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RFC Process Summary:

RFC Process Concerning Key Credit Factors For The Operating Leasing Industry

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On July 19, 2016, S&P Global Ratings published a request for comment (RFC) on our proposed Key Credit Factors (KCF) for companies for which operating leasing is the chief driver of earnings. In the RFC, we encouraged interested market participants to submit their written comments to us.

We'd like to thank the market participants who provided feedback. After careful consideration, we finalized and published the final criteria article, "Key Credit Factors For The Operating Leasing Industry," on Dec. 14, 2016.

This RFC process summary provides an overview of the feedback and the clarification between the request for comment and the final criteria.

Points Of Clarification

Scope of the criteria

Clarification. The final criteria make clear that this methodology does not apply to companies that engage in full-payout leases (leases that essentially transfer the economic risk mostly to the lessee) and companies that engage in a combination of lending and leasing activity. We would rate these companies using our nonbank financial institutions criteria.

Methodology

Clarification. The final criteria clarify that we apply the same methodology to operating leasing companies that we apply to many other corporate entities. We view operating leasing companies as corporate entities. Therefore, we assign issue ratings using the same methodology we use for entities rated under "Corporate Methodology," published Nov. 19, 2013. We link short-term and long-term ratings on corporate issuers including operating leasing entities using "Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers," published May 7, 2013.

Feedback. We received a comment as to whether it is appropriate to revise ratings based solely on the content of revised criteria.

Response. For consistency and comparability of ratings, when we publish any new or revised criteria, we apply those criteria to any relevant ratings.

Competitive position

Feedback. One area where we would like to challenge the proposed criteria is the measurement of the financial leverage of a company. The proposed change in the core ratio to EBIT interest coverage from funds from operations (FFO) to debt is most welcome albeit it doesn't fully address the grievance that we have raised over the last few years. That grievance has stemmed from the fact that in order for the businesses to grow or even remain at the current number of vehicles, there is a continuing need to invest in new capital projects. New business is governed by the franchising process and is therefore uneven in its nature. Recently there have been numerous significant asset procurement processes in the market with many more expected in the coming years. We do not believe that the business's ability to participate in these procurement processes should be stifled by credit metrics that don't recognize a significant timing delay between the initial capital outlay and the revenue being generated when the stock is delivered into operating service several years later Typically a manufacturer will require progress payments of 20% of capital cost in year 1, 30% in year 2, and the balance in year 3 on delivery. The impact of this on financials is a spike in debt and capitalized interest in years 1 and 2 with no revenue generation until year 3. This historically has put pressure on the business's credit metrics, particularly the FFO to debt ratio in the short term.

Response. We typically measure all credit ratios over a five-year period (previous two years, current year, and the forecasted two years), somewhat smoothing out this effect. Also, the criteria provide flexibility to adjust the weightings to place greater emphasis on the current and future years to more appropriately reflect credit quality. Finally, a business that has large capital outlays but does not recover the benefit in earnings until years later is inherently riskier than one less dependent on "chunky" capital spending, and therefore, the standard weighting may be appropriate in many situations. To the extent that a leasing company makes large outlays for equipment but, because of its market or regulatory situation, has a high degree of confidence in receiving future revenues from those investments, that would be considered positively in judging its asset class economics and competitive advantage, in the business risk part of our analysis.

Feedback. Differentiation in company's logistical strengths should be considered and evaluated in assessing business risk.

Response. The operating leasing industry methodology captures the superior effectiveness of individual market participants in the Operating Efficiency component of Competitive Position. We rank companies that achieve higher utilization rates and shorter turnaround times and are able to consistently realize other operational advantages more positively in our assessment of their operating efficiency. In addition, as part of our overall assessment of competitive advantage, we consider characteristics such as more favorable locations that allow a company to attract a higher amount of customer traffic. The benefits of a company's superior operating efficiency and distinct competitive advantage over its competitors should be reflected in its profitability relative to its competitors in order for us to give meaningful credit to these characteristics in our analysis.

Feedback. The asset class economics (ACE) component of the criteria does not provide sufficient consideration for asset characteristics that provide long-term value to operating results and residual realization.

Response. The asset class economics (ACE) component of the methodology considers many characteristics of a leasing sub-sector. For example, if an asset type has a particularly long service life but shorter lease terms, a robust used equipment market, and the fact that the leased assets are still core and contributing highly to the operations of the lessee customers, may partially offset the negative properties of older assets. Also, to the extent that a leasing company realizes significant proceeds from sales of its assets, that would be reflected in lesser amounts of debt to fund capital expenditures and thus stronger credit measures.

