GCR GLOBAL CREDIT RATING CO.
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Rating Methodology

Corporate Sector Debt

Global Structurally Enhanced Corporate Bonds Rating Criteria

Updated November 2018

Introduction

Global Credit Rating Co.'s ("GCR") Global Structurally Enhanced Corporate Bonds Rating Criteria (the "Criteria") applies to senior secured securities issued by corporates that benefit from certain structural enhancements. These enhancements can, for example, take the form of cash reserves, guarantees or transaction specific security packages. This rating criteria report lays down the fundamentals for structurally enhanced senior secured corporate bond issues that are not covered by other specific GCR rating criteria reports. Each transaction will be accompanied with a transaction specific report that will disclose any additional observations or deviations to the Criteria.

This Criteria is an update to the version published in November 2017. There are no significant amendments to the Criteria. The update of this Criteria will not have an impact on any existing transactions that have been rated under it. Going forward, all new transactions will be rated using this Criteria.

Fundamental Approach

The rating of structurally enhanced corporate bonds is derived by applying a notching approach, starting from the long term, corporate credit rating of the intended issuer of such bonds. In determining the appropriate number of rating notches to be applied, GCR compares the estimated overall recovery rate after a potential default of the bonds with the assumed average corporate senior unsecured debt obligation recovery rate. If overall estimated recoveries are higher than the assumed average recovery rate, a notching uplift may be applicable in line with the recoveries notching table detailed on Page 2. Where relevant, the credit quality of the transaction parties facilitating structural enhancements (e.g. a guarantee) relating to the transaction is taken into account. In some instances, dependant upon the rating of the underlying corporate, the rating of the secured obligation may be capped.

The rating of the senior secured structurally enhanced corporate bonds incorporates recoveries potentially arising from the structural enhancements (e.g. the proceeds of a guarantee claim payment). In effect, the rating accorded to these securities is an expected loss rating (which is a function of probability of default and loss severity), and relates to an assessment of the ability to meet ultimate (as opposed to timely) payment of interest and principal. Such a rating can therefore not be fully compared with a traditional corporate credit rating (the latter, which is also an expression of expected loss, but refers to probability of default and an average historical loss given default (LGD) for generalised senior unsecured debt). Where a tap issue occurs, GCR expects to receive sufficient notice prior to issuance in order to carry out its analysis to accord and/or affirm the ratings of the bonds. Where such notice is not provided, GCR may withdraw the ratings at its discretion.

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Estimating Overall Recoveries

It is necessary to estimate the overall recovery rate assuming a default takes place on the bonds. Only if this recovery rate is higher than the recovery rate range one would typically expect in relation to corporate senior unsecured debt obligations, does an argument exist to consider a higher rating for the bonds than the corporate credit rating. In some cases a notching down approach may be appropriate. It should also be considered that secured bonds may potentially have an impact on the unsecured rating of an entity.

In according a credit rating to any entity, an opinion is being given both in terms of the probability that the entity/instrument will default on its obligations, and the expected recovery should such an event of default occur. This is embodied in the concepts of expected loss and probability of default.

Looking more specifically at unsecured issuer ratings, while such ratings often speak to probability of default primarily, statistical evidence has borne out that each level of probability of default is aligned to a level of recovery, and that the lower a company's probability of default, the better the recoveries are expected to be on an unsecured basis. In other words, the higher the rating of an issuer and the lower its probability of default, the more likely that a lender will report strong recoveries should the issuer default. This is for various reasons including the fact that the assets of highly rated issuers tend to be of higher quality, and that such issuers rarely default for governance or solvency reasons, but more usually for liquidity reasons. This assumption is of course subject to various sub-elements such as the nature of the business (and assets) of the issuer and the level of encumbrance reported over the assets (and which assets are secured), amongst others. However, these elements are incorporated and considered in the accordance of the issuer rating, and the principal abides that a rating embodies both facets of risk.

Structured bonds typically serve to improve recovery prospects to a lender in the event of default, without usually reducing or changing the risk of default (which is more akin to structured finance). In this regard, the security and/or guarantees that underpin the structured bond tend to only come into force should a default occur and don't prevent it from occurring. Thus, when such structural enhancements are considered from a ratings perspective, they are considered in respect of how much they improve the recovery prospects of the lender relative to the unsecured issuer rating. The instrument rating that is then accorded thus represents the probability of default of the issuer and the bespoke recovery expectations of the instrument.

