



RATINGS

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RATING METHODOLOGY: CORPORATE CREDIT RATINGS

SUMMARY

This paper provides an overview of RAM Ratings' generic rating approach to analysing a corporate's ability and willingness to fully redeem its debt obligations on a timely basis.

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RAM Ratings defines credit rating as "an objective and impartial opinion on the ability and willingness of an issuer to make full and timely payments of financial obligations." This opinion is conveyed in a simple alphanumerical scale, for easy reference and comparability.

Rating is essentially an opinion. It is an art as much as a science. Rating takes into consideration both quantitative and qualitative factors. Qualitative factors include opinions on management quality, views on the future operating environment of the company and other soft factors. On the other hand, quantitative factors come into play when assessing a company's financial strength.

RAM Ratings' ratings are meant to be forward-looking and sustainable throughout business cycles. Nonetheless, new complexities and risks may emerge which could affect the assigned ratings. As such, changes in ratings can happen as time progresses.

CORPORATE RATING SYSTEM

RAM Ratings rates both long-term and short-term debt issues. RAM Ratings defines long-term issues as those with tenures which exceed 1 year, while short-term issues span less than a year. Correspondingly, RAM Ratings has a long-term rating scale as well as a short-term one.

The long- and short-term rating scales are correlated, although the latter may consist of some overlaps. For example, an issue with a long-term rating of A₂ could either carry a short-term rating of P1 or P2, depending on the corporate's ability to service its short-term obligations. Table 1 highlights the typical relationship between RAM Ratings' long- and short-term rating scales:

Table 1: Correlation between RAM Ratings' rating scales

Long-term Rating Scale	Short-term Rating Scale
AAA	
AA ₁	
AA ₂	
AA ₃	P1
A ₁	
A ₂	P2
A ₃	
BBB ₁	
BBB ₂	
BBB ₃	P3
BB ₁	
BB ₂	
BB ₃	
B ₁	
B ₂	NP
B ₃	
C ₁	
C ₂	
C ₃	
D	

The diagram shows the correlation between the Long-term Rating Scale and the Short-term Rating Scale. A large double-headed vertical arrow connects the top of the Long-term scale (AAA) to the bottom (D). A smaller double-headed vertical arrow connects AA₃ to P1. Another double-headed vertical arrow connects A₂ to P2. A third double-headed vertical arrow connects BBB₃ to P3. A fourth double-headed vertical arrow connects B₂ to NP. The arrows indicate that higher long-term ratings generally correspond to higher short-term ratings, with some specific overlaps.

Our corporate rating scale is provided as Appendix 1.

CORPORATE CREDIT RATING METHODOLOGY

The main building blocks of RAM Ratings' corporate credit rating methodology are industry risk, business risk, financial risk and management quality.

INDUSTRY RISK

Credit risk assessment for corporates always begins with an understanding of their operating environment, which would then set the framework for evaluation of their business strategies and financial profiles.

As a general rule, the industry profile and growth prospects dictate the limits and constraints of business activities. For instance, it would be extremely difficult for an individual operation to generate significant growth should the industry be in the doldrums. Likewise, it would be hard to capture a larger slice of the market if competition is rife or product differentiation is virtually non-existent.

Industry assessment may therefore dictate the level of financial strength required to weather the inherent risks of particular industries that are beyond the control of the rated company. In this context, a company in a stable and growing industry is likely to be able to tolerate a higher debt level than one which operates within a volatile environment.

Apart from that, changes within the industry may have significant implications on other areas of analysis. It is vital that one be mindful of the underlying reasons for conducting an industry analysis. Firstly, it is important to form a view on the prospects as well as the risks inherent in a particular industry. The assessment should also relate to the analysis of other major segments. For instance, certain industry characteristics may be the lead/basis for the sensitivity analysis on a company's cash flow. Likewise, understanding the general level of operational efficiency for an industry may help in assessing an individual company's business risks. Nevertheless, a favourable industry assessment does not necessarily translate into high corporate ratings as the latter would also depend on the corporate's market position, financial profiles and management quality.

For a company with a number of products where each one falls under a different industry, each business/industry is analysed separately with respect to industry risk. Also critical is the company's ability to manage diverse operations as the skills and experience required to run each industry are vastly different. At the end of it, a weighted assessment may need to be done to arrive at a conclusion about this segment of the rating exercise.

Some of the industry factors to be considered are as follows:

Growth Potential

The concept of "industry life cycle" can be used to ascertain the various growth phases (i.e. introductory, growth, maturity and decline) of a particular industry. Growth potential in itself does not necessarily mean an industry is

viewed more favourably. While there may be strong growth potential for infant industries (e.g. advanced technology industry), it is also associated with high risk due to the strong likelihood of companies becoming a cash drain. Similarly, companies in a matured industry may not be entirely at a disadvantage if they operate within a stable business environment, with a moderate level of competition.

