic and financial conditions, as well as institutional settings, clearly matter for corporate credit quality. In addition, each industry has its own characteristics which give rise to specific risks that are company independent. Where an industry falls on this sectoral risk spectrum has a direct bearing on the credit strength of companies operating in that industry.

Our Economic and Industry Risk Assessment (EIRA) therefore takes into account (i) the risks to the repayment ability of a company arising from economic, financial, institutional, and political factors in the country, or countries, in which it operates, and (ii) the risks associated with the structure, characteristics, and dynamics of the principal industry or sectors in which it is active.

Our assessment of the economic environment utilises the Operating Environment Risk Anchor (OPERA) we establish for national banking systems as this captures those factors that are important for economic growth and broader macroeconomic and financial stability, including the strength of a country's legal and financial infrastructure.

We use OPERA as a baseline from which we notch up or down, depending on an industry's relative risk profile, to establish EIRA.

Business and Financial Risk Assessment

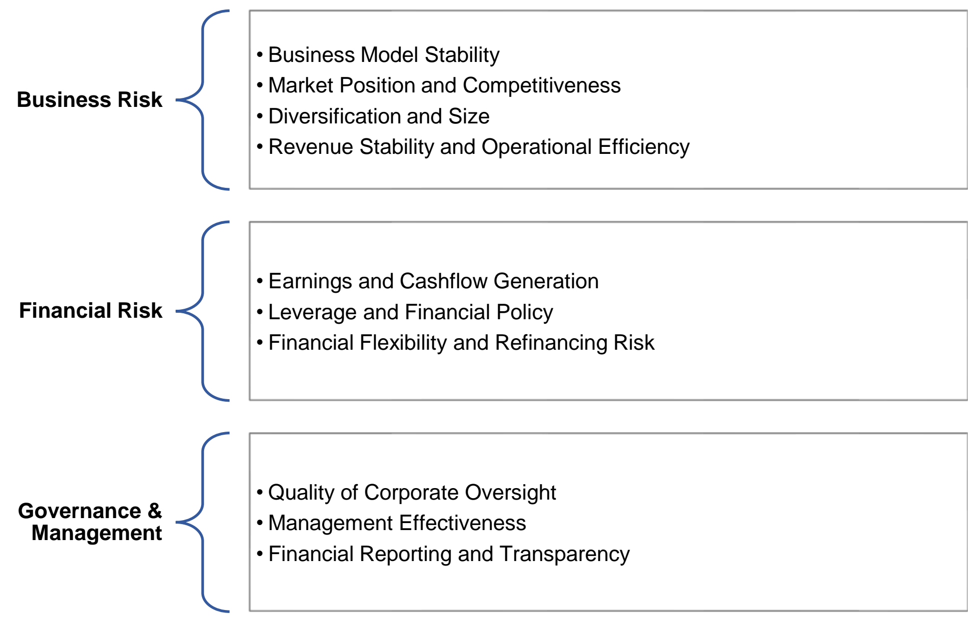
Once we have established EIRA, we then evaluate the intrinsic financial, operational and business risk profile of the rated company, which we summarise in the Business and Financial Risk Assessment (BFRA). In essence, the BFRA captures those financial and company-specific non-financial factors (i.e. excluding the operating environment and certain sovereign risk factors) that have a significant bearing on the likelihood of a company becoming non-viable on a standalone basis and requiring extraordinary support in order to ensure full and timely debt service. The BFRA is largely determined by Analytical Pillars 2 to 4.

Each of these three pillars consists of a number of key rating factors. A company's relative strength in terms of each key rating factor is evaluated and the results of our analysis are combined to form an overall assessment of each pillar. The assessments of all three pillars are then combined to arrive at an opinion of the BFRA. The relative weights of the key rating factors and analytical pillars are

decided by CI's rating committee and may vary according to company-specific circumstances.

The three pillars and associated key rating factors are shown in Box 2.

BOX 2: ANALYTICAL PILLARS OF BFRA



The principal characteristics of each key rating factor by assessment category ('very strong', 'strong' etc) are tabulated in each of the report sections below. These 'key characteristics' tables are offered for guidance. They do not constitute a checklist and are not exhaustive. Some, but not necessarily all, of the characteristics of a particular assessment category may apply to the rated company, and there may be cases where the company is best described by attributes from a combination of assessment categories. It is ultimately for the rating committee to determine which category fits best.

Entity Standalone Assessment

We combine EIRA and BFRA using internal guidelines and taking into account the company's business and financial profile relative to industry peers, as well as any other relevant rating considerations, to derive an indicative standalone rating for the firm, which we call the Entity Standalone Assessment (ESA). To avoid any confusion with the ICR, the ESA is published in lowercase letters and does not have an outlook (it may, however, include the '+' or '-' modifiers).

Issuer Credit Ratings (ICRs)

We then establish a baseline for the LT ICR either by (i) mapping the company's ESA to the LT ICR scale and notching the rating up for extraordinary government-related support (if applicable) or, (ii) if group considerations are relevant, applying the criteria contained in Parent-Subsidiary Considerations in the Determination of Corporate and NBFI Credit Ratings. At the same time, we also take into account sovereign risk factors, including the risk of transfer and convertibility restrictions and other state-imposed controls that could impede the company's ability to meet its financial obligations in a timely manner.

The final LT ICR for the company will generally be set at the same level as the baseline for the issuer rating provided the latter is no higher than the sovereign rating. The company's long-term foreign and local currency ratings would also be equalised (if both are assigned) unless there are convincing reasons for judging default risk to be materially lower in one currency type compared to the other. However, where the baseline issuer rating is higher than the sovereign rating, we would apply our criteria for rating above the sovereign (see section 5) to determine whether the company's ratings

could be higher than the sovereign, or whether they should be constrained by the appropriate sovereign rating.

ST ICRs are mapped from LT ICRs using the guidelines shown in Annex 2.

Rating Scale and Definitions

The scale for ICRs and the associated rating definitions are provided in Annex 1. Outlooks are also assigned to LT ICRs to indicate the likely direction of a change in the ratings over the next 12 months. A Positive (Negative) outlook signals a better than even chance that the rating will be raised (lowered) within a year. A Stable outlook indicates that the rating is unlikely to change in the next 12 months.

National Ratings

In some markets CI may also assign long- and short-term issuer (and issue) credit ratings on a national scale. Unlike international ICRs, national ratings are not comparable across countries and refer instead to the creditworthiness (usually in terms of local currency) of the issuer or issue relative to all other issuers or issues in the same country.

The main purpose of national ratings is to allow greater differentiation among issuers and issues in countries whose sovereign credit ratings are some way below ‘AAA’ on CI’s international ratings scale. In this way, CI’s national ratings aim to provide capital market investors with clear credit distinctions between issuers and issues that may not be possible under internationally comparable rating scales.

3. ENTITY STANDALONE ASSESSMENT: ANALYTICAL PILLARS

In this section we explain the rationale for each of the four analytical pillars of the ESA and outline the criteria used to assess the underlying key rating factors. The analytical pillars are:

1. Economic Environment and Industry Risk
2. Business Risk
3. Financial Risk
4. Governance and Management

ANALYTICAL PILLAR 1

ECONOMIC ENVIRONMENT AND INDUSTRY RISK

This Analytical Pillar focuses on the risks to the repayment ability of a company arising from economic, financial, institutional, and political factors in the country, or countries, in which it operates, as well as risks associated with the structure, characteristics and dynamics of the principal industry or sectors in which it is active.

We divide our analysis into two key rating factors:

- Economic Environment
- Industry Risk

KEY RATING FACTOR 1

Economic Environment

Our assessment of the economic environment utilises the Operating Environment Risk Anchor (OPERA) we establish for national banking systems as this captures those factors that are important for economic growth and broader macroeconomic and financial stability, including the strength of a country's legal and financial infrastructure.

OPERAs are based on an analysis of five (broad) key rating factors, which are further divided into a number of sub-factors. They are:

1. Macroeconomic Strength – which is based on the economic strength, external strength, and macro-financial imbalances components of our Sovereign Rating Methodology.

Economic strength refers to the capacity of an economy to generate robust output growth, increase per capita income, and be resilient to adverse shocks, or at least able to recover quickly after they occur and considers factors such as economic growth performance, economic diversification, competitiveness, and inflation.

External strength refers to a country's ability to generate the foreign exchange needed to meet its current and future external debt service obligations in full and takes into account current account performance and financing, external debt capacity, and international liquidity.

Macro-financial imbalances refer to significant and sustained deviations in macro-financial variables (such as aggregate credit growth, corporate and private sector indebtedness, and asset prices) from historical trends or norms. Such imbalances pose a material risk to the economy because they are often unsustainable and may ultimately result in a sharp slowdown in economic activity and potentially severe financial sector stress or a currency crisis.

2. Monetary Flexibility and Capital Market Development – which draws on the monetary policy flexibility and capital market development components of our Sovereign Rating Methodology.

Monetary policy flexibility considers the ability of the authorities to use policy instruments to influence

domestic demand, manage inflation and ensure the sustainability of the country's exchange rate regime. Monetary policy flexibility also captures the capacity of the monetary authorities to adjust the policy stance to counteract economic shocks and to provide temporary liquidity support to the financial system in times of severe disruption.

Capital market development serves as proxy for the level of development of the financial system and is also indicative of the range of funding options and interest rate and liquidity risk management tools available to corporates and financial institutions. The development of local capital markets is also important for the conduct of monetary policy and may help to bolster financial stability.

3. Banking Industry Structure and Performance – which considers the strengths and vulnerabilities associated with the organisation and operation of the banking sector. This includes an examination of the financial profile of the banking sector drawing on aggregated micro-prudential indicators of financial soundness, specifically ratios measuring asset quality, profitability, liquidity, and capital adequacy.

In the context of our corporate ratings architecture, we retain banking sector considerations as part of OPERA since (a) banking sector strength serves as a proxy for the overall health of the financial system and (b) corporates in emerging markets, as well as SMEs globally, tend to rely on domestic banks for funding and financing working capital (albeit to differing degrees).

4. Regulatory Environment and Institutional Frameworks – which focuses on the effectiveness of bank regulation and supervision and the quality of the legal and financial infrastructure more broadly.

Regulation and supervision considers the extent to which regulatory and supervisory frameworks support a sound and healthy banking sector, while legal and financial infrastructure captures a number of important institutional factors that impact operations and risk management. In particular, a clear and effective legal framework is especially relevant to issuers of debt for the simple reason that financial instruments are legal contracts. The risk profile of financial and non-financial corporates is therefore strongly affected by the certainty of legal rights within a country and the predictability and speed of their fair and impartial enforcement.

Other elements of a country's legal infrastructure that are of high importance to corporates and financial institutions include those governing creditor rights, ownership, contract enforcement, accounting, auditing, and disclosure. We consider, in particular, the strength of creditor rights, including the effectiveness and efficiency of: (a) bankruptcy or insolvency procedures for corporations and financial firms; and (b) the legal framework to enforce collateral and property.

5. Political and Policy Risk – our assessment of this key factor is drawn from our Sovereign Rating Methodology and primarily refers to policy decisions and political events – domestic and external – that could materially affect sovereign creditworthiness. It also takes into account the durability of the social and political fabric of a country and the existence of any underlying vulnerabilities that could potentially engender political instability and undermine the workings of government.

The assessment scale for OPERA is shown below. In most cases we would expect our economic environment assessment to be the same as OPERA. We may however deviate from this practice – usually by no more than one notch – in cases where we believe the economic environment for a particular industry is better or worse than the level implied by OPERA as one or more of the five drivers of OPERA matters significantly more (or less) for non-financial corporates compared to banks.

OPERA Assessment Scale	
Very Strong	a+
	a
	a-
Strong	bbb+
	bbb
	bbb-
Moderate	bb+
	bb
	bb-
Weak	b+
	b
	b-
Very Weak	c+
	c
	c-

KEY RATING FACTOR 2

Industry Risk

Industry risk considers the relative strengths, risks and vulnerabilities associated with a specific sector (or sub-sector) and the resulting influence on a company's overall credit risk profile. In particular, we examine the extent to which structural and secular industry factors affect the stability, competitiveness, and growth prospects of individual entities, as well as the cyclicality of the sector in terms of business volumes, revenues, and profitability.

The main factors we view as important drivers of industry risk include the following:

- Revenue and profit cyclicality and variability
- Industry structure and competition
- Industry growth prospects
- Barriers to entry
- Secular and structural industry risk

1. Revenue and profit cyclicality and variability

Industries that are highly cyclical or volatile in terms of demand and earnings are generally riskier than sectors that benefit from predictable and relatively stable volumes, prices, and profitability.