The overall recovery rate is calculated by comparing expected recovery proceeds from the structural enhancements with the assumed aggregate exposure of the bondholders. The recovery proceeds are estimated on the basis of all relevant information provided in respect of the structural enhancements. For example, in respect of a guarantee, the mechanics of the guarantee will need to be analysed to determine what the likely claim payment upon default of the bond will be. Aggregate bondholders' exposure is calculated by adding the assumed missed interest payments, plus expected legal costs to the assumed principal amount outstanding upon default.

Assumed Average Recovery Rates

International rating agency studies indicate that the average recovery rate on defaulted corporate senior unsecured debt obligations is approximately 40%. Note must be taken that the data supporting these studies is mainly derived from observations from the US market and other developed markets where typically rated debt issuance takes place. For other jurisdictions lower average recovery rates may be expected, particularly if such jurisdictions have less developed legal systems and/or where practical enforcement of creditor rights is deemed to be a challenge. In addition, a corporate that has ceded the vast majority of its assets as security for debt obligations, will typically have a lower average senior unsecured debt obligation recovery rate. Recovery rates will be estimated on a case-by-case basis by GCR's rating panel.

Recoveries Notching Table

A recovery rating is accorded using a notching approach. The recovery rating considers the value of recoveries that may be obtained on the underlying collateral and also takes into consideration the amount of time allowed for business rescue proceedings to take place. The number of notches that is applied from the corporate credit rating is determined by comparing the calculated overall recovery rate with the table listed below:

Overall Recovery Prospects	Recovery Prospects	International Scale Notching
> 90% – 100%	Excellent	+2 to +3
> 70% – 90%	Superior	+1 to +2
> 40% - 70%	Good	0 to +1
> 20% - 40%	**Average**	**0 to -1**
≤ 20%	**Poor**	**-1 to -2**

It should be noted that the table represents the International Scale notching, which may be mapped to a national scale rating through the relevant country specific mapping table - please see further information in this regard detailed later in this report.

Under certain circumstances, GCR may cap the number of notches uplift. This may be the case, for example, in respect of bonds that are issued in jurisdictions with legal systems that are deemed not to be sufficiently developed. In addition, depending on the circumstances, a rating panel may decide to deviate from the guidelines provided by the Recoveries Notching Table. If, for example, the average overall recovery prospects in a certain jurisdiction are expected to be lower than the average of 40% observed in the international rating agencies' studies, GCR's rating panel may decide to notch up from a lower base. The transaction specific rating report will highlight such deviations. A rating cap may be applied to secured bonds where the underlying corporate rating is 'BB+' or lower. GCR may also deem a particular security package or underlying collateral inappropriate for such a transaction. Stable, long term assets are considered most appropriate for this type of methodology. Where the underlying collateral is short-term in nature or highly revolving, an alternative methodology or more severe haircuts may be applied.

It should be noted that the number of notches applied relates to the international rating scale. This is then mapped across to the national rating scale. A 1 or 2 notch uplift on the International rating scale may relate to a higher notch uplift on the national rating scale. This may also differ dependant upon the mapping table in place for each jurisdiction.

Credit Quality of Counterparties
GCR also considers the credit quality of transaction parties facilitating structural enhancements in its analysis. As mentioned above, the corporate credit rating of the enhancement provider may place a cap on the maximum achievable rating on the bonds. For example, if the Recovery Notching Table indicates a 3 notch uplift from a corporate credit rating of 'A' to 'AA', but the guarantor is only rated 'AA-', the bonds are likely to be accorded the latter rating.

In other words, if a transaction benefits from a guarantee, but such guarantee is provided by a counterparty that is rated lower than the corporate credit rating of the issuer, no notch uplift will be accorded. However, if the corporate credit rating of the guarantor is higher, then the mechanics and the nature of the guarantee will need to be analysed to determine an appropriate number of notches uplift. If a guarantee is irrevocable, unconditional, pays immediately upon demand and covers 100% of principal and interest payable under the bonds, as well as penalty charges, the rating of the bonds would typically, but not always, be aligned with the (higher) corporate credit rating of the guarantor.

If the guarantee provides less than 100% cover, the rating of the bonds may be somewhere in between the corporate credit ratings of the issuer and the guarantor.

Where a transaction benefits from a funded reserve account which is legally segregated from insolvency risk relating to the issuer, benefit may be given to the estimated cash balance in the reserve account at the assumed time of default. A notching up approach will only be considered if the relevant account bank's corporate credit rating is higher than the issuer's corporate credit rating.