Vulnerability to Industry Factors

This analysis determines the susceptibility of an industry's earnings to changes in industry factors. Relevant elements include the degree of sensitivity of demand to economic situations, government policies - frequency and impact of changes or reviews, as well as the volatility of supplies and prices of raw materials/end-products. Other factors to be considered include a company's vulnerability to technological changes, obsolescence risk, product fashion or trends, and changes in consumer preferences.

Excess capacity and industry life cycle are some of the factors that contribute to an industry's cyclicity. A company operating in a cyclical industry would typically need a stronger balance sheet and cash flow to ride through the business cycles. Industry diversification could potentially reduce the vulnerability of a corporate to a single business sector, provided these industries do not react similarly to economic cycles, i.e. pharmaceuticals business vis-à-vis palm oil plantation companies. The goal is to rate a corporate through its various business cycles. However, there are times when the cyclical highs or lows run against industry patterns; this may then warrant an adjustment to the corporate's current rating(s). In spite of this, the variation in ratings should be within a relatively narrow band.

The frequency and impact of changes in government policies also affect an industry. For instance, excise duties on liquor affect consumption; frequent changes in transportation policies (i.e. licensing, area zoning, tariffs on single-occupancy transportation entering cities) result in an uncertain level of competition for the public transportation sector and can influence vehicle sales.

Meanwhile, the volatility of raw material supplies or prices could affect the demand and supply of major products and also the cost structure of a company. For example, movements in crude palm oil prices would aggravate oleochemical companies' cost structures as well as the performances of plantation firms. Trades that are not only limited to the country of domicile, such as imports of raw materials or exports, expose the rated company to foreign exchange rate fluctuations.

Barriers to Entry/Exit

Although large capital outlays and economies of scale are common prohibitive factors, these need not be limited to monetary terms. Soft factors such as technological requirements, strong track records and distribution networks, entrenched regulatory support and brand identification could also heighten entry barriers. Essentially, it boils down to how easy it is for a new player to come in on a commercial basis, rather than as a marginal player.

The reverse also needs to be considered. Is it hard for the rated company to cease operating in the industry? Are there too many stakeholders to be considered? For instance, for capital-intensive industries like steel or petrochemical plants, it is harder to close down the operation due to the vast amount of money invested, or even to sell the operation, compared to a plastic injection-moulding company or a trading house. Even when demand is lacking or in a distress situation, the manufacturing facility will still have to keep running to generate cash flow to at least cover fixed costs. Too much is at stake for shareholders and lenders, who have no choice but to continue providing working capital to keep the corporate as an ongoing concern.

High barriers to entry/exit are viewed to be good for existing players in an industry. However, for a rated corporate that wishes to venture into an industry with high entry barriers, we need to assess the company's financial resources, network and support against such challenges.

Threats of Substitutes

Apart from the existing players in an industry, the availability of cheaper alternatives would also intensify competition due to the likelihood of a diversion in demand for a given product. Analysis should also cover existing and potential substitutes. It is also vital to ascertain if the product under review is a threat to others, or vice versa. However, we must also bear in mind the commercial viability of substitutes. For instance, although solar energy can replace fossil fuels in powering vehicles, it is still not commercially viable or available. As such, it does not as yet pose a big threat to fossil fuels.

Level of Competition

Perhaps one of the most important determinants of the success of a company is the level of competition. Companies operating in a highly competitive industry usually require more effective business strategies and financial resources to survive price wars, or to fund continuous advertising campaigns and promotions, compared to stable industries with an oligopolistic structure. In assessing the level of competition, it is crucial to examine both the local and global scenarios.

BUSINESS RISK

A corporate's ability to deal with the inherent industry risks assumes greater importance. Under this segment, RAM Ratings evaluates the debt issuer's business model, business strategies and competitive strength relative to its peers.

The business assessment of industrial companies may differ from that of, say, securities firms and trading-oriented businesses. Companies involved in the provision of financial services, such as leasing and hire-purchase companies and insurance companies, need a different approach and set of criteria to measure their fundamental strengths; utility companies, investment holding companies and property companies would need yet another set of assessment criteria. Therefore, there is no single universal way of determining the risk factors in all businesses. Each business needs to be looked at differently, as appropriate.

Of the risk areas, the qualitative or business risk is as important as the quantitative or financial risk. In general, one would find the assessment of qualitative risk as being less conclusive or exact since the parameters used in ascertaining, say, the operating efficiency of a company, are more subjective than financial ratios and numbers.

A comprehensive understanding of the debt issuer's business risk provides the platform for understanding financial risk. Interpretation of the financial numbers and ratios of a trading company could vary from that for a property company due to their way and nature of asset deployment. The implications of financial performance from historical data can only be meaningful once the nature of the company's business is understood. To illustrate, although a net gearing ratio of between 3 and 5 times is deemed acceptable for a utility company, it would be deemed too high for a manufacturing company.

In evaluating diversified companies, each business segment is analysed separately. Different weighting is accorded based on the relative contribution of each segment to the firm's overall profitability. Less benefit would be given if the various businesses react similarly to economic cycles. While diversification can help a firm withstand a downturn in a particular sector, management's expertise in each sector and their ability to run diverse operations assume greater importance.

