# NON-FINANCIAL CORPORATE ENTITIES RATING CRITERIA

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This is an update to the methodology previously published in March 2020.

There are no material changes and as such no rating impact.

March 2021

# I. CRITERIA SUMMARY

This criteria report is an update to the version published in March 2020 (under the name of Corporate Entities Rating Methodology, now renamed to Non-Financial Corporate Entities (NFC) Rating Criteria). This updated version has no material changes compared to the previous one but adds some clarifications that are described below. For the purposes of this Criteria report, ARC will refer to the NFC as the corporate, the entity, or the issuer.

Clarifications to the Criteria:

- ARC has separated its Group Relations and Group Support section into two sections to clarify its position on both, in particular its approach regarding operating subsidiaries within a larger group.
- ARC has rearranged/grouped the key areas of its analysis (which have not changed) into two main groups: qualitative elements and quantitative elements, with the aim of making its analytical process clearer.

These changes, together with other minor wording changes, have been made to improve the reading of the Criteria, keeping nevertheless ARC's analytical approach unchanged.

# II. INTRODUCTION

ARC NFC rating is a forward-looking view of an issuer's ability and willingness to meet its financial obligations as they fall due. Corporate credit quality and default risk is assessed over both the short term and the long term, with separate short-term and long-term ratings being accorded where necessary. While the Criteria are applicable to all NFCs, there might be certain industries, with specific characteristics, where ARC might need to adjust some aspects of these criteria and those adjustments will be disclosed and explained in the supporting rating reports.

Typically, a strong linkage exists between short and long-term ratings. However, the rating process is dynamic and this linkage may be broken under certain circumstances, at the discretion of the rating panel. ARC's table of mapping between medium-long-term and short-term ratings is available in a separate document, 'Credit Ratings and Other Analytical Products - Definitions and Scales', available at www.arcratings.com.

ARC's approach to corporate ratings is to integrate quantitative analysis with qualitative analysis relating to key areas of financial performance and management. The objective is to assign ratings that are applicable throughout the various stages of the business cycle, as well as examining the ability of an issuer to meet its obligations under reasonable and stressed scenarios. This analysis takes into account the different fundamentals evidenced across the various industries that fall under the corporate sector.

## III. ISSUER VS ISSUE RATING

Issuer corporate credit ratings accorded by ARC are an expression of an issuer's ability and willingness to service its debt obligations, which are generally underpinned by a legal obligation to make repayments and failure to meet these can lead to a default of the issuer. However, a complete assessment of credit risk requires that the issuer's ability to meet all liabilities, including the ongoing ability to meet its operating expenses and trade creditors, inter alia, be considered.

Different liabilities or obligations of an issuer can carry different levels of credit risk for reasons that include the size of the obligation, timing of the related payment, collateral and other structural enhancements or legal characteristics. As a result, ARC's first step is to assign an Issuer Credit Rating (ICR) which is deemed to be equivalent to the rating of senior (i.e. unsubordinated), unsecured debt, from which the ratings of all other debt issuances (Issue Credit Ratings) are notched up or down according to their characteristics and ranking and to the issuer's debt structure as a whole.

While the debt maturity profile of an entity may differ from year-to-year, ARC assesses the creditworthiness of the entity over a full economic cycle. If principal and interest payments would appear to be especially onerous during any one-year period, the related default risk of the corporate in that year may define the overall rating in the context of all other meaningful considerations. Likewise, if an assessment of major risk events projects the occurrence of a risk related event within the horizon being analysed, the firm's ability to manage the impact of such an event on its business will also become a key element to be considered within the rating analysis. Cyclical peaks and turnarounds are typical examples of such risks.

In order to issue an opinion on a NFC's creditworthiness, ARC typically analyses the last five years of historical audited financial statements, but if the company has less than five years history the decision on whether the information is sufficient to perform a rating analysis will be taken on a case-by-case basis. These statements are typically considered together with the most recent interim financial information and at least two years' forward looking financial projections.