Interaction with National Scale ratings
In certain jurisdictions, mainly National Scale Ratings (as opposed to International Scale Ratings) will be used by issuers as an international 1 notch uplift may equate to a greater notch uplift on the national scale. This is particularly the case for countries that have sovereign international ratings in the 'B' or 'BB' rating bands, which substantially limit the number of corresponding attachment points in the applicable international to national scale rating mapping tables. For example, in a situation where the sovereign is rated 'B' on the international scale, many corporates are likely to be rated 'B-'. Technically, in the absence of structural enhancements or special circumstances, there would likely be room for only 1 international notch uplift. However, on the national scale one could differentiate further. A transaction with an estimated overall recovery rate of 50% (being on the lower end of the relevant recovery band) may be accorded only 1 national scale notch uplift, whilst a transaction with an estimated overall recovery rate of 65% (being on the higher end of the relevant recovery band) may be accorded more national scale notches uplift. GCR will limit the maximum number of notches uplift on the national scale to 5 notches. It is to the discretion of GCR's rating panel to decide on the appropriate number of national scale notches uplift after reviewing the underlying collateral, structural mechanics and transaction party ratings. Further information on how National Scale Ratings are accorded and their definitions is available on GCR's website at www.globalratings.net.

Legal and Audit Opinions
It should be noted, credit is only given to structural enhancements if a satisfactory transaction specific legal opinion is analysed. As a minimum, GCR expects the legal opinion to include capacity language in respect of transaction parties, a description of the security and an opinion that transaction documentation is legal, valid, binding and enforceable against the relevant transaction parties.

In the event that the security is shared with other creditors (e.g. senior or pari passu ranking parties or parties that have subrogation rights), GCR expects this to be described in the legal opinion as this may influence the calculation of the estimated overall recoveries. GCR also expects confirmation from the issuer in writing that the underlying security is not dual-ceded to another party.

An independent audit opinion on the underlying collateral is required for each transaction, except in cases where the collateral is fully insured by an external insurance counterparty. GCR may request an additional audit opinion where it is felt the auditor has a conflict of interest or is not a highly recognised audit firm. In instances where an audit opinion is not provided, GCR will do a file review on a random selection of files relating to the underlying collateral. GCR will also conduct site visits in order to sight some of the assets that may be pledged as collateral in cases where the collateral includes capital equipment or immovable property.

GCR also expects to receive a tax opinion determining any tax liability of the SPV or that may be incurred by the transaction.

Simplified Calculation Examples

Notching uplift in the following examples is based upon the International Scale notching table detailed on Page 2 of this report. It should also be noted that costs and claims may vary dependant upon the type of the underlying collateral.

Example with a Guarantee:

Principal amount outstanding	100,000,000
Assumed missed interest upon default of bonds	+1,250,000
Assumed missed interest to give time to realise recoveries	+1,250,000
Aggregate exposure bondholders	**102,500,000**
Guarantee claim payment	-50,000,000
Unsecured claim on corporate	**52,500,000**
Assumed recovery on unsecured claim	-15,750,000
Legal costs	+2,250,000
Remaining claim	**39,000,000**
Overall recovery rate (1- 39/102.5)	62.0%

- Rating issuer: BBB+
- Rating guarantor: AA
- Interest rate: 5% p.a., paid quarterly.
- Assumed 1 Quarter of missed interest in the event of default.
- Guarantee: 50% of principal amount outstanding.
- Assumed recovery rate on unsecured claim: 30%.
- Recovery timing: 3 months.
  Expected legal costs: 2,250,000

The overall recovery rate of 62.0% carries the qualification '*Good Recovery Prospects*' and is in the higher end of the relevant recovery band. This particular bond would likely be accorded a 'A' rating (i.e. a 2-notch uplift). The corporate credit rating of the guarantor is 5 notches higher than the issuer's corporate credit rating, and does not therefore constrain the bond rating.

Example with a Reserve Account:

Principal amount outstanding	100,000,000
Assumed missed interest upon default of bonds	+1,250,000
Assumed missed interest to give time to realise recoveries	+2,500,000
Aggregate exposure bondholders	**103,750,000**
Reserve account balance	-10,000,000
Unsecured claim on corporate	**93,750,000**
Assumed recovery on unsecured claim	-37,500,000
Legal costs	+1,000,000
Remaining claim	**57,250,000**
Overall recovery rate (1- 57.25/103.75)	44.8%

- Rating issuer: BBB-
- Rating account bank: AA
- Interest rate: 5% p.a., paid quarterly.
- Assumed 1 Quarter of missed interest in the event of default.
- Funded Reserve Account: 10,000,000, immediately available.
- Assumed recovery rate on unsecured claim: 40%.
- Recovery timing: 6 months.
  Expected legal costs: 1,000,000.