Industries that are comparatively cyclical or prone to volatility tend to share one or more of the following characteristics:

- Principal activity is commodity based or linked, with demand fluctuating with economic activity and prices subject to significant volatility (reflecting supply conditions, as well as demand).
- Fixed costs are high relative to total costs, so EBITDA margins tend to fall by much more than revenues during economic downturns as costs cannot be adjusted quickly enough.
- Reliant on highly discretionary (non-essential) spending by consumers, business, or government.
- Distinct product life cycles (which may compound economic cyclicality).
- Prone to boom-bust, under capacity-overcapacity cycles.

We also consider here sectors that are particularly vulnerable to event risk and non-economic shocks (including geopolitical risk factors, terrorism, natural disasters, other environmental risks, and pandemics).

Our initial cyclicality classification for some, but not all, sectors is provided below.

Cyclicality Assessment	Industry/Sub-Sector
High	Mining; Homebuilding and Property Development; Auto Manufacturing; Shipping
Moderately High	Engineering & Construction; Building Materials; Oil & Gas (upstream and downstream); Hotels; Restaurants
Moderate	Business Services; Logistics; Food Retail; Capital Goods; Real Estate Investment
Low	Regulated Utilities; Pharmaceuticals; Healthcare; Telecommunications

Our focus in this sub-factor is on general risk at the overall industry (or sub-sector) level. However, not all companies within an industry or sub-sector will be affected in the same way by cyclical changes in the economy. Credit strengths that may contribute to a rated company being less affected by cyclicality relative to the industry (for example a high degree of product and geographical diversification) are captured in the BFRA.

2. Industry structure and competition

This sub-factor focuses on certain credit-relevant structural features of an industry, particularly the degree of market concentration, the level and nature of competition, and the risks associated with the supplier and customer bases.

Companies operating in concentrated industries in terms of the number of rivals are often able to achieve greater market power and scale, and are typically subject to less price competition than those operating in more diffuse, competitive environments. In sectors characterised by a high degree of fragmentation even the largest companies may have relatively modest market shares. Fragmentation may also make the industry landscape less certain by increasing the likelihood of mergers and acquisitions as larger companies seek to overcome the limited opportunities for organic growth.

The level and nature of competition within an industry is a related consideration. A high level of competition can be a source of risk, especially if associated with aggressive or predatory commercial practices, and high or excessive risk taking. Conversely, limited competition due to market concentration may help to support an industry's overall risk profile. However, this might not always be the case, for example if the lack of competition contributes to inefficiency, limited innovation, and secular decline.

The basis for competition within an industry is a critical factor in this context. Sectors where competition is based primarily on price (and switching costs are low) tend to exhibit greater overall volatility than sectors where product quality matters most to customers.

Structural risk associated with the supplier and customer bases is also a key consideration. Industries reliant on a small number of critical suppliers tend to have less bargaining power and pricing flexibility compared to industries that are able to obtain key inputs from a variety of sources. Similarly, pricing power may be more constrained when the customer base is concentrated or when final demand for products is highly price sensitive.

3. Industry growth prospects

Strong medium- to long-term growth prospects for demand and revenues is beneficial for an industry's overall risk profile and may help to partially mitigate risks associated with the degree of

cyclicality. Most favourable is when the upward trend is expected to be sustained over the longer term, driven by fundamental factors (not simply cyclical forces) and contributing to higher industry profitability.

Growth prospects are often subject to greater risk (all other things being equal) at the extremes of the life-cycle spectrum – i.e. when a sector is in its infancy and growing rapidly, but with long-term commercial viability not yet assured, and in the sunset phase, when profitability tends to be declining.

When assessing medium- to long-term growth prospects we consider potential opportunities or threats arising from a broad range of factors. These include:

- The price and availability of key production inputs (raw materials, components etc), and the ability to pass-on price increases without harming growth.
- Changes in the cost, quality and supply of labour and capital.
- Government policies (including taxation) and sector-relevant regulations.
- Technological developments, including the impact on costs and potential for competitiveness challenges from other or new sectors.
- Product substitution risk.
- Customer demand and the strength of underlying drivers of demand.
- Maturity of the industry (particularly the implications for organic sales growth).

4. Barriers to Entry

Strong barriers to new entry typically afford incumbents with a degree of market protection and may serve to restrict competition overall, thereby supporting pricing power. By contrast, the absence of any obstacles to entry may fuel market fragmentation, making it more challenging for a company to develop its brand, build its franchise and secure a robust market position.

Sources of strong barriers to entry may include:

- National or local government policies – ranging from the creation of monopolistic or oligopolistic market structures (typically for state-owned companies or natural monopolies) to stringent regulatory or licensing requirements, as well as trade restrictions (including tariffs and import quotas) designed to limit competition and preserve a particular sector for local firms.
- Technology and intellectual property – with factors such as superior know-how, costly-to-develop R&D capabilities, and patent protection reducing the field of potential entrants (at least for a period of time).
- Strong product differentiation and brand loyalty – which give rise to a degree of market power and competitive advantage for incumbents because potential rivals need to invest heavily in product development and marketing to overcome the accumulated brand loyalty of existing products.
- High capital requirements – as capital-intensive sectors are typically costly to enter, and new players may find it difficult to obtain sufficient funding for the required upfront investment.
- Scale economies – which may limit the number of companies that are commercially viable and able to operate competitively in a market of a given size.
- Market dominance by vertically integrated companies – which makes it challenging for non-integrated potential entrants to compete successfully.

5. Secular and structural industry risk

Shifts in customer preferences, technological advances, regulatory changes, or the emergence of a new, highly innovative competitor can have a profound impact on an industry's structure and the financial strength of incumbents. We include here transition risks associated with the process of adjustment towards lower-carbon and more sustainable economies.

Such developments are not always easy to foresee, but can pose significant rating challenges when they occur, for example by rapidly making existing products obsolete and disrupting traditional distribution channels.

More broadly, companies in sectors that are highly vulnerable to substitution risk might, in the absence of timely changes to the business model, eventually face the challenge of structurally declining demand and downward pressure on prices and operating margins.

Combining the two key rating factors to establish EIRA

Our overall economic and industry risk assessment (EIRA) is derived by combining the industry risk assessment with the economic environment assessment (based on OPERA), as shown below.

Industry Risk		Notching from OPERA
High	⇨	Minus 3 notches
Moderately High	⇨	Minus 2 notches
Moderate	⇨	Minus 1 notch
Low	⇨	No adjustment or Plus 1 notch

For example, if industry risk is ‘moderately high’ and OPERA is ‘bbb’, EIRA will be either ‘bb+’ or ‘bb’ (depending on analytical judgement).

Due to the limited number of notches on the assessment scale used for EIRA and OPERA, downward notching may be reduced (or even eliminated) when OPERA is below ‘bbb-’. This also reflects the fact that the operating environment risk differential between banks and non-banks tends to be much narrower, or non-existent, when the anchor rating is low, since the much higher level of economic and financial risk is likely to be material for all sectors.

We may also deviate from the above notching guidelines in the event of industry-specific stress (i.e. by setting EIRA more than 3 notches below OPERA), or should a specific industry demonstrate significant resilience in the event of banking sector stress (e.g. by raising EIRA above OPERA by one or more notches regardless of the industry risk classification).

The application of this criteria results in an EIRA for the country in which a company operates. For corporates with substantial business exposure to more than one country, we may adjust the ‘home’ EIRA to reflect operating environment risk in other countries. The extent of any notch adjustments (positive or negative) will depend on the relative size of foreign exposures and the difference in strength (or risk) between the home and foreign markets.

Similarly, if a company is active in more than one sector, we may use a blended industry risk assessment to better reflect its industry risk exposure.

ANALYTICAL PILLAR 2

BUSINESS RISK

Business risk refers to the risks (and vulnerabilities) inherent in a company's business model and operations, independently of the way it is financed.

To assess relative business risk, we consider how a company makes its money, the stability and defensibility of its market position, its capacity to generate stable revenues, and its growth prospects.

The robustness and resilience of a company's business model typically reflects its underlying competitiveness and operational efficiency, the strength of its brand and reputation, and the diversification of its business activities.

Companies often have to adjust their business models over time to remain relevant in competitive markets. Consequently, management's ability to develop and execute appropriate strategic plans is also critical for ensuring a company is able to adapt in order to take account of changing client expectations, new technologies, and other developments affecting the wider industry.

We divide our assessment of Business Risk into four key rating factors:

- Business Model Stability
- Market Position and Competitiveness
- Diversification and Size
- Revenue Stability and Operational Efficiency

Characteristics common to higher rated companies include: a leading market position; reliance on relatively stable revenue sources; a diversified business mix; comparatively strong business performance through the cycle; strong strategic planning and execution; and good growth prospects. These characteristics are often, but not always, associated with companies whose size and scale of operations is relatively large compared to industry peers.

Ratings are more likely to be constrained when a company has a short, untested operating history; has a weak franchise or market share; is reliant on unstable business activities (typically reflected in volatile earnings); exhibits high business concentrations (particularly in terms of product or business line, client base, and geography); or is expected to struggle to adapt to competitiveness challenges or changes in the operating environment (including secular changes in consumer behaviour and regulatory changes).

Complexity of the business model and/or organisational structure may also be a constraining factor in cases where it significantly stretches management's capacity to identify and address risks and emerging challenges, or greatly hampers operational flexibility and the ability to adapt to changing circumstances.

KEY RATING FACTOR 1

Business Model Stability

Business model analysis focuses on how a company generates revenues, as well as the risks and vulnerabilities arising from what it does and how it does it.

We consider how a company's business model has evolved over time (with the emphasis on stability and resilience), the seriousness of any threats to the way the company currently operates, and the appropriateness of any strategic intentions to modify or change the business model in order to ensure sustainability or cope with emerging challenges.

We pay particular attention to the strengths and weaknesses of the business model relative to peers and competitors, including new entrants to the industry or sector with different business models. Common sectoral or industry specific risks are underweighted in our assessment of this key rating factor since they are also captured to some extent in our assessment of industry risk.

Challenges to the business model can emanate from a variety of sources including secular shifts in customer/client preferences, changes in technology, changes in regulations, or the arrival of new competitors with innovative ways of delivering value. Low or declining business model stability may be reflected in large shifts in balance sheet composition, high earnings volatility, increased reliance on non-operating sources of revenue for income, and generally limited visibility of future revenues.

The risk to business model stability tends to be higher when product or services offerings are narrow in scope, the customer base is highly concentrated, or production and operational flexibility is very limited.

We also consider whether prospects for business growth are broadly favourable and sustainable, or whether the strategy for growth is overly aggressive (e.g. relying on major acquisitions in non-core areas or expansion into unproven markets), or based on overly optimistic assumptions.

The scalability of the business model in terms of the ability to greatly expand the company in a reasonably short period of time (with revenues growing much faster than costs and without encountering internal structural constraints) may also be an important consideration for some companies.

Key considerations when assessing Business Model Stability include the following:

- The stability of the business model over time and through economic cycles or, conversely, whether the company has a track record of significantly altering the business mix or shifting strategic focus and, if so, with what degree of success.
- Whether the company's principal business activities are highly volatile, particularly in comparison with sector norms and peers.
- The likely efficacy of, and execution risks associated with, strategies to develop, modify or change the business model (or business mix) in order to enhance the company's value proposition, competitiveness, and long-term profitability.
- Whether planned acquisitions are likely to improve business model stability or be a source of new challenges.
- Potential challenges to the current business model arising from expected changes in laws, regulations, or technology, including changes driven by environmental, social and governance (ESG) considerations, such as climate change and the associated transition risks.
- Whether planned changes to the size, scale or scope of the business are prudent, or whether expansion plans and growth expectations are unrealistic and a potential source of vulnerability.
- The complexity of the business model and organisational structure, and whether this significantly hinders the ability of management to identify, evaluate and address risks and challenges, or whether it weakens the company's resilience and ability to adapt quickly.

Business Model Stability, Key Characteristics

Very High

Business model is well-established, very stable, and highly resilient to operating environment adversities in absolute terms and relative to peers.

Company has a very strong track record of adapting and enhancing the business model in a timely manner in order to meet industry challenges, business threats, or secular changes in client preferences and technology and is not expected to be significantly affected by any foreseeable medium- to long-term challenges.

Growth potential and prospects across all key markets and segments is very good.

High

Business model is well-established, stable, and fairly resilient to operating environment adversities.

Company has a strong track record of modifying the business model when necessary but may face significant (though likely manageable) medium- to long-term challenges.

