

ARCHIVE | Criteria | Corporates | General:

# The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities

April 29, 2014

*(Editor's Note: This article is no longer current. It has been superseded by "Methodology For Assessing Financing Contributed By Controlling Shareholders.")*

1. This article describes S&P Global Ratings' methodology for analyzing non-common equity financing--such as shareholder loans or preference shares--that financial sponsor owners provide to nonfinancial corporate entities. Preference shares are commonly used to finance financial sponsor-owned companies in the U.S., while shareholder loans are commonly used to finance financial sponsor-owned companies in Europe and other regions.
2. In this article S&P Global Ratings also provides guidance on the circumstances in which we exclude from our financial analysis, including our leverage and coverage calculations, the non-common equity financing that a strategic owner provides to a nonfinancial corporate entity. Non-common equity can take the form of shareholder loans or preference shares.
3. This paragraph has been deleted.

## PRIMARY CREDIT ANALYSTS

**David W Gillmor**

London  
+ 44 20 7176 3673  
david.gillmor  
@spglobal.com

**James A Parchment**

New York  
(1) 212-438-4445  
james.parchment  
@spglobal.com

## SECONDARY CONTACTS

**Tuan Duong**

New York  
+ 1 (212) 438 5327  
tuan.duong  
@spglobal.com

**Karl Nietvelt**

Paris  
(33) 1-4420-6751  
karl.nietvelt  
@spglobal.com

## CRITERIA CONTACT

**Peter Kernan**

London  
(44) 20-7176-3618  
peter.kernan  
@spglobal.com

## Glossary Of Key Terms

**Financial sponsor-owned companies.** We define financial sponsor-owned companies as nonfinancial corporate entities in which one or more financial sponsors own at least 40% of the entity's common equity, or retain the majority of the voting rights and control through preference shares, and where we consider that the sponsors exercise control of the company either solely or jointly. "Control" refers to the sponsors' ability to dictate an entity's strategy and cash flow. The strategic goals of the sponsors must be aligned for us to consider the sponsors as having joint control.

**Financial sponsors.** We define financial sponsors as entities that follow what we deem to be an aggressive financial strategy in using debt and debt-like instruments to maximize shareholder returns. Typically, in our experience, these sponsors dispose of assets within a short to intermediate time frame. Financial sponsors typically include private equity firms, hedge funds, and other types of investors that consistently use aggressive financial strategies that we believe will lead to the deterioration of credit quality.

**Financial sponsor non-common equity financing.** We define financial sponsor non-common equity financing as investments in the form of shareholder loans or preference shares that sponsors make in the top company (topco) within S&P Global Ratings' scope of consolidation for the group. Non-common equity financing can also take the form of intercompany loans that sponsors use to downstream shareholder loans or preference shares to other group companies.

If the financial sponsor non-common equity financing meets our criteria, we exclude the financing from our consolidated financial analysis, including our leverage and coverage calculations.

If any part of the financial sponsor non-common equity financing does not meet our criteria, we include it in our consolidated financial analysis, including our leverage and coverage calculations.

If the topco non-common equity financing is of a different size to any intercompany loans, and the investments and intercompany loans meet our criteria, we exclude the topco financing from our consolidated financial analysis, including our leverage and coverage calculations.

**Strategic sponsor-owned companies.** We define strategic sponsor-owned companies as nonfinancial corporate entities in which one or more strategic owners owns at least 40% of the entity's common equity, and where we consider that the strategic owners exercise control of the company either solely or jointly. "Control" refers to the sponsors' ability to dictate an entity's strategy and cash flow. The strategic goals of the strategic owners must be aligned for us to consider the owners as having joint control.

**Strategic owners.** We define strategic owners as investors that are not financial sponsors and that have a long-term investment horizon and the resources and incentives to support their investment financially in case of need. We consider that such an owner invests predominantly for strategic reasons--such as geographical diversification or the realization of synergies through vertical or horizontal integration. Strategic owners may include governments and do not include financial sponsors.