In the business assessment of a company, the 2 areas normally covered are **market risk** and **operational risk**.

Market Risk

Basis of Competition

The nature of competition is, obviously, different for different industries. The basis of competition determines which factors will be analysed for a given company. Normally, in a fragmented industry or where products are generic and commodity-like, the basis of competition tends to be pricing. To survive, a company has to be cost efficient - through internal innovations, processes and sourcing ability. For example, original equipment manufacturers ("OEMs") are constantly under pressure to reduce prices given the numerous players willing to take on their jobs despite stringent standards. Being dependent on the principals for business, OEMs are also required to move up the value chain by investing in equipment so as to be in sync with the principal's technology and products. Since these entities do not

have much room to manoeuvre in terms of product pricing, we will have to assess the corporate's ability to improve efficiency and keep up with the requirements of the principal for its cash flow-generating ability in the future.

Some companies' competitive edges lie in the quality of their products, distribution capabilities and service. Normally, such products fall between being branded and commodity-like. Due to a certain amount of customisation, margins can be justified when value is added. Companies selling such products are less vulnerable to pricing risks but have to bank on their track records and reliability to grow their revenue.

Meanwhile, demand for branded products is more certain as the population can identify with the goods, compared to a new product which requires substantial marketing efforts to penetrate the market. Revenue for a company with patented products such as pharmaceuticals can be more certain as the patent creates a natural protection until it expires. Similarly, a rated corporate which has secured long-term contracts with assured margins and revenue is also viewed more favourably.

Competitive strength	Industry
Pricing and lean cost structure	Cement, OEMs, building materials, petrochemicals, textiles
Extensive distribution coverage	Retail chains, warehousing and logistics
Brand identification	Consumer goods, fashion labels, airlines, automobiles
Research and development	Pharmaceuticals, high-end technology

Market Position and Size

Market position and size are some of the major factors that affect the competitiveness of a company. In some industries, size matters if it confers major advantages in terms of operating efficiency and competitive position. Normally, large conglomerates are able to leverage on purchasing synergies, lower per-unit cost of production, larger volume spread for research and development expenditure and capital intensity, and more extensive distribution channels. Large firms often have more diverse product offerings, customers and geographical sales than smaller companies, and they tend to have more staying power during trying times, especially those with strong financial resources.

Nevertheless, a large market share and sheer size may not always be synonymous with pricing leadership in a highly fragmented industry or an oligopolistic one where no single company is a dominant player. While size does matter in certain industries, some small companies can possess competitive advantages such as production flexibility, particularly in an industry with excess capacity (minimises over-expansion risk). They can also benefit in terms of responsiveness as a result of their less complex organisational and reporting structures compared to corporate behemoths. What may be more appealing would be firms specialising in niche markets, where there is less price undercutting and intense competition.

Product/Service Diversity

Diversity is key to mitigating concentration risk. As such, a company which has more than a single product line, with proportionate revenue contribution, is viewed more favourably than one that relies solely on a single product line. Diversity of product or services provides the corporate the flexibility to grow its revenue, and provides a cushion in the face of adversity. Should one of the products lose market share or have to be pulled out of the market for certain reasons (e.g. protein allergy claim about latex gloves, poisoning scare in relation to food products), the company would still have room to manoeuvre compared to single-product company. In addition, corporates with a wide range of related products could also offer them as a package (e.g. corrugated cartons, flexible packaging and other packaging materials) and command some price advantage. In the interest of time and convenience, purchasers may be enticed to purchase from such “one-stop” centres.

Customer Analysis

RAM Ratings carries out a thorough analysis of a company’s customers’ profile to determine the sustainability of its cash flow. To evaluate customer concentration risk, RAM Ratings looks at the proportion of total revenue (in terms of volume and value) taken up by the top 20 customers over a period of time.

