GCR GLOBAL CREDIT RATING CO.
Local Expertise • Global Presence

Rating Methodology

Corporate and Public Sector Debt

Global Master Criteria for Rating Public Entities

Updated February 2018

GLOBAL CREDIT RATING CO.

Introduction

GCR's public entity[1] credit ratings are a measure of an entity's relative ability to honour its financial obligations. A public entity's ability to honour payments is assessed over both the short term and the long term, with separate short term and long term ratings accorded.

- Short term ratings are an opinion of an Issuer's ability to meet all financial obligations over the upcoming 12 month period, including interest payments and debt redemptions.
- Long term ratings reflect an Issuer's ability to meet its financial obligations over a 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.

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 GCR Rating Panel.

This Criteria report is an update to the version published in February 2017. There have been some updates to the discussion on grant income and liquidity. However, the amendments to the Criteria will not have an impact on any existing Public Entity ratings. Going forward, the Criteria will be applied to all Public Entity ratings.

[1] Public Entities refer to government entities possessing revenue raising capacity that are responsible for the administration of public policy for a given jurisdiction. These include metropolitan councils, municipalities, district councils and state governments, as well as water and power utilities, public service companies, roads boards and transport entities.

Rating methodology

GCR's rating approach employs analytical techniques that assess quantitative and qualitative factors. Our ratings reflect an evaluation of the organisation's current financial position, as well as how the financial position may change in the future. To this end, the analysis focuses on a range of administrative, economic and legislative factors. GCR examines the ability of the organisation to meet its obligations under reasonable and stressed scenarios.

GCR's ratings are based on a clear understanding of the operating fundamentals of the rated organisation and the economic environment in which it operates, so as to draw conclusions regarding the rated entity's risk profile. Nevertheless, assigning a credit rating is a dynamic process, as each entity possesses unique characteristics and assumes varying levels of risk. Ultimately, the goal of any credit analysis is to assess if, and to what extent, future cash flows cover interest and principal payments (as well as ongoing operating expenses and liabilities), and the relative certainty associated with this coverage.

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

1. Economic and operating environment
2. Legal and institutional framework
3. Financial performance and ratio analysis
4. Funding profile
5. Future prospects
6. Management and administrative structures

1. Economic and operating environment

The economic environment refers to the institutional and fiscal state of the country within which the public entity operates. GCR's evaluation of economic performance addresses the circumstances that may either lend support to, or undermine, performance of the public entity, from both a national and local government perspective. This analysis covers demographic trends, measures of output and regional diversification, labour market performance, wealth levels and recent long term growth trends. Further, the maturity of national government is taken into account. This is to ascertain the ability of the general economic base to support national government policies, and in turn indicates the financial health of the government and economy over the long term.

GCR uses a wide array of information sources to support its economic and environmental analysis. This may include local sources such as the statistics authority or Central Bank in a particular jurisdiction, or external parties such as the World Bank or IMF. Utilised information ranges from general economic data to indicators of government effectiveness, transparency and human development (amongst others).

As the general population of an area forms the revenue base of most public entities, the financial health of households is critical. Thus, the nature of the consumer base is evaluated, including employment levels, income levels (measured by per capita income and per capita GDP), household indebtedness and consumption statistics. In general, higher per capita income levels translate into firmer revenues, and greater flexibility to raise taxes and access other funding. Conversely, lower per capita income levels increase the burden on public entities to provide the necessary utilities for dignified living (water, electricity, sewerage etc.), as well as social services (healthcare, education, recreation etc.).

Akin to this, the state of commercial enterprises operating within the public entity's jurisdiction is considered. As businesses are typically much larger than households, they often form a significant component of the revenue base of public entities (whether it be in terms of property taxes, or the utilisation of services like water and electricity). Thus, debtors concentrations tend to be weighted to corporates as opposed to households. More generally, corporate entities underpin employment within a jurisdiction, which in turn has a direct impact on the financial health of households and thus the level of income available to the public entity and ease of collection from this segment.