## SUMMARY OF THE CRITERIA

### Non-common equity financing from financial sponsors

4. We exclude from our financial analysis, including our leverage and coverage calculations, the non-common equity financing that a financial sponsor has provided to a nonfinancial corporate company under the following set of conditions. First, the financial sponsor must control the company. This creates an economic incentive for the owner not to enforce any creditor rights associated with the non-common equity financing, because doing so could threaten its control and ownership of the company in the way we describe in paragraphs 10 and 11. Second, the non-common equity financing includes terms and conditions that we believe in aggregate are favorable to third-party creditors in the way we describe in paragraphs 12 and 13. Third, the company's and financial sponsor's financial policy does not lead us to believe that the company's leverage and coverage ratios (excluding the financial sponsor non-common equity) are likely to weaken in the way we describe in paragraph 14.

### Non-common equity financing from strategic owners

5. We exclude from our financial analysis, including our leverage and coverage calculations, non-common equity financing that a strategic owner has provided to a nonfinancial corporate entity when we consider the owner to be a strategic owner and when the non-common equity financing includes terms and conditions that we believe in aggregate are favorable to third-party creditors in the way we describe in paragraphs 16 and 17.

## SCOPE OF THE CRITERIA

6. The methodology applies to nonfinancial companies owned by financial sponsors and strategic owners. The methodology does not apply to real estate investment trusts, because these companies have different financial structures.
7. This paragraph has been deleted.
8. This paragraph has been deleted.

## METHODOLOGY

### A. Non-common equity financing provided by financial sponsor owners

9. We exclude the non-common equity financing provided by financial sponsors from our financial analysis, including our leverage and coverage calculations, if:
  - The financial sponsor controls the company through either its ownership of at least 40% of the company's common equity or its retention of the majority of the voting rights through preference shares if management holds all or substantially all of the common equity; and we believe that this ownership structure creates an incentive for the financial sponsor not to enforce any creditor rights associated with the non-common equity financing in the way we describe in paragraphs 10 and 11;

- The non-common equity financing includes terms and conditions that we believe in aggregate are favorable to third-party creditors in the way we describe in paragraphs 12 and 13; and
- The company's and financial sponsor's financial policy does not lead us to believe that the company's leverage and coverage ratios (excluding the financial sponsor non-common equity) are likely to weaken in the way we describe in paragraph 14.

### **Creating an alignment of economic incentives**

10. An alignment of economic incentives is created between the common equity and the non-common equity financing if, first, we believe that a financial sponsor controls a company through its ownership of common equity and the financial sponsor also provides substantial non-common equity financing; and second, the conditions we list in paragraphs 12 and 13 are present. In this case, we believe that the financial sponsor would not exercise any creditor rights associated with the non-common equity financing because doing so could jeopardize its control of the company. To strengthen the alignment of economic incentives and avoid the possibility of the non-common equity financing being sold to a third party with no interest in the common equity, the sale of the non-common equity financing to a third party must be prohibited by the documentation of the non-common equity financing and any intercreditor agreement of which the non-common equity financing is part, unless the non-common equity financing and common equity are owned and sold together (sometimes called "stapling"). Absent such explicit protection, we do not exclude the non-common equity financing from our financial analysis, including our leverage and coverage calculations.
11. When a financial sponsor controls a company through its ownership of preference shares and provides no additional financing, and management holds the common shares, we could exclude the financing from our financial analysis, including our leverage and coverage calculations. We would exclude the non-common equity financing if we believed that the financial sponsor would not exercise any creditor rights associated with the financing because doing so could jeopardize its control of the company; and if the conditions listed in paragraphs 12, 13, and 14 are met.
12. The following conditions must be met for us to exclude the non-common equity financing from our financial analysis, including our leverage and coverage calculations.
  - The non-common equity financing does not pay interest, dividends, or distributions at 15% or more per year above the relevant central bank base interest rate. For example, if the U.S. federal funds rate is 2%, the non-common equity financing must pay less than 17% to meet this condition. In our opinion, this could give the financial sponsor a strong incentive to refinance the non-common equity instrument with debt.
  - The financial sponsor does not have other interests that could affect its economic incentives--such as being a creditor and holding a position in the company's existing debt instruments--unless we consider that such position supports the consolidated company's credit quality. For example, if the financial sponsor had purchased the company's debt at a distressed value, we include the entire non-common equity financing in our leverage measures. To exclude the non-common equity financing from our leverage measures, we must believe that the financial sponsor's incentives and financial policy will lead the sponsor to act as an equity holder, rather than a creditor, as we assess in paragraph 14.

