Rating Methodology

Corporate and Public Sector Debt

Global Master Criteria for Rating Corporate Entities

Updated February 2018

Introduction

GCR's corporate credit ratings are a measure of the ability of an Issuer to honour its financial obligations, relative to other Issuers. Corporate credit quality is assessed over both the short term and the long term, with a separate short term and long-term rating accorded.

- Short term ratings provide an indication of an Issuer's ability to meet its financial obligations over the following 12-month period, including interest payments and debt redemptions.
- Long term ratings reflect an Issuer's ability to meet its financial obligations over a period greater than 12 months, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.

Typically, a strong linkage exists between short and long-term ratings. However, as the rating process is dynamic, this linkage may be broken under certain circumstances, at the discretion of the Rating Panel. GCR's approach is to integrate quantitative analysis with a strategically based qualitative analysis. The objective is to assign ratings that are applicable throughout the various stages of a 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.

This Criteria report is an update to the version published in February 2017. There are no significant amendments to the Criteria. Some additions to the sections dealing with ratio analysis, liquidity and the assessment of a rated entity's funding profile have been made. The update of this Criteria will not have an impact on any existing Corporate ratings. Going forward, the updated Criteria will be applied to all Corporate ratings.

GLOBAL CREDIT RATING CO.

Rating Methodology

Incorporating a mix of quantitative and qualitative factors, fundamental analysis forms the basis for ratings assigned by GCR. GCR's ratings are based on a clear understanding of the fundamentals and risks of the rated organisation 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 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, GCR will benchmark a corporate's financial performance and metrics against market peers. Nevertheless, the individual financial metrics or credit ratios are not considered solely against the peer group, but their strength and relevance is determined by their relationship to all other company characteristics.

GCR's analytical process focuses on the following key areas:

1. operational analysis;
2. economic and industry analysis;
3. corporate governance and management;
4. financial performance and ratio analysis;
5. funding profile; and
6. outlook.

1. Operational Analysis

Gaining an in-depth understanding of the particular Issuer's business and ***corporate philosophy*** is the foundation upon which GCR's credit ratings are based. At the outset, GCR will devote substantial efforts to understand, amongst other things, the Issuer's organisational history, corporate structure, management profile, business model, and the key strengths and weaknesses as perceived by those both involved with and external to the Issuer.

Building on this understanding, the analysis shifts towards the various ***divisions and/or subsidiaries***, which comprise the income generating units of the business. Divisional/subsidiary performance is benchmarked against historical trends, industry norms and competitors. Financial data such as turnover growth and profit margins are critical in measuring such performance. Within this context, GCR's analysis takes account of industry fundamentals and key determinants of growth, as well as competitive advantages (such as the cost profile, product differentiation, degree of product integration) and barriers to entry. Apart from relative strengths and opportunities, the threats and weaknesses of an entity are also assessed.

Emphasis is placed on the ***diversification*** of earnings. Issuers are penalised for being heavily reliant on one revenue stream, supplier or customer, particularly where the loss of that income would impact the sustainability of the business. Where significant exposure to one counterparty exists, GCR may assess the risk of the counterparty to determine its credit rating, and thereby form an opinion as to the risks relevant to the Issuer under review. Should the exposure be sufficiently material, the Issuer's rating may be constrained by/capped to that of the relevant counterparty.

With a growing number of emerging market corporates participating in global trade, strong consideration is also given to the ***geography of earnings***. While increasing regional or global reach would have the benefit of diversifying economic risk factors, it may introduce currency mismatches. This is especially pertinent given the currency volatility of emerging market economies.

2. Economic and Industry Analysis

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 in particular. Given the increased interconnectedness of business, economic analysis extends beyond country or regional borders to global trends, which could reasonably impact on the Issuer's credit strength and thus rating. Nevertheless, GCR has discerned that, particularly in the less developed markets, the economic environment is driven more by domestic factors than by international trends.

Global factors have a more significant impact on national scale ratings through ***commodity price*** movements. As the corporate environment in most developing countries 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, GCR analyses historical price trends and current supply/demand factors to develop an opinion of future movements. Nevertheless, determining the impact that changes in commodity prices will have on earnings is more important than the absolute price movements.

Commodity dependent manufacturers are generally exposed to substantial liquidity pressures in periods of rising commodity prices, particularly where price movements are rapid. GCR considers the Issuer's risk management procedures in relation to this volatility, as well as assessing whether sufficient unutilised funding facilities are available to meet unforeseen requirements.