Feedback. We would like S&P Global Ratings to elaborate more on aircraft lessors and U.K. rolling stock operating companies (ROSCOs) as they represent a large and active portion of this sector.

Response. We believe that we have appropriately addressed the sub-industries in these criteria. We will provide further detail as we publish analyses on individual companies. While not scheduled at this time, we may publish commentaries on the sub-industries as appropriate.

Feedback. We believe S&P Global Ratings should clearly specify what the ACE assessment is of each specific sub-sector: paragraph 44 refers to railroad tanks on North America, paragraph 45 refers to car rental and modular space rental; however, certain subsectors are missing from this description (aircraft leasing in particular and also the U.K. ROSCOs).

Response. We do not feel that it is necessary to publish a list of ACE scores by sub-industry, as this is well beyond the type of assessment that we disclose when analyzing other corporate issuers. Also, ACEs of individual companies may vary based on particulars for that company.

Feedback. Under paragraph 44, we think it would be useful to clarify whether aircraft leasing companies and U.K. ROSCOs belong to the list of examples given for strong/strong adequate ACEs (based on long lease terms, liquid assets, and moderate cyclicality).

Response. We chose intentionally not to prescribe which sub-sectors' ACE might be scored in a certain way, because it is a sub-factor of a sub-factor and we wanted to preserve flexibility to consider the different situations of companies in particular sub-sectors and markets.

Analytical adjustments

Feedback. We see scope for analytical adjustments above and beyond what is explicitly articulated in the criteria. In the spirit of additional transparency, could you please give us more details on when analytical adjustments will happen for the most material and/or commonly recurring items? For instance, a big one would concern how growth/acquisitions would be treated. These can have a distorting impact on the volatility of profitability.

Response. Our analytical adjustments will be consistent with those in the 2013 Ratios and Adjustments criteria and our disclosure will be similarly transparent to the disclosure for other issuers rated in Corporate Ratings. Regarding adjustments for growth and acquisitions, we will follow the Ratios and Adjustment criteria.

We typically measure all credit ratios over a five-year period (the prior two years, the current year, and the forecasted two years), somewhat smoothing out this effect (of acquisitions and growth). Also, the criteria provide flexibility to adjust the weightings to place greater emphasis on the current and future years to more appropriately reflect credit quality.

Feedback. The EBIT interest coverage metric appears to provide greater flexibility than FFO to debt but the calculation of interest expense, which continues to follow the current Corporate Methodology, means that interest expense will be as stated in the relevant company's financial accounts adjusted for any capitalized interest incurred. An alternative view is that capitalized interest should be excluded from the interest calculation or an appropriate adjustment is made to EBIT to ensure that the interest and earnings in respect to the new build is matched appropriately as it is under international accounting standards.

Response. Our practice of including capitalized interest in interest expense for the period in which the interest was incurred is driven by the 2013 Ratios and Adjustments criteria and should be applied consistently across companies subject to the Ratios and Adjustments criteria (including operating leasing companies).

Per paragraphs 93-96 of S&P Global Ratings' Corporate Methodology: Ratios and Adjustments: under most major accounting regimes, financial statements show interest costs related to the construction of fixed assets as capitalized, that is, as a component of the historical cost of capital assets. This can obscure the total interest that has been incurred during the period, hindering comparisons of the interest burden of companies that capitalize and do not capitalize interest.

Under our methodology, interest costs that have been capitalized are adjusted and included as interest expense in the period in which the interest was incurred.

In the statement of cash flows, we reclassify any capitalized interest shown as an investing cash flow to operating cash flow. This adjustment reduces cash from operations and capital expenditures by the amount of interest capitalized in the period. Free operating cash flow remains unchanged.

We make no adjustment for the cumulative effect on the value of property, plant, and equipment resulting from any prior-year interest capitalization, tax effects, or depreciation, due to disclosure limitations and the minimal analytical benefit this would provide.

Feedback. Paragraph 68 seems a bit ambiguous: could you confirm that S&P Global Ratings' intention is for gains and losses on sale of assets to be included into operating revenues or expenses, and depreciation related to these assets to be deducted from overall depreciation expense?