### **Credit-protective terms and conditions of the non-common equity financing**

13. In addition, for us to exclude the non-common equity financing from our financial analysis,

including our leverage and coverage calculations, all of the following conditions must be met:

- The non-common equity financing does not contain any events of default, provisions for cross default or cross acceleration, or financial covenants that could lead to an event of default or the acceleration of repayments.
- The non-common equity financing must at all times mature at least 30 days later than all of the company's other debt, and no contractual repayment of the non-common equity financing, including accrued interest, can be made while the other debt is outstanding. This means that repayments of principal of the non-common equity financing do not burden the issuers' debt maturity profile, liquidity, and cash flow while the other debt is outstanding. The financial sponsor must record its intention to meet this condition at all times--including if it undertakes any debt refinancing--in the non-common equity financing documentation.
- The non-common equity financing cannot require fixed, periodic cash interest or dividend payments to the financial sponsor, such as payments that are not based on earnings or other financial performance measures.
- The non-common equity financing is structurally and/or contractually subordinated to all the debt in the capital structure. This ensures that the non-common equity financing would be available to act as loss-bearing capital in a stress scenario while the other debt is outstanding.
- The non-common equity financing is unsecured and does not benefit from any financial guarantee or security.

## Financial policy assessment

14. The financial sponsor's historical behavior or our perception of its financial policy must not lead us to believe that the company's leverage and coverage ratios (excluding the financial sponsor non-common equity) are likely to weaken under the financial sponsor's ownership.
  - We assess redemption risk--or the risk that the non-common equity is replaced with external financial debt--and the company's and financial sponsor's risk tolerance by analyzing the company's and financial sponsor's financial policy (see Section H, titled "Financial Policy" in "Corporate Methodology." Financial policy refines the view of a company's risks beyond the conclusions arising from the standard assumptions in the cash flow/leverage assessment in our Corporate Methodology. Those assumptions do not always reflect or entirely capture the short- to medium-term event risks or the longer-term risks stemming from a company's financial policy. To the extent movements in one of these factors cannot be confidently predicted within our forward-looking evaluation, we capture that risk within our evaluation of financial policy.
  - Our cash flow/leverage assessment will typically factor in operating and cash flows metrics we observed during the past two years and the trends we expect to see for the coming two years based on operating assumptions and predictable financial policy elements, such as ordinary dividend payments or recurring acquisition spending. This holds unless the company has undergone a transformational event (such as a leveraged buyout) during the two-year period, in which case our focus will be more forward looking. Over that period and, generally, over a longer time horizon, the company's financial policies can change its financial risk profile based on management's or, if applicable, the company's financial sponsor owner's or controlling shareholder's appetite for incremental risk or, conversely, plans to reduce leverage.
  - We assess financial policy as 1) positive, 2) neutral, 3) negative, or as being owned by a financial sponsor. We further identify financial sponsor-owned companies as "FS-4", "FS-5", "FS-6", or

"FS-6 (minus)". These criteria apply to all FS categories.