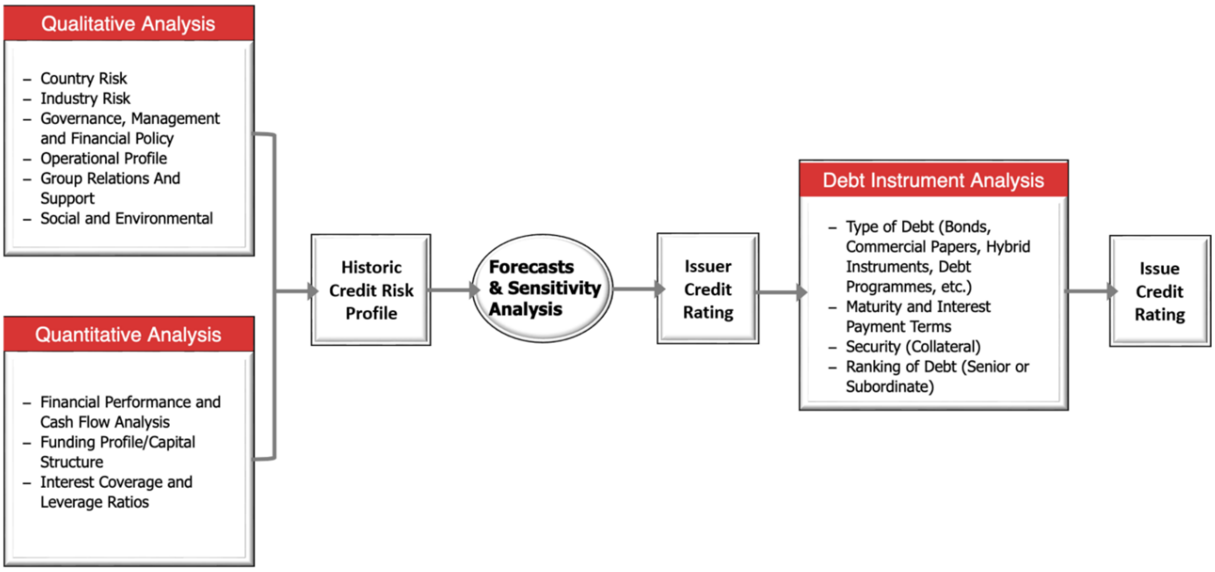
## IV. RATING CRITERIA

Incorporating a mix of quantitative and qualitative factors, fundamental analysis forms the basis for ARC's analytical approach. ARC's ratings are based on a clear understanding of the fundamentals and risks of the rated organization and the industry (or industries) in which it participates. The goal of any credit analysis is to determine if and to what extent future cash flows will cover interest and principal payments. Thus, assigning a credit rating is a dynamic process, as each entity possesses unique characteristics and assumes varying levels of risk. Whilst appropriate financial and credit metrics will vary amongst companies in different sectors, ARC will benchmark a corporate's financial performance and metrics against its peers. However, the individual financial metrics or credit ratios are not considered solely against the peer group, but their strength and relevance is determined by reference to all other company characteristics.

Gaining an in-depth understanding of the particular issuer's business, and its vision and strategy, is the foundation upon which ARC's corporate credit ratings are based. At the outset, ARC will devote substantial efforts to understand, amongst other things, the issuer's organisational history, corporate structure, management profile, business model, competitive position and its key strengths and weaknesses. ARC will meet with the entities' management at the outset of the process as well as on an annual basis to determine if there have been any changes to the strategy, governance and performance among other things.

ARC's analytical process focuses on the key areas identified in Figure 1 below. Each element of the analysis can be categorised as qualitative or quantitative, with each item explained further in the narrative that follows.

**Figure 1: ARC's Corporate Rating Process**




## QUALITATIVE ANALYSIS

### Country Risk

In ARC's view, political stability/instability, macroeconomic conditions and other operational environment considerations in the territory(ies) in which the analysed entity operates may greatly influence its creditworthiness. This is because entities exposed to emerging or developing countries are susceptible to operational uncertainty of greater frequency and/or severity than their counterparts based in more stable territories.

For example, an unstable political environment may create uncertainty about government intervention or policy implementation. By the same token, vigorous economic growth or high per-capita income levels may offer opportunities for issuers across the economy regardless of sector. The factors ARC will assess include economic scale and diversity, sovereign indebtedness and fiscal discipline, monetary policy, institutional strength (including the rigour of the legal system and enforceability of laws), and an enabling business environment (or lack thereof).