Growth potential and prospects in most key markets and segments is good.

Adequate

Reasonably stable business model but may be more affected by operating environment adversities compared to higher categories and peers.

Company has a moderate track record of modifying the business model when necessary and may face significant and likely constraining medium- to long-term challenges.

Average growth potential and growth prospects in key markets and segments.

Moderate

Business model stability is moderate, possibly due to the company's stage of development and still evolving business mix or shift towards potentially higher risk and more volatile business lines or geographies.

Company may have a mixed (or untested) track record of modifying the business model when necessary and/or may face significant short- to medium-term challenges, which it may not be sufficiently well-positioned to meet.

Organisational complexity may be significant and some of the main legal/group entities may be somewhat opaque. Related operational risks may be significant.

Moderate growth potential and prospects in key markets and segments, albeit somewhat conditional on favourable business conditions.

Low

Limited business model stability, possibly reflected in frequent shifts in strategic focus and risk appetite.

Business mix may be unstable/evolving rapidly or exposure to high-risk activities may be high.

Company may have a poor track record of modifying the business model when necessary and/or may face major short- to medium-term challenges, which it may be unable to meet.

Organisational complexity and opacity may be high and the business raison d'être for some legal/group entities unclear.

Very limited growth potential and prospects due to inherent shortcomings/constraints.

KEY RATING FACTOR 2

Market Position and Competitiveness

The strength and durability of a company's market position provides a good indication of the sustainability and predictability of its future earnings and cashflow generating capacity. A company's market position is underpinned by those factors that make it competitive, differentiate it from its rivals, protect it from new market entrants, and which are difficult or costly for others to replicate.

Strong market positions are often, but not necessarily, associated with competitive advantages such as economies of scale, cost efficiency, pricing power, strong product innovation and technological capabilities, stable customer/client relationships, and higher operational barriers to entry for competitors.

In assessing market position and competitiveness we consider:

- The strength of the company's market position (as evidenced by, for example, indicators of market share) as well as the company's actual and expected business performance through the economic cycle.
- The strength of the company's brand, reputation, and pricing power.
- The loyalty or 'stickiness' of its customer/client base (supported by factors such as long-standing client relationships, long-term contracts, and high customer switching costs).
- Whether the company's market position benefits from formal barriers to entry (such as compliance with regulations, licensing/certification requirements or exclusive dealing arrangements), or from obstacles to market entry associated with economic advantages such as economies of scale, network effects, entry costs, strong distribution channels, and technology.
- Whether recent changes in market share reflect aggressive business practices or excessive risk-taking by the company (or rivals) and whether such changes are likely to result in a durable improvement (or worsening) in profitability.
- The company's vulnerability to competition as indicated, for example, by the quality or substitutability of products and services (often reflected in price-sensitive key business lines and limited product differentiation).
- Whether new market entrants pose a significant challenge to the company's market position.
- The company's plans to strengthen its market position and competitiveness, including the adequacy of capex given future production or diversification plans and the age and efficiency of existing infrastructure, production processes, and technology.
- Potential threats to the company's market position and/or reputation arising from its exposure to regulatory/compliance risk, licence renewal risk, and legal risk.
- Whether the company's market position benefits from it being a member of a larger, well-established and successful group or, conversely, whether the company's market position might be adversely affected by weaknesses, failings, or brand erosion at the parent level.

Market Position and Franchise Strength, Key Characteristics

Very Strong

Leading and sustainable market position in all or most key business lines and/or geographies, with no discernible weaknesses.

Strong competitive advantages internationally (e.g. in terms of economies of scale, distribution channels, product innovation, product differentiation, pricing power and client relationships). Likely benefits from very high formal or informal barriers to entry.

Expected to maintain or increase its market position in the medium to long term, supported by ongoing investment and innovation in product/service development, quality, and delivery.

Strong

Sound and sustainable market positions in most key business lines and/or key geographies. May be reliant on a leading position in a single large economy.

Sound competitive advantages with limited weaknesses. Likely benefits from high formal or informal barriers to entry.

Adequate

Adequate (mid-tier) brand/franchise with moderately good or average market positions in key business lines and/or key geographies. Alternatively, may have a strong market position in a single small- or medium-sized economy, or a leading and defendable position in a niche sector or activity.

Adequate competitiveness with some weaknesses. Barriers to entry likely provide moderate protection against new entrants.

Moderate

Moderate (below average) market positions in key business lines and/or key geographies. Operating history may be limited.

Moderate competitiveness with possibly significant constraints (e.g. weak pricing power/price-sensitive market position, limited brand presence, limited economies of scale, scope etc, customer base that exhibits significant turnover).

Weak

Weak market positions and very limited franchise strength across business lines and geographies. Operating history may be very limited.

No significant competitive advantages, very limited brand presence, and possibly serious weaknesses in a number of key areas.

Market position is not expected to change in the medium to long term due to inherent shortcomings/constraints and substantial competitiveness challenges.

KEY RATING FACTOR 3

Diversification and Size

The breadth and diversification of a company's products and services, as well as its customer base, contributes to the growth, reliability and diversity of earnings. Moreover, well-diversified companies with low concentrations and limited correlations in terms of business segment, product, geography, and customer are generally better positioned to withstand cyclical swings and extended periods of economic stress, as well as adapt to changes in customer preferences and in the broader competitive or regulatory environment.

A diversified product range will be reflected in a mix of revenue sources by business line. In general, the more varied that revenue, the less vulnerable a company will be to a downturn or loss of custom in any single business line. The extent of any correlations between products and/or business lines is also relevant as revenues of closely correlated, but formally different, products may be hit equally hard in the event of an economic downturn.

Geographic diversification can also minimise business risk. The internationalisation of a company's asset base can have positive implications, not only in terms of minimising production risk, thereby allowing flexibility in the transfer of production lines, but can also help in some cases, mitigate against sovereign risk. For exporters, the geographical distribution of the customer base provides distinct advantages in terms of the ability to diversify revenue streams, generate hard currencies and to smooth out the potentially negative impact of local or regional economic downturns.

Diversification is not always a positive ratings factor. A diverse product mix, for example, also brings challenges and risks to management, especially if that mix bridges across industry lines and increases the overall risk profile or lowers overall competitiveness. Similarly, extensive geographical reach can place heavy demands on a company's resources and stretch management's ability to oversee operations and direct strategy.

Size is a related rating consideration and is often associated with diversification. Large and diversified companies tend to be better able to weather downturns in the business cycle and are generally less vulnerable to single adverse events. Relatively large companies also tend to benefit from economies of scale and scope and often possess greater operational flexibility, which makes it easier to adapt to changing business conditions and shifts in demand, as well as to exploit market opportunities.

Small companies tend to be less diversified in terms of products, customers and geography, and the resulting concentration risk is often a significant rating constraint. (They also tend to have undiversified funding bases and limited access to funding markets.)

However, in CI's view, size does not guarantee sustainable economic success as the complexity of larger companies requires more sophisticated managerial and risk-management capabilities – the cost of which may partially offset some of the benefits of scale and scope.

Moreover, SMEs may thrive as niche players with defendable and profitable business positions. SMEs may also exhibit strong dominance in their home market due, for example, to the market's preference for domestically produced goods or local brands, as well as the presence of a national distribution network, which may be difficult for foreign entrants to replicate. Such characteristics may partially, but not necessarily fully, offset some of the risks and vulnerabilities associated with small size, particularly if reflected in relatively stable cashflows and strong operating profitability on a sustained basis.

Key considerations include:

- The degree of revenue concentration risk posed by high reliance on a single product/business line or geography, or by having a small number of key customers/clients.
- Whether the company is highly exposed to business disruption risk due to a high reliance on a small number of key suppliers.

- The expected riskiness of new or recent diversification efforts (e.g. launching new products with no obvious synergies, or aggressively entering new markets where the company has limited expertise).
- Whether the product range is narrow or highly correlated and, if so, whether the attendant risks are mitigated to a significant extent by an associated revenue stream that has proven to be reasonably stable during economic downturns.
- Size and scale of operations relative to peers (typically gauged by annual revenues) and whether this confers any business advantages, for example in terms of economies of scale, purchasing power, product and geographical diversity, and access to capital at more attractive rates.

Business Diversification and Size, Key Characteristics

Very High

Very high level of diversification and very low levels of concentrations and correlations across business segments, customers, and geographies, including by industry standards and relative to peers. Supplier risk is very low.

The size and scale of business operations are very large by industry standards globally and confer substantial benefits.

High

High business diversification and generally low levels of concentrations and correlations relative to most peers.

Geographical diversification may be moderate but the markets the company operates in are relatively large and a source of stable business volumes. Supplier risk is low.

The size and scale of business operations are large by industry standards globally and confer significant benefits.

Adequate

Adequate diversification with material, but manageable, levels of concentrations and correlations that are in line with the average for peers.

Alternatively, business or geographical concentrations may be significant but associated risks are partly mitigated by relatively stable and consistent client demand. Supplier risk is manageable (e.g. because suppliers can be switched at reasonable cost).

The size and scale of business operations is in line with global industry peers. Alternatively, size and scale may be above local or regional competitors but below global peers.

Moderate

Significant business concentrations and less diversified than average for peers.

May be reliant on a few key business lines, for which demand is variable, and have little or no geographical diversification.

Business volumes and revenue streams may be reliant on a few key clients. Supplier risk may be relatively high. It may be dependent on a small number of critical suppliers that it could not replace easily or without incurring high costs.

The size and scale of business operations may be moderate, for example in line with local and regional standards but below global peers.

Low

High business concentrations and substantially less diversified than most peers.

May be very reliant on a very small number of possibly volatile business lines.

Business volumes and revenue streams may be highly dependent on a few large customers.

Supplier risk may be very high.

The size and scale of business operations may be relatively small even compared to local and regional peers.

KEY RATING FACTOR 4

Revenue Stability and Operational Efficiency

Corporate business risk is reflected in the relative strength, stability and predictability of revenues and net operating income. It is therefore influenced by the variability of sales volumes, prices, and costs. Put differently, a company's sales and operating performance over time and through the cycle provides an indication of its relative success in deriving the benefits of its business model, market position, competitiveness, product mix and customer base.

Revenue volatility is typically associated with greater vulnerability to sudden changes in economic and financial conditions and other business adversities, as well as event risk. It is also much harder to assess future business and financial prospects when a significant proportion of revenue is derived from volatile or non-recurring sources. Indeed, companies with revenues that fluctuate markedly between economic upturns and downturns often have less reliable cash flows compared to companies with more consistent, sustained revenues throughout cycles. High revenue volatility or cyclicality may also make it harder for a company to access external financing during downturns, or at least not on particularly favourable terms.

Operational efficiency and the flexibility of the company's cost base are important (and potentially mitigating) considerations in this context since nimble companies are generally better able to adjust quickly to changes in demand, prices, or supply chain issues without hurting profit margins, product/service quality or the ability to innovate and grow.

We therefore analyse the relative size of the cost base, the balance between fixed and variable costs, and management's ability to reduce both types of cost in the short term.

Our assessment of a company under this key rating factor includes consideration of the following, including vis-à-vis competitors/peers:

- The degree of revenue volatility, including compared to industry peers.
- The sensitivity of revenues and operating income to downturns in the business cycle.
- Whether the business model underpins revenue stability (e.g. due to a high share of contractual or others types of recurring revenue, or high client retention rates) or whether revenues depend substantially on discretionary and less predictable spending by customers/clients.
- The company's ability to adjust the cost base (if necessary) to offset the impact of a decline in demand or revenue without significantly weakening margins, the quality of its core offerings, or its business franchise and without incurring significant social costs (e.g. associated with the treatment of workers).
- The company's ability to pass on increases in input prices without significantly weakening margins.
- Whether the company has a demonstrated track record of successfully implementing cost-management initiatives and improving operational efficiency.
- The reliability and flexibility of supply chains, including the likelihood of disruption/bottlenecks in response to swings in demand.
- Quality of productive assets in terms of those features that support efficiency and cost flexibility (e.g. physical condition, age, size, standard/maturity of production technologies).
- Capacity/asset utilisation, particularly whether current and expected rates are likely to confer cost advantages or weigh on long-term profitability (e.g. in the case of structural overcapacity).
- Comparative strength of working capital and inventory management.
- The company's track record of successfully integrating acquired businesses.

Revenue Stability and Operational Efficiency, Key Characteristics

Very High

Revenue stability is very high with low variability through economic cycles.

Revenue stability may be supported by a high share of recurring revenue (e.g. based on multi-years contracts, recurring sales, or high client retention rates) and/or good geographical and segmental diversification of customers and products/business lines.