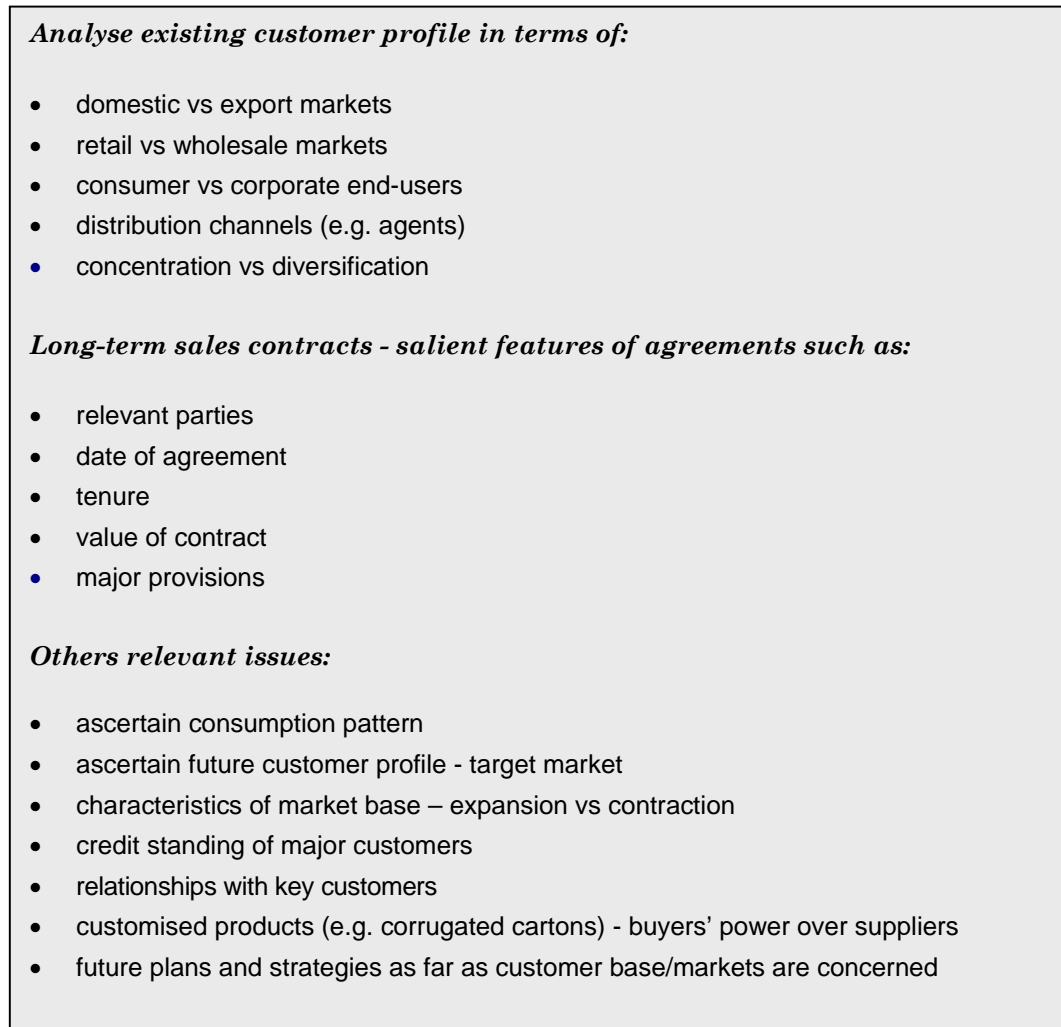
The basic questions raised are: “Who are these customers?” and “How dependent is the firm’s revenue on these sales orders?” If customer concentration risk is deemed high, what is the likelihood of these customers switching to another supplier? Heavy reliance on a few customers increases the rated entity’s exposure to these customers’ performance and credit risks. Should these major customers decide to cut their orders, it would take time for the corporate to fill the ensuing vacuum. Furthermore, should these customers delay payments or face financial distress, the rated corporate’s debt-servicing ability could then be affected.

Are future sales tied to fixed-term contracts? If so, are they fixed in terms of volume and/or price and the tenure of the contract? What is the credit standing of these customers and what are the chances of them winding up? What are its customers’ consumption patterns like and are they seasonal or cyclical? As far as possible, we would check the financial positions of these customers to ascertain their ability to continue business with the rated entity, and purchasing policies which may affect the rated entity.

From the list of customers, some level of customer satisfaction can be determined. If major customers ceased to exist, we need to evaluate whether it is due to their own fundamental weaknesses, or was it a result of the rated company’s poor service or product quality. Customer satisfaction can also be gauged via statistics on reject rates or returns. Such information can provide a rating agency with an insight into the sustainability of the rated corporate’s business and competitive edge.

Apart from evaluating sales to individual clients, RAM Ratings also analyses geographical spread. Should exports be confined only to a few countries, the company is considered exposed to these countries’ sovereign risks, i.e. currency fluctuations, economic conditions (e.g. sales of building materials to Singapore were hit due to the recession), and government policies (e.g. Malaysian plywood manufacturers’ sales declined due to the Chinese government’s decision to encourage downstream processing in its own timber industry).

Figure 1: Factors considered in conducting customer analysis



Operating Risk

Plant Facilities and Location

For manufacturing concerns, plant facilities are key to their survival. As such, RAM Ratings assesses the condition and age of plant facilities, as well as the technological advancement required to continue being cost efficient and competitive. For high-technology sectors with high capital intensity, keeping up with technology is vital. Normally, the integration of processes results in higher efficiency and cost savings. However, it can also result in non-optimal utilisation at certain levels of production. Therefore, it depends on what form of integration and at which point of the business cycle the plant was set up.

The importance of location is dependent on the product. For packaging companies, it is best to be situated near customers to minimise transportation costs, while paper manufacturing facilities are best located near their raw material sources. To minimise concentration risk, manufacturing facilities which are geographically spread out are viewed more favourably.

Availability of Raw Materials

The availability of raw materials is crucial to ensure no major disruptions to a company's value chain. This is especially important for companies adopting the just-in-time strategy or those depending on scarce or depleting commodities, e.g. timber and oil companies. In such instances, the existence of long-term supply contracts is looked upon favourably. RAM Ratings also takes into account the concentration in suppliers, track record and business relationships as part of our evaluation of the firm's supply chain management.