A comprehensive analysis of the political and economic environment provides the context against which both historical performance and future expectations are considered. Economic trends and government policies are analysed to determine their impact on the demand/consumption function within the economy in general and the relevant industry. Given the increased interconnectedness of business, economic analysis extends beyond country or regional borders to global trends, which could reasonably be expected to have an impact on the issuer's credit strength and thus its credit risk profile. While the profitability of some NFCs may be highly correlated to global economic growth, others will have an inverse relationship.

In assessing this risk, ARC will analyse country risk for the jurisdiction in which the analysed entity is headquartered. For multinational corporates, the analysis typically counterbalances the country risk dynamics of the territories to which the issuer is exposed. Depending on, inter alia: the nature of the industry, the evolution or dynamism of the entity and the availability of information, ARC will use revenue, earnings or asset values to determine an entity's territorial exposures.

This is especially relevant with regard to assigning ratings to NFCs dependent on funding from global financial markets, and hence vulnerable to the conditions and performance of such markets, even when they are unrelated to the actual credit quality of the analysed entity.

**Industry Risk**

In the industry overview, fundamental industry and business risks that could have an impact on cash flows are identified, and broad credit rating parameters are set accordingly. For example, highly cyclical industries, where sales (in terms of volume/price) are closely tied to fluctuations in macroeconomic indicators, such as GDP and interest rates, would incur a negative rating bias in the long term. This is due to pronounced volatility in earnings, as these types of issuers are characterized by high operating leverage, arising from their large fixed-to-variable cost ratio. Notwithstanding this, there are diversified businesses whose cycles often offset each other, thereby reducing the variability in earnings and cash flow exhibited by single-cycle issuers.

Global factors have a more significant impact on ratings through commodity price movements. As the corporate environment is weighted more towards basic manufacturing industries, earnings are often highly susceptible to fluctuations in commodity prices, over which the corporate has no control. Whilst forecasting commodity price movements is difficult, ARC analyses historical price trends and current supply/demand factors to develop an opinion of the future movements. Nevertheless, determining the impact that changes commodity prices will have on earnings is more important than the absolute price movements.

In most instances, commodity dependent manufacturers are exposed to substantial liquidity pressure in periods of rising commodity prices, particularly where price movements are rapid and unexpected. ARC considers the organisation's risk management policies and actions taken in relation to this volatility, as well as assessing whether sufficient unutilized funding facilities are available to meet unforeseen liquidity requirements.

The nature and state of the industry is a particular focus, as those play a fundamental role in the analysis. For example, in an industry in decline or under high growth, it may adversely affect ARC's assessment on industry risk. The former may be characterized by waning profitability and weaker cash flows, the latter may require larger capital or R&D expenditure, which may lead to higher gearing levels. In contrast, the stability of an industry could be assessed as a positive rating factor, owing to the less volatile nature of revenue and cash flow streams. Acknowledging the risks related to cyclicality and other industry factors, rating ceilings may be applied to specific industries.

ARC's evaluation of industry risk focuses primarily on:

1. Competitive environment (looking at both local and international competition);
2. Barriers to entry, for example capital spending requirements and threats of new entrants;
3. Industry sensitivity to macro-economic drivers, such as interest rates, household expenditure and gross fixed capital formation;
4. Existence of substitutes;
5. Influence and power from customers and suppliers;
6. Regulatory environment.

In developing economies, issues relating to political and social risks have a substantial impact on the industry environment, and this trend is also being recently evidenced in stable developed economies. ARC's analysis accounts for prospective changes in legislation, whether impending or merely being raised in government circles. An issuer's ability to adapt to both a changing regulatory environment and to shifting social norms is an important factor in the long-term assessment of the industry risk.

**Operational Profile**

The analysis shifts towards the core competencies of the issuer, to establish if there are any defensive features or risks that could cause the entity to out/underperform relative to the industry. In this regard, ARC typically assesses the following competitive advantages:

- cost leadership;

- scale, product, sectoral and geographic diversification;
- branding and franchise value;
- supply chain advantages;
- first mover advantages and technological efficiencies.

