Rating Methodology

TRIS RATING
A Strategic Partner of S&P Global

Issue Rating Criteria

15 June 2021

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Overview and Scope of the Criteria

This paper outlines how TRIS Rating assigns a rating to a debt issue. The criteria apply to debts issued by corporates, non-bank financial institutions (NBFIs), and government-related entities (GREs). The paper covers mainly long-term issue ratings for debt issues with a maturity longer than one year. For short-term issue ratings, which are derived from the long-term issue ratings, please refer to our paper on "Short-term Ratings".

Unlike issuer credit ratings (ICRs), in which we focus mainly on the default probability of the debt issuer, issue ratings take into consideration both the default probability and recovery prospects of a specific debt issue. Depending on the terms and conditions of the debt issue, the recovery prospects tend to be dictated by the priority of claims and/or the value of assets pledged as collateral (if any). Thus, an issue rating could be the same, lower, or higher than the relevant ICR.

Issue ratings could be notched up or higher than the ICRs if those issues are well secured or guaranteed by higher rated entities. The rating on a secured debt issue could be notched up if the issuer does not have a significant proportion of secured debt and/or priority debt and the value of pledged assets after discounting by an appropriate discount rate is at least equal to the outstanding principal value of the debt issue. On the contrary, issue ratings could be notched down from the ICR due to the lower priority of claims and/or recovery prospects.

The notch-down of issue ratings could be due to (i) legal subordination, (ii) a high proportion of secured debt relative to the total debt of the issuer, and (iii) structural subordination. Structural subordination is typically associated with the debt obligations of holding companies whose earnings are derived mainly from dividends from subsidiaries. However, structural subordination may not lead to a notch down of issue ratings if the level of consolidated secured debt and unsecured debt at the subsidiary level (so called priority debts) amount to less than 50% of total consolidated debt. In addition, issue ratings may not be notched down in the case that the priority debts of holding companies are more than 50% but there are significant mitigants that help alleviate the effect of structural subordination on recovery prospects.

Previously, we applied a specific level of secured debt to the issuer's total assets as the trigger for notching down the ratings assigned to the issuer's senior unsecured debt issues. The revised criteria set the specific level of secured debt and/or priority debt to total debt ratio as the trigger for the notch down. Generally, the notching down of issue ratings due to subordination will be limited to one notch. This will be applicable across the rating categories, whether the ICR on the issuer is of investment grade or non-investment grade. However, for hybrid securities, the issue rating will be at least two notches below the ICR, depending on the features of the hybrid securities and the possibility that the issuer may defer the coupon payment. Generally, the number of notches down for hybrid securities reflects both the subordination risk and the interest payment deferral risk.

Methodology

Unlike ICRs that are based primarily on the probability of default by the relevant issuer, issue ratings are assigned based on both the default probability and the recovery prospects of the relevant debt issue. Therefore, a rating assigned to a specific debt issue could differ from the ICR assigned to the issuer of that specific debt issue. However, an issue rating is still based primarily on the ICR assigned to the relevant issuer, or the guarantor of the debt issue. The ICR on the issuer or guarantor of the debt issue must first be determined to reflect the probability of default by the issuer or the guarantor before a rating can be assigned to the debt issue. Once the ICR is determined, a notch up or notch down from the ICR may then be applied to reflect the priority of claims and/or recovery prospects of the debt issue.

Rating of Each Issue Type

I. Guaranteed debts

Guaranteed debts refer to debt obligations that are fully guaranteed by the guarantor. However, there could be more than one guarantor for a debt issue. In the case that the debt issue is guaranteed by more than one guarantor and each guarantor guarantees only a proportional amount of the obligation, we usually assign the lowest ICR (or senior unsecured debt ratings) on any of the guarantors to that debt issue. On the contrary, if two or more guarantors jointly and severally guarantee the full amount of the issue and those guarantors are not highly correlated (i.e., the guarantors are not in the same industries and/or the same countries/regions), the issue could be assigned a rating higher than the highest ICR (or senior unsecured debt ratings) among the guarantors. In most instances, the ICR on the guarantor stays at a higher level than the ICR on the issuer over the duration of the debt issue. However, in the case of a deterioration in the guarantor's creditworthiness, to the extent that the ICR on the guarantor falls below the ICR on the issuer, the rating assigned to the guaranteed issue will be equal to the senior unsecured debt rating of the issuer.