Pricing trends and foreign exchange rate risk are also considered to determine the degree of volatility. Although hedging methods could assist in managing price fluctuations, they need not be necessary in some cases where there are natural hedges. What is more important is the firm's ability to pass on cost increases to its customers. Still, time lags in passing on these cost hikes can destabilise profits. Payment terms are also assessed since supplier's financing (in terms of longer days payable) can be used to fund working capital requirements. However, prolonged delay in payments may suggest a liquidity crunch.

Efficiency of Assets

Yield rates, rejects rates, man (labour) hours per unit and utilisation rates are some of the measures used to evaluate a corporate's efficiency over the years and in comparison with its peers. A more efficient outfit naturally results in lower costs and broader margins. Things to note include any variations from the norm, particularly deterioration, and if such incidences will be permanent due to the process flow and/or machine efficiency.

Cost Structure

Cost structure can provide important indications about a firm's performance and cost management policy. In this analysis, the various elements that contribute to the firm's cost structure are analysed separately. Those for manufacturing concerns can broadly be divided into raw materials, labour and overhead costs. Trend analysis of the overall production cost per unit and scrutiny of the individual cost vis-à-vis sales per unit show how the company has been managing its margins over the years. Cost savings by relocating or replacing certain materials with cheaper ones can be tied back to these figures. They also provide a check and balance on management's arguments for change. For example, if labour costs only account for a minute fraction of the total production cost, relocating to a country with an abundance of labour will not necessarily benefit the company. Cross-analysis with peers provides further insights on how well the management can innovate to save costs without jeopardising revenue generation.

Nevertheless, cost structures differ according to the rated corporates. For a service-oriented entity, wages may form the bulk of its costs and there may be less room to raise productivity, while wages are likely to continue rising annually.

Labour Relations

As human resource is another important asset to a company, labour relations are also evaluated when arriving at a rating. Here, we analyse the history of labour disruption, the number of union vs non-union staff, its union contract expiration schedule and staff retention policy.

Credit Controls

One of the leading indications of corporate failure is a long operating cash cycle, which essentially results in liquidity problems. The operating cycle extends from the time a company commits cash to acquire raw materials, to the time when cash is received from the sale of the finished goods. While a higher ratio indicates a collection problem and/or overstocking, the benefits and costs of holding various amounts of each component need to be evaluated.

While a construction-related industry tends to exhibit long-dated receivables, this should be viewed as an exception rather than the norm. Key considerations include sales terms, how cross-border payments are conducted, trade debtors ageing profile, the company's provisioning policy, and measures to recover bad debts. Related-party's receivables ageing should be analysed separately to detect systemic risks, if any.

Inventory Management

Factors considered in assessing inventories are stocking policies, lead time, inventory compositions, ageing profiles, history of write-offs and mode of funding stocks (e.g. whether stockholding cost is borne by the manufacturer or dealers). A comparison with its peers should be made to provide some perspective to the numbers. For a trading company, the ageing profile of the goods and its policies in clearing stocks are paramount when minimising write-offs. Inventory management is particularly important for industries which have high obsolescence risk such as those in the fashion or information technology-related sectors.

FINANCIAL RISK

RAM Ratings assesses a firm's financials through 3 broad segments, namely the firm's historical profile, its future financial projections, and financial flexibility. Based on its track record and our discussions with management in regard of the company's funding requirements, opinions can be formed about their financial policies in relation to dividend and cash flow protection. We examine the accounting policies and the extent to which they accurately represent a company's financial performance. This includes treatment of goodwill, off-balance sheet items, capitalisation of expenses, revenue recognition, inventory costing methods, and recognition of hybrid securities. RAM Ratings also assesses the impact of changes in accounting standards on a firm's bottom line and, more importantly, its cash flow. While accounting treatments may be cosmetic in nature, greater emphasis is placed on a firm's cash flow statement. The key is to evaluate the **stability** and **adequacy** of its future cash flow, although cash flow projections cannot be viewed as an attempt to accurately forecast performance.

Profitability

This begins with the evaluation of turnover, sales growth and, ultimately, how they translate into the bottom line. Although absolute profit figures are important, a trend analysis of profit margins is equally significant when gauging a firm's vulnerability to fluctuations in prices and its ability to pass on costs to customers. Its earning power against its peers can provide some insight into a firm's competitive strength and pricing flexibility. Since credit rating evaluates the likelihood of meeting future debt obligations in a timely manner, the assessment also emphasises the sustainability of these profit trends and future performance. Findings from the industry and business analyses will play a role in determining the likelihood of management achieving their forecasts.

Funding Structure and Liquidity

We examine the proportion of short- against long-term debts, and essentially whether there is any mismatches in the company's sources and uses of funds. Is the company supporting its long-term assets with short-term borrowings? We view the funding of long-term assets with short-term funds to be less favourable because it subjects the company to additional uncertainty. Although some long-term debts are also sensitive to interest rate movements, the availability of the term loan is more certain than a banking facility. Certainty of financing and costs allows a company to plan better and permits more resources to be deployed on its operations.