- Generally, financial sponsor-owned issuers will receive an assessment of "FS-6" or "FS-6 (minus)", leading to a financial risk profile assessment of '6', under the corporate criteria. In a small minority of cases, a financial sponsor-owned entity could receive an assessment of "FS-5". In even rarer cases, we could assess the financial policy of a financial sponsor-owned entity as "FS-4" (see paragraphs 157–184 in "Corporate Methodology" for further details).

15. We include in our financial analysis, including our leverage and coverage calculations, non-common equity financing that a financial sponsor owner has provided to a financial sponsor-owned entity, but that does not meet all the conditions listed in paragraphs 12, 13, and 14.

## **B. Non-common equity financing provided by strategic owners**

16. When we consider the owners of a nonfinancial corporate entity to be strategic owners, we exclude any non-common equity financing they have provided from the entity's financial analysis, including our leverage and coverage calculations, if both of the conditions listed below and the conditions in paragraph 17 are met:
  - The strategic owner holds a controlling interest; the investment is a long-term holding; and the owner has the resources and incentives to support the investment.
  - The entity or subsidiary is reasonably successful at what it does or has realistic medium-term prospects of success relative to group management's specific expectations or group earnings norms.
17. Our exclusion of any non-common equity financing provided by strategic owners from our financial analysis, including our leverage and coverage calculations, is also contingent on our belief that all of the following conditions are met:
  - The strategic owner would not trigger an event of default, and the financing includes no financial covenants that will lead to either an event of default or acceleration of repayment.
  - We classify the subsidiary as a moderately strategic, strategically important, highly strategic, or core subsidiary under our "Group Rating Methodology" criteria, if applicable.
  - If we consider the entity to be a government-related entity (GRE), there is a strong, very strong, or integral link between the entity and its related government under our GRE criteria, if applicable.
  - The strategic owner would restructure the financing, if necessary, without creating an event of default.
  - The effective maturity date of the non-common equity financing is beyond the maturity dates of all debt by virtue of strong contractual or intercreditor provisions. Such provisions include those that would prevent the non-common equity financing from becoming due and payable until any senior debt has been fully repaid. This condition would not be met if the non-common equity financing includes a call option or any economically similar mechanism that would enable the non-common equity financing to be bought back. This holds unless the non-common equity financing is funded by an instrument that would not become due and payable before all senior debt has been repaid. Alternatively, the non-common equity financing matures at least 30 days after all other debt if the financing is not a perpetual instrument, or the instrument has at least 10 years of remaining life and we believe that the issuer intends to extend the maturity date of the non-common equity financing to at least 30 days after all the other debt matures.

- The non-common equity financing is unsecured, does not benefit from any financial guarantees, and is structurally and/or contractually subordinated to all other debt in the capital structure.

## FREQUENTLY ASKED QUESTIONS

### Ownership And Control

#### **Does the word "owned" in the definition of financial sponsor-owned companies refer to economic ownership or ownership of voting interests?**

The intent of the criteria that state "or retain the majority of the voting rights and control through preference shares" is to capture within the scope of the criteria situations in which a financial sponsor demonstrably has control but through some other means than through owning 40% or more of the common equity. Such other means could include if the sponsor has control through one or a combination of interests such as common shares, preference shares, shares with supervoting rights, or other mechanisms.

#### **How do we treat shareholder financing partially owned by a controlling shareholder and partially owned by a non-controlling shareholder?**

If the financing is provided through one security and the documents give the controlling shareholder the ability to make decisions that bind all of the lenders, then we could exclude the full financing from our leverage and coverage calculations if all other conditions are met.

If the financing is provided through more than one instrument, or through one instrument where the lenders can act independently, then we would only exclude from our leverage and coverage calculations the portion held by the controlling shareholders, provided all other conditions are met.

If the financing is provided by several shareholders that exercise control jointly, such as a joint venture, our treatment would depend on whether we view the shareholders' goals and strategy to be aligned, provided all other conditions in the criteria are met.