GCR's analysis of the demographic composition is viewed in conjunction with the economic structure and infrastructural development within a region, in order to gain a thorough understanding of the socio-economic status of the public entity. This takes into account access to basic services, communications and housing, as well as the population growth in the area. This is particularly important with regards to emerging or under-developed economies, and cognisance is taken of whether the population under the public entity's jurisdiction is growing and the extent to which the entity is able to extend these services to its population. In this regard, GCR will closely examine the capital expenditure budgets of the public entity and key utility companies within the area, assessing these relative to the service delivery backlogs and the ability of the entities to fund the required expenditure.

2. Legal and institutional framework

The legal and institutional framework refers to the legislation (whether enacted, impending, or merely being raised within government circles or amongst social activists) for the governance of a public entity within a given jurisdiction. In this regard, GCR examines the adequacy of government support to the fulfilment of an entity's policy responsibilities. Further, the manner in which the higher-tier government may affect the objectives and policies of the public entity is assessed. Given the above, an entity's ability to adapt to both a changing legislative environment and a shift in social norms is an important factor in the long term risk assessment. However, undue political influence, and a low degree of fiscal and operational independence, may affect the ability of a public entity to act effectively and efficiently.

The first step in this regard is to gain a thorough understanding of the laws, regulations and practices that shape the public entity's operations. This is to ascertain the operational flexibility afforded by the existing framework, the ability to alter the legislation in response to changing needs, and the way in which changes are implemented. This, in turn, affects the degree to which the entity may determine the nature and level of taxes and fees to be imposed, and whether it may rely on a stable and predictable flow of government-related funding. An evaluation is made on how well traditional funding matches the cost of service delivery and the degree of independence and/or discretion that an entity may employ in deciding how much debt to issue and for what purpose.

Assumed support from national government, or lack thereof, plays an important role in the rating of public entities. An assessment is made of whether the public entity can rely on national government support in the event of stress or financial difficulties. To the extent that an entity is responsible for the provision of services to a large portion of the population, or plays a central role in government's overall development framework, the likelihood of support is considered high. However, the support assessment must be considered in conjunction with the ability of the national government to provide support. This is a factor of the health of the country's economy and the level of income available to the government relative to its other commitments. Thus, even if a public entity is considered critical to service delivery, in times of economic stress the extent of financial support that can be made available may be limited. In such cases, the GCR rating panel could penalise the entity by not according the full uplift that is implied by the government support, or could accord a lower short term rating than is typically linked with a particular long term rating. A lower short term rating would reflect the potential for delayed payments to short term creditors, or even the need for some sort of debt restructuring, whilst still considering the likelihood of long term financial support to be high.

Corporate governance: Corporate governance for public entities must be considered in terms of the legal and institutional framework in place. Cognisance is taken of the propensity for malfeasance and other corrupt activities in public institutions, given the (often) vast size of such institutions and the large sums of money often involved. To this end, GCR also considers the scope and effectiveness of higher-tier government oversight of the entity's performance. This includes service standards, budget approval, borrowing restrictions, reporting requirements and the authority to conduct an audit. Statutory bodies tasked with investigating allegations of improper activity, and the independent legal powers of these bodies also play a critical oversight role. The incidence of malfeasance, as well as the extent to which corrupt or wasteful activities are investigated and guilty parties held to account, are amongst the best indicators of the importance accorded to good governance within a public entity.

3. Financial performance and ratio analysis

Quantitative analysis involves scrutinising the entity's financial performance, cash generation and financial position, typically over a five-year period. Before a public entity's results are analysed, due consideration is given to their composition and accounting quality. As the rating process explicitly excludes any type of audit, accounting quality is assessed by examining accounting policies such as:

- Consolidation principles;
- Reserving policies;
- Valuation of assets;
- Treatment of off-balance sheet items;
- Revenue recognition;
- Depreciation and asset impairment; and
- Debtors write-offs and provisioning.

GCR assesses the ability of the public entity to implement policy decisions that generate balanced and positive fiscal outcomes, in order to enhance long-term financial strength. To maintain a sound financial base, a public entity must generate sufficient cash flows to cover its operating and capital expenditures, as well as to meet its interest expenses and debt principal payments. Crucially, the financial performance is assessed not only relative to the historical performance, but also in relation to budgets provided by management. The strength of its performance relative to budget is a reflection of management's understanding of its revenue base and expense structure, as well as the economic environment in which it operates. A key focus of GCR's analysis aims to determine if recurring revenue will cover ongoing spending commitments, given existing policies and expected demographic trends, and (where applicable) to allow for growth whilst maintaining appropriate service levels.