GCR's industry analysis assesses fundamental industry and business risks that could impact an Issuer's cash flows, and broad credit rating parameters are set accordingly. For example, highly cyclical industries such as construction and property development, where demand/deal flow and by extension revenues (in terms of volume/price) are closely tied to fluctuations in macroeconomic indicators, such as GDP growth 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 characterised by high operating leverage, arising from their large fixed to variable cost ratio. By contrast, there are diversified businesses whose cycles often offset each other, thereby reducing the variability in earnings and cash flow exhibited by single-cycle Issuers.

The nature and state of the industry is also analysed, as this plays a fundamental role in determining a rating category. For example, an industry in decline or a high growth industry may adversely affect a corporation's long-term rating. The former may be characterised by waning profitability and weaker cash flows, whereas the latter may require large capital or research and development expenditure, which may lead to higher gearing levels. In contrast, a corporation operating in a stable industry could enjoy a higher long-term rating, owing to the less volatile nature of revenue and cash flow streams. Acknowledging the risks related to cyclicality and other industry factors, rating ceilings will inherently apply to specific industries.

GCR's evaluation of industry risk encompasses a number of potential barriers to entry, with a focus on the following key areas:

1. competitive environment (looking at both local and international competition);
2. capital spending requirements;
3. sensitivities to industry drivers such as interest rates, household expenditure and gross fixed capital formation; and
4. regulatory environment.

In developing economies, issues relating to ***political and social influences*** have a substantial impact on the industry environment, although this trend is also evidenced in stable developed economies. GCR's analysis thus accounts for prospective changes in legislation, whether impending, or merely being raised within government circles or amongst social activists. An Issuer's ability to adapt to both a changing legislative environment and to shifting social norms is an important factor in the long-term risk assessment. The sophistication and stability of the prevailing regulatory framework is considered in respect of each industry, as is the degree to which such laws are enforced.

3. Corporate Governance and Management

Corporate governance codes and frameworks exist in many countries, but are generally applicable only to companies that issue shares in regulated markets. Nevertheless, GCR expects the principles outlined in such frameworks, where applicable, to be implemented across all forms of corporate structures. In South Africa, corporate governance principles are laid down in the King III Corporate Governance Code, while there are no corporate governance codes in most countries in Africa. The Sarbanes–Oxley Act sets out corporate governance principles in the US. However, corporate governance principles are not always legally enforceable and are very often implemented through recommendations and best practices. Thus, it is as important to understand the compliance culture within an organisation and to take note of more subjective measures of strong corporate governance.

GCR's assessment of management structures includes the evaluation of the quality and level of oversight and support of all of the institution'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 must 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 exercise appropriate oversight over risk taking, compensation or conflicts of interest.

Ultimately, the performance of an organisation 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 its operations, if the key personnel were lost to the business. Further to this, adequate depth of management and succession planning are characteristics 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 strategies/models.

4. Financial Performance and Ratio Analysis

Quantitative analysis involves scrutinising a corporate's financial performance, cash generation and financial position, typically over a five-year period (being GCR's review period and aligned with the horizon of the long-term rating accorded). Before a corporate's financial statements are analysed, due consideration is given to their composition and accounting quality. As the rating process explicitly excludes any type of audit, GCR's analysis relies on audit and legal and tax opinions from reputable, registered entities. The directors' accounting policy choices and the external auditors' opinion on the financial statements provide context to their appropriateness as a basis for informing the Issuer's ratings. Accounting quality may be assessed by taking cognisance of the accounting standards used in a particular jurisdiction and the reputability of the audit firm. GCR also examines how the implementation of, and/or changes to, accounting policies can affect the treatment of:

- consolidation principles;
- changes in group structure;
- reserving policies;
- off balance sheet items; and
- goodwill and other intangible assets.

Financial Performance

The focus of GCR's analysis is to assess the extent to which cash generated from the business covers the Issuer's debt (interest and principal) service requirements. Accordingly, certain adjustments are made to the financials to determine the normalised level of earnings and cash generation. Typical adjustments relate to non-cash charges/provisions, as well as fair value movements. Such adjustments typically include depreciation, amortisation, changes in reserving, changes in valuations (translating to anomalous fair value gains/losses), fixed asset impairments, profits realised from asset disposals (where such disposals are not a part of the Issuer's everyday operations), and pension-related expenses (*inter alia*). Expenses that arise from the day-to-day operations of the business are typically not stripped out to arrive at a normalised EBITDA which serves as a proxy of cash generated by a rated entity before working capital movements. Expense items treated in this manner include bad debts, the impairment of inventories, and rationalisation costs logged over multiple financial years (which due to their repetitive nature are not aligned to a clearly delineated strategy, and are considered as a regular operational charge for the purposes of this analysis, unless proven otherwise).