Apart from relative strengths and opportunities, the threats and weaknesses of an entity are also assessed. Performance is benchmarked against historical trends, industry standards and competitors. Financial data such as turnover growth and profit margins are critical in measuring such performance.

Emphasis is placed on diversification of earnings. Issuers are penalized for being too heavily reliant on only single revenue stream, supplier or customer, particularly where the loss of that income would impact the sustainability of the business. Where significant exposure to a single counterparty exists, ARC may undertake an analysis of the counterparty creditworthiness, and thereby form an opinion as to risks relevant to the analysed entity. Should the exposure be sufficiently material, the Issuer's credit rating may be constrained accordingly.

**GOVERNANCE, MANAGEMENT AND FINANCIAL POLICY**

ARC expects principles of corporate governance to be applied by all corporates that it rates. Corporate governance principles are not always legally enforceable and are very often implemented through recommendations and best practices. Thus, it is important to understand the governance culture within an organisation and to take note of more subjective measures and/or unwritten corporate governance behaviour. ARC will review the issuer's corporate governance principles, guidelines and application and will highlight any material concerns or flaws.

ARC's assessment of management structures includes an evaluation of the quality and level of oversight and support of all the entity's activities. Competent, independent and high performing boards are important to set an entity's strategic direction, constructively challenge executive management's decisions and ensure that the entity is run in a sustainable way. Effective boards should include non-executive and independent members with diverse skills, competencies, views and professional experience. The oversight role of the board of directors plays an integral part in how management performance is measured, rewarded and disciplined/sanctioned as it fulfils its fiduciary and management responsibilities. An independent, active, knowledgeable and committed board with no conflict of interest generally signals a robust governance framework. Corporate governance is considered weak when the board can no longer maintain its independence from management and ability to exercise appropriate oversight over risk taking, competition or conflicts of interest.

Ultimately, the performance of an organization depends, to a large extent, on the strengths and capabilities of management. A management team with good depth and breadth is considered important to ensure that the entity does not have a 'key-man' risk. Relying on one or a few key managers could result in a significant disruption to the operations if the key personnel were lost to the business. Further to this, adequate depth of management and succession planning are characteristic of soundly managed organisations. Management's ability is primarily assessed by considering historical budgeted expectations relative to actual performance for all key earnings, liquidity and gearing metrics. The analysis also encompasses the success and impact of past expansionary efforts, as well as the utilisation and management of financing methods.

A comprehensive list of questions and topics that are usually discussed when evaluating corporate governance and management includes:

- Composition of the board of directors/supervisory board, background and independence.
- Concentration of power of decision-making processes.
- Are strategy and objectives communicated within the organisation and how aligned are they within the organisational structure?
- Is the ownership structure a limitation to adequate corporate governance?
- Is risk tolerance appetite clearly determined and communicated?
- How is the risk management function structured and managed?
- How experienced is the senior management?
- Are internal procedures and practices clearly defined, communicated and applied?
- Is there any evidence of complexity of the ownership structure?
- Structure of the management compensation packages. Are the incentives for management compensation aligned with a sustainable long-term perspective of the entity?
- Is there any evidence of moral hazard risk?
- Is there any evidence of key man risk?
- Quality of reporting, controls and monitoring of the board to management level.
- Evidence of any legal or regulatory dispute that can affect the reputation of the entity.
- Any compliance breach, exception, or fine from a regulatory institution.
- Other relevant aspects.

As part of the governance assessment, ARC also highlights the importance of financial reporting in terms of quality, transparency and timing. The disclosure of financial information of poor quality that lacks transparency, or is published late, is viewed as a negative factor by ARC.