The overall recovery rate of 44.8% carries the qualification '*Good Recovery Prospects*' but is in the lower end of the relevant recovery band. This particular bond would likely be accorded a 'BBB-' rating (i.e. no notch uplift). The corporate credit rating of the reserve account bank is 7 notches higher than the issuer's corporate credit rating, and is therefore no constraint to the bond rating.

Example with Real Estate as Security:

Principal amount outstanding	100,000,000
Assumed missed interest upon default of bonds	+1,250,000
Assumed missed interest to give time to realise recoveries	+5,000,000
Aggregate exposure bondholders	**106,250,000**
Stressed value real estate	-100,000,000
Unsecured claim on corporate	**6,250,000**
Assumed recovery on unsecured claim	-625,000
Legal costs	+3,000,000
Remaining claim	**8,625,000**
Overall recovery rate (1- 8.625/106.25)	91.9%

- Rating issuer: BBB+
- Interest rate: 5% p.a., paid quarterly.
- Assumed 1 Quarter of missed interest in the event of default.
- Market value real estate: 200,000,000.
- Market value haircut applied: 50%.
- Assumed recovery rate on unsecured claim: 10%.
- Recovery timing: 12 months.
  Expected legal costs: 3,000,000.

The overall recovery rate of 91.9% carries the qualification '*Excellent Recovery Prospects*' but is in the lower end of the relevant recovery band. This particular bond would likely be accorded a 'AA-' rating (i.e. a 4-notch uplift). The appropriate market value haircut in respect of the real estate depends on the relevant rating scenario and the specifics of the transaction, and will be determined at the discretion of GCR's rating panel based upon information provided. In general: the higher the rating scenario, the higher the haircut. The assumed recovery rate on the unsecured claim on the corporate is low because, in this example, the assumption is that the real estate forms the largest part of the assets, and that not many assets will be left for unsecured claim holders upon default.

Example with a Guarantee:

Principal amount outstanding	100,000,000
Assumed missed interest upon default of bonds	+2,500,000
Assumed missed interest to give time to realise recoveries	+2,500,000
Aggregate exposure bondholders	**105,000,000**
Guarantee claim payment	-25,000,000
Unsecured claim on corporate	**80,000,000**
Assumed recovery on unsecured claim	0
Legal costs	+1,000,000
Remaining claim	**81,000,000**
Overall recovery rate (1- 81/105)	22.9%

- Rating issuer: BB-
- Rating guarantor: AA
- Interest rate: 10% p.a., paid quarterly.
- Assumed 1 Quarter of missed interest in the event of default
- Guarantee: 25% of principal amount outstanding. Guarantor has subrogation rights and has a first ranking claim on any unsecured recovery proceeds.
- Assumed recovery rate on unsecured claim: 0%. Normally expected recovery rate on unsecured claims: 25%.
- Recovery timing: 3 months.
  Expected legal costs: 1,000,000.

The overall recovery rate of 22.9% carries the qualification '*Average Recovery Prospects*' but is in the lower end of the relevant recovery band and is lower than the normally expected recovery rate. Despite the receipt of the guarantee claim payment, this particular bond would likely be accorded a 'BB-'. The assumed recovery rate on the unsecured claim on the corporate is zero because, in this example, the assumption is that all normally expected unsecured recovery proceeds are being channelled to the guarantor.

Disclaimer
Note that GCR is not a legal, tax or financial adviser and will only provide a credit opinion of the rated securities.

For example, a rating does not cover a potential change in the applicable laws nor can it be regarded as an audit. Moreover, GCR is not a party to the transaction documents.

Surveillance
On an on-going basis GCR will review all of its secured bond ratings at a minimum on an annual basis or as events warrant. For certain transactions these may be reviewed on a quarterly or semi-annual basis depending upon the type of the underlying collateral or potential performance issues.