GCR assigns great importance to consistency in revenue and cash generation. Crucially, financial performance is assessed not only relative to historical performance, but also in relation to budgets provided by management. This allows for due consideration to be taken of the climate and circumstances in which the financial results were produced.

Thus, while a successive decline in the operating profit margin could be negatively perceived, it may be attributable to management's strategy of penetrating a lower margin segment of the market or increasing market share. Once the necessary adjustments are made, a careful dissection 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 scrutinised to identify the sources of cost pressures.

Gross margin analysis provides an important tool in identifying the effect of external cost pressures on the Issuer's 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, earnings volatility is likely to be minimised. Moreover, maintaining fairly stable margins (or consistently profiting from price fluctuations) points to above average management quality.

EBITDA and operating profit margins help identify a rated entity's success in managing those costs over which it does exercise some control. While cost controls may be crucial in ensuring the efficiency of an organisation, GCR always seeks to identify the point at which such reductions may have a negative impact on the entity's future growth prospects.

While the analysis primarily focuses on free cash flows, GCR also assesses the net profit margin and RoaE trends. This provides insights into an Issuer's ability to sustain a reasonable balance between dividend flow (which enhances the participation in future equity raises) and the retention of earnings to stimulate long term earnings growth.

Cash flow analysis

GCR assigns ratings to an Issuer primarily based on the extent to which its cash flow covers interest and principal payments. Accordingly, the Issuer's cash generation capability and assessment thereof is of paramount importance to GCR's Corporate rating process. Cash flow analysis focuses on the cash flows that are generated by the corporation's core businesses that are expected to be sustainable going forward. An assessment of the sustainability of both the Issuer's operating and free cash flows is based on the following main parameters:

- **strength** - the quantum of cash flow generated by the corporation's core operations in relation to its capital requirements;
- **variability** - volatility in cash flow across business cycles, determining the sensitivities of cash flows to changes in economic conditions; and
- **predictability** - of future cash flows, asset disposal and acquisitions.

Ratios

Cash flow and interest coverage ratios are key credit protection metrics and are analysed in conjunction with gearing levels and funding structure (as discussed below). GCR assesses the various ratios in relation to the Issuer's historical trends, as well as those of the industry in which it operates. Various modelling techniques may be applied 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. Net interest coverage examines the interest charge after all interest risk mitigants, such as interest income, hedging instruments and capitalised interest on development funding have been accounted for.
- **Cash flow coverage of debt** – as an Issuer will ultimately 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 have been met) relative to its maturing debt obligations and the interest due. 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.
- **Free cash flow coverage of interest (and/or debt redemptions)** - attempts to isolate the level of cash available to settle all cash interest charges. The metric is calculated by dividing cash flow from operations (calculated before the net interest payment) by net interest. An alternative ratio measures the free cash flow coverage of both net interest due and short-term debt redemptions. Free cash flow is considered in conjunction with unused, but committed debt facilities, which can be used by the Issuer to bridge funding gaps.

5. Funding Profile

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***. Cognisance is taken of the corporate's lifecycle and type of industry in which it operates. For example, a corporation 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. GCR'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 for a corporate's annual replacement capital expenditure.

As the credit rating ultimately pertains to an Issuer's ability to service its debt, the core of the funding analysis focuses on the quantum and profile of its debt in relation to other entities on an ordinal scale. Particular emphasis in this regard is placed on debt concentrations, be they by source or by maturity. A diverse range of debt 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), GCR expects the Issuer to have initiated refinancing or redemption arrangements at least 6 months in advance. For facilities that will be redeemed, GCR requires 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 paper ("CP"), a rated entity is required to maintain sufficient unencumbered liquid assets or adequate ***standby facilities*** at all times to ensure full redemption of the CP if necessary. Such facilities may include the unutilised portion on existing facilities. However, GCR recognises that unutilised facilities may be withdrawn at any time. Thus, significantly greater weighting is accorded 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, GCR calculates the ratio of unutilised facilities to all cash requirements over the ensuing 12 months, including short term programmes, all maturing Issues, as well as committed capital or other expenditure.

As part of the liquidity assessment, GCR takes into account various efficiency metrics where applicable, including the trading assets turnover, receivables and inventory days outstanding, and the current ratio. The quality of the trading assets is also a key consideration, and as such, the performance of the receivables book, the profile of underlying debtors, concentration risk, provisioning, and insurance against credit risk are also considered. Other metrics taken into account include coverage of short term debt by debtors and inventories, especially where operations are highly working capital intensive, or in cases where such assets serve as collateral for trade facilities.