#### **How do ownership changes, including through an IPO, affect the treatment of shareholder financing? If the seller holds a minority ownership interest or the prior management team continues to hold some of its shareholder financings, can these financings continue to be excluded from our leverage and coverage calculations?**

Following any ownership change, a key consideration in our analysis is whether and to what extent the alignment of economic incentives between common equity and non-common equity holders is maintained. Notwithstanding a change in ownership structure, when a seller retains equity in the entity, it's important in our analysis that we are almost certain there is no adverse impact on the seller's commitment to the business. For example, a partial sale of equity and ownership change could be considered neutral if the sale partially monetizes an investment but the owner retains

control, or if a new shareholder is brought into the business to raise capital or provide expertise or other benefits that will improve the company's financial performance, as long as we believe that the economic incentives between the common equity and the non-common equity financing remain aligned and the conditions in paragraphs 12 and 13 of the criteria continue to be met. In such a case, we would believe that the owners would not exercise any creditor rights associated with the non-common equity financing because doing so could jeopardize their control of the company. If they do not retain effective control, we would treat the financing as debt.

If an IPO is used to monetize a minority interest by a strategic owner, and the owner maintains control, then we may continue to exclude the shareholder financing from our leverage and coverage calculations, subject to paragraph 16 , which includes the condition that "the investment is a long-term holding; and the owner has the resources and incentives to support the investment."

Conversely, if we believe that a sell down or IPO by either a strategic owner or financial sponsor presages its near-term exit from the company, we would question the commitment of the strategic owner/financial sponsor and whether the economic incentives between the common equity and the non-common equity financing remain aligned. In such a scenario, and if documents allow it, we would likely expect the exiting owner to request repayment of its portion of the shareholder financing, and therefore we likely would view its shareholder financing as debt-like, regardless of the strength of documentary protection.

Similarly, notwithstanding ownership changes, if the prior management team continues to hold shareholder financing, it is more likely we will consider this a temporary holding rather than reflective of any intent to remain as a long-term investor in the company. This scenario is more likely to occur following an exit by a financial sponsor when management held shares as part of its incentive structure. Accordingly, we would generally consider this shareholder financing as debt-like, irrespective of documentary protection.

### **When applying the criteria discussed in this article, under what conditions could an owner, such as an infrastructure fund, that is neither a financial sponsor nor a strategic owner have its non-common equity contribution to a subsidiary excluded from S&P Global Ratings' financial analysis?**

Infrastructure funds are distinguished from financial sponsors in their long-term investment horizon. Many of the conditions identified in these criteria for evaluating non-common equity from financial sponsors are designed to deal with investors with short-term horizons. The basic approach for financial sponsor issuers is that the seemingly equity-like hybrid security does not offer creditors a permanent equity cushion if we know or believe the sponsor is going repay the loan in relatively short order. We assume that the financing would likely be replaced with debt at or before the time the financial sponsor sells its equity. Most of the conditions attempt to guard against creditors being disadvantaged during that short-term horizon. In both the Corporate Methodology (paragraph 164) and again in this criteria article, we exclude infrastructure funds from the definition of financial sponsors. Given that infrastructure funds have a longer investment horizon than financial sponsors, and their financial policies differ, this answer provides guidance on how to evaluate non-common equity financing from these types of controlling shareholders. Alternatively, since these funds do not meet the definition of strategic owners we are also distinguishing the conditions we use for infrastructure funds from those we apply to strategic owners.

When an owner does not meet the conditions for being a strategic owner or a financial sponsor

owner, then we will evaluate the owner's non-common equity contribution to a subsidiary based on the following conditions if we believe the owner has a long-term investment horizon and the resources and incentives to support its investment financially in case of need. We exclude the non-common equity financing provided by the owner from our financial analysis of the corporate investee, including our leverage and coverage calculations, if all of the following apply.

