Rating Research Services

Archive: TRC Corporate Sector Issue Rating Criteria

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(Editor's note: This criteria article is no longer current. It has been superseded by the article titled "Criteria | Corporate | Reflecting Subordination Risk In Corporate Issue Ratings," published by S&P Global Ratings on Sept. 21, 2017.)

- Taiwan Ratings Corp. (TRC) is updating its issue rating criteria for corporate issuers in Taiwan, following the publication of S&P Global Ratings' criteria article, "National And Regional Scale Credit Ratings," on Sept. 22, 2014. This article illustrates how TRC assigns issue ratings on its TRC scale. The criteria describe how, for obligations issued by the corporate sector, issue ratings may be equivalent to or notched down from the corporate credit ratings as a result of various analytical considerations. This article is also related to S&P Global Ratings' criteria article, "2008 Corporate Criteria: Rating Each Issue," published April 15, 2008. S&P Global Ratings' criteria articles are available on www.standardandpoors.com.

SCOPE OF THE CRITERIA

- These criteria are related to only long-term issue ratings on the TRC scale and do not affect any S&P Global Ratings' global scale ratings assigned to Taiwanese issuers. The notching determinations for TRC scale ratings relate to the TRC scale issuer ratings, rather than S&P Global Ratings' global scale ratings. Moreover, these criteria do not address short-term ratings or other non-TRC scale ratings.

IMPACT ON OUTSTANDING RATINGS

- This criteria update will not result in rating actions on current outstanding TRC rated corporate bonds.

EFFECTIVE DATE AND TRANSITION

- This criteria update is effective immediately.

METHODOLOGY

Rating Each Issue

- Taiwan Ratings Corp. (TRC) assigns two types of credit ratings--one to corporate issuers and the other to individual corporate debt issues (or other financial obligations). The first is called a TRC corporate credit rating. It is our current opinion on an issuer's overall capacity to pay its financial obligations, i.e., its fundamental creditworthiness. This opinion focuses on the issuer's ability and willingness to meet its financial commitments on a timely basis. It generally indicates the likelihood of default regarding all financial obligations of the company, because, in most countries, companies that default on one debt type--or file for bankruptcy--virtually always stop payment on all debt types.
- The corporate credit rating does not reflect any priority or preference among

obligations.

- Generally, a corporate credit rating is published for all companies that have issue ratings--in addition to those companies that have no ratable issues, but request just an issuer rating.
- We also assign credit ratings to specific issues. In fact, the vast majority of 'tw' credit ratings pertain to specific debt issues. Long-term issue ratings are a blend of default risk (sometimes referred to as "timeliness") and the relative ranking in bankruptcy associated with the specific debt being rated. Notching does not apply to short-term ratings.

Notching Down

- The practice of differentiating issues in relation to the issuer's fundamental creditworthiness is known as "notching." TRC issue ratings can be notched down from the corporate credit rating level. Payment on time as promised obviously is critical with respect to all debt issues. The potential for recovery in the event of a default--i.e., ultimate recovery, albeit delayed--also is important, but timeliness is the primary consideration. That explains why issue ratings are anchored to the corporate credit rating. TRC issue ratings can be notched down from the corporate credit rating in accordance with established guidelines explained here.
- As default risk increases, the concern over what can be recovered takes on greater relevance and, therefore, greater rating significance. Accordingly, the LGD aspect of ratings is given more weight as one moves down the rating spectrum. For example, subordinated debt can be rated up to two notches below corporate credit rating of 'twBB+' or lower, but one notch at most if the corporate credit rating is 'twBBB-' or above.
- We seek to differentiate those financial obligations judged to have materially inferior recovery prospects by virtue of being unsecured or subordinated--either contractually or structurally. Priority in bankruptcy is considered in broad terms; there is no attempt to specify a default scenario.
- Notching relationships' underlying issue ratings are subject to review and change when actual developments vary from expectations. Changes in notching do not necessarily have to be accompanied by changes in default risk.
- Notching guidelines are a function of the bankruptcy law and practice in the legal jurisdiction that governs a specific instrument.

Preferred stock and other hybrid capital instruments

- Preferred stock and other hybrid capital instruments carry greater credit risk than debt in two important ways: The dividend is at the discretion of the issuer, and the obligation represents a deeply subordinated claim in the event of bankruptcy. We follow the following steps when rating such obligations on the TRC scale:
- First, we establish, on S&P Global Ratings' global scale, the rating level that indicates the default risk of the instrument. (We usually consider a deferral on dividends as payment default according to our criteria, as per S&P Global Ratings' criteria. Such default risk usually includes our assessment of the likelihood of an issuer deferring dividends, even if such deferral is permitted by the terms of the instrument.) Second, the rating level on S&P Global Ratings' global scale is used to map to the indicative TRC scale rating. Third, we apply incremental notches down from the indicative TRC scale rating for subordination.