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. GCR 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). Where financial hedges, such as currency swaps or forward contracts, have been employed, GCR may review the adequacy, economic benefit and sustainability thereof.

The ***interest rate structure*** (that is, 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 may be restricted to subsidiaries, joint ventures or specific projects and cannot be accessed. Similarly, cash holdings may be deposited in foreign banks or subsidiaries with the corporate unable or unwilling to repatriate the funds. To the extent cash is restricted, GCR 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. Equity is measured by GCR 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. Equity may also be adjusted to include shareholder loans that are fully subordinated to senior (secured and unsecured debt), interest free, or without a fixed tenor/repayment period.

Dividend payment trends may provide some insight into the likelihood of shareholder support. Whereas excessive dividend distributions may be negatively considered as it drains cash flow from a business, the lack of sufficient dividend payments may be equally detrimental in that it could discourage shareholders from providing further equity in times of need. Thus rated entities are expected to have clearly articulated dividend policies, which are adhered to through the business cycle, with any deviations being temporary.

Preference shares and other ***hybrid debt equity instruments*** can take several forms, depending on the reasons for raising capital in such a manner (for example, to avoid dilution of existing shareholders' interests or providing an incentive to potential funders by way of guaranteed returns/fixed dividends). In this regard, preference shares with features that are more akin to paid-in capital than debt are treated as equity, as they reduce the Issuer's future debt and interest payments. To be considered low risk and like equity, preference shares should have no maturity date, or should have coupon and other mandatory payments that may be deferred over the medium term. In this respect, the Issuer should always have the option to redeem the shares or cancel the moratorium on fixed dividends. Where these features do not exist, the preference shares present a potential drain on cash resources, making it more prudent to treat them as debt.

Understanding a Subsidiary in the context of an Issuer rating

A Subsidiary is a separately incorporated legal entity that is owned in part or in full by the parent company. Subsidiaries are characterised by some or all of the following factors which entrench their status as independent entities, even where the parent may have a majority shareholding. These include: the presence of outside shareholders; a separate Board of Directors; distinct operational management and management structure, and the need for its own paid up capital (ring-fenced from the parent). The subsidiary may also be subject to specific laws and regulations (such as in the case of a registered bank or insurance subsidiary).

GCR assesses the credit quality of the Issuer's strategically important Subsidiaries, reviewing their contribution to the parent's cash flows via upstreaming dividends and related party loans. The extent of influence the Parent Company has on the operations of the Subsidiary and its dividend payment policies are crucial in determining the sustainability of cash flows. Although the Subsidiary's debt will generally not have recourse to the parent, guarantees and other undertakings that increase the financial obligation of the Parent Company must be factored into the analysis of group gearing metrics. Where entities within the same group have separate issuances or note programmes, GCR assesses the risks inherent in the legal jurisdiction within which the bulk of the respective Subsidiaries' assets/operations are domiciled, the Subsidiaries' strategic importance to the Parent, the extent to which they are integrated into the group, and the level of autonomy given to management in executing group strategy. Also of importance is the parent's ability and proven willingness to support its Subsidiary Companies.

Optional ***convertible securities*** are normally considered debt, in line with the directors'/auditors' treatment. In such instances, GCR also considers the holder of the preference shares. In cases where the counterparty is a large entity with a development mandate, has board representation, or has made a firm commitment to secure control of the Issuer (*inter alia*), conversion is deemed more likely, and as such, the security may be treated both as debt and as equity (in equal or varying measures) to outline the risk parameters.

A more favourable rating is 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). Financial flexibility is assessed in terms of two key gearing ratios. ***Net gearing*** (net debt to tangible equity) measures the prominence of debt within a corporate's financial structure. ***Net debt to EBITDA*** assesses the extent to which on-going operations could meet principal obligations.

Given the diverse nature of corporates analysed, GCR does not impose an optimal gearing limit, but rather assesses gearing levels relative to management's self-imposed gearing limits and industry norms. In addition, GCR assesses the gearing trends within the Issuer's respective business cycles. 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 thus GCR examines interim and/or management accounts to assess this element.

Funding flexibility may be constrained by the existence of ***secured credit facilities***. Many securitised 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 impacted by the existence of secured facilities, as the former will rank subordinate in a default situation, leading to lower expected recoveries.

GCR 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.