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

Account Bank	A bank where the transaction account is held.
Asset	An item with economic value that an entity owns or controls.
Bond	A long term debt instrument issued by either: a company, institution or the government to raise funds.
Bondholder	Investor of capital market securities.
Business Rescue	A term under the Companies Act 71 of 2008 (South Africa) Chapter 6 to remedy an entity that is likely to become insolvent. Entities that are likely to become insolvent (where liabilities exceed assets) or unlikely to be able to pay their debts as they fall due and payable in the coming six months.
Capital	The sum of money that is used to generate proceeds.
Claim	A formal request or demand.
Collateral	An asset pledged as security in event of default.
Corporate Credit Rating	A credit rating accorded to a corporate entity.
Credit	A contractual agreement in which a borrower receives something of value now, and agrees to repay the lender at some date in the future, generally with interest. The term also refers to the borrowing capacity of an individual or company
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.
Creditor	A credit provider that is owed debt obligations by a debtor.
Debt	An obligation to repay a sum of money.
Default	A default occurs when: 1.) The Borrower is unable to repay its debt obligations in full; 2.) A credit-loss event such as charge-off, specific provision or distressed restructuring involving the forgiveness or postponement of obligations; 3.) The borrower is past due more than 90 days on any debt obligations as defined in the transaction documents; 4.) The obligor has filed for bankruptcy or similar protection from creditors.
Enforceable	To make sure people do what is required by a law or rule et cetera.
Enforcement	To make sure people do what is required by a law or rule et cetera.
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.
Guarantee	An undertaking for performance of another's obligations in event of default.
Guarantor	A party that gives the guarantee.
Haircut	The percentage by which the market value of a security used as collateral for a loan is reduced. The size of the haircut reflects the expected ease of selling the security and the likely reduction necessary to the realised value relative to the fair value.
Insolvency	When an entity's liabilities exceed its assets.
Insurance	Provides protection against a possible eventuality.
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.
Irrevocable	Not able to be changed, reversed, recovered and final.
Issuer	The party indebted or the person making repayments for its borrowings.
Legal Opinion	An opinion regarding the validity and enforceable of a transaction's legal documents.
Lender	A credit provider that is owed debt obligations by a debtor.
Liability	All financial claims, debts or potential losses incurred by an individual or an organisation.
Liquidity	The ability to repay short-term obligations or short-term availability of liquid assets to a market or entity.
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.
Loss	A tangible or intangible, financial or non-financial loss of economic value.
Market	An assessment of the property value, with the value being compared to similar properties in the area.
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.
Notching	A movement in ratings.
Obligation	The title given to the legal relationship that exists between parties to an agreement when they acquire personal rights against each other for entitlement to perform.
Pari Passu	Side by side; at the same rate or on an equal footing. Securities issued with a pari passu clause have rights and privileges that are equivalent to those of existing securities of the same class.
Pledge	Constituted by an agreement between the pledgor, who undertakes to deliver the article, and the pledgee, and subsequent delivery of the property in question as security for debt. A pledge is only applicable to movable property.
Principal	The total amount borrowed or lent, e.g. the face value of a bond, excluding interest.
Proceeds	Funds from issuance of debt securities or sale of assets.
Property	Movable or immovable asset.
Ranking	A priority applied to obligations in order of seniority.
Rated Securities	Debt securities that have been accorded a credit rating.
Real Estate	Property that consists of land and / or buildings.
Recovery	The action or process of regaining possession or control of something lost. To recoup losses.
Reserves	A portion of funds allocated for an eventuality.
Securities	Various instruments used in the capital market to raise funds.

Security	An asset deposited or pledged as a guarantee of the fulfilment of an undertaking or the repayment of a loan, to be forfeited in case of default.
Security Package	Security offered to Noteholders for debt securities issued that should increase the recoveries in an event of default.
Senior	A security that has a higher repayment priority than junior securities.
Senior Unsecured Debt	Securities that have priority ahead of all other unsecured or subordinated debt for the payment in the event of default.
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.
Structural Enhancement	This may be provided as credit enhancement or as various other methods to enhance the security of a transaction such as performance triggers, short revolving periods et cetera.
Structured Finance	A method of raising funds in the capital markets. A Structured Finance transaction is established to accomplish certain funding objectives whist reducing risk.
Surveillance	Process of monitoring a transaction according to triggers, covenants and key performance indicators.
Transaction	A transaction that enables an Issuer to issue debt securities in the capital markets. A debt issuance programme that allows an Issuer the continued and flexible issuance of several types of securities in accordance with the programme terms and conditions.
Unconditional	Not subject to any conditions.
Unsecured Claim	Debt securities that have no collateral.

For a detailed glossary of terms, please click here.