***Revenue**:* GCR's analysis in this area focuses on the diversification of sources of revenue and volatility of each source. A distinction is made between internally and externally generated sources of income and the relative contribution from each source.

GCR considers internally generated funds (such as rates and taxes) to be those income streams that are directly under the control of the public entity, or where the pricing mechanism is determined by a regulatory body in a sufficiently transparent manner. A greater proportion of internally generated funds is indicative of enhanced financial flexibility. Further, a more diversified revenue base may allow the public entity to access additional sources of funding, such as licence fees or service charges. While such income may fluctuate through economic cycles, it is generally stable and relatively predictable, particularly if a high level of diversification is evident. This is even more so the case where an entity is providing basic services like water and electricity, for which demand is relatively inelastic.

A key criterion in this area is the ability of the public entity to collect its revenue, a factor that is usually more pronounced in emerging markets. Collecting on rates and taxes and service charges remains a major challenge in most jurisdictions wherein GCR conducts ratings. To the extent that debtors are properly managed and the performance of the debtors' book remains within appropriate performance standards, this will have a positive impact on the credit rating. Where relevant, GCR will evaluate the distribution losses in utility accounts (such as water and electricity), and the extent to which this leads to lost potential revenue.

Public entities that are more reliant on external sources of revenue (such as grants or subsidies) are considered more vulnerable, as grants are subject to the discretion of the national government. If funding at the national level is insufficient, grants to public entities will likely be curtailed. This is particularly true for governments that rely heavily on commodity sales for tax revenue, as this income is inherently linked to economic cycles and volatile commodity prices. However, there are exceptions to this; for example, GCR would consider it favourable if such external revenue sources were guaranteed for a certain minimum period of time. Government grants also reduce the administrative burden and credit risk associated with consumer debtors, allowing entities to focus on service delivery and infrastructure development.

Grant income can be scrutinised further by considering the relationship between conditional and unconditional grants and comparing this to operational and capital expenditure. Unconditional grants are generally those that an entity is free to use for operational purposes. The risk is greater where the public entity is reliant on such funding to meet recurrent expenditure, as a decrease in grant funding could result in operating deficits. However, often grant funding is provided for specific purposes, such as for capital projects or to fund the ongoing operations of schools or clinics. In these instances, the public entity would essentially be undertaking an activity on behalf of the national government (even though it may appear in its financial statements as operating expenditure), and the amount of funding would be directly related to the scope of the work. This could lead to greater volatility in income and expenditure, without impacting the real liability of the public entity (which would remain with the national government or another entity). High levels of conditional grants could thus distort expenditure ratios and make the days cash coverage metric appear low.

***Expenditure**:* The assessment of expenditure revolves around fixed versus variable expenses, and whether these expenses are discretionary or non-discretionary. At all times, comparison is made to the public entity's historical trends, as well as local and national norms. The relationship between discretionary expenses (such as non-essential capital expenditure) and non-discretionary expenses (such as debt service payments) is important. GCR's aim is to assess the minimum level of expenditure necessary to maintain current operations and cater for expected future growth.

Staff costs often make up the single largest portion of expenditure, and special attention is placed on the public entity's ability to rationalise these costs in need. GCR considers a staff cost to total cost ratio of around a third to be prudent. Levels higher than this suggest that service delivery and long term planning are being compromised by short term consumption. Nevertheless, some types of public entities, such as utility companies, tend to have higher staff cost ratios (due to the greater number of skilled technical employees) and thus ratios should be considered against a peer group where practical. Other key variable costs are also analysed in a similar manner.

GCR will also make an assessment of the cost structure to broadly determine the extent to which costs can be considered consumptive, and which are related to service delivery and ongoing capital development. The greater the level of consumptive expenditure the less cash will be available for productive purposes.

While non-cash costs may not have an immediate effect on expenditure, how they are treated provides some insight into future cash flows. Thus, where provisioning for items such as staff pensions, environmental damage (etc.) are not adequate, such funding deficits will need to be corrected in future periods, resulting in cash outflows in those periods. Deprecation is utilised to estimate the necessary level of capital expenditure required to repair and maintain operations, although its usefulness is limited by the difficulties in accurately valuing assets that do not directly produce revenue (such as public roads and bridges).