Although GCR typically follows the directors' treatment and disclosure in respect of external debt, further analysis is made by incorporating on-and off-balance sheet items in the calculation of adjusted debt serviceability and gearing measures. Such adjustments include the following:

- The debt of any unconsolidated subsidiaries that represent potential claims on the Issuer. In cases where debt is disclosed as ring-fenced from the Issuer's operations, an assessment is made of the strategic reasons/motivation for such treatment (for example insulating shareholders from the downside risk of debt drawn to fund international expansion). Depending on the level of disclosure provided by the rated entity, debt serviceability ratios are also adjusted under scenarios where cash flows related to such debt are excluded. This may entail assessing the Issuer's ability to service its obligations in a certain country from the cash flows of specific territories or subsidiaries.
- Unfunded pension and medical obligations, guarantees, and/or contingencies related to legal

disputes may be deemed part of debt when adjusting gearing and debt service metrics. This is important to assess the extent to which these potential obligations could impact future cash flows and/or impair the Issuer's funding profile.

- Operating lease obligations related to equipment and/or rental agreements represent an ongoing commitment that will have to be serviced from future cash flows. These obligations may exceed the amount of on-balance sheet debt, especially in consumer-oriented businesses (most retail formats being a case in point). Accordingly, GCR's analysis includes an assessment of gearing and debt serviceability ratios when debt is adjusted to include the present value of these liabilities in its debt calculations, particularly where the off-balance sheet obligation is material. In this instance, adjusted EBITDA is calculated before the portion of the lease meant to be expensed each year, while the interest expense would be adjusted to include the finance charge arising from the additional liability that would be incurred, in order to determine the adjusted earnings gearing and debt service ratios. The analysis may also include; where disclosure allows, an assessment of the operating lease maturity profile, and how this may detract from financial flexibility in the medium term.
- Capital commitments, including any planned replacement and expansionary expenditure not yet contracted for, as well as any deferred purchase consideration. For example, a commitment to make a 'phased' purchase of various related operating entities (usually contingent upon the performance of the initial business acquired) means a corporate incurs a quantifiable liability, which it will have to draw on future cash flows to discharge. Accordingly, GCR adjusts gearing metrics by assuming that term facilities or medium-term notes will be drawn/issued to finance these future obligations, unless shareholders have made a firm commitment to inject additional equity capital.

6. Outlook

GCR's credit ratings provide a forward-looking assessment of an Issuer's risk characteristics. Thus, it is critical to gain a clear understanding of not just the corporate's current financial position, but of how cash flows and risk metrics are likely to perform under various scenarios.

As part of the analysis, and where available, the Issuer's budgets/performance targets are assessed to determine management's ability to successfully execute group strategy. GCR assesses the veracity of the budgets that are provided by management, looking specifically at the validity of the assumptions made, the attainability of targeted earnings and cash flows, the budgets' comparability in respect of peer performance and industry trends, as well as the likelihood of successful execution given management's track record. These tests are important in determining whether future operating profit and cash flows will be sufficient to ensure the timely payment of interest and principal obligations. Often it is through a review of budget assumptions that future sources of risk can be accurately identified. While the actual inputs that are stressed by GCR differ significantly across Issuers, common factors include revenue growth, gross or operating margins and raw material or other cost pressures.

Where GCR's assessment indicates reasonable or acceptable prospects in respect of the attainability of management's performance targets, the projected cash flows and expected funding needs over a period of one to three years are incorporated into the rating analysis, and are also used to assess strategy execution in future reviews (amongst other factors). If, however, GCR's assessment of the budgets or performance guidelines reveals material disparities between management expectations and what is considered realistic future performance, much closer investigation of the underlying assumptions is conducted. The process may include further engagement with management, as these discrepancies may be due to previously undisclosed changes in strategy or internal processes (*inter alia*). If the differences are determined to be a result of poor planning (which reflects weak oversight and could curtail future performance), this may negatively affect the ratings.

Crucially, the extent to which the stress factors are applied by GCR is linked to the credit rating level being considered. For credit ratings within the higher rating bands, greater stringency is applied, as the higher ratings indicate less vulnerability to adverse changes in the operating environment.

Conclusion

While thorough quantitative analysis is important, the qualitative characteristics of our 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 GCR's analysis is an understanding of the strategic characteristics of an organisation as well as the quality of management. Ultimately, GCR's emphasis is on determining how these strategic aspects will impact the rated entity's capacity to sustain the generation of free cash flows into the future.