A key responsibility of management is the definition of the company's financial policy, determining the company's tolerance for financial risk and its capital and indebtedness structure (both present and its future direction). ARC expects a clear financial policy to be in place consistent with the company's goals and strategy. ARC assesses the company's track record in terms of meeting its pre-defined goals and its ability to achieve its objectives for capital structure and credit profile. Particular attention is given to the company's operating performance and use of cash flow through different phases of economic cycles, management response to key events and appetite for mergers and acquisitions. The materiality, type of acquisitions and, in particular, the chosen form of financing them is key to ARC's assessment, with a record of significant debt financed acquisitions being assessed as a negative rating factor unless a clear strategy to restore the previous equilibrium is in place. The historical balance between shareholder returns and debtholder' interests is also a relevant factor, with an imbalance towards the first being a potential negative rating factor.

## GROUP RELATIONS AND SUPPORT

### GROUP RELATIONS

If an entity is part of a financial group, for analytical reasons we assess not only the financial profile of the entity on a stand-alone basis, but also the financial and business profile of the group. ARC therefore will usually use the group's consolidated financial statements. ARC carefully analyses the linkages between the various group companies to determine both the potential for contagion or explicit financial support by the group to the rated issuer. In the case where the issuer is the group's holding or parent company, a consolidated approach is typically applied so that the operating subsidiaries' cash flow generation, funding needs and impact on the issuer creditworthiness are all incorporated in ARC analysis, unless the holding or parent company is an investment holding vehicle, or if there are exceptional factors such as material minority interests, which could advise against using this approach.

If the analysed issuer is not the holding company of the group, but just one of its operational subsidiaries, the consolidated approach could also be used whenever ARC's analysis reveals the existence of shareholding, operational, financial or contractual linkages (including intra-group guarantees to the issuer debt).

If the issuer is, in practical terms, segregated from its group, that is, when there is no legal obligation from the group's holding or any other subsidiary of the group to support the issuer due to shareholding relations or any other substantial operational, financial or contractual (including intra-group guarantees of the issuer debt) linkages, ARC will assess the capacity and the interest that the issuer's group might have of providing any kind of support to the issuer, or, conversely, the group need and capacity to strip cash from the subsidiary. Such a situation could negatively affect the financial profile of the analysed entity, which could lead to an assessment of the credit risk profile of both entities independently.

GROUP SUPPORT

Group support could come from an identified support provider (e.g. ultimate parent, holding, group, credit enhancement, explicit guarantee among others). After the identification of the support provider, ARC assesses the potential support that will be translated into notching adjustments.

It is also important to note that the ultimate parent could still strip cash from a subsidiary that it has no obligation to support via dividends or intra-group loans. Accordingly, subsidiaries typically cannot be assigned ratings higher than their parent's even when the subsidiary's standalone profile is stronger, unless the subsidiary's cash flows are legally/contractually ring-fenced or otherwise restricted.

It is worth noting that group support would be typically a neutral or positive factor to the analysed entity. However, in specific cases in which ARC analysts consider that because of particularities of the group structure, or due to conditions that limit the financial independency of the analysed company, support could negatively affect the analysed entity. These cases, although rare, will be disclosed accordingly. In case of the existence of any form of guarantee or legal obligation to support the analysed entity by the parent company, holding company or group, the support could be taken to the level of the support provider. Even though the analysed entity may not have any formal or explicit support, ARC evaluates the strategic importance of the entity and its effects on the parent's (or group) reputation and market confidence if a potential default affects its operation. In that context, we use the concept of 'strategic importance' and consider as a benchmark the financial strength of the parent company, holding or group. Although ARC evaluates the existence of eventual support, the track record and previous examples of support highlighted during past crisis are considered a key element. ARC also evaluates the structure and organisation of the group, the legal ownership, organisational structures, direct and indirect control mechanisms and intragroup relationships to evaluate the potential for support when there is no explicit guarantee or legal obligation to provide it.

**SOCIAL AND ENVIRONMENTAL RISKS**

ARC also incorporates an analysis of environmental and social factors, whenever they might impact the issuer's creditworthiness. ARC typically takes a forward-looking perspective of potential risk factors impacting each issuer, acknowledging that in the case of some ESG factors (climate change or demographics as examples) the credit impact of such factors will only be known in the long term. Accordingly, factors are also captured and highlighted in ARC's analysis whenever it is considered that these might have a material impact on credit quality.

Environmental factors that could be included into the analysis are:

- Climate change.
- Biodiversity loss.
- Air pollution.
- Water management and pollution.
- Resources depletion.
- Energy management.