1. The owner controls the company through either its ownership of at least 40% of the company's common equity or its retention of the majority of the voting rights through preference shares if management holds all or substantially all of the common equity; and we believe that this ownership structure creates an incentive for the owner not to enforce any creditor rights associated with the non-common equity financing in the way we describe in paragraphs 10 and 11 in these criteria.
2. Neither the company's nor the owner's financial policy lead us to believe that the company's leverage and coverage ratios (excluding the owner's non-common equity) are likely to weaken in the way we describe in paragraph 14.
3. The owner provides substantial non-common equity financing; and we believe that the owner would not exercise any creditor rights associated with the non-common equity financing.
4. The sale of the non-common equity financing to a third party is prohibited by the documentation of the non-common equity financing and any intercreditor agreement of which the non-common equity financing is part, unless the non-common equity financing and common equity are owned and sold together (sometimes called "stapling"). Without this explicit protection, we exclude the non-common equity financing from our financial analysis, including our leverage and coverage calculations, only when we believe that the sale of the non-common equity financing to a third party is highly unlikely.
5. The owner does not have other interests that could affect its economic incentives--such as being a creditor and holding a position in the company's existing debt instruments--unless we consider that such position supports the consolidated company's credit quality.
6. We believe that the owner would not trigger an event of default, and the financing includes no financial covenants that will lead to either an event of default or acceleration of repayment.
7. The effective maturity date of the non-common equity financing is beyond the maturity dates of all debt by virtue of strong contractual or intercreditor provisions. These provisions include those that would prevent the non-common equity financing from becoming due and payable until any senior debt has been fully repaid. This condition would not be met if the non-common equity financing includes a call option or any economically similar mechanism that would enable the non-common equity financing to be bought back--that is, unless the non-common equity financing is funded by an instrument that would not become due and payable before all senior debt has been repaid. Finally, this condition would be met if the non-common equity financing matures at least 30 days after all other debt or the instrument has at least 10 years of remaining life and we believe that the issuer intends to extend the maturity date of the non-common equity financing to at least 30 days after all the other debt matures and to repeat rollovers if necessary.
8. The non-common equity financing is unsecured, does not benefit from any financial guarantees, and is structurally and/or contractually subordinated to all other debt in the capital structure.

## **Considerations With Respect To Stapling**

### **Can a shareholder financing held by financial sponsors be excluded from our leverage and coverage calculations if it is not stapled to common equity but sales to third parties are prohibited?**

One of the main considerations to exclude shareholder financing from our leverage and coverage calculations is the extent to which we can expect that the economic interests of the common and non-common equity (i.e., the shareholder financing) will remain aligned. To maintain this alignment, we expect, as stated in paragraph 10 of the criteria, that the financing documents either prohibit the transfer of the shareholder financing outside of the controlling group or mandate the non-common equity financing and common equity be owned and sold together (sometimes called "stapling").

However, in the absence of stapling, even with the prohibition to transfer the shareholder financing to third parties, we also consider the risk that one (or a small group of) shareholder could end up with a grossly disproportionate holding of the shareholder financing relative to its equity holdings so that the incentives for one and the other begin to diverge. In these cases, the decision as to whether the documentation--including, for example, the shareholder agreement--is strong enough to mitigate the potential misalignment and whether the shareholder financing should be excluded from leverage and coverage calculations would be a matter for rating committee judgement.

For example, when a 10% equityholder, which is part of a controlling group, holds 90% of the shareholder financing, the value of the loan may approximate or even exceed the value of the equity. If the company's economic performance materially weakens or becomes distressed such that the equity value diminishes, the larger value of the shareholder financing holdings compared with the equity can create a misalignment of economic interests, notwithstanding the prohibition of sales of shareholder financings to third parties. This scenario would raise concerns that equityholders and holders of the shareholder financing are subject to different behavioral incentives. Under such circumstances, as per paragraph 14 of the criteria, we consider financial policies and how these could influence the company's leverage and coverage ratios. In general, the lower the control a shareholder has and the greater the value of shareholder financings relative to equity, the more likely it is that the shareholder financings will be treated as debt.