Annexure 1: Issuer versus Issue Ratings

Corporate credit ratings issued by GCR are typically an expression of an Issuer's ability to service all of its debt and other obligations. This is an assessment of the entirety of the Issuer's asset base, cash flows and operations relative to all of its obligations. Most significantly, this relates to the interest bearing obligations of an Issuer, which are generally underpinned by a legal obligation to make repayments, and can most easily lead to a default of the Issuer. However, a complete credit assessment 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 report different levels of credit risk for reasons that include the size/quantum of the obligation, timing of the related payment, collateral, and other structural enhancements or legal characteristics. As a result, GCR also accords Issue ratings to specific debt Issues/Instruments and assesses these in terms of their unique credit risk characteristics relative to that of the Issuer as a whole. To the extent that the particular Issue has stronger recovery prospects than the Issuer as a whole (due to enhancements, which may take various forms), the Issue rating may be notched upwards from that accorded to the Issuer. Conversely, where such an Issue reports weaker recovery prospects than the Issuer as a whole, the Issue rating may be notched downwards from the rating accorded to the Issuer. An Issue may also be notched downwards in the case of subordination, either legal or structural.

In reality, given the complex nature of a corporate entity and its operations, it is usually not possible or practical to assess different likelihood of default across Issues as compared to that of an Issuer as a whole (such assessment falls under the purview of structured finance, and typically entails the full securitisation of assets and liabilities). However, many corporate debt Issues are usually accompanied by structural enhancements such as collateral pledged or a guarantee. As these features can improve the expected recovery to a debt funder in the case of a default on the Issue, and can readily be quantified, such structural enhancements are typically utilised to improve the credit risk profile of a specific Issue by a corporate. Such Issue ratings are examined in conjunction with the Issuer or corporate credit ratings accorded and are assessed in terms of GCR's *Global Structurally Enhanced Corporate Bonds Rating Criteria.*

Annexure 2: Explanation of National Scale and International Scale Ratings

GCR's local currency National Scale ratings are designed to enable appropriate differentiation of credit quality within a specific country. Particularly in developing countries, where the sovereign ratings tend to be below investment grade, utilising the International Scale has the consequence of compressing ratings within a limited number of rating bands, thus providing limited differentiation among credits.

In according National Scale ratings, sovereign risk factors are neutralised as it is assumed that all corporates within a given country or jurisdiction will be impacted equally. This allows for ratings to be tiered against an assumed lowest risk rating of 'AAA' within each country or jurisdiction. This lowest risk will normally, although not always, be assigned to the financial commitments issued or guaranteed by the sovereign state. Certain markets may, however, be characterised by inherent limitations that impose a ceiling on the ratings that can be accorded to entities that operate in these markets. National Scale corporates ratings are intended to be comparable only in a single country or jurisdiction (denoted by a special modifier).

On the other hand, GCR's International Scale ratings are tiered against a global pool of corporates. Thus, the highest rating that can be achieved will be limited by the credit quality of the country in which the corporate is domiciled (or conducts the majority of its business). Exceptions can arise where the corporate's rating may pierce the sovereign rating; for example where the entity has significant assets domiciled or revenue sourced offshore, or there are guarantees from foreign guarantees in place.

Rating corporates on an International Scale introduces additional factors related to sovereign risk, including political risks, the robustness of the legal system and transfer and convertibility risk. While such risks are generally considered when according all corporates ratings, this is done on a more micro level with regard to the specific factors affecting the company or industry under review. For International Scale Ratings, a greater macro approach is followed, and the risk factors of the sovereign as a whole are measured against other sovereigns or business jurisdictions.

Political risks are more acute in countries where the democracy is young or even limited. Nevertheless, the principles of good governance and the ability of the government to deliver on development goals are constant across all jurisdictions. Closely related to political risk is societal stability. To the extent there is social instability, the business environment is likely to be negatively impacted and accordingly the rating of entities in the jurisdiction constrained. To the extent that such factors improve, due to sound economic growth or the successful delivery of development plans, ratings would be positively impacted.

Political stability also adds greatly to the strength of the legal system. History has also shown that changes in Government can have a destabilising impact on policies and regulations. Well defined and defensible property rights are critical for a strong business environment; while the absence of such rights or weak enforceability would significantly constrain the International Scale ratings of all entities in the country due to the much higher risk. Even where a sound legal system is in place, GCR is cognisant of the fact that in many developing countries historical case law regarding financial transactions may be lacking. This would introduce increased uncertainty into the enforceability of rights detailed in more complex financial products.