A guarantee agreement between the relevant guarantor and issuer, based on which TRIS Rating may consider the payment risk of the debt issue to have effectively been transferred to the guarantor, shall contain the following provisions:

- The guarantee is unconditional and irrevocable;
- The guarantor promises to pay the guaranteed debt in full, not just any deficiency remaining after the beneficiary has used all remedies against the collateral and the primary obligors;
- The guarantor agrees to pay the guaranteed obligations on the date due and waives demand, notice, and marshaling of assets;
- The guarantor waives the right of set-off or counterclaim;
- The guarantee is reinstated if any guaranteed payments made by the primary obligors are subsequently voided as preferential and must be returned (in the case of the primary obligor's bankruptcy or insolvency);
- The guarantee is binding on successors of the guarantor;
- The guarantor's right to terminate or amend the guarantee is appropriately restricted and cannot be undertaken without the consent of debtholders.

Generally, the guarantor's obligations under the guarantee rank pari passu with its senior unsecured debt obligations. However, if the guarantor's obligations in relation to the guaranteed debt issue are subordinated to its senior unsecured debt obligations, the rating assigned to the guaranteed debt issue will be equivalent to the rating on the subordinated obligations of the guarantor. We require a legal opinion which states that the transaction documents are legal, valid, binding, and enforceable against all relevant parties.

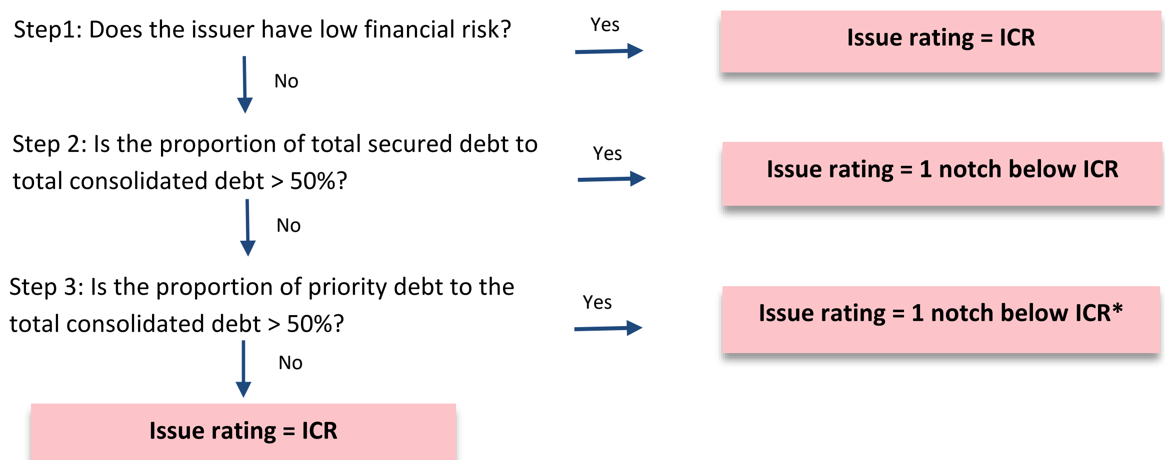
II. Partially guaranteed debts

In assigning ratings to partially guaranteed debt issues, we start by assigning the senior unsecured debt rating on the issuer, then notching up the rating to reflect the benefit from the partial guarantee. We limit the notch up to not more than three notches from the ICR on the issuer. The level of notch up is determined based on the percentage of principal amount and accrued interest being guaranteed, the ICR on the issuer, and the ICR on the guarantor. For partially guaranteed obligations, the default risk is still linked to the credit worthiness of the issuer as reflected by the ICR on the issuer. For further details, please refer to our publication on "Partially Guaranteed Debt Rating Criteria".