Cost management and cost discipline are very strong. Cost base is very flexible.

Comparatively low cost-base supports industry leading profit margins during downswings in the business cycle.

High

Revenue stability is high with modest variability through economic cycles.

Revenue stability may be supported by a reasonably high share of recurring revenue and/or good geographical and segmental diversification of customers and products/business lines.

Cost management and cost discipline are strong. Cost base is flexible.

Comparatively low cost base supports higher-than-peer profit margins during downswings in the business cycle.

Adequate

Revenue stability is typical for the industry and somewhat variable through economic cycles.

Cost management, cost discipline, and cost flexibility are adequate and in line with peers.

The revenue mix and degree of operational efficiency enable the company to at least break-even during downswings in the business cycle.

Moderate

Revenues are more volatile compared to peers and fluctuate significantly through economic cycles.

Cost management, cost discipline, and cost flexibility are below industry norms. Production technology/asset base may be ageing faster than peers.

The revenue mix and comparatively weaker operational efficiency contribute to weaker profitability relative to peers and a greater vulnerability to economic downturns.

Low

Revenues volatility is very high for the sector.

The company may have a much higher cost base compared to peers and/or more limited cost flexibility. Production technology/asset base may be outdated versus peers.

Profitability is dependent on favourable business conditions; the sensitivity of profit margins to the economic cycle is high.

ANALYTICAL PILLAR 3

FINANCIAL RISK

Financial Risk focuses on the risks (and vulnerabilities) associated with the way a company funds its activities and structures its balance sheet. Central to this is an assessment of a company's ability to generate sufficient cash to meet its debt and debt-like obligations as they fall due.

We divide our assessment of Financial Risk into three key rating factors:

- Earnings and Cashflow Generation
- Leverage and Financial Policy
- Financial Flexibility and Refinancing Risk

KEY RATING FACTOR 1

Earnings and Cashflow Generation

Earnings are a key driver of a company's financial strength as they affect capital growth, the ability to withstand adverse events, and debt service capacity. Strong earnings performance and returns on capital enable a company to increase its equity capital internally through retained income and also generates confidence among shareholders and investors, in turn helping to secure continuous access to equity and debt markets. It is therefore essential for growing the business and remaining competitive over the long term. Strong earnings performance also provides a cushion to sustain profitability through economic downturns and, as the basis for cashflow, supports a company's ability to service its debt.

CI's analysis of earnings and cashflow generation is based on trends over time and future prospects, and is not overly influenced by the latest annual results. The strength of earnings in the short term can be obscured by a number of factors including tax strategies, asset valuation methods, extraordinary or non-recurring items, as well as accounting practices.

We focus on the quality of revenues and a company's ability to sustain favourable earnings and cashflow performance over time. Indeed, a company that has strong headline indicators of current profitability could be assessed more cautiously if there are concerns about its ability to maintain this performance and continue generating sufficient cashflows.

We emphasise cashflows measures of earnings since it is cashflow strength that provides the most reliable indicator of a company's ability to service debt and meet other cash obligations arising from business operations and capital investment without recourse to potentially large and recurring amounts of external (debt) funding.

We consider a variety of metrics, from narrow indicators of operating profitability to broader measures of cashflow generation, with each taking into account additional payment obligations beyond operating expenses (e.g. interest, then working capital investment, then capital expenditure) to enable a comprehensive assessment of a company's performance.

The main metrics we use to assess profitability and cashflow generation are as follows:

- **EBITDA Margin** (EBITDA to total revenue) – This indicates the share of a company's revenues that finds its way into operating profit (defined broadly as earnings before interest, taxes, depreciation, and amortisation) after operating and certain other expenses have been taken into account. EBITDA excludes the impact on earnings of past capital expenditure and other investing and financing activities, and is adjusted where possible for non-cash, non-recurring and one-off items to approximate cash earnings. Since it is essentially neutral to capital structure, capital intensity and the tax situation, the EBITDA margin provides a useful comparative gauge of fundamental cash-generation capacity of companies across a range of sectors. We may adjust the numerator of this metric by removing the impact of rental or lease expenditure for companies with significant lease or rental obligations (resulting in the EBITDAR margin).

- **EBIT Margin** (EBIT to total revenue) – This metric is similar to the above with the crucial difference being that depreciation and amortisation costs are subtracted from the numerator. The metric therefore provides some insight into a company's earnings strength after costs associated with maintaining the quality of the asset base (e.g. through maintenance and capacity expansion) have been factored in. We emphasise the EBIT margin over the EBITDA margin for companies in capital-intensive industries that have substantial amounts of depreciation and amortization and require continued capital investment to maintain their competitiveness.
- **FFO Margin** (FFO to total revenue) – Funds flow from operations (FFO) is derived by subtracting cash interest and taxes from EBITDA. It is a core measure of a company's ability to generate recurring cash flows above the level needed to cover operating expenses and cash payments for interest and taxes, but before considering capital expenditure and working capital. The FFO margin is an important cashflow-type profitability metric as it is not affected by the volatility of working capital. However, it is less useful for companies in working-capital-intensive sectors.
- **CFO Margin** (CFO to total revenue) – Cash flow from operations (CFO) captures the cash flow available from core operations for capital spending and debt repayment. CFO is derived by subtracting working capital movements from FFO. It therefore provides a way of differentiating between companies with similar FFO but possibly very different working capital needs and debt-servicing capacities.
- **FCF Margin** (FCF to total revenue) – Free cash flow (FCF) represents the cashflow remaining from core operations after capital expenditure is deducted from CFO. FCF is key for the analysis of debt-repayment capacity and financial flexibility since it measures the gap between operating cashflows and the sum of payments for operational requirements, capital expenditure and working capital needs. As such, it more closely captures the cash flow available for distribution to creditors compared to CFO and FFO. However, the inclusion of changes in working capital tend to result in FCF (and CFO) being a comparatively volatile metric.
- **Return on Capital** (ROC) – This measure provides a gauge of the return earned by a company on capital invested in operating assets. The ROC is derived by dividing EBIT by the sum of total equity, debt, and leases.
- **Cost-to-Income Ratio** (operating expenses to gross income) – This measure essentially compares the administrative and other overhead costs incurred in generating a company's gross income with the level of that income. As such it provides an indication of the efficiency of a company's use of resources and the extent to which earnings are absorbed by operating expenses. The lower the cost-to-income ratio, the greater the company's ability to cope with a decline in earnings without having to resort to drastic cost-cutting measures. Conversely, a high ratio implies less operating flexibility and could reflect excessive salaries and bonuses, as well as relative weaknesses in income generation.

In assessing profitability and cashflow generation, we consider outcomes in recent years and expectations for at least the intermediate term (1-3 years). We take account of cyclical movements in earnings and cashflows, as well as the characteristics of the industry the company operates in, the competitive environment, and pricing flexibility.

A company's performance is considered in the context of the industry or sector and relative to competitors since differences in market structure may mean, for example, that what is a strong margin for a manufacturer of heavy goods may be more modest for an asset-light, service-oriented company. We also take into account industry norms when considering the weight to place on variations in cashflow generation that are due to working capital and capital spending cycles.

The components of each metric are also analysed as headline numbers may provide a possibly misleading signal of relative strength. For instance, FCF may improve in the short term due to lower capital spending or working capital needs arising from, for example, declining business prospects, or competitiveness-harming underinvestment. Conversely, high capital expenditure could potentially translate into stronger future earnings and margins, but may drag down FCF in the short term. In such cases, broader repayment-related considerations such as access to external financing will have an important bearing on the rating impact (assuming the project is not highly risky or unlikely to yield an adequate return).

As profits can be boosted by short-term (transient) factors, we always examine sudden improvements in reported income by companies that do not have a track record of consistent and resilient earnings.

Likewise, we do not automatically assess earnings growth that outpaces the sector average as favourable and instead analyse the quality and durability of the drivers of that growth and the riskiness of any underlying business strategies.

More broadly, we typically consider whether current trends in key metrics are overly influenced (favourably or unfavourably) by cyclical developments, rather than any structural changes, and are therefore unlikely to be sustained.

We also assess whether structural earnings performance is likely to be significantly affected (positively or negatively) beyond the forecast horizon by company-specific developments (e.g. by M&A activity and divestitures, as well as enhancements on the product or cost side), or by expected changes in regulations.

As part of our analysis, we may also draw upon other indicators of earnings and profitability, including sector-specific metrics and general accrual or fair value-based measures. This includes consideration of the potential longer-term impact on cash flows of items not captured immediately in cash flow metrics, such as unrealised changes in the fair value of assets and liabilities.

Earnings and Cashflow Generation, Key Characteristics

Very Strong

Earnings and cashflow generation are very strong.

Company is able to sustain structurally very high operating profitability through the business cycle and generate very strong and stable cashflows even during downturns.

Key metrics are consistently very strong relative to peers and reflect underlying business strengths.

Strong

Earnings and cashflow generation are strong.

Company is able to sustain structurally high operating profitability through the business cycle and generate strong and reasonably stable cashflows even during downturns.

Key metrics are consistently strong relative to peers and reflect underlying business strengths.

Adequate

Earnings and cashflow generation are generally good, but somewhat variable. FCF is nevertheless comfortably positive through the cycle.

Key metrics are adequate and generally on par with peers.

Moderate

Earnings and cashflow generation are moderate, but relatively volatile for the industry. FCF is positive but may be low through the cycle (or slightly negative if the company operates in a capital-intensive sector).

Key metrics tend to be below the peer average.

Weak

Earnings and cashflow generation are generally weak and volatile, varying significantly with the business cycle.

EBITDA is low and FCF neutral or negative through the cycle, with performance well below industry norms. Company has some ability to bolster FCF during a downturn by reducing costs and/or working capital investment.

Very Weak

Earnings and cashflow generation are very weak or weak and deteriorating. Company incurs losses at the EBITDA level and negative FCF due to structural earnings weaknesses (which are not likely to be remedied by an improvement in the broader economic environment).

KEY RATING FACTOR 2

Leverage and Financial Policy

The focus of this key rating factor is on how a company finances its operations and funds its assets and the risks associated with the resulting liability structure, particularly the degree of indebtedness.

Borrowing may help a company to take advantage of investment opportunities and expand its asset base, thereby supporting future earnings growth. However, excessive leverage reduces financial flexibility and may be particularly problematic during times of stress as it typically increases the risk that the cash flow generated from a company's business operations or assets will be insufficient to cover the fixed servicing obligations associated with debt.

A company ultimately has to service its debt with cash. Consequently, indicators of cashflow adequacy are central to our assessment of leverage and debt capacity. We use a combination of payback ratios and interest coverage ratios – the former to gauge a company's cashflow strength (measured in a variety of ways) relative to its debt burden; the latter to assess the headroom to meet financing costs from operational cash earnings.

The principal ratios we use are described below.

- **Total debt to EBITDA** – This metric provides an indication of long-term solvency risk by measuring the extent to which a company has borrowed against its future operating earnings (as measured by EBITDA). The ratio indicates how many years of cashflow would be needed to repay all debt, assuming no new borrowing or equity issuance.
- **Total debt to FFO** – This metric ratio is a useful complement to the above as FFO (unlike EBITDA) is measured after interest payments and so may provide a more accurate gauge of the operating earnings available to repay debt.
- **Total debt to CFO** – This variation is more relevant for companies with relatively high or volatile working capital needs (typically arising from the characteristics of the sector and business model), which must be reflected in cashflow availability in order to prevent debt payback ability from being overstated.
- **Total debt to FCF** – In essence, this metric compares the operating cashflows generated internally by a company – after capital expenditure and changes in working capital – to the level of gross debt outstanding. It is a key indicator for assessing the leverage of companies operating in capital-intensive sectors, and also provides insight into the repayment capacity of companies with reasonably weak credit profiles for whom cash generation relative to debt over the intermediate term may be a ratings challenge and/or in cases where access to sufficient external financing is less than assured.
- **EBITDA to gross interest paid** – This coverage ratio provides insight into the risk that a company might not be able to meet required interest payments from its cash earnings (proxied by EBITDA). The higher the ratio, the larger the cushion a company has to absorb pressure on operating profits while continuing to pay interest in full and on time (all other things equal).

Gross debt – In some cases, reported gross debt may result in leverage being understated due to omission of off-balance sheet and other debt-like items that are in actuality a source of potentially significant leverage and financial risk. Where material, we take such items into account when assessing gross debt and leverage. Examples include the following: operating lease commitments; hybrid capital; financial guarantees; securitisations and factoring of receivables and other assets; and deficits in defined benefit pension schemes.