ARC assesses both the consequences (existing or potential) from the environmental factors, as well as the impact of regulatory or policy initiatives aimed at minimising or preventing the deterioration of these environmental factors.

Social factors that could be included into the analysis are:

- Consumer protection, including privacy and data security.
- Labour relations and practices.
- Integration in the community and affordability.
- Stakeholders' opposition.

ESG factors typically may differentiate ratings between different sectors, but generally will only differentiate ratings from issuers within the same sector when an issuer is unusually strong or weak in a specific ESG factor.

Where ESG factors are a key driver behind the assignment or change of a credit rating or rating outlook this will be outlined, the ESG factor that was considered a key driver identified and its materiality will be explained in the accompanying press release or report.

For ARC, ESG factors are not based on quantitative data neither have a specific score; the impact of the analysis is applied using notching adjustments if, from the analysis, it is determined that a potential risk for the issuer is identified that can affect the rating in the long term.

## QUANTITATIVE ANALYSIS

### Financial Performance and Cash Flow Analysis

Quantitative analysis involves scrutinizing the corporate's financial performance, cash generation and financial position, ideally over a five-year period. Before any financial information is analysed, due consideration is given to their composition and accounting quality. ARC will review the accounting standards applied and quality of the audit firm used.

FINANCIAL PERFORMANCE

ARC assesses as a positive rating factor the entity's stability in revenue and cash generation. Financial performance is assessed not only relative to historical performance, but also in relation to the management goals and strategic objectives. This allows for due consideration to be taken of the assumptions on which the financial results were produced. Thus, while a decline in the EBITDA and/or operating profit margin could be negatively perceived, it could, for example, be attributable to a deliberate management strategy of penetrating a lower margin segment of the market or increasing market share.

The analysis of an issuer's profit margins is a central element in assessing the quality of earnings. Both the gross margin and the operating margin are scrutinized to identify the sources of cost pressures. Gross margin analysis provides an important tool in identifying the effect of external costs pressures on corporate profitability. This is particularly true for commodity-dependent corporates, where earnings can be substantially affected by sudden commodity price volatility. To the extent that gross margins can be maintained within a predictable band, or input costs can be subject to appropriate hedging mechanisms, earnings volatility is likely to be minimized. Moreover, maintaining fairly stable margins (or consistently profiting from price fluctuations) points to above-average management quality. A crucial part of ARC's analysis is a peer comparison, and accordingly, margins (as well as the quantum and trajectory of earnings) are typically compared to those of global (and/or domestic) peers.

Profit margins help identify an issuer's success in managing those costs over which it does exercise some control. Whilst cost controls may be crucial in ensuring the efficiency of an organisation, ARC seeks to identify the point at which such reductions may have a negative impact on the entity's future growth prospects.

CASH FLOW ANALYSIS

ARC assigns ratings to an issuer primarily based on the extent to which its cash flow covers interest and principal payment obligations. Accordingly, of paramount importance is the analysis of the group's cash generation capabilities with particular focus on the cash flows generated by the corporate's core business, which are expected to be sustainable going forward. Both operating and free cash flow are analysed according to the following parameters:

- Strength – the quantum of cash flow generated by the corporate's core operations in relation to capital requirements.
- Variability – volatility in cash flow across business cycles, determining sensitivities of cash flows to changes in economic conditions.
- Predictability – of future cash flows, asset disposal and acquisitions.

**INTEREST COVERAGE AND LEVERAGE RATIOS**

Cash flow and interest coverage ratios are key credit metrics and are analysed in conjunction with gearing levels and funding structure (as discussed below). ARC assesses the various ratios in relation to the issuer's historical trends, as well as those of the industry in which it operates. ARC may apply various analytical assumptions to identify possible sources of liquidity pressure and understand the effect they may have on debt serviceability.