Companies with too many short-term debts are more likely to come under stress if market conditions change. During the 1997/98 regional financial crisis, companies with such funding structures were caught with exorbitant interest expenses. Some even had their short-term banking lines pulled back due to banks limiting their own exposures to that particular industry/sector. Therefore, even though there was a backlog of orders, such unfortunate companies were unable to fulfil them due to lack of working capital. As they could not grow their revenue, cash flow generation to service debts was therefore limited. We prefer companies to not be too dependent on banking lines for their working capital requirements.

RAM Ratings also takes into consideration the tenure of a company's funding vis-a-vis the returns on its investments or capital expenditure. For instance, if a plant takes 2½ years to be built and another 6 months to commence commercial production, principal repayment for the debt assumed to fund the plant should only start - at the earliest – after 4 years, to allow the plant to generate cash first. The repayment of the debt should also be spread out to match the cash flow. If this is not possible, we would then have to consider is there are any other avenues where the other operations of the company can support this debt.

Leverage and Coverage

RAM Ratings evaluates debt on both gross and net bases (total debt minus cash balance), its maturity schedule, debt composition and off-balance sheet items. However, debt and equity elements may not be straightforward at times, as in the case of hybrid securities and convertible debts.

A company's debt level may vary with the type of business it is in. Generally, a capital-intensive business requires heavier capital spending and yearly investment plans. This could provide an indication on future financing requirements, which would affect the corporate's debt level in the medium term. While a corporate may be debt-ridden, this is often compared to the size of its shareholders' funds and operating cash flow, which measures its debt-servicing ability. Again, these financial ratios cannot be assessed in isolation. A comparison across similar industries would be more relevant.

Cash Flow Stability and Adequacy

Cash flow analysis is the most important element when determining the creditworthiness of a company, although a corporate rating can sometimes be affected by qualitative factors. Here, the cash-generating capability of a company is assessed relative to its capital spending and other outlays. Companies with long-term secured contracts are generally preferred over those without, as they provide more a predictable and sustainable cash flow in the medium term. In cases where the subsidiary is not wholly owned by a parent company, RAM Ratings generally assumes a dividend payout from the subsidiary rather than consolidating it with the overall group's cash flow projections. Two common ratios used by RAM Ratings in assessing cash flow adequacy are operating cash flow debt coverage and free cash flow debt coverage.

Financial Flexibility

Financial flexibility refers to the potential sources of funds (e.g. disposal of unencumbered assets) available to a company in times of distress. Unencumbered assets here do not include operating assets, e.g. machinery and motor vehicles. Other factors that contribute to financial flexibility are access to the equity market and availability of marketable securities. While financial flexibility can provide an added advantage to the issuer in times of financial distress, it is critical to assess the relative need for such back-up resources.

MANAGEMENT QUALITY

A company's performance is essentially a reflection of the quality of its management. Although it entails a great deal of subjectivity, management evaluation is one of the key factors that underscores RAM Ratings' corporate rating methodology. Our analysis centres on corporate strategies, risk tolerance, funding policies, succession planning, and management's competence and integrity.

Corporate Goals and Strategies

Understanding the strategic direction of a company is important as it provides useful insights on what to expect in the near term. For example, a firm embarking on an expansion strategy to increase its market share naturally requires further capital spending. In this analysis, it is also crucial to evaluate the consistency of a firm's goals and strategies vis-à-vis its performance in the coming years.

Risk Tolerance

Unfortunately, a corporate with a higher risk tolerance tends to face a greater degree of uncertainty. Management's aggressive style of maximising potential returns may come at the expense of its balance sheet strength. A firm, which undertakes a series of acquisitions over a short time to pump earnings growth, is viewed to be risky. Nonetheless, not all acquisitions have negative connotations, especially synergistic mergers. As potential earnings growth is not conclusive, the impact on the balance sheet should be taken into consideration.

Funding Policies

A firm's funding policies may also provide a good indication of its risk tolerance with regard to debt capacity. Additionally, understanding dividend payout policies is important in assessing the potential outflow of funds to parent companies.

Succession Planning

Significant reliance on a few top management personnel is viewed negatively. The idea here is to have continuity or succession planning in place to ensure minimal interruptions to business activities.

Competence and Integrity

Management's competence is often reflected in the firm's performance. Under this analysis, the track record and expertise of management is evaluated to determine its ability to achieve its stated goals and strategies or to manage diverse operations. A write-up on a firm's key management team is usually required. Integrity, on the other hand, can become a critical issue when certain transactions or management philosophies appear dubious and had been conducted for the benefit of certain related parties.

O **THER RATING CONSIDERATIONS**

PARENT-SUBSIDIARY RELATIONSHIP

In general, no unit within a group is accorded a higher rating than that of the parent company, to reflect the systemic risk of the group. The rating of the parent company, meanwhile, would have taken into consideration the strengths and weaknesses of its subsidiaries.