Liquidity: GCR's focus on liquidity involves an evaluation of the operating cushion afforded by a public entity's cash balances and current assets (such as debtors). Liquidity may be complemented by access to internal and external sources of funding. In this respect, GCR does not only focus on year-end balances, but also takes into account the entity's liquidity needs during the year, bearing in mind the seasonality of liquidity requirements. Thus, inter-year accounts form an important part of GCR's analysis. Particular emphasis is placed on the quality of cash and equivalent investments, taking into account credit ratings (if available) of the counterparties. Cash on hand may need to be adjusted for any restricted cash or for underfunded provisions.

The key ratios considered are the level of days cash on hand and cash coverage of short term debt and interest payments (in addition to the efficiency metrics detailed below). These measures essentially quantify the ability of an entity to cover its operating and debt servicing costs. Although these ratios may vary by country, ratios that are less than 60 days cash on hand and/or less than 2.5x gross interest coverage are usually indicative of some liquidity constraints.

In less developed jurisdictions, a public entity's accounts may be integrated with the national treasury and/or the country's reserve bank. Under such a format, grant funding may be paid to suppliers directly from the national treasury and even own source revenue collections may be maintained in bank accounts controlled by the national treasury. Accordingly, the public entity would have little control over its liquidity and generally hold minimal cash reserves. This is negatively considered by GCR, as it entrenches operational dependence of the entity on the national government. However, such considerations may be tempered by a review of the historical relationship between the national government and the public entity, with a view to identifying the ease and timeliness with which the entity's liquidity requirements have been met in the past.

Efficiency: The management and administration capacity of a public entity (discussed further on in this methodology) will directly impact on the organisation's efficiency, in tandem with the composition of revenue and expenses. As such, these areas are all evaluated concurrently and are compared with relevant benchmarks, including local, national and international norms.

Most importantly, as it impacts directly on cash flows, an analysis of the actual debtors book is performed in order to ascertain the quality of the book and the adequacy of provisions. This is compared against bad debt recognition and provisioning policies, collection procedures and historical trends. Thereafter, the ratio of debtors (or collection) days outstanding is calculated in order to determine the entity's ability to collect on its debtors. Debtors over 90 days in arrears usually warrant further attention. Other indicators of credit quality may be derived by comparing the ratio of gross and net debtors (by value) to revenue.

In the event that the public entity is a reseller or supplier of utility services (such as electricity or water), the extent of distribution losses must be determined. In general, losses should not be greater than 15%, although water losses are typically higher than electricity losses in South Africa for example. These may be true losses (due to leaks and theft amongst others) or technical losses (typically due to the provision of free services to indigents).

Lastly, the revenue and expense accounts are analysed in order to determine if there are any undue inefficiencies or concentrations. For example, GCR examines the ratio of trading income to total income and staff expenses to total expenses.

4. Funding profile

An appraisal of the funding profile commences with the various sources of funding available to the public entity to address capital expenditure requirements.

Borrowings[2]: A public entity's debt burden is assessed in terms of the historical trend, future expectations and its ability to service obligations at present and over the medium term. GCR examines the trend in the gross quantum of debt, as well as in debt serviceability. In this regard, net debt to total income and operating cash flow coverage of debt are the key metrics used to determine whether current and future income levels can support existing debt. Future debt requirements are determined by projecting free cash flows versus capex/ investing requirements. Furthermore, GCR

[2] Borrowings include vanilla loans, debt guaranteed by government, debt obligations issued by subsidiaries that may or may not be explicitly guaranteed by the government, and debt-like instruments or commitments such as capital leases, public-private partnerships, and securitised transactions for which the entity is or may become liable.

examines the public entity's exposure to interest rate risk and the entity's ability to accommodate adverse interest rate movements.