III. **Senior unsecured debts**

In most cases, we assign ratings to senior unsecured debt issues at the same level as the ICR on the issuer. However, there are instances where we assign ratings to senior unsecured debt issues at levels below the ICR on the issuer if we assess the recovery prospects of the relevant unsecured obligations to be weaker than the average of the issuer's debt obligations. The notch down is usually limited to one notch below the ICR. Weaker-than-average recovery prospects in relation to unsecured debt issues are typically associated with circumstances where (i) the issuer has substantial amounts of secured debts, or (ii) the issuer is a holding company (holdco) whose debt-servicing capacity depends largely on dividends received from its subsidiaries since the holdco itself has insignificant operating assets relative to the size of its debt obligations (structural subordination).

To assign a rating to the senior unsecured debt, we apply the following steps:



* *In the case that there are significant mitigants that alleviate the subordination effect, the senior unsecured debt rating could be rated at the same level as the ICR.*

The details of each step are explained as follows:

Step 1: Determine the issuer's financial risk profile (FRP) or the group's FRP.

If the issuer or the group is assessed to have minimal financial risk, there is low likelihood that the debt to be rated would be significantly disadvantaged to more senior debt with respect to its lower priority of claim. Therefore, we would assign the unsecured debt issue rating at the same level as the ICR. For general corporates, our guidance for the minimal financial risk profile is a debt to earnings before interest, taxes, depreciation and amortization (EBITDA) ratio of less than 2 times. However, for investment-grade regulated utilities and real estate investment trusts (REITs) and real estate for rent companies, our guidance for the minimal financial risk profile is a debt to EBITDA ratio of less than 3.5 times and 4.5 times, respectively.

We would look at the FRP of the group, if the issuer's group status is "core" or "highly strategic." For an issuer that is a "strategically important," "strategic," or "non-strategic" member of the group, we would look at the FRP of the issuer's stand-alone credit profile (SACP). For insulated subsidiaries, the FRP of the issuer's SACP would be applicable.

Step 2: Determine the level of total secured debt to total consolidated debt.

If the issuer's total secured debt to total consolidated debt ratio is higher than 50%, we consider the senior unsecured debt creditor of the issuer to be significantly disadvantaged. Thus, we would rate the senior unsecured debt issue one notch below the ICR of the issuer.

Based on the issuer's consolidated financial statements, total secured debt includes debt to which the issuer and its subsidiaries pledge asset(s) as collateral for the obligation while total consolidated debt includes interest-bearing debt, convertible debentures, and the full principal amount of hybrid securities. We exclude financial guarantees provided by the issuer to other entities (unless the guarantee is expected to be enforced in the near term), non-recourse debt of joint ventures and affiliates, intercompany loans, and other non-debt claims such as unfunded pension liabilities and net asset retirement obligations which are included in our calculation of adjusted debt. Generally, we will exclude all lease obligations from the calculation of secured debt ratio, except for some businesses that rely heavily on financial lease as a source of funds, like airline and shipping businesses. For these businesses, we will include financial lease as secured debt in the calculation of this ratio.

Step 3: Determine the level of priority debt to total consolidated debt, where priority debt includes the total secured debt and unsecured debt obligations of subsidiaries.

If the level of an issuer's priority debt is higher than 50% of its total debt and most of the group's operating assets are held at the subsidiary level, we consider the issuer's senior unsecured creditors to be disadvantaged and may rate the issue rating one notch below the ICR.

Structural subordination typically refers to the weaker position of a holdco's creditors in relation to their ability to claim against the operating assets and cash flow of the holdco's operating subsidiaries. A holdco typically functions as the highest-level legal entity to hold equity interests in multiple businesses, with itself involved in insignificant business operation. As most of the operating assets and cash generation are at the operating subsidiaries, the creditors of the holdco will be in a disadvantaged position vis-à-vis the creditors of the operating subsidiaries from a recovery perspective. In effect, the creditors of a pure holdco have only residual legal claims on the assets and cash flows of its operating subsidiaries. Thus, we typically rate the senior unsecured debt issues of a holdco one notch below the ICR assigned to the holdco.