In a situation where the subsidiary is much stronger than the parent, the stand-alone rating of the former would normally be capped by the latter's rating, unless there are definite indications that the parent would not drain the subsidiary's resources and/or the subsidiary had been established as an autonomous entity.

If the subsidiary is weaker than the parent, the stand-alone rating of the former may be enhanced through support from the latter. The importance of the subsidiary to the welfare of the group and the degree of integration between them are key to the assessment. If the strong parent guarantees the debt(s) of the subsidiary, the rating of the parent prevails.

At times, though, RAM Ratings may view a parent and its affiliates as having distinct default risk. The difference in default risk may arise from covenants, restrictions or regulations.

In a regulated industry such as banking and insurance, however, the subsidiary's rating can be higher than the parent's.

The guiding principle in determining whether a strong subsidiary can be rated higher than a weak parent is the degree of linkage that exists between them. Unless it can be proven with a high degree of certainty that the subsidiary is autonomous, the rating of the subsidiary should still be capped by the parent's rating.

CREDIT ENHANCEMENTS

WELL-SECURED DEBTS

Enhancements will only be accorded if our analysis indicates that there are prospects of a full recovery of principal after severe stress tests on the collateral, i.e. above 1 time collateral coverage of principal after severe stressing.

Timeliness remains the primary consideration. Any enhancement is pegged to the senior debt rating/credit profile rating of the company. The rationale behind this is that although collateral does not decrease the probability of default of an issue, it does provide the debt holder a better chance of recovering the amount owed.

Given that there is a high likelihood of a lengthy delay in realising the ultimate recovery, a well-secured debt which satisfies the full recovery criterion will only be given a 1-notch enhancement from the senior debt rating/credit profile rating of the company. For short-term papers, enhancement will only be given if the enhanced long-term rating corresponds with a higher short-term rating. In cases where the long-term rating may be mapped to either P1/P2 or P2/P3, depending on the assessment on the short-term fundamentals of the entity, the enhancement to the short-term rating will only be accorded if the collateral is extremely liquid.

Types of Collateral

In assessing the prospects of full recovery of the principal, a comprehensive analysis of the collateral should be undertaken. The analysis should focus on the various potentials of different types of assets to retain value over time and into the default context - based on their liquidity characteristics, special-purpose nature, and dependence on the health of the company's business.

Typically, assets offered as collateral include property and shares. RAM Ratings does not accept collateral in the form of operating assets, such as manufacturing facilities, as the debt issuer relies on such facilities as a going concern. While the abovementioned analysis should always be carried out, we have listed some general ground rules with regard to certain common types of collateral:

Property

The quality and nature of the property has to be taken into account. Generally accepted types of property for collateral include commercial properties such as offices and hotels, which are already generating cash flow.

Other types of property will be assessed, focusing on the aspects mentioned above.

Calculation of collateral cover will be based on 60% of the property's market value (according to the latest valuation report) unless our in-house analysis concludes that the property is significantly overvalued or undervalued. The analyst should also understand the basis of the third party's valuation. If the property is significantly overvalued or undervalued, a value lower or higher than 60% may be used.

Listed Shares

Shares are inherently volatile in value, rendering it difficult to make a definite conclusion about their future prices. They are, however, commonly pledged as collateral. Some of the ground rules include:

- The securities can be either government notes or papers listed on a recognised bourse. The securities should not only be limited to shares. As far as permissible securities are concerned, if they are priced at market and traded on a formal exchange, they should be acceptable.

- The pledger owns the underlying securities.
- Once the securities are pledged to the debt holders, they are not allowed to be removed throughout the tenure of the debt issue.
- Compliance monitoring will be on a marked-to-market basis. Once a breach of the minimum coverage exceeds 30 consecutive days (including non-trading days), the debt issuer will have an additional 5 working days to remedy the breach. Otherwise, the rating will revert to the stand-alone rating. Reinstatement of the enhanced rating will only be done when the cover exceeds the minimum coverage for 30 consecutive days (including non-trading days).

The following confirmation will be provided by the trustee:

- 1) At the point of issuance - the securities pledged, detailing the amount and coverage.
- 2) 30-day countdown cycle – the first day of every cycle. Details on the breached coverage should be included.
- 3) Top-up cycle - details on any additional securities added to the collateral during the 5-day remedial period. These include the securities pledged, the amount and the new coverage level.
- 4) Reinstatement point - after 30 days of consecutive coverage. Details include the daily movements in coverage.

With a minimum basket of 3 shares, initial coverage will be 2 times the debt issue amount (at the point of issuance), with a minimum of 1.67 times throughout its tenure. When less than 3 shares are pledged, the upfront coverage is 2.5 times the debt issue amount (at the point of issuance). Having an initial coverage is to have an additional buffer above the minimum coverage.

BANK GUARANTEE/CORPORATE GUARANTEE

Guarantee from Local Bank or Corporation

Where an issue is guaranteed by either a local bank or corporation, RAM Ratings will assign the rating of the guarantor to the issue - if it is rated by RAM Ratings and is higher than the stand-alone rating of the debt issuer. If the rating of the guarantor is lower or if it is not rated by RAM Ratings, then the issue will reflect the stand-alone rating of the issuer.