Transfer and convertibility risk relates to the ability of corporates in a country to convert earnings between local and foreign currencies and to transfer funds abroad in the normal course of business. Countries where such risks are high tend to be those where currency controls are in place and approval from the relevant authorities is necessary for cross border transactions to occur. Challenges may also occur in small economies, were the currency market does not have sufficient scale to timeously convert large amounts of currency at the prevailing conversion rate. Transfer and convertibility is of greater concern where a corporate generates the majority of its revenue in the local currency but has foreign currency debt. If sufficient funds cannot be converted and transferred cross-border a default on obligations may occur, even when the entity has sufficient financial resources.

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S CORPORATE GLOSSARY

Amortisation	From a liability perspective, the paying off of debt in a series of instalments over a period of time. From an asset perspective, the spreading of capital expenses for intangible assets over a specific period of time (usually over the asset's useful life).
Bad Debt	A bad debt is an amount owed by a debtor that is unlikely to be paid due, for example, to a company going into liquidation. There are various technical definitions of what constitutes a bad debt, depending on accounting conventions, regulatory treatment, and the individual entity's own provisioning and write-off policies.
Balance Sheet	Also known as Statement of Financial Position. A statement of a company's assets and liabilities provided for the benefit of shareholders and regulators. It gives a snapshot at a specific point in time of the assets the company holds and how they have been financed.
Bond	A long term debt instrument issued by either a company, institution or the government to raise funds.
Budget	Financial plan that serves as an estimate of future cost, revenues or both.
Business Cycle	Regular fluctuations in overall activity in an economy over time. The cycle has four distinct elements: recession, recovery, peak and slowdown.
Capital	The sum of money that is invested to generate proceeds.
Capital Expenditure	Expenditure on long-term assets such as plant, equipment or land, which will form the productive assets of a company.
Capital Intensive	A project, a business or a production process is said to be capital intensive if it uses large amounts of assets to produce goods or services. Examples are oil refineries, and airlines. Projects/businesses can be either fixed capital intensive or working capital intensive or a combination.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Commercial Paper	Commercial paper is a negotiable instrument with a maturity of less than one year.
Commitment Fee	A fee paid by a borrower for a lender's commitment to make funds available when required.
Commodity	Raw materials used in manufacturing industries or in the production of foodstuffs. These include metals, oil, grains and cereals, soft commodities such as sugar, cocoa, coffee and tea, as well as vegetable oils.
Corporate Governance	Corporate governance broadly refers to the mechanisms, processes and relations by which corporations are controlled and directed, and is used to ensure the effectiveness, accountability and transparency of an entity to its stakeholders.
Coupon	The interest paid on a bond expressed as a percentage of the face value. If a bond carries a fixed coupon, the interest is usually paid on an annual or semi-annual basis. The term also refers to the detachable certificate entitling the bearer to the interest payment.
Covenant	A provision that is indicative of performance. Covenants are either positive or negative. Positive covenants are activities that the borrower commits to, typically in its normal course of business. Negative covenants are certain limits and restrictions on the borrowers' activities.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Debt Service Ratio	A measure of a company's ability to service its interest and principal redemption costs, expressed as the ratio of earnings or cash flows over a period to the sum of interest and principal payments over the same timeframe.
Default	Failure to meet the payment obligation of either interest or principal on a debt or bond. Technically, a borrower does not default, the initiative comes from the lender who declares that the borrower is in default.
Diversification	Spreading risk by constructing a portfolio that contains different investments, whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Dividend	The portion of a company's after-tax earnings that is distributed to shareholders.
Equity	Equity is the holding or stake that shareholders have in a company. Equity capital is raised by the issue of new shares or by retaining profit.
Exercise	To exercise an option is to use the right of the holder to buy or sell the underlying asset on which the option is based at the strike price.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset. For a company, its exposure may relate to a particular product class or customer grouping. Exposure may also arise from an overreliance on one source of funding.
Fair Value	The fair value of a security, an asset or a company is the rational view of its worth. It may be different from cost or market value.
Financial Year	The year used for accounting purposes by a company or government. It can be a calendar year or it can cover a different period, often starting in April, July or October. It can also be referred to as the fiscal year.
Fix	The setting of a currency or commodity price for trade at a future date.
Fixed Capital	Fixed capital is the part of a company's total capital that is invested in fixed assets such as land, buildings and equipment that remains on the balance sheet, usually for years, but for at least one accounting period.
Forward Contract	A forward contract, colloquially known as a forward, is an agreement to buy or sell a commodity, security or financial instrument at a specified future date at a predetermined price.
Fundamental Analysis	A method of evaluating a security that entails attempting to measure its intrinsic value by examining related economic, financial and other qualitative and quantitative factors.
Gearing	With regard to corporate analysis, gearing (or leverage) refers to the extent to which a company is funded by debt and can be calculated by dividing its debt by shareholders' funds or by EBITDA.
Goodwill	Arises upon the sale/acquisition of a business and is defined as an established entity's reputation, which may be regarded as a quantifiable asset and calculated as the price paid for a company over and above the net value of its assets. Negative