Net debt – We may also calculate leverage ratios using net debt as the numerator instead of gross debt in order to take into account cash reserves and liquid investments that are readily available and accessible by the rated company to support financial flexibility. Similarly, we may take into account the potential for a company to dispose of non-core assets and unconsolidated investments to repay debt, provided such assets could be monetised in a timely manner and the proceeds would have a meaningful impact on leverage metrics.

We are mindful however that in some cases part of a company's cash balances may be needed for

working capital and day-to-day operations rather than debt repayment and the amount can fluctuate significantly throughout the year, making year-end balances an unreliable indicator of the resources that would actually be available to repay maturing obligations. If the company is part of a group, fungibility and transferability may also be concerns as cash appearing on a consolidated balance sheet might not necessarily be easily accessed by the company being rated.

When assessing net debt, we therefore consider the variability of cash balances through the year and over time, in addition to whether they can be used freely by the rated company to repay debt.

Overall, we generally put more weight on gross debt rather than net debt when assessing leverage. When assessing net debt – including how meaningful the measure is relative to gross debt – we will generally give more credit to companies that have a long-standing policy of maintaining buffers of cash reserves and liquid investments to support financial flexibility.

Other leverage-related considerations

Where the ratios provide conflicting signals about the degree of and trends in leverage, we examine the underlying drivers of the relevant denominators to gain a clearer understating of the relative risk. For example, leverage indicated by debt-FCF could be higher and increasing at a faster rate than debt-FFO due to high levels of growth-enhancing capital investment. This may not necessarily be a cause for concern if other leverage ratios, including interest coverage, are expected to remain relatively favourable and the prognosis for the return on that investment and operating profits is good. Conversely, FCF based leverage could be reduced significantly by cutting capital spending, potentially at the cost of future competitiveness and earnings.

Like indicators of cashflow generation, leverage ratios will inevitably vary over time with business and investment cycles. However, if changes in leverage ratios are largely driven by highly volatile cashflows, particularly relative to peers, we will generally be more conservative in our overall assessment of leverage.

A company's equity position is generally a secondary ratings consideration since our analytical focus for non-financial corporations is on cashflow generation. That said, we would normally expect a company to maintain sufficient tangible equity to absorb unexpected losses in the event of a deterioration in economic or operating conditions.

Very low or negative tangible equity may be considered a credit challenge depending on the nature of the underlying cause and the length of time before the position is expected to improve to an adequate level. Where negative tangible equity reflects goodwill from acquisitions, we will consider the company's track record of successfully integrating acquisitions versus the potential for future goodwill impairment. If the latter is likely to be significant, we will consider to what extent it might signal the prospect of weaker earnings and cashflow generation in the future.

Debt Structure

An assessment of leverage is only one aspect of capital structure risk. Critically, leverage ratios reveal little about the potential risks and vulnerabilities emanating from the composition of a company's outstanding and future debt (as opposed to the level) and funding profile.

A poorly structured debt stock is typically harder to manage and is a prime source of financial vulnerability as it can contribute to potentially large and unanticipated changes in debt servicing requirements and exacerbate refinancing risk.

Repayment risk in the short to intermediate term is considered more fully in Financial Flexibility and Refinancing Risk. Nevertheless, we may modify our ratio-based assessment of leverage if any of the following are relatively high and not fully mitigated by other factors:

- **Foreign currency and external borrowing risk** – A high share of foreign currency debt in total debt may create a significant currency mismatch between a company's revenues and debt service, making payments of principal and interest sensitive to exchange rate movements. Any significant currency mismatches will generally be considered a source of potential vulnerability

unless appropriately managed and hedged or unless the rate of exchange between the currencies is highly stable due to the exchange rate regime (e.g. a credible pegged arrangement).

Heavy reliance on cross-border funding may also be a source of risk, particularly if the foreign investor base is confidence sensitive and therefore more likely to withdraw funding should the company suffer setbacks or market conditions become stressed. Cross-border funding has often displayed significant volatility, especially for emerging markets.

- **Maturity concentration** – Debt maturity concentrations may be a cause for concern, especially if the investor base is narrow or potentially volatile, or if market conditions or company-specific factors suggest that refinancing may be challenging. Conversely, relatively smooth and elongated debt repayment schedules may help partially mitigate risks associated with the relative size of the debt stock.
- **Creditor concertation** – High reliance on borrowing from a single or very small number of creditors might indicate limited access to, or availability of, funding sources and therefore higher refinancing risk.
- **Interest rate risk** – A high share of floating rate debt in total debt can increase the variability of both interest costs – making debt service less predictable – and cashflow availability (as measured by FFO or FCF). Interest rate risk is generally less of a ratings consideration for companies with moderate or low debt/leverage and robust earnings. However, for companies with weaker cashflow strength or high interest burdens, a hike in interest rates could potentially result in significantly lower EBITDA or FFO interest-coverage ratios, in turn reducing financial flexibility (as well as potentially causing interest coverage covenants to be breached).

Financial Policy

A company's financial policies with respect to the funding of its investments and management of its balance sheet, coupled with its general risk appetite, have a major bearing on future trends in debt leverage – potentially shifting the balance of risks to debt projections up or down, and either supporting longer term leverage expectations or making them more uncertain.

In this context we would generally view the following characteristics – taken together – as favourable and possibly sufficient to at least partially mitigate any concerns about likely changes in leverage metrics in the intermediate term:

- Comprehensive financial policies and credible commitment to meeting quantitative targets, including for leverage, supported by appropriate market and public disclosure (as a self-disciplining device).
- Demonstrated track record of taking decisive steps to reverse any significant deterioration in leverage metrics, for example via asset disposals, reducing dividends/payout ratios, or raising new equity.

By contrast, any of the following might have a negative impact on our overall assessment of this key rating factor since they could lead to permanently higher leverage ratios:

- The company is pursuing (or has a tendency to pursue) a relatively aggressive, debt-funded growth strategy that is subject to high execution risk.
- There is a strong propensity to engage in opportunistic (speculative) debt-funded acquisitions.
- Financial policies and discipline are weak and there is track record of making payments to shareholders (e.g. in the form of buy-backs or higher dividends) that exceed operating cashflow generation.

Leverage and Financial Policy, Key Characteristics

Very Low

Leverage is very low but appropriate for the business model and the company's strategic objectives.

Financial policies are very conservative. The company has a very strong track record of meeting targets and of successfully reducing debt leverage when necessary.

Funding structure is highly favourable (e.g. no material foreign currency mismatches or maturity concentrations) and poses no additional risks.

Low

Leverage is low but appropriate for the business model and the company's strategic objectives.

Financial policies are conservative. The company has a good track record of meeting targets and of successfully reducing debt leverage when necessary.

Funding structure is favourable and poses no additional risks.

Moderate

Leverage is moderate.

Financial policies are less conservative compared to higher peers but are generally applied consistently. The company has a demonstrated willingness and ability to lower debt leverage when necessary.

Funding structure is adequate; associated risks are low due to strong mitigants (e.g. effective hedging in place for foreign currency exposures).

Moderately High

Leverage is moderately high but is not expected to increase further. The company may have credible plans to deleverage over the intermediate term.

Financial policies are in place but are not applied consistently, allowing for leverage to rise above peers/industry norms.

Funding structure may pose moderate additional risks.

High

Leverage is high and sensitive to business conditions, with key metrics prone to deteriorating during downturns.

Company may lack financial policies or have a mixed track record of adhering to them. There may be some commitment to reducing or at least containing leverage over the intermediate term.

Funding structure may pose significant additional risks (e.g. may have significant foreign currency exposure with limited mitigants in place).

Very High

Leverage is very high and favourable business conditions are generally required to prevent default risk from escalating.

Financial discipline is either very weak or the company is pursuing highly aggressive or opportunistic debt-funded strategies.

Funding structure may pose significant additional risks.

KEY RATING FACTOR 3

Financial Flexibility and Refinancing Risk

Financial flexibility refers to the ability of a company to generate or obtain sufficient financial resources when needed in order to: (a) meet financial obligations as they fall due, including during periods of stressed financial market conditions, without diminishing its own credit strength; and (b) sustain ongoing projects or take advantage of new investment opportunities.

The focus of the former is on short-term liquidity risk, while the latter is more concerned with longer-term funding risks, particularly whether a company would be able to borrow the amounts required at an appropriate tenor and at an acceptable cost to fund its business strategies and help manage it debt.

Liquidity Risk

Liquidity is central to our assessment of this key rating factor since a liquidity squeeze, whether driven by company-specific factors or market-wide stress events, may potentially trigger a payments default – even for companies that might still be solvent on a balance-sheet basis.

Sources of liquidity considered by CI to be generally reliable include unrestricted cash, unencumbered marketable securities, and available committed bank credit lines with a tenor of more than one year.

Net cash generated by operating activities is also a key source of liquidity on an ongoing basis for all entities, and companies with strong and resilient cashflows though the economic cycle are often better able to withstand temporary strains in funding markets. We therefore consider a company's ability to generate positive net cashflow internally by including projected FFO as a source of liquidity if positive, or a potential drain on liquidity if not.

As there is no single metric that captures all aspects of liquidity risk, we use a variety of measures to gauge a company's liquidity position and resilience to shocks.

The two most important ones are akin to simple stress tests that assume the absence of debt rollovers or external financing. They are:

- **Liquid resources to short-term debt** – where liquid resources consist of readily available liquid assets (i.e. cash balances that can be easily accessed and freely used by the rated company plus marketable securities) and the undrawn portion of committed credit facilities with more than one year to maturity, while short-term debt is measured on a remaining maturity basis. We would not normally take into account cash held by other entities within a corporate group unless we had reason to believe this could be readily accessed by the rated company to repay debt.
- **Liquidity coverage ratio** – where the numerator is the sum of liquid resources (defined as above) plus projected FFO for the next 12 months, and the denominator is short-term debt on a remaining maturity basis. The numerator will be lower than liquid resources if FFO is negative.

  We may compute an additional liquidity coverage ratio using FCF (instead of FFO) in the numerator, particularly where investment in fixed assets and working capital are important elements of the business model or are generally expected to pose a potential challenge to liquidity in the short term.

Since ratios require context to be meaningful and each has its own limitations, our liquidity analysis draws on qualitative considerations as well.

For example, while it may be straightforward in normal times to generate liquidity by selling securities, this might be far more challenging during periods of stress. Consequently, when assessing liquidity buffers that include securities, we also consider whether the instruments are likely to remain liquid at times of stress and, if so, whether their sale is likely to entail sizeable discounts.

Similarly, we consider whether committed credit facilities would likely remain available in a stress situation, taking into account the financial strength of the providing bank, the length of its business

relationship with the company, and whether the company is close to breaching associated covenants – the consequence of which might be total or partial line cancellation.

We may also put less weight on backup credit facilities that contain material adverse change (MAC) clauses, although these have tended to be less commonly invoked by banks. Uncommitted facilities are far less likely to be available in stressed situations and are therefore not considered an appropriate source of potential liquidity in our assessment.

Disposals of non-core assets are another potential source of proceeds for debt repayment, but are also vulnerable to market conditions. We must therefore have good reasons for believing assets could be monetised in the short term (for example because a sale has been or is in the process of being agreed to a creditworthy buyer) in order to include potential asset sales as a supporting factor.

We also consider the extent of any contingent liquidity drains the company faces (and which might increase in a stressed environment), such as the need to meet additional margin or collateral calls in connection with derivative contracts or collateral maintenance covenants, or to support other group entities. Liquidity ratios will overstate the true strength of a company's liquidity position where such contingent risks are high, and we will temper our overall liquidity assessment accordingly.

Finally, where we have relied on an FCF-based measure of liquidity coverage, we will take into account the ability of the company to generate additional cashflows internally in the short term by reducing discretionary outlays, for example on capital spending, and adjusting working capital – thereby improving the contribution from FCF. However, we weigh this against the potential impact on competitiveness if prolonged.