However, we may rate the senior unsecured rating at the same level as the ICR of the issuer if we have reasons to believe that senior unsecured creditors are not significantly disadvantaged even if the level of priority debt is higher than 50%. There are a number of key mitigating factors that will be taken into consideration that include but are not limited to the following:

- **Operating assets at the holdco level**

  We may not notch down the senior unsecured debt rating of the holdco if the holdco has its own operating assets that generate more than 30% of its consolidated earnings, cash flow, or a similar financial metric.

- **Substantial investments at the holdco level.**

  We may not notch down the unsecured debt rating of the holdco, if the holdco has substantial investments other than the shares of its operating subsidiaries, and these investments are assessed to materially improve the recovery prospects of its unsecured creditors.

- **Upstream guarantees**

  Unconditional and irrevocable guarantees by the operating subsidiaries of the holdco's debt will allow the holdco's unsecured creditors to have direct claims against the holdco's operating subsidiaries in a default scenario. The guarantee should be provided by subsidiaries or a subsidiary that generate(s) at least 30% of the consolidated earnings, cash flow, or a similar financial metric.

- **Diversity**

  The holdco may benefit from engaging in more than three uncorrelated businesses or having multiple operating companies in various geographical locations. In the scenario that the holdco has at least three unrelated businesses, each business should contribute more than 20% of earnings or cash flow to the group. In the case that it has multiple operating subsidiaries, the operating performance of each subsidiary should be independent from each other with no single unit contributing more than 50% of total earnings or cash flow. In addition, there should not be cross guarantees between subsidiaries. The priority debt threshold guideline could be higher than 50% to correspond with the degree of business diversity of the group.

- **Government-related issuers**

  We may not notch down the senior unsecured debt issues of GREs that have "integral" linkages with the government or have an "extremely high" or "very high" degree of support from the government.

Other considerations:

- We apply a different trigger for notching down the senior unsecured debt of REITs and real estate for rent companies. For further details, please refer to the updated version of "Real Estate Investment Trust" rating methodology.
- For investment-grade regulated utilities, we may assign a rating on a senior unsecured debt issue at the same level as the ICR if all of the following conditions are met:
  - The issuer offers an essential infrastructure product and has a business model that is shielded from competition, and subject to regulatory oversight on its rates or tariffs and service quality. The rates are usually set based on the cost recovery and expected return on investments rather than on a market price.
  - The issuer is subject to regulatory constraints on its ability to add debt.
  - The issuer's mortgage indenture restricts the issuance of secured debt. Generally, we expect the amount of secured debt to be less than 70% of the book value of the issuer's net assets.

IV. Secured debts

We may rate a secured debt issue higher than the ICR of the issuer if the issuer does not have secured debt and/or priority debt exceeding 50% of consolidated debt and the expected liquidation value of the assets pledged against the debt obligations covers at least 100% of the outstanding debt. The legal procedures and the parties responsible for monitoring the assets and executing the procedures to liquidate the pledged assets in an asset enforcement scenario must be clearly spelled out in the terms and conditions of the secured debt issue. The expected liquidation value of the pledged assets will be based on generally accepted professional valuation. For tradable securities to be pledged as security, only government bonds or investment-grade corporate bonds with an appropriate discount to reflect valuation in a forced sale scenario will be considered for a notch up from the ICR.

However, if most of the assets of the issuer are pledged against its debt obligations, we do not consider the secured creditors to have any advantages over one another. In this scenario, we may rate the secured debt issues at the same level as the ICR on the issuer while rating the issuer's unsecured debt issues one notch below the ICR.

V. Contractually subordinated debts

A debt issue is contractually subordinated if the terms of the issue specifically provide that the debt holders will receive payments in a reorganization or liquidation only after the claims of other creditors have been satisfied. We generally rate subordinated debt issues one notch below the ICR of the issuer.

Generally, hybrid securities are contractually subordinated debts. However, the rating assigned to hybrid securities will be at least two notches below the ICR as hybrid securities typically provide the obligor with the right to defer interest payments, in addition to the subordinated status of the debt holders. For further details of the rating methodology for hybrid securities, please refer to the "Hybrid Securities Rating Criteria".

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