Key ratios analysed include:

- Interest coverage – gross interest coverage assesses the ability of an issuer to honour its interest obligations, including the capitalized interest on development funding (if material). Net interest coverage examines the interest charge after all interest risk mitigants, such as interest income, hedging instruments and capitalized interest on development funding have been accounted for. ARC typically assesses interest coverage against EBITDA, although in instances, the more stringent EBIT measure is applied. ARC may also utilise free cash flow coverage of interest where EBITDA is not considered to be a reasonable proxy of cash generation. The metric is calculated by dividing cash flow from operations plus the net interest charge by net interest.
- Cash flow coverage of debt – as ultimately an issuer will require sufficient cash to settle its debt obligations, the ratio provides a measure of the level of available cash (after all operational and working capital requirements are met) relative to debt obligations. A more conservative measure is discretionary cash flow (cash flows after operational commitments, working capital requirements and replacement or maintenance capital expenditure) relative to the issuer's interest-bearing obligations. Net debt to EBITDA assesses the extent to which on-going operations could meet principal obligations. Given the diverse nature of corporates analysed, ARC does not impose an optimal gearing limit, but rather assesses gearing levels relative to management's self-imposed gearing limits and industry norms. Cognisance is taken of the fact that working capital requirements fluctuate seasonally and hence gearing levels at reporting dates may not accurately reflect the issuer's risk profile. Further to this, many issuers set their reporting dates to coincide with the most favourable balance sheet position possible, and ARC examines interim and/or management accounts to assess this element.

Funding flexibility may be constrained by the existence of secured credit facilities. Many securitisation or secured bond structures have fairly onerous terms and financial covenants, which significantly limit an issuer's ability to raise additional funding. Moreover, the position of unsecured creditors is adversely affected by the existence of secured facilities, as the former will rank subordinate in a default situation, leading to lower expected recoveries. ARC thus calculates the level of unencumbered assets relative to unsecured creditors, to determine whether average recoveries could be expected. Where expected recoveries are deemed to be below average, the corporate credit rating (relating to all creditors) would necessarily be constrained.

Other liabilities also considered include:

- Off balance sheet financing.
- Contingent liabilities or guarantees provided.
- Legal disputes.

Insurance policy: ARC will assess the insurance policies in place regarding the issuer's facilities, machinery, etc., including any insurances for business interruption and for damages to third parties.

**FUNDING PROFILE/CAPITAL STRUCTURE**

An appraisal of the company's funding profile commences with the various sources of funding available to the company, in relation to its asset profile. While no optimal mix of short-term and long-term funding is prescribed, emphasis is placed on the match between assets and liabilities. For example, it is prudent for working capital intensive businesses to predominantly make use of short-term funding, whereas capital intensive businesses would be expected to utilise longer term facilities.

The unique characteristic of each corporate entity dictates that there are no hard and fast rules with regards to the debt composition. Cognizance is taken of the corporate's lifecycle and type of industry in which it operates. For example, an entity operating in the telecommunications or diversified industrial sectors will generally be capital intensive in nature and have greater funding requirements than a cash retail business, while a credit retail business will have sizeable working capital requirements. ARC's corporate analysis also takes into account the need to repair or replace infrastructure that has deteriorated or become obsolete. Where specific data is not available, depreciation is usually used, as a proxy of a corporate's annual replacement capital expenditure.

As the credit rating ultimately reflects the issuer's ability to service its debt, the core of the funding profile analysis is to address the amount and tenor of the total debt. Particular emphasis is placed on debt concentrations, be they by source or by maturity. A diversification of funding sources, either through different banks or financial institutions, or through capital markets, is positively viewed. Conversely, debt concentration by source points to lesser funding flexibility, even if the arrangement has positive operational aspects (such as strong banking relationships or specific collateral agreements).

Maturity concentration is assessed relative to an entity's ability to meet debt redemption obligations in the absence of refinancing options. Where there are substantial short-term maturities (over the next 12 months), ARC expects the issuer to have initiated refinancing or redemption arrangements at least 6 months in advance. For facilities that will be redeemed, ARC expects that cash trapping mechanisms are instituted, albeit that this requirement may be waived where the issuer can provide acceptable assurances that sufficient cash will be available.