### **If a company owned by a financial sponsor undertakes a proportional stapling of a shareholder financing to equity, does the stapled portion of debt satisfy the requirements relating to the alignment of economic incentives and therefore support the exclusion of the shareholder financing from our leverage and coverage calculations?**

No. In general, if a company owned by a financial sponsor undertakes a proportional stapling of a shareholder financing to equity--for example 50% of the financing is stapled and 50% is not stapled--we would not consider the debt stapled to equity as having sufficient equity-like characteristics to exclude this financing and its interest payments from our adjusted financial metrics. For the purposes of the criteria, we typically think of a shareholder financing with uniform terms and conditions that is intended to mimic equity as a single unit, rather than an instrument that could be sliced and diced, which could lead to different treatments for different "slices." We view such a proportionate stapling structure as potentially undermining the alignment of economic interests.

## Considerations With Respect to Prepayments

### Can a non-common equity financing that includes prepayment clauses be excluded from leverage and coverage calculations?

An important focus of our assessment of prepayment/repurchase clauses is to what extent they undermine the principle that financing provided by controlling shareholders will be outstanding and would act as subordinated loss-absorbing capital if the company experiences credit stress.

If shareholder loans include terms that enable prepayment at the borrowers' (or shareholder parents') absolute discretion without any offsetting constraints, we do not exclude the loans from our leverage and coverage calculations. The same applies to preferred shares whose terms and conditions include mechanisms that allow for those securities to be bought back without any offsetting constraints.

However, if strong contractual or intercreditor provisions exist, we may take the view that the prepayment option is neutralized. For example, this may happen if the payments are seen as similar to dividends by virtue of being variable, linked to a level of company profitability, or if senior lender approval is required to make any prepayment. Importantly, if we are forecasting a shareholder loan prepayment, we expect that the majority portion of the shareholder loan would remain in the capital structure until after the point of the longest debt maturity. This would be consistent with the principle in the criteria that the effective maturity date of the shareholder loan is beyond all other debt and the loan could be excluded from our leverage and coverage calculations. For financial sponsors that typically have shorter-term ownership horizons, we require that they record their intention to meet this condition at all times in the documentation.

On the other hand, relatively uniform or non-variable (re)payment profiles that are not dependent on the issuer's financial performance would be considered more akin to servicing a debt-like obligation than being a voluntary dividend-like payment based on the company's financial performance. Likewise, if the senior debtholders provide a blanket advance approval, then the instrument would not be excluded from the debt calculations.

### What constitutes "strong contractual or intercreditor provisions"?

There is a wide variation in shareholder financing terms; however, the more debate and judgment that are needed to interpret the strength of the provisions, the less likely it is that a rating committee would consider the provisions "strong." Typically, what would support us considering provisions "strong" is a clear statement that acts as a constraint to discretionary prepayments (that are significant and not tied to performance). As a result, we would have greater confidence that the financing will function as loss-absorbing capital because the financing is subordinated and its effective maturity date is beyond all other debt.

Examples of constraints that we may consider supportive include:

- No ability to repay shareholder loans or repurchase preferred stocks while senior debt may be outstanding;
- Requirement for senior lender approval of any shareholder loan repayment or preferred stock repurchases; and
- Maturity clauses that mean shareholder loans must remain outstanding if senior debt is outstanding.

Examples of weak terms include:

- Financial covenants that do not preserve creditworthiness, but rather give the borrower flexibility that could lead to weakening credit quality, while being set at a high enough level that there would still be value in the business.
- Management's intent included only in financial policy statements. The strength of financial policies may vary over time depending on the company's capital structure relative to its financial performance and the risk tolerance of its owners. Consequently, the risk objectives of the company's board and management may also change.