For example, a debt issue by Company A, which had a stand-alone rating of A₁, would be assigned a rating of AA₁ if the guarantor carried a rating of AA₁ by RAM Ratings. If the guarantor carried a rating of A₃, which is lower than the debt issuer's stand-alone rating of A₁, then no enhancement consideration would be given to the guarantee. As such, the debt issue would still carry a rating of A₁.

Where an issue is guaranteed by a consortium of financial institutions on a proportionate basis, RAM Ratings adopts the weakest-link approach in assigning the enhanced rating in accordance with our definition of full and

timely payment of interest and principal. This approach reflects the probability of obtaining full and timely payment of interest and principal from the lowest-rated guarantor.

For example, if Bank Y and Bank Z are guarantors to a debt issue by Company A and are rated AA₁ and AA₃ respectively, the issue would be assigned a rating of AA₃(bg). The “bg” suffix reflects the backing of the guarantee which enhances the credit risk profile of Company A beyond its inherent or stand-alone credit risk.

JUNIOR DEBT

Whenever the recovery prospects of a financial obligation are deemed materially worse than those of the issuer’s other debts, the issue’s rating will be notched down from the senior debt rating/corporate profile rating. Notching is only meant to differentiate between recovery prospects, while it is presumed that a default will interrupt payments on all the company’s debt issues.

A debt is considered to be junior if it is:

- 1) Subordinated
- 2) Unsecured - and significant secured debts exist.
- 3) Secured, but does not have a first-mortgage charge or quality collateral, unless the debt with the first-mortgage right is relatively small compared to the assets.

INDUSTRY SPECIFIC RATING METHODOLOGY

The above rating methodology is generally applied to evaluate corporates across industries. However, given the peculiar nature of certain industries RAM Ratings uses specific rating methodologies that are derived from the general one. These include

- Food & Beverage
- Independent power producers
- Petroleum
- Ports
- Poultry
- Printing media
- Telecommunication
- Toll road
- Trading (Retail)

Notching Guidelines

The junior debt of a company with a senior debt rating/corporate profile rating of AA₂ and above may not necessarily be notched down because the fundamentals of the company are deemed very strong.

The junior debt of a company with a senior debt rating/corporate profile rating of BBB₃ to AA₃ can at most be rated 1 notch below its senior debt rating/corporate profile rating.

The junior debt of a company with a senior debt rating/corporate profile rating of BB₁ and below can be rated up to 2 notches below the senior debt rating/corporate profile rating. As default risk increases, the recovery prospects become more important and carry greater rating significance.

RAM RATINGS' CORPORATE CREDIT RATING DEFINITIONS

LONG-TERM RATINGS

AAA	Issues rated AAA are judged to be of the best quality and offer the highest safety for timely payment of interest and principal.
AA	High safety for timely payment of interest and principal.
A	Adequate safety for timely payment of interest and principal. More susceptible to changes in circumstances and economic conditions than debts in higher-rated categories.
BBB	Moderate safety for timely payment of interest and principal. Lacking in certain protective elements. Changes in circumstances are more likely to lead to weakened capacity to pay interest and principal than debts in higher-rated categories.
BB	Inadequate safety for timely payment of interest and principal. Future cannot be considered as well-assured.
B	High risk associated with timely payment of interest and principal. Adverse business or economic conditions would lead to lack of ability on the part of the issuer to pay interest or principal.
C	Very high risk of default. Factors present make them vulnerable to default. Timely payment of interest and principal possible only if favourable circumstances continue.
D	Payment of interest and/or repayment of principal are in arrears. Already in default.

SHORT-TERM RATINGS

P1	Very strong safety with regard to timely payment on the instrument.
P2	Strong ability with regard to timely payment of obligations.
P3	Adequate safety with regard to timely payment of obligations. Instrument is more vulnerable to the effects of changing circumstances than those rated in the P1 and P2 categories.
NP	High investment risk, with doubtful capacity for timely payment of short-term obligations.

For long-term ratings, RAM Ratings applies the signs plus (+), flat and minus (-) in each rating category from AA to C. The sign plus indicates that the issue ranks at the higher end of its generic rating category; the flat indicates a mid-ranking; and the sign - indicates that the issue ranks at the lower end of its generic rating category.

In addition, RAM Ratings applies the suffixes (bg) or (s) to ratings which have been enhanced by a bank guarantee or other supports, respectively.

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RATING METHODOLOGY: CORPORATE CREDIT RATINGS

No statement in this methodology is to be construed as a recommendation to buy, sell or hold securities, or as investment advice, as it does not comment on the security's market price or suitability for any particular investor.

While every effort has been made to incorporate the salient points of RAM Ratings' experience in relation to the methodology, we note that the information contained could be updated and altered depending on changes in our internal views, market conditions, accounting practices and regulations. The methodology is also based on factors relevant to Malaysia and may require adaptation to local conditions.

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