Funding Risk

In addition to evaluating a company's short-term liquidity risk profile based largely on the use of currently available assets and operational cashflows, we consider broader aspects of potential funding availability, particularly:

- The diversity of the funding base – especially a high reliance on borrowing from a single or very small number of creditors as this may indicate limited access to, or availability of, funding sources and therefore higher refinancing risk.
- The strength of a company's access to capital markets – taking into account its relationship with investors and its track record of issuing debt or raising equity in a timely manner (including in stressed conditions) – and at an acceptable cost (i.e., without significantly impacting earnings) in order to support the implementation of business strategies and repay maturing obligations. Ratings will typically be impacted negatively in cases where market access on a forward-looking basis is expected to be limited or potentially unreliable, taking into account also the magnitude of projected financing needs and expected financial market conditions.
- Whether the company faces any contractual funding constraints – specifically if covenants, including negative pledges, and other restrictions within current credit lines or capital market arrangements could potentially restrict the ability to raise additional funding, especially on a secured basis, thereby constraining financial flexibility.
- The extent to which the company relies on secured financing (as measured by the ratio of secured debt to gross assets) – particularly whether financial flexibility is constrained by a low level of unencumbered assets.
- The availability of funding and liquidity on an ongoing basis from a stronger parent or group – provided there are no foreseeable regulatory or legal obstacles to the continuation of the arrangement.

We also consider whether a company has put in place effective systems to monitor liquidity requirements and manage funding risk. Strategies for meeting expected funding needs on at least an intermediate-term horizon are important for the continuity of business performance, cost optimisation, and eliminating or reducing potential obstacles to timely and affordable debt service.

Accordingly, we expect companies to have operationalised appropriate funding policies and decision-

making processes (taking into account the scale and complexity of the business model), and may lower our overall assessment of this key rating factor if there is little evidence that active planning is taking place.

We also view active debt management favourably, including the practice of pre-funding approaching debt repayments well in advance of the maturity date and retaining financial flexibility through the cycle by, for example, reducing debt leverage during periods of strong earnings.

Financial Flexibility, Key Characteristics

Very High

Financial flexibility is very high and refinancing risk very low, supported by very robust liquidity. The ability to withstand highly stressed market conditions (including the inability to refinance maturing debt) for at least 24 months is very high.

Sources of reliable and unencumbered liquidity (including cash from operations) greatly exceed liquidity needs.

Funding sources are well diversified. Relations with banks and other creditors are very strong; financial market reputation is very high, and company has good access to both local and international markets.

Contractual funding constraints are negligible. Funding and liquidity management is very prudent.

High

Financial flexibility is high and refinancing risk low, supported by robust liquidity. The ability to withstand highly stressed market conditions (including the inability to refinance maturing debt) for at least 12 months is high.

Sources of reliable and unencumbered liquidity (including cash from operations) comfortably exceed liquidity needs.

Funding sources are reasonably diversified. Relations with banks and other creditors are strong and company has good access to local markets but possibly limited access to international markets.

Contractual funding constraints are modest. Funding and liquidity management is prudent.

Adequate

Financial flexibility is adequate and refinancing risk low-to-moderate. Sources of reliable and unencumbered liquidity (including cash from operations) moderately exceed liquidity needs.

The company is expected to be able to withstand stressed market conditions (including the inability to refinance maturing debt) for at least 12 months. Although unlikely to be required, it would be able to implement cash preserving or cash generating measures if necessary.

Funding sources may be somewhat concentrated. Relations with banks and other creditors are good and the company has good access to local markets but possibly very limited access to international markets.

Contractual funding constraints are moderate. Funding and liquidity management is adequate.

Moderate

Financial flexibility and refinancing risk are moderate. Sources of reliable and unencumbered liquidity are in line with or modestly exceed liquidity needs.

The company should be able to withstand stressed conditions for a period of 12 months provided it is able to retain some, albeit limited, access to refinancing and/or implements modest cash preserving/cash generating measures.

Relations with banks and other creditors are reasonable, although funding sources may be concentrated. The company has average access to local markets, but access may be somewhat restricted during periods of stress, including compared to the categories above.

Reliance on secured forms of borrowing may be significant. Covenants and negative pledges in existing debt arrangements may mean there is limited flexibility in arranging new borrowing.

Debt maturities are expected to be manageable over at least the intermediate term, although compared to higher categories the company may be somewhat reliant on financial conditions being favourable when debt falls due.

Financial Flexibility, Key Characteristics (continued)

Low

Financial flexibility is low and refinancing risk moderate-to-high. Sources of reliable and unencumbered liquidity are generally slightly below liquidity needs; cash from operations may be weak to moderate even after cost-cutting measures and asset disposals.

The company would only be able to withstand stressed conditions for a period of 12 months if it is able to refinance a significant portion of maturing debt and/or implements significant cash generating/cash preserving measures (e.g. possibly large spending cuts).

Funding may be highly concentrated. Relations with banks and other creditors may be mixed or not long-standing, and access to credit and markets may be uncertain at times of market stress.

Reliance on secured forms of borrowing may be fairly high. Covenants and negative pledges in existing debt arrangements may mean there is very limited flexibility in arranging new borrowing.

Debt maturities are expected to be manageable in the short term but more challenging in the intermediate to medium term, where there may be some uncertainty with regard to the sources of debt repayment.

Very Low

Refinancing risk is high, financial flexibility is low.

Sources of reliable and unencumbered liquidity are below liquidity needs.

The company is unlikely to be able to implement sufficient measures to enable it to withstand stressed conditions for a period of 12 months.

Relations with banks and other creditors are poor.

The capacity to service debt falling due in the short to intermediate term is low. The company may face significant challenges refinancing maturing obligations in a timely manner and/or the sources of repayment are uncertain.

ANALYTICAL PILLAR 4

GOVERNANCE AND MANAGEMENT

The focus of this analytical pillar is on how the governance and management of a company may support or potentially hinder its operational and business performance and overall risk profile.

Governance is an important ratings consideration given the number of corporate failures that have been associated with factors such as inadequate oversight by passive or uniformed boards of directors, ineffective internal controls, and weak risk management.

Good corporate governance helps to protect the legitimate interests of creditors, shareholders and other stakeholders, including employees. It also plays an important role in an entity implementing successful business strategies, using resources efficiently, and conducting day-to-day operations in a safe and sound manner, consistent with its established risk appetite and overall risk profile.

Good corporate governance is also a key contributor to a company's ability to identify and respond to new risks and emerging challenges, and to cope with adverse changes in business, economic and financial conditions. Conversely, governance deficiencies can lead to a range of credit-relevant problems. For example, concentrated ownership structures may give rise to potentially harmful conflicts of interest, while overly complex or non-transparent structures can create significant challenges for board of director oversight.

Boards of directors that lack independence or sufficient diversity and expertise may be less committed to fulfilling their fiduciary and other responsibilities, opening the door to ineffective or irresponsible management behaviour. Similarly, weak governance may contribute to the pursuit of aggressive business growth strategies and excessive risk taking – particularly if accompanied by inadequate risk management or inappropriate incentive structures and compensation schemes.

Our overall assessment of Governance and Management is based on three key rating factors:

- Quality of Corporate Oversight
- Management Effectiveness
- Financial Reporting and Transparency

The assessment focuses on company-specific policies, procedures, and practices. Any legal or institutional impediments to good corporate governance are captured in our assessment of the operating environment. At a minimum we would expect companies to adhere to the established corporate governance standards in their domestic market. However, meeting minimum local standards may not be enough to avoid a negative assessment if we observe policies, practices or relationships that diminish the quality of corporate governance.

Indeed, significant governance deficiencies may result in a rating being notched below the level that might otherwise have been assigned because of the high associated risks, such as poor decision making, insufficient planning, and excessive risk-taking (e.g. if the board of directors is uninformed or passive). Moreover, where governance and oversight are weak, there is greater scope for financial and other key risks to be missed by senior management and directors or, more nefariously, hidden from investors and other stakeholders.

In our assessment we typically give greater emphasis to practices and actions as opposed to codes and policies. Many companies have adopted explicit corporate governance standards and codes of conduct and ethics. However, there are sometimes doubts as to whether the professed standards are actually applied consistently and whether, in practice, governance checks and balances function in the ways indicated on paper.

KEY RATING FACTOR 1

Quality of Corporate Oversight

The focus of this key rating factor is on the effectiveness of the board of directors, specifically whether the board has sufficient independence, authority, expertise, diversity, and resources to discharge its core responsibilities effectively, hold management to account, and provide appropriate checks and balances against conflicts of interest.

We generally expect the board to perform a number of key oversight functions, including the following: reviewing (and guiding) corporate strategy, risk management, annual budgets and business plans; monitoring company performance; and reviewing remuneration/compensation structures (including with a view to minimising incentives for excessive risk-taking).

We also expect the board to consist of a sufficient number of suitably qualified independent non-executive members who are proactive in performing their oversight duties and have a demonstrated track record of holding management and other ‘insiders’ to account.

The quality of corporate oversight may have a negative impact on ratings in cases where deficiencies in arrangements or practices raise significant concerns about the stewardship of the company and/or the protection of creditor and other stakeholder rights.

Characteristics that may result in an unfavourable assessment include:

- Limited board independence (as indicated, for example, by the relative strength of executive directors/insiders, including if they make up more than two-thirds of the board’s members).
- A lack of diversity of experience and expertise among board members or inadequate experience and expertise (including family members holding board positions without appropriate knowledge or qualifications).
- Passive or inactive boards that say little, fail to remove and replace underperforming directors, seldom change members (e.g. non-executive directors tend to remain in post for more than 10 years), or that are dominated by one individual.
- A board size that is either too small to have an appropriate balance of directors or too large to be effective (given the size, complexity and risk profile of the business).
- Preferential treatment to related parties (particularly where related party transactions lack transparency and board oversight, or do not appear to serve a legitimate economic purpose).
- Complex or opaque organisational structures which might impede the ability of the board to oversee business performance and to identify and assess risks (complexity may also pose similar challengers for management, investors, and regulators).
- A track record of regular violations of laws or regulations that have resulted in losses and/or significant harm to the company’s corporate identity or social responsibility profile.
- A lack of board committees (considering the size, complexity and risk profile of the company), or committees that consist of an insufficient number of members or include members without appropriate qualifications and experience (especially in the case of audit and risk management committees).
- Inadequate independent oversight of the audit and risk management functions.

Moderate and low board effectiveness is often reflected in the following: under-developed strategic planning; management incentive schemes that (inadvertently) increase the risk profile of the company; and inadequate succession planning for senior management.

Quality of Corporate Oversight, Key Characteristics

Good

Board is proactive and exercises strong oversight of senior management, corporate strategy, risk-taking activities, and conflicts of interest.

Majority of board members are independent. All board members have substantial experience and expertise, as well as access to sufficient information and resources, to understand and evaluate the company's risk profile and conflicts of interest.

Board committees are proactive, independent, and exercise strong oversight of internal control functions.

Satisfactory

Board is active and exercises satisfactory oversight of senior management, corporate strategy, risk-taking activities, and conflicts of interest.

At least one-third of board members are independent. All board members have sufficient experience and expertise, as well as access to sufficient information and resources, to understand and evaluate the company's risk profile and conflicts of interest.

Board committees are active, independent, and exercise satisfactory oversight of internal control functions.

Moderate

Board exercises a moderate (less than adequate) degree of management and risk oversight.

Board may contain an insufficient number of independent members and/or some board members may lack adequate experience and expertise.

The size or structure of board and/or board committees may not be appropriate given the risk profile and complexity of the company. Board members and resources may be stretched, impeding proper oversight.

Compensation arrangements may undermine the objectivity of independent members by linking their compensation to short-term business performance.

Low

Board may lack any effective independence. Board decisions may be dominated by one member or a small number of executives/insiders; other board members may be largely passive.

Little or no evidence of proper (independent) board scrutiny of the company's senior management and risk taking.

Evidence that strong executives/individuals are able to override compliance or control-related policies and procedures without sanction.

Board may primarily serve the interests of the controlling shareholder, possibly to the detriment of other shareholders. Related party transactions may be high and not subject to proper review/challenge.

KEY RATING FACTOR 2

Management Effectiveness

Management effectiveness is to some extent revealed by a company's performance over time, particularly through changes in the business cycle and when confronted by market adversities. Management effectiveness may therefore be gauged by the company's financial track record and indicators of its competitive position or franchise strength, such as the size of, and trends in, its market share.

Financial performance and market position are captured in other key rating factors. However, there are a number of aspects of management quality that may be important on a forward-looking basis for long-term performance. These include:

- Experience and recent track record of the current management – which we consider a good starting point for assessing the ability to grow the business and respond to new challenges.
- Depth and breadth of management – in particular whether the company is reliant on a small number of key people and to what extent associated risks are mitigated by, and broader continuity supported by, succession planning.
- Senior management turnover – which if high may indicate excessive interference by the board or owners – as well as the ability to attract and retain qualified staff throughout the organisation.
- Management's capacity to develop comprehensive and plausible business plans; its success in meeting strategic objectives, including related financial and operational goals; and its ability to adapt plans and policies to unanticipated challenges and events.
- Treasury function arrangements – specifically whether the company has adequate systems and resources to support timely cash management and debt service, as well as other financial management objectives.
- Risk management capabilities – whether the company has appropriate policies, procedures and resources for identifying, assessing, monitoring and controlling all relevant risks, including non-financial risks (such as operational, strategic, reputational and legal risks) as well as financial risks.
- Management risk culture – whether management (other than risk managers) has a clear understanding of the amount of risk that is acceptable in order to implement the company's business plan, and whether this is consistent with corporate strategy.