For short-term debt issuances such as commercial papers ("CP"), issuers are expected to maintain sufficient standby facilities at all times to ensure full redemption of the CP if necessary. The absence of such facilities might negatively affect the short-term rating. Such facilities may include the unutilised portion on existing facilities. However, ARC recognises that unutilised facilities may be withdrawn at any time. Thus, significantly greater weighting is given to committed facilities, for which the issuer pays a commitment fee or has placed collateral. To assess the level of liquidity available to the issuer, ARC calculates the ratio of unutilised facilities to all cash requirements over the following 12 months, including short-term programmes, maturing issues and committed capex or other expenditure.

The analysis of a corporate's funding composition also examines the currency associated with its debt exposure. To the extent that obligations may be denominated in a currency outside of a corporate's transacting currency, this implies greater risk. ARC would assess the extent to which these mismatches are mitigated, and the effectiveness of the mitigants employed. The analysis would determine the extent to which cash flows, as well as cash and equivalents within a specific geography are matched to the obligations in that jurisdiction (or currency). Alternatively, financial hedges, such as currency swaps or forward contracts may be employed where feasible.

The interest rate structure, i.e. whether fixed or floating interest rate facilities are utilised, is also assessed. While corporates may prefer floating interest rates, due to the costs involved in fixing the rate, this leaves them exposed to changes in the interest rate cycle, which are very difficult to predict. Accordingly, a conservative approach is to maintain a balance between fixed and floating rates, such that adverse changes in the environment will not have a severe impact on the financial stability of a corporate.

The accessibility and domicile of cash holdings is also critical. Often a corporate will report substantial cash holdings, but the cash will be restricted to subsidiaries, joint ventures or specific projects and cannot be accessed. Similarly, cash holdings may be deposited in foreign banks with the corporate unable or unwilling to repatriate the money. To the extent cash is restricted, ARC may exclude it from net gearing calculations.

Access to equity markets provides an important source of funding diversification, which could reduce the risk within an organisation. ARC measures equity on a tangible net equity basis, after excluding goodwill and certain intangible assets. The inclusion or exclusion of intangible assets is considered on a case-by-case basis with the key considerations being whether such assets directly produce cash flows and whether they can be sold to a third-party on a standalone basis.

A more favourable rating could be awarded to a company that is financially flexible (in other words, can incur additional debt with greater ease and less strain on its balance sheet).

### FORECASTS AND SENSITIVITY ANALYSIS

ARC's credit ratings provide a forward-looking assessment of an issuer's credit risk profile. Thus, it is critical to gain a clear understanding not only its current financial position, but also how cash flows and risk metrics are likely to perform under various scenarios in the medium to long-term.

ARC typically incorporates two years' forecasts into its forward-looking view (aligned also with the period covered by the accorded outlook, for details please refer to 'ARC Rating Definitions', available at arcratings.com. These forecasts and its assumptions are discussed at length with the company's management and reviewed by ARC analysts in order to make adjustments if needed, including assessing different scenarios and applying appropriate stresses to determine inflection points at which the credit risk metrics under consideration could deteriorate further. Often it is through these assumptions that future sources of risk can be accurately identified. Crucially, the extent to which stress factors are applied is linked to the credit rating level being considered. For credit ratings within the higher categories, greater stress factors are typically applied, as these ratings indicate less vulnerability to adverse changes that could affect the credit risk profile.

## V. CONCLUSION

While thorough quantitative analysis is important, the qualitative characteristics of ARC's analysis cannot be over emphasised. It is critically important to look "beyond the numbers" to evaluate the intangible strengths and weaknesses of an entity. An important aspect of ARC's analysis is an understanding of the strategic characteristics of an entity and the quality of management. Ultimately ARC's emphasis is on determining how these strategic aspects will affect the organisation's capacity to generate cash in the long-term.

# DISCLAIMERS



# CONTACT DETAILS

ARC Ratings (UK) Limited

30 Churchill Place
Canary Wharf
London E14 5RE
UNITED KINGDOM
+44 203 927 8600
arcratings_uk@arcratings.com

ARC Ratings, S.A.

Rua de São José
35 – 1º B
1150-321 Lisbon
PORTUGAL
+351 21 304 11 10
arcratings_eu@arcratings.com

Site: www.arcratings.com

Vitor Figueiredo
Sector Head – Special Projects
vitor.figueiredo@arcratings.com