Response. The phrasing in Paragraph 68 is clear, but the specific word "turnover" may have caused confusion regionally. Yes, our intention is to include gains and losses as an adjustment to depreciation and an operating expense. However, there is no adjustment to revenue. We use the phrase "turnover of leased assets" to refer to a leasing company's ongoing operations which includes the regular acquisition and disposal of leased assets. Paragraph 68 is as follows:

Operating lease companies often sell equipment as part of a normal pattern of acquiring, leasing out, and disposing of their assets. To the extent that gains and losses realized on such equipment sales are part of the normal turnover of leased assets, we include such gains and losses as an adjustment to depreciation and an operating expense.

Profitability

Feedback. The KCF for the Operating Leasing Industry and the "Corporate Methodology," published Nov. 19, 2013 are not clear on the calculations used to determine the standard error of regression (SER) of profitability and the implications to ratings.

Response. The KCF for the Operating Leasing Industry uses the same overall approach to measuring volatility of profitability as in the "Corporate Methodology." EBIT margin is the ratio that we have selected as the most appropriate for measuring the SER on operating leasing companies. The SER is a statistical measure that is an estimate of the deviation around a "best fit" linear trend line. A key advantage of SER over standard deviation or coefficient of variation is that it doesn't view upwardly trending data as inherently more volatile. At the same time, we recognize that SER, like any statistical measure, may understate or overstate expected volatility and thus we make qualitative adjustments where appropriate. Furthermore, we calculate SER only when companies have at least seven years of historical annual data and have not significantly changed their line of business during that period, to ensure that the results are meaningful. We believe that seven years is generally an adequate number of years to capture a business cycle. For operating leasing companies, we may adjust the results of the SER assessment in a favorable direction if material write-downs are distorting the volatility of profitability. If we do not have sufficient historical information to determine the SER, we follow the global corporate criteria guidelines to determine the volatility of profitability assessment.

Feedback. We understand the rationale of having EBIT margin as a starting point of S&P Global Ratings' assessment of the profitability of an operating leasing company. However, volatility calculation as described in paragraphs 61-62 will imply adjustments for a majority of lessors (impairments, acquisitions, etc.). We would like to point out here that a generalized use of those adjustments could impair the greater transparency provided by this methodology. Also, we would request some additional guidance on how S&P Global Ratings will adjust volatility calculation on asset impairment, acquisitions, and lack of historical information. We would also want to better understand how S&P Global Ratings will deal with leasing companies that have fewer than seven years of historical results.

Response. We did not see volatility of profitability adjustments for the majority of lessors in our testing. Furthermore, this approach is consistent with our well-established 2013 Corporate Methodology, and provides for appropriate analytical judgment. We believe volatility adjustments for impairments will be used only for large write-offs, which overstate volatility. As to large acquisitions overstating volatility, this can be an issue for any company but the criteria provide the right amount of flexibility. This has proven to be the case when applying the same concepts in the 2013 Corporate Methodology.

Feedback. The EBIT margin profitability threshold levels are not appropriate for operating leasing companies with significant amounts of revenues and earnings from other activities that have EBIT margins lower than levels that would be considered typical for a leasing company.

Response. The EBIT margin profitability threshold levels are only one consideration in our assessment of operating leasing companies' profitability. We also assess the volatility of a company's total EBIT margin, using the SER, when forming our overall evaluation of profitability. Additionally, companies with diversified operations (for example, service related activities) may receive favorable consideration under our company-specific aspects of Competitive Advantage and our Scale, Scope, And Diversity analyses within our assessment of Competitive Position. Lastly, the Comparative Ratings Analysis (CRA) part of our methodology suggests that a rating committee may consider the positive and negative effects on a leasing company's credit profile of a significant minority of revenues or earnings from non-leasing businesses in determining a final rating. Our methodology was designed with great consideration to accommodate for the positive and the negative characteristics that exist across the wide variety of operating leasing companies.

Cash flow leverage

Feedback. An alternative core ratio that could be followed is one that is more long-term such as net present value of forecast earnings as a percentage of debt. In the company's case this addresses the timing issue on new build between revenue generation and interest expense borne.

Response. The suggested approach is not consistent, nor comparable, with the well-established methodology that we apply in our 2013 Corporate Methodology today. Also, both EBIT (part of the core ratio) and FFO (part of the supplemental ratio) are correlated with earnings. Finally, forecasting the distant future years (well beyond the two future years required under the proposed criteria) required for a net present value calculation would be difficult and subject to considerable uncertainty.

Feedback. The use of an income statement metric of EBIT interest coverage as the primary (core) ratio allows for a wide range of noncash accounting distractions to the assessment of financial risk profile.