Management Effectiveness, Key Characteristics

Very High

Highly experienced and stable management team, with good depth and a very successful track record of steering the business through economic/market cycles and adapting to unexpected adversities.

Key person risk is very low and succession planning is very strong.

Strategic plans cover medium- to long-term time horizons and are comprehensive and credible. Related financial and operational targets are consistently met.

Treasury and risk management are very strong, with very good architecture, procedures, policies, systems and tools in place.

Management risk culture is very strong, with a very strong understanding across senior management of the company's risk profile and risk appetite, and risk considerations permeate through the organisation.

High

Experienced and stable management team, with good depth and a successful track record of steering the business through economic/market cycles and adapting to unexpected adversities.

Key person risk is modest and succession planning is strong.

Strategic plans cover medium- to long-term time horizons and are comprehensive and credible. Related financial and operational targets are routinely met.

Treasury and risk management are strong, with good architecture, procedures, policies, systems/ tools in place.

Management Effectiveness, Key Characteristics (continued)

Adequate

Reasonably experienced and generally stable management team, with adequate depth and a reasonable track record of steering the business through economic/market cycles and adapting to unexpected adversities.

There may be some reliance on a small number of key individuals, although associated risks are likely mitigated to a significant degree by succession planning.

Strategic plans extend at least to the medium term but may be less than comprehensive and/or subject to significant changes from time to time. Related financial and operational targets are often, but not always, met.

Treasury and risk management are adequate, with fairly good architecture, procedures, policies, systems and tools in place.

Management risk culture is adequate, with a generally good understanding across senior management of the company's risk profile and risk appetite.

Moderate

Management team may have a moderate degree of depth and experience and a mixed track record of steering the business through economic/market cycles and adapting to unexpected adversities.

Management turnover may be significant or there may be strong reliance on a small number of key individuals, with limited succession planning.

Strategic plans may not be well developed or sufficiently forward looking and/or may be subject to regular change, possibly driven by short-term opportunism or due to overly optimistic underlying assumptions. Financial and operational targets are often missed.

Management effectiveness may be undermined by resource constraints, which are unlikely to be resolved in the short to medium term.

Treasury and risk management functions are in place but may have some shortcomings in terms of procedures, resources, and systems.

Low

Management team may lack depth and experience and may be untested or have a generally poor track record of steering the business through economic/market cycles and adapting to unexpected adversities.

Management turnover may be elevated or there may be very high reliance on a small number of key individuals, with little or no succession planning.

Strategic planning may be weak and not properly documented and/or subject to frequent and possibly sizeable shifts. Financial and operational targets are typically missed.

Management effectiveness may be greatly undermined by resource constraints, which are unlikely to be resolved, even in the medium to long term.

Treasury and/or risk management functions are weak due to the significant lack of resources, systems, expertise, and processes.

Management risk culture may be weak, possibly reflecting shortcomings in risk-related policies and procedures, limited or inconsistent risk messaging/communication, weak enforcement of rules/standards, or incentive structures that encourage high risk activities/behaviour.

KEY RATING FACTOR 3

Financial Reporting and Transparency

Comprehensive, accurate and timely disclosure of information on a company's financial condition and performance, business activities, and risk management practices is essential for sound and effective corporate governance. Otherwise, it is difficult for shareholders, non-executive board members, creditors and other stakeholders to monitor management effectiveness and the company's performance, and to identify adverse developments at an early stage. Moreover, accounting deficiencies and weak internal controls may enable operational and other risks to go undetected, or be used to hide fraudulent activity or corrupt practices.

Financial reporting and transparency is a largely asymmetrical rating factor. The impact of good disclosure on ratings is usually neutral, in part because it cannot on its own outweigh weaknesses in a company's business or financial risk profile. However, significant shortcomings in the quality of financial reporting and disclosure would normally have a negative impact on ratings, while severe deficiencies would pose an insurmountable obstacle to ratings been assigned or maintained.

Consequently, when assessing the quality of transparency and disclosure we focus on potential weaknesses and warning indicators that may warrant further investigation and ultimately lead to an unfavourable assessment. These include:

- External and internal auditors who appear to operate without sufficient independence, lack quality, or do not have a good reputation in the local market;
- Instances where external auditors have issued an adverse opinion, determining that the financial statements are materially misstated and do not conform to the relevant accounting, regulatory or legal standards;
- Aggressive interpretation of accounting standards; and
- Shortcomings in the timeliness, comprehensiveness, and consistency of financial disclosures.

Financial Reporting and Transparency, Key Characteristics

Satisfactory

Financial statements are prepared in accordance with international standards and have been reliable and consistent over time.

Financial and related disclosures are considered to be comprehensive, accurate and timely.

Less Than Adequate

Financial statements are prepared using local standards that are somewhat below international norms and/or there are some moderate concerns about their comprehensiveness and reliability.

Shortcomings with regards to accounting practices and internal controls may raise some questions about the accuracy and completeness of some key aspects of financial and related disclosures. The company's accounting practices may be aggressive or obfuscatory.

External auditors may have issued a qualified opinion, identifying some important issues, financial statements may be subject to periodic (unusual) restatement, and the company may be occasionally late with its regulatory filings.

Weak

Financial statements are prepared using local standards that are significantly below international norms and/or there are substantial concerns about their comprehensiveness and reliability.

Financial and related disclosures may be very limited in scope and/or there may be serious concerns about the accuracy of the company's disclosures. The company's accounting practices may be particularly aggressive or obfuscatory.

External auditors may lack independence or may have issued an adverse opinion or a disclaimer. Financial statements may be subject to regular (unusual) restatements, and the company may be frequently late with regulatory filings.

4. EXTRAORDINARY SUPPORT AND GROUP CONSIDERATIONS

Once we have established the ESA, we evaluate the likelihood that, in the event of difficulties, the rated company would receive sufficient and timely financial assistance from its parent, shareholders, the government, or other support providers to enable it to remain current on its liabilities and avoid a payments default or insolvency.

Such support, which we label ‘extraordinary support’, can potentially mitigate weaknesses in a company’s standalone financial profile and therefore improve its creditworthiness, resulting in its ICR being notched up above the ESA.

This type of temporary assistance is different to the ‘ordinary support’ that a company might receive, for example from its parent, during the normal course of business, such as an increase in equity to facilitate business growth or to meet changes in regulatory requirements. Ordinary financial support, as well as the operational and business benefits (and risks) that may accrue to an entity from being part of a larger group, is reflected in the ESA.

Where the company is a member of a corporate group, we apply the criteria contained in Parent-Subsidiary Considerations in the Determination of Corporate and NBFI Credit Ratings to determine the likelihood of extraordinary support and to assess the rating impact of other potential group influences.

For subsidiaries, the application of our parent-subsidiary criteria may result, inter alia, in:

- The ICR being notched above its standalone level due to the likelihood of such extraordinary support from a stronger parent (or group).
- The ICR being constrained by the rating of a weaker parent due to group interference risk even though it may be the stronger of the two entities on a standalone basis (interference risk aside).
- The ICR being set higher than the rating of the parent due to greater standalone strength and limited linkages, which may include effective constraints on potentially harmful parental interference. If linkages are limited and autonomy high, a company’s default risk may be largely (or wholly) unaffected by stress at the parent level or elsewhere within the group. Consequently, its ICR will largely depend on its standalone strength and may potentially be notched above (or decoupled from) the actual or notional rating of the parent/group.

Where an entity’s ICR incorporates extraordinary support, we indicate the degree of uplift and the reasons for it in the published credit rating rationale.

5. SOVEREIGN CONSIDERATIONS

The final LT ICR assigned to a company will generally be set at the same level as the baseline for the issuer rating provided the latter is no higher than the sovereign rating of the country in which the company is based.

If the baseline ICR is higher than the sovereign rating, we apply analogous considerations to those contained in our criteria for rating financial institutions above the sovereign (explained in our Bank Rating Methodology) to determine whether the company's ratings could be higher than the sovereign and, if so, by how many notches.

This entails considering whether the company's financial strength and debt-servicing capacity would be sufficiently robust to withstand: (i) the direct impact of a government default, including losses on any holdings of sovereign debt and reduced business and payment delays from the government and government entities; and (ii) highly stressed operating conditions, including a marked decrease in demand, sharply higher borrowing costs, limited access to bank and market financing, and potential losses on other domestic financial instruments.

Even if a company is able to withstand severe sovereign and related economic stresses, it could still default should the government decide to interfere with its ability to service financial obligations in a timely manner by imposing highly restrictive measures, such as exchange controls and payments moratoria. We refer to this direct impact as sovereign interference risk.

Sovereign credit risk and sovereign interference risk are often highly positively correlated; but they can differ (or decouple), and interference risk is usually much harder for firms to mitigate or circumnavigate.

In general, where sovereign interference risk in the event of a government debt crisis is high, a company will be rated no higher than the sovereign rating.

Where sovereign interference risk is moderate or low, a company could be rated above the sovereign if: (i) it has a sufficiently strong and resilient standalone credit profile; or (ii) it is likely that it would be supported by financially stronger foreign owners in the event of a sovereign debt crisis.

Favourable standalone characteristics are likely to include all or most of the following:

- Relatively strong financial flexibility, including a comfortable liquidity position and modest debt maturity schedule, as well as low or moderate leverage and strong cashflow generation.
- Low or moderate sensitivity to domestic economic conditions, including for revenues and cashflows, possibly reflecting robust export activities. In some cases, producers of goods and services in domestically focused sectors with low cyclicality/volatility may also display sufficient resilience.
- Low or moderate direct exposure to sovereign credit risk.
- Demonstrated resilience to previous episodes of sovereign stress or adverse economic and financial shocks.

In such cases the maximum rating differential would normally be restricted to three notches above the sovereign long-term local currency rating for a company's long-term local currency ICR and two notches above the sovereign long-term foreign currency rating for its foreign currency ICR.

Maximum Potential Notch Differential between Corporate Issuer Ratings and Sovereign Issuer Ratings

Sovereign Interference Risk					
High		Moderate		Low	
FC	LC	FC	LC	FC	LC
0	0	1	2	2	3

FC=foreign currency; LC=local currency

Our policy of generally restricting ICRs in the ratings space above the sovereign rating reflects the degree of uncertainty in the assessment of a company's capacity to withstand sovereign-induced stress. This in turn reflects several key unknowns, including the scope and severity of a future crisis and the policy reaction of the authorities in the event of financial stress (including the severity of any restrictive measures).

We may deviate from this practice when the likelihood of a government default in the short term is very high, and we are better able to evaluate with greater certainty the rated company's ability to survive the associated stress.

In addition, we may increase the notching differential in cases where we are convinced that the government would not impose transfer and convertibility or other debt-service impeding restrictions were it to default on its own obligations, or that the rated company would be exempt from, or able to mitigate or circumvent, any such restrictions.

Such cases are most likely to involve companies with highly favourable standalone characteristics (as outlined above) and, in particular, entities with substantial revenue-generating operations and cash balances outside of the country, and the ability to service debt in a timely manner from abroad. Strong foreign parent support might also be a mitigating factor in some cases.

6. Additional Considerations for Real Estate Companies

While CI's Corporate Rating Methodology is broadly applicable to the property sector, there are certain characteristics of real estate companies that require a more nuanced approach when establishing the ESA. We outline these additional considerations below. Most of these are applicable to real estate investment companies, which we define as companies that own and operate a portfolio of residential and/or commercial properties and accordingly derive the majority of their operating revenue from rental income. However, many of these factors may also be relevant to property developers engaged in the construction, development, or acquisition of properties for sale – particularly if they also undertake real estate investment activities.

Supplementary considerations include the following.

Business Risk

Market Position and Competitiveness

Market position – For real estate investment companies this is generally evaluated with reference to the market value of a company's assets, as well as the gross leasable area (or similar metric), and its market share in both the overall real estate market of the country (or countries) in which it operates and in the specific market segments it is active in. Rental income per square metre compared to peers may provide additional information about a company's relative pricing power.