Debt serviceability is also a factor of the maturity profile of the debt. Broadly, debt is classified as short term (maturity under one year) or long term (maturity greater than one year). However, highly rated public entities should exhibit a well-diversified long term debt profile, with maturities extending up to 10 years or longer. In this respect, public entities typically report long dated assets that should ideally be funded by long term debt, matched to the useful lives of these assets. However, in practicality, the short dated nature of debt capital markets and funding available from private financial institutions often limits the tenor of debt used to fund fixed capital. Thus, development finance institutions comprise an important alternative funding channel, as the loans provided may have much longer tenors (up to 20 years) and often yield concessional interest rates. However, such loans are generally project specific and contain stringent non-financial conditions.

Particular emphasis is placed on any undue maturity concentrations, and the ability of the entity to meet these debt redemption obligations in the absence of available refinancing options. Where there are substantial short term maturities (over the next 12 months), GCR expects the public entity to have initiated refinancing or redemption arrangements at least six months in advance. For facilities that will be redeemed, GCR requires cash trapping mechanisms to be instituted, albeit that this requirement may be waived where the public entity can provide a level of certainty that sufficient cash will be available or refinancing remains possible.

In evaluating credit quality, GCR considers the laws that govern the purposes for which debt may be issued and the amount that may legally be borrowed. For public entities, legal restrictions may impede access to borrowings. It should be noted that GCR also takes into account items that may not be consolidated into the entity's financial statements and/or cannot provide credit support. An example of this is public works such as roads and bridges, which cannot be pledged to a debt funder as collateral.

GCR also takes note of contingent liabilities, as these may impact credit quality. Contingent liabilities may arise from debt issued by other entities, whether through guarantees, ownership, or some other means, even in the absence of debt, if the public entity considers the entity's operations important enough to support. The funding analysis also takes into account the need to repair or replace infrastructure that has deteriorated.

The unique characteristics of each public entity dictate that there are no hard and fast rules with regards to the debt position. Cognisance is taken of the public entity's lifecycle - a developing public entity will usually require additional debt in order to expand its infrastructure.

Grant funding: Grant funding from higher-tiered government organisations is typically earmarked to fund specific expenditure or projects, and in all instances requires some level of compliance and reporting. GCR assesses the timing, quantum and appropriateness of these funds. Further, the entity's capacity and ability to effectively utilise grant funding is evaluated. Where conditional grant funding has not been fully utilised during a given period, GCR expects the public entity to ring-fence the equivalent cash value of the unspent portion (as conditional grant funding may not be utilised in the day-to-day operations of the entity). Given the above, GCR evaluates the relative financial strength of the public entity, and any potential liquidity strain, should these funds be excluded.

5. Future prospects

GCR's credit ratings provide a forward looking assessment of a public entity's financial commitments and its ability to meet these commitments. Thus, it is essential to gain a clear understanding of not just the public entity's current financial position, but of how cash flows and credit metrics are likely to perform under various future scenarios.

GCR stresses budgets and forecasts provided by management to assess if recurring earnings and cash flows will be sufficient to ensure timely payment of interest and principal obligations. Furthermore, these forecasts are analysed for accuracy and reliability, based on the historical performance of an entity relative to forecast. Where forecasts diverge from preceding trends, or do not match the economic environment, GCR investigates the underlying assumptions more closely. Often it is through these assumptions that future sources of risk can be accurately identified and quantified.

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

6. Management and administrative structures

Ultimately, the performance of an organisation depends, to a large extent, on the strengths and capabilities of management. Management's ability is assessed throughout the review process, as GCR considers historical budgeted expectations relative to actual performance for all key earnings, liquidity and gearing metrics. In addition, a number of aspects specific to management are also considered.

Management structure: GCR analyses the ability of management to react to changes in the operating environment in an efficient and effective manner, recognising that flexibility is crucial. The "depth of management" is also important and the entity should not be unduly exposed to "key man" risk. In this respect, succession planning is considered an important mitigant to staffing risks.

Systems and controls*:* These are assessed to determine the level of management oversight within a public entity. The effectiveness of systems and controls enables better revenue collection, limits wastage and malfeasance and mitigates cost overruns, thereby improving the predictability of internally generated cash flows.

Credibility and track record*:* GCR focuses on management's ability to understand its environment (and the current trends therein), project earnings performance accordingly and to execute higher-tiered government strategy within the parameters set in the budget. The analysis also encompasses the success and impact of past expansionary efforts, as well as the utilisation of financing methods.