Response. We researched various financial metrics in order to determine which ones best captured the different characteristics across all operating leasing subsectors without overly complicating the methodology. We found that volatility adjusted EBIT interest coverage, debt to total capital, and FFO to debt ratios performed very well in allowing the comparison of financial risk across operating leasing companies in different subsectors. The volatility adjusted EBIT interest coverage and debt to total capital metrics avoid the distortion caused by significant fluctuations in funds flows due to very different asset lives, holding periods, and capital spending needs across subsectors.

Feedback. While we see the role EBIT interest coverage plays in your credit analysis, we would have expected a more balanced use of more market conventional ratios, i.e. FFO to debt and debt to capital. As cost of debt is more difficult for a company to control, financial risk profile evolution is potentially more uncertain with this metric. Supplemental debt to capital ratio is therefore arguably important and it would be useful if you could be more precise about the extent to which you intend to consider the debt to capital supplementary ratio as part of your overall assessment, especially in cases that it is not two categories different from EBIT interest coverage assessment.

Response. The impact of the two supplemental ratios (FFO to debt and debt to capital) is consistent with the structure and approach of the 2013 Corporate Methodology. Also, the choices for core and supplemental ratios were influenced by regression analysis on ratios against our existing financial risk profiles. Debt to capital matters most when it is materially different from the core ratio assessment, but it is available as a possibility in other cases.

Feedback. The methodology needs a way to accommodate for unusual non-cash accounting expenses which may reduce EBIT, but which may never materialize as cash requirements for a company.

Response. We do modify the adjustment of volatility of EBIT interest coverage if we believe that the conclusion indicated by the SER of EBIT interest coverage is not representative of a company's ongoing future volatility, or the level of volatility observed in a peer. Some examples of when we may modify the adjustment of volatility of EBIT interest coverage include: large asset write-downs that, when accounted for, make EBIT appear volatile but whose revenue and cash flow implication are spread out over many years; the acquisition or disposal of other companies or of large portfolios of equipment; EBIT volatility caused by business units or subsidiaries that have since been sold or closed down; and stable EBIT, which we believe is unrepresentative because it occurred during a period of benign economic conditions and the company operates in a leasing sub-sector that we believe is likely to be more volatile in the future.

Feedback. There must be an adjustment for cash proceeds that are not captured in the income statement metric (EBIT interest coverage). In some industries, cash proceeds from sale are generated on a consistent monthly basis and contribute a meaningful amount to cash flow available for debt service.

Response. We do account for cash proceeds from ongoing asset disposals in our Liquidity assessment. We include as a potential source of funds normal, ongoing disposals of equipment at levels that we expect would pertain in the stress scenario we are modeling. In the case of leasing companies that hold their equipment for short periods of time, such as car rental companies, we net the estimated equipment disposals against capital spending for new equipment and use net capital spending as a use of cash (or source if disposals exceed capital spending).

Financial policy

Feedback. EBIT interest coverage has the advantage of equalizing companies regardless of their growth trajectory, the economic lives of their underlying assets and depreciation method, which is a good point in our view. However, the quantum of debt appears to be deemphasized with respect to the cost of debt in your new analysis. As such lessors with a higher proportion of floating-rate debt would potentially be favorably affected by the new criteria. How are such financial policy considerations contemplated? Additionally, the positive impact of the current low interest rate environment might be distorting your initial calibration of metrics and interest rate fluctuations in the future may result in a high volatility level of this ratio.

Response. Leasing companies tend to spread out maturities, so any changes would evolve over time. We do consider asset/liability matching in assessing a management team's financial policy, and in extreme cases an interest rate mismatch could cause a negative adjustment in our Capital Structure analysis.

Comparable ratings analysis

Feedback. We understand that S&P Global Ratings places significant emphasis on the debt structure and on the level of asset encumbrance in the assessment of leasing companies' ratings. This is not clearly mentioned, and we believe it would be interesting for S&P Global Ratings to articulate how this particular aspect will impact the rating assessment.

Response. The new criteria do not focus as much on the proportion of unencumbered assets, though this would be a reasonable topic for a rating committee to consider in a Comparable Ratings Analysis. Also, a lower proportion of encumbered assets and secured debt make it more likely that we would rate unsecured debt of the leasing company at the same level as the corporate credit rating, rather than notching it down.

Related Criteria

- Recovery Rating Criteria For Speculative-Grade Corporate Issuers," published Dec. 7, 2016
- S&P Global Ratings Definitions, June 29, 2016
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- Principles Of Credit Ratings, Feb. 16, 2011
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008