	goodwill refers to a situation when the price paid for a company is lower than the value of its assets.
Hedge	A form of insurance against financial loss or other adverse circumstances.
Hedging	A financial risk management process or function to take a market position to protect against an eventuality. Taking an offsetting position in addition to an existing position. The correlation between the existing and offsetting position is negative.
Impairment	Reduction in the value of an asset because the asset is no longer expected to generate the same benefits, as determined by the company through periodic assessments.
Intangible Assets	The non-physical assets of a company such as trademarks, patents, copyright, information systems and goodwill.
Interest	Scheduled payments made to a creditor in return for the use of borrowed money. The size of the payments will be determined by the interest rate, the amount borrowed or principal and the duration of the loan.
Interest Cover	Interest cover is a measure of a company's interest payments relative to its profits. It is calculated by dividing a company's operating profit by its interest payments for a given period.
Interest Rate	The charge or the return on an asset or debt expressed as a percentage of the price or size of the asset or debt. It is usually expressed on an annual basis.
International Scale Rating LC	International local currency (International LC) ratings measure the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled. Therefore, the rating does not take into account the possibility that it will not be able to convert local currency into foreign currency or make transfers between sovereign jurisdictions.
Joint Venture	A project or other business activity in which two persons or companies partner together to conduct the project.
Leverage	With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liabilities	All financial claims, debts or potential losses incurred by an individual or an organisation.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Long-Term Rating	A long-term rating reflects an issuer’s ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation’s current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
Mandate	Authorisation or instruction to proceed with an undertaking or to take a course of action. A borrower, for example, might instruct the lead manager of a bond issue to proceed on the terms agreed.
Margin	A term whose meaning depends on the context. In the widest sense, it means the difference between two values.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.
Moratorium	A period of time in which an activity is suspended until such time as a change in circumstances permits its removal. For example, a borrower can declare a moratorium on the repayments of the principal, and sometimes the interest, on a loan.
National Scale Rating	The national scale provides a relative measure of creditworthiness for rated entities only within the country concerned. Under this rating scale, a ‘AAA’ long term national scale rating will typically be assigned to the lowest relative risk within that country, which in most cases will be the sovereign state.
Off Balance Sheet	Off balance sheet items are assets or liabilities that are not shown on a company's balance sheet. They are usually referred to in the notes to a company's accounts.
Operating Margin	Operating margin is operating profit expressed as a percentage of a company's sales over a given period.
Operating Profit	Profits from a company's ordinary revenue-producing activities, calculated before taxes and interest costs.
Option	An option gives the buyer or holder the right, but not the obligation, to buy or sell an underlying financial asset at a pre-determined price.
Preference Share	Preference or preferred shares entitle a holder to a first claim on any dividend paid by the company before payment is made on ordinary shares. Such dividends are normally linked to an interest rate and not determined by company profits. Preference shares are normally repayable at par value in the event of liquidation. They do not usually carry voting or pre-emptive rights. Preference shares can be redeemable or perpetual.
Principal	The total amount borrowed or lent, e.g. the face value of a bond, excluding interest.
Redemption	The repurchase of a bond at maturity by the issuer.
Refinancing	The issue of new debt to replace maturing debt. New debt may be provided by existing or new lenders, with a new set of terms in place.
Risk	The possibility that an investment or venture will make a loss or not make the returns expected. There are many different types of risk including basis risk, country risk, credit risk, currency risk, economic risk, inflation risk, liquidity risk, market or systemic risk, political risk, settlement risk and translation risk.
Risk Management	Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.
Shareholder	An individual, entity or financial institution that holds shares or stock in an organisation or company.
Short-Term Rating	A short-term rating is an opinion of an issuer’s ability to meet all financial obligations over the upcoming 12-month period, including interest payments and debt redemptions.
Swap	An exchange of payment streams between two parties for their mutual benefit. Swaps can involve an exchange of debt obligations, interest payments or currencies, with a commitment to re-exchange them at a specified time.
Turnover	The total value of goods or services sold by a company in a given period. Also known as revenue or sales. Turnover can also refer to the total volume of trades in a market during a given period.
Working Capital	Working capital usually refers to the resources that a company uses to finance day-to-day operations. Changes in working capital are assessed to explain movements in debt and cash balances.

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