Strategic vision and business objectives*:* The overall strategic vision is reviewed, taking cognisance of management's operating, capital expenditure and revenue forecasts within the context of both the internal and external operating environment. GCR also takes comfort from entities whose management forms part of the community being serviced, and who are therefore vested in its performance and service delivery.

Conclusion

Credit ratings play a unique role within the public entity space as they are often the only independent research conducted on the entity and, more importantly, the only independent opinion as to the credit worthiness of the entity. The increased demand for credit ratings reflects the growing usage of capital markets by public entities, particularly in emerging and under-developed markets.

While a thorough quantitative analysis is important, the qualitative characteristics of GCR's analysis cannot be overemphasised. 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 to gain an understanding of the strategic characteristics of an entity and the quality of management, with emphasis on determining how these strategic aspects will affect the entity's credit rating.

Appendix 1: Issuer versus Issue Ratings

Public sector 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 regarding 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 represent 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 a lower probability of default and/or stronger recovery prospects than the issuer as a whole, the Issue rating may be notched upwards from that accorded to the Issuer. Conversely, where such an Issue reports a higher probability of default and/or 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 public entity and its operations, it is usually not possible or it is impractical to assess different probabilities 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 public sector debt Issues are 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 public entity. Such Issue ratings are examined in conjunction with the Issuer rating accorded and are assessed in terms of GCR's *Global Structurally Enhanced Corporate Bonds Rating Criteria.*

Appendix 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 bunching all ratings within a limited number of rating bands, thus providing little differentiation among credits.

In according National Scale ratings, sovereign risk factors are neutralised as it is assumed that all public entities 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 public entity 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 issuers. Thus, the highest rating that can be achieved will be usually limited by the credit quality of the country in which the public entity is domiciled (or conducts the majority of its business). Exceptions can arise where the rating may pierce the sovereign rating; for example where an issuer has significant assets domiciled or revenue sourced offshore, or there are guarantees from a foreign entity in place. However, this is highly unlikely in the case of public entities as their activities are limited to providing services in a particular jurisdiction and are typically dependent on government support.

Rating public entities 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 public entity ratings, this is done on a more micro level with regard to the specific factors affecting the municipality or utility under review. For International Scale ratings, a more 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 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 will likely be negatively impacted and accordingly the rating of entities in the jurisdiction constrained. To the extent that such factors improve, due to firm 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 entities 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, where the currency market does not have sufficient scale to timeously convert large amounts of currency at the ruling conversion rate. Transfer and convertibility is of greater concern where an entity generates the majority of its revenue in the local currency but has foreign currency debt, albeit this is not generally applicable to public entities other than central governments. 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

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.
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.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
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.
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.
Credit Risk	The possibility that a bond issuer or any other borrowers (including debtors/creditors) will default and fail to pay the principal and interest when due.
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.
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.
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.
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.
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.
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.
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.
Interest Rate Risk	The potential for losses or reduced income arising from adverse movements in interest rates.
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.
Investment Grade	Credit ratings equal to or higher than 'BBB-'.
LC	An LC is a guarantee by a bank on behalf of a corporate customer that payment will be made if that entity cannot to meet its obligations.
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.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.
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 Cash Flow	A company's net cash position over a given period, i.e. money received from customers minus payments to suppliers and staff, administration expenses, interest payments and taxes.
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.

Pledge	An asset or right delivered as security for the payment of a debt or fulfillment of a promise, and subject to forfeiture on failure to pay or fulfill the promise.
Political Risk	The risk associated with investing and operating in a country where political changes may have a negative impact on earnings or returns.
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.
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.
Tenor	The time from the value date until the expiry date of an instrument, typically a loan or option.
Under Review	Failure to carry out a full review of a rated entity within the designated timeframe, either through lack of information or delays in finalisation, i.e. review is ongoing.
Variable Costs	A cost that varies with the volume of production or sales, such as the cost of raw materials or packaging. In contrast with fixed costs, such as rent, which stay the same regardless of the volume of production or sales.
Yield	Percentage return on an investment or security, usually calculated at an annual rate. Also an agricultural term describing output in terms of quantity of a crop.