## Considerations With Respect To Releveraging

**The criteria state that to exclude financial sponsor non-common equity from your financial analysis, including your leverage measures, the sponsor's historical behavior or your perception of its financial policy must not lead S&P Global Ratings to believe that the company's leverage and coverage ratios (excluding the financial sponsor non-common equity) are likely to weaken under the financial sponsor's ownership. Would a financial sponsor that releverages a company after a period of deleveraging fail this condition?**

No, not necessarily. The sponsor would fail the condition only if leverage increased beyond the level of leverage that the sponsor had previously indicated to S&P Global Ratings as its maximum leverage tolerance (and we believed this to be credible), excluding the non-common equity financing. For example, an issuer indicates a maximum leverage target of 6x debt to EBITDA and S&P Global Ratings believes this to be credible and incorporates this maximum leverage target into the rating. The company subsequently deleverages to 4x and then releverages up to 6x. This releveraging would meet the condition in principle, as long as we believe that the issuer will not breach the 6x leverage target.

## REVISIONS AND UPDATES

This article was originally published on April 29, 2014. These criteria became effective on April 29, 2014.

The criteria constitute specific methodologies and assumptions under "Principles Of Credit Ratings," published Feb. 16, 2011.

The definitions of financial sponsor-owned companies and financial sponsors in this article superseded:

- The definitions in paragraphs 164 and 165 of our "Corporate Methodology," published Nov. 19, 2013;
- The section "Corporate methodology: Leveraged buy-out equity hybrids: Too good to be true" in "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008; and
- The sections "Does it matter whether the ownership represents a strategic or a financial investment?" and "So who owns a company's debt securities matters?" in "Credit FAQ: Knowing The Investors In A Company's Debt And Equity," published April 4, 2006, which was

subsequently archived.

Changes introduced after original publication:

- We republished this article on May 2, 2014, to detail in paragraph 3 the criteria that have been superseded and partly superseded.
- On Sept. 16, 2014, we first included the "Frequently Asked Questions" section, to which we added a new question on Oct. 22, 2015.
- Following our periodic review completed on March 31, 2016, we updated criteria references and deleted paragraphs 3, 7, and 8, which were related to the initial publication of our criteria.
- After the publication of "Key Credit Factors For The Operating Leasing Industry" on Dec. 14, 2016, transportation equipment leasing and car rental companies now fall in the scope of these criteria.
- We republished this article on May 24, 2017, to remove incorrect but insignificant wording in the fifth sentence of paragraph 7 of the second question in the "Frequently Asked Questions" section.
- Following our periodic review completed on March 29, 2017, we updated the contact list and added a question to the "Frequently Asked Questions" section.
- Following our periodic review completed on March 27, 2018, we updated the contact list.
- On May 22, 2019, we republished this criteria article to make nonmaterial changes to update criteria references.
- On May 20, 2020, we republished this criteria article to make nonmaterial changes to update criteria references.
- On May 3, 2022, we republished this criteria article to make nonmaterial changes related to the archiving of "Guidance: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities," published April 30, 2018. As announced in "Evolution Of The Methodologies Framework: Introducing Sector And Industry Variables Reports," published Oct. 1, 2021, we are phasing out guidance documents over time. As part of that process, we have archived "Guidance: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities" and moved its contents to the "Frequently Asked Questions" section of these criteria without any substantive changes. In addition, we made the following nonmaterial changes to these criteria: 1) We updated contact information; 2) we made editorial changes to the "Frequently Asked Questions" section to improve readability; and 3) we updated the "Related Publications" section.
- On April 17, 2025, we republished this criteria article to make nonmaterial changes. We updated the definition of financial sponsor to match the definition in our corporate methodology. We also removed Tables 23 and 24 because they duplicate Tables 23 and 24 in "Corporate Methodology." Finally, we updated publication names and dates in the related publications section.

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