Asset quality – This is given more weight for real estate companies compared with many other types of non-financial corporates. We generally differentiate real estate investments by asset class and location, with property age and condition being related considerations. Asset classes are categorized into residential, office, retail, and logistics properties, as well as hotels. We further distinguish locations as class A, B and C, with class A comprising core locations and central business districts, class B being secondary locations in larger national or international cities with an active real estate market, and class C covering mainly suburban and rural locations with limited business activities.

We believe that modern buildings in class A locations will generally provide higher stability in terms of occupancy rates and operating cash flow even in times of economic stress, while older buildings in class C locations may be subject to substitution risk and obsolescence.

Occupancy rates – While past occupancy levels are not necessarily a guide to the future, a high occupancy rate tends to indicate that the properties concerned are attractive and the rents set at levels seen as satisfactory by the market. Conversely, a low occupancy level (either across the portfolio or for a particular property) typically indicates uncompetitive rental levels and/or bad locations and/or bad service quality – or simply that the demand is not there.

Portfolio management – We also consider the ability of a real estate company to support its market position through timely acquisitions and disposals, as well as by being able to anticipate changes in market trends and client requirements in order to ensure its portfolio remains attractive to tenants of good credit quality.

Diversification and Size

Concentration risk – Diversification is considered with respect to geography, property type and tenant type. Vulnerability to market volatility tends to be higher when a company is heavily concentrated in one type of real estate or in a narrow geography, and sales and receivables risk tends to increase (and pricing power weaken) when reliance on a single client is high.

Higher diversification enables real estate companies to better offset cash flow volatility arising from economic and real estate cycles, industry trends (including the substitution of assets), and the loss of a single tenant. We generally consider geographical diversification to be a credit strength. However, we would not necessarily constrain a company's ratings for a lack of diversification if it were able to combine high regional concentration with a clear market-leader position and has a demonstrated ability to outperform the market over the real estate cycle.

Revenue Stability and Operational Efficiency

Lease duration, maturity schedule, and renewal rates – Revenue stability tends to be well supported when the property portfolio is dominated by long-term leases with a smooth expiration profile and high renewal rates. By contrast, risks to stability and the likelihood of cashflow disruption tend to increase when a high proportion of leases are of comparatively short duration, or the maturity profile is lumpy.

Rental rates is a related consideration, and the risk to revenues may be significant if a high proportion of leases are approaching maturity at rates that are currently well above market levels.

Market conditions are also important in terms of both demand and supply. For example, it may take time for companies to adapt to weak demand or for oversupply to be absorbed, and addressing imbalances may require tenant incentives or inducements that depress short- to medium-term rental yields. This in turn may adversely affect the rental rates achievable on a company’s existing units as tenants may either want to move to new units or demand similarly advantageous terms on their existing space.

Occupancy volatility and default rates – Significant variations in occupancy rates and/or tenant default rates through economic cycles can increase revenue and cashflow volatility. Conversely, revenue stability tends to be high when a company is able to attract and retain tenants of good credit quality at market rates or, better still, premium rates.

Inventory and working capital management – Working capital management is a key part of a property developer’s operational efficiency and also has significant implications for cashflow adequacy. This is because developers invest in inventories of land and work-in-progress, which increases exposure to financial risk if the asset conversion cycle lengthens due, for example, to project execution difficulties or weaker-than-expected sales demand.

Key considerations in this context include a company’s track record in terms of the following: maintaining prudent land holdings; completing development projects within budget and on time; the ability to pass on construction costs increases; and its relative reliance on riskier speculative developments that are undertaken without formal commitments from end users.

These considerations are also applicable to real estate investment companies that undertake development projects. For such companies the risks of construction cost overruns and vacancies at delivery frequently reflect project management shortcomings or asset quality issues, but they also tend to increase when the number of projects under development is relatively high (e.g. above 20% of total assets). Comparatively high exposure to development risk may weigh on the ratings of a real estate investment company relative to peers (all other thigs being equal).

Land inventory at any point in time should be sufficient to support business activity and cashflow over at least the intermediate term. For developers, future revenue growth may become more constrained if the availability of land for purchase or lease is limited. Where land is utilised by developers under lease or lease-type arrangements, aggressive accounting treatments can boost near-term profitability but at the cost of eventual substantial impairments (or accelerated amortization), while the economic consequence of termination when land supply is tight could potentially be the loss of a significant portion of the cash income of the company.

Financial Risk

Leverage and Financial Policy

Fixed-charge coverage ratio – We evaluate real estate companies using the leverage and interest coverage ratios identified in Analytical Pillar 3 of our methodology, typically focusing on EBITDA and FFO ratios, but also assessing cashflow adequacy using CFO and FCF metrics – particularly for property developers as these latter measures capture the cashflow impact of investment in working capital and therefore provide a more accurate gauge of the cashflow available for debt repayment.

However, where a company is organized as a REIT, and therefore subject to mandatory dividend requirements, we also examine trends in the fixed-charge coverage ratio. This is defined as the ratio of EBITDA to the sum of interest expense, capitalised interest, and preferred dividends. We include the latter since distribution rules make it less likely that a REIT would suspend preferred dividend payments to preserve financial flexibility compared to other types of corporates as it would also have to refrain from paying common dividends in accordance with the dividend stopper provisions typically included in preferred stock term sheets. This is also consistent with our treatment of hybrid forms of capital as debt-like obligations.

Supplementary leverage ratios – We use the gross and net debt payback ratios (described in Analytical Pillar 3 above) to assess the leverage of real estate companies. However, we may also review additional metrics, particularly to help distinguish between companies that may have similar core indicators. The main supplementary measures we may consider are:

(i) **Loan-to-value (LTV) ratio** for real estate investment companies, where the numerator is net debt (including preferred stock) and the denominator is the balance sheet value of net property, plant and equipment (PPE) *less* construction in progress *less* land held for development; and

(ii) **Net debt to capitalisation**, where the numerator is net debt (including preferred stock) and the denominator is the sum of net debt and shareholder's equity. Although equity is generally a secondary consideration in our corporate analysis, we may take it into account as a loss-absorption buffer for real estate companies – particularly developers – due to the large amounts of capital needed to acquire land and develop properties, and the potential financial risks associated with unsold holdings of property and land, should final demand fail to materialise or valuations decline. This ratio is also useful for identifying differences in companies' capital structures.

ANNEX 1: ISSUER CREDIT RATINGS: RATING SCALE AND DEFINITIONS

CI's international issuer credit ratings (ICRs) indicate the general creditworthiness of an entity (such as a corporate or financial institution) and the likelihood that it will meet its financial obligations in a timely manner. Foreign currency ratings refer to an entity's ability and willingness to meet its foreign currency denominated financial obligations as they come due. Foreign currency ratings take into account the likelihood of a government imposing restrictions on the conversion of local currency to foreign currency or on the transfer of foreign currency to residents and non-residents.

Local currency ratings are an opinion of an entity's ability and willingness to meet all of its financial obligations on a timely basis, regardless of the currency in which those obligations are denominated and absent the risk of transfer and convertibility restrictions that may constrain the servicing of foreign currency obligations. Both foreign currency and local currency ratings are internationally comparable assessments.

Foreign and local currency ratings take into account the economic, financial and country risks that may affect creditworthiness, as well as the likelihood that an entity would receive external support in the event of financial difficulties.

The following rating scale applies to both foreign currency and local currency issuer ratings. Short-term ratings assess the time period up to one year.

Long-Term Issuer Credit Ratings

Investment Grade	
AAA	The highest credit quality. Exceptional capacity for timely fulfilment of financial obligations and most unlikely to be affected by any foreseeable adversity. Extremely strong financial condition and very positive non-financial factors.
AA	Very high credit quality. Very strong capacity for timely fulfilment of financial obligations. Unlikely to have repayment problems over the long term and unquestioned over the short and medium terms. Adverse changes in business, economic and financial conditions are unlikely to affect the institution significantly.
A	High credit quality. Strong capacity for timely fulfilment of financial obligations. Possesses many favourable credit characteristics but may be slightly vulnerable to adverse changes in business, economic and financial conditions.
BBB	Good credit quality. Satisfactory capacity for timely fulfilment of financial obligations. Acceptable credit characteristics but some vulnerability to adverse changes in business, economic and financial conditions. Medium grade credit characteristics and the lowest investment grade category.
Speculative Grade	
BB	Speculative credit quality. Capacity for timely fulfilment of financial obligations is vulnerable to adverse changes in internal or external circumstances. Financial and/or non-financial factors do not provide significant safeguard and the possibility of investment risk may develop.
B	Significant credit risk. Capacity for timely fulfilment of financial obligations is very vulnerable to adverse changes in internal or external circumstances. Financial and/or non-financial factors provide weak protection; high probability for investment risk exists.
C	Substantial credit risk is apparent and the likelihood of default is high. Considerable uncertainty as to the timely repayment of financial obligations. Credit is of poor standing with financial and/or non-financial factors providing little protection.
RS	Regulatory supervision (this rating is assigned to financial institutions only). The obligor is under the regulatory supervision of the authorities due to its weak financial condition. The likelihood of default is extremely high without continued external support.
SD	Selective default. The obligor has failed to service one or more financial obligations but CI believes that the default will be restricted in scope and that the obligor will continue honouring other financial commitments in a timely manner.
D	The obligor has defaulted on all, or nearly all, of its financial obligations.

Short-Term Issuer Credit Ratings

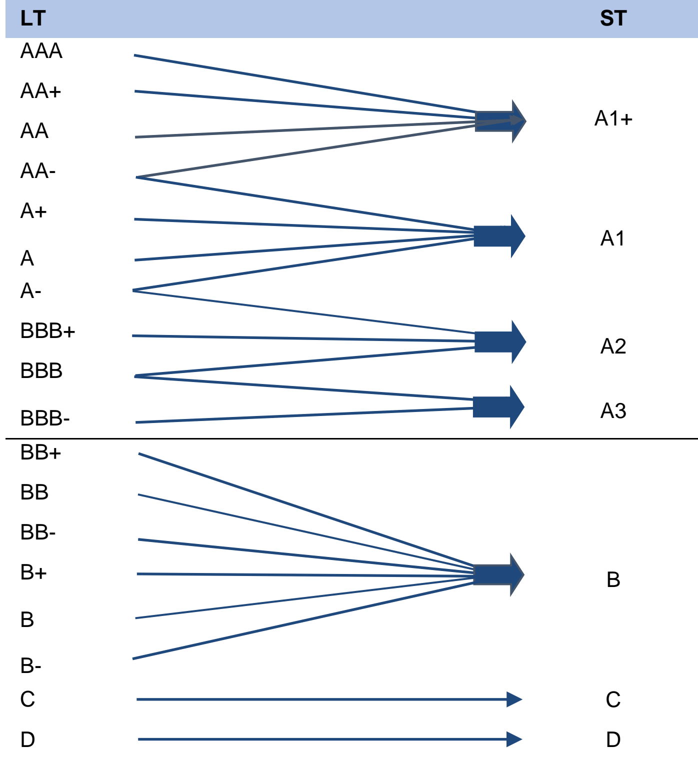
Investment Grade	
A1	Superior credit quality. Highest capacity for timely repayment of short-term financial obligations that is extremely unlikely to be affected by unexpected adversities. Institutions with a particularly strong credit profile have a '+' affixed to the rating.
A2	Very strong capacity for timely repayment but may be affected slightly by unexpected adversities.
A3	Strong capacity for timely repayment that may be affected by unexpected adversities.
Speculative Grade	
B	Adequate capacity for timely repayment that could be seriously affected by unexpected adversities.
C	Inadequate capacity for timely repayment if unexpected adversities are encountered in the short term.
RS	Regulatory supervision (this rating is assigned to financial institutions only). The obligor is under the regulatory supervision of the authorities due to its weak financial condition. The likelihood of default is extremely high without continued external support.
SD	Selective default. The obligor has failed to service one or more financial obligations but CI believes that the default will be restricted in scope and that the obligor will continue honouring other financial commitments in a timely manner.
D	The obligor has defaulted on all, or nearly all, of its financial obligations.

CI Ratings appends '+' and '-' signs to foreign and local currency long-term ratings in the categories from 'AA' to 'C' to indicate that the strength of a particular rated entity is, respectively, slightly greater or less than that of similarly rated peers.

Outlook: expectations of improvement, no change or deterioration in an entity's long-term issuer ratings over the 12 months following its publication are denoted 'Positive', 'Stable' or 'Negative'.

ANNEX 2: CORRESPONDENCE BETWEEN LONG-TERM AND SHORT-TERM ISSUER RATINGS

Short-term ratings are mapped from long-term ratings using the guidelines below. Deviations may be permitted where entity-specific circumstances render the guidelines inappropriate.



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