- In reference to the paragraph above, we usually consider a deferral on dividends as payment default according to our criteria, even if such deferral is permitted by the terms of the instrument, as per S&P Global Ratings' criteria "Use of the 'C' and 'D' Rating," published Oct. 24, 2013.

Reflecting Recovery In Issue Ratings

- We notch down when a debt issue's junior standing, relative to other debt issues of the company, indicates relatively poor recovery prospects, reflecting relative position/ranking in bankruptcy as a proxy for recovery prospects.
- The weighting of recovery aspects in issue ratings also varies as the potential for default becomes more meaningful, as explained below.

'twBBB-' or above

- For companies rated 'twBBB-' or above, notching relationships are based on broad guidelines that combine consideration of asset protection and ranking. The guidelines are designed to identify material disadvantage for a given issue by virtue of the existence of better-positioned obligations. The analyst does not seek to predict specific recovery levels, which would involve knowing the exact asset mix and values at a point well into the future. Therefore we do not generally perform a fundamental recovery analysis, given the difficulty of doing meaningful default scenario analysis while the company is still so strong.
- Rather, we use a rule-of-thumb approach to identify debt issues with inferior recovery prospects.

Rating below the corporate credit rating: "Notching down"

- When a debt issue is judged to be junior to other debt issues of the company, and thereby to have relatively poor recovery prospects, that issue is notched down from the corporate credit rating. As a matter of rating policy, the differential is limited to one rating designation in the 'twBBB-' or above issuers given the critical role of timeliness for 'twBBB-' or above debt. Relative ranking in bankruptcy is just less significant in the scheme of things for 'twBBB-' or above--leading to less weight given to recovery; investors are focused on getting paid in the first place.
- Whenever a threshold percentage of the company's assets would first be used to satisfy other claims, this translates into a meaningful disadvantage for the junior creditors. The threshold for notching is reached when more-senior claims cover more than 20% of the assets (unless less-valuable assets make up the collateral or there mitigating factors exist, such as upstream guarantees).
- The threshold level takes into account that it normally takes more than $1 of book assets--as valued today--to satisfy $1 of priority debt. In the case of secured debt--which limits the priority to the collateral pledged--the remaining assets are still less likely to be sufficient to repay the unsecured debt, inasmuch as the collateral ordinarily consists of the company's better assets and often substantially exceeds the amount of the debt.
- Moreover, in all likelihood, there will be additional debt by the time of default, as pointed out above. Since such debt--as well as the refinancing of existing debt--will be incurred as the company approaches default, it is more likely to be on a secured basis (or directly to the entity that holds the operating assets, in the case of an

operating company/holding company structure).

- To the extent that certain obligations have a priority claim on the company's assets, lower-ranking obligations are at a disadvantage because a smaller pool of assets will be available to satisfy the remaining claims. As mentioned above, debt can be junior by virtue of being contractually subordinated--that is, the terms of the issue specifically provide that debt holders will receive recovery in a bankruptcy only after the claims of other creditors have been satisfied.
- Another case is when the issue is unsecured, while assets representing a significant portion of the company's value collateralize secured borrowings. (If the collateral that secures a particular debt issue is of dubious value, while the more valuable collateral is pledged to another loan, even secured debt may be notched down from the corporate credit rating.)
- A third form of disadvantage can arise if a company conducts its operations through an operating subsidiary/holding-company structure. In this case, if the whole group is bankrupt, creditors of the subsidiaries--including holders of even contractually subordinated debt--would have the first claim to the subsidiaries' assets, while creditors of the parent would have only a junior claim, limited to the residual value of the subsidiaries' assets remaining after the subsidiaries' direct liabilities have been satisfied. The disadvantage of parent-company creditors owing to the parent/subsidiary legal structure is known as "structural subordination." Even if the group's operations are splintered among many small subsidiaries, the individual debt obligations of which have only dubious recovery prospects, the parent-company creditors may still be disadvantaged compared with a situation in which all creditors would have an equal claim on the assets.
- If a company has an atypical mix of assets, the 20% threshold could be higher or lower to reflect the relative amounts of better or worse assets. Goodwill especially is suspect, considering its likely value in a default scenario. In applying the notching guidelines, TRC generally eliminates from total assets goodwill in excess of a "normal" amount--10% of total adjusted assets. As distinct from goodwill, intangibles are considered potentially valuable--for example, established brands in the consumer products sector. We do not, however, perform detailed asset appraisals or attempt to postulate specifically about how market values might fluctuate in a hypothetical stress scenario (except in the case of secured debt).
- The concept behind these thresholds is to measure material disadvantage with respect to the various layers of debt. At each level, as long as the next layer of debt still enjoys plenty of asset coverage, we do not consider the priority of the top layers as constituting a real disadvantage for the more junior issuers. Accordingly, the nature of the individual company's asset is important: If a company has an atypical mix of assets, the thresholds could be higher or lower to reflect the relative amounts of better or worse assets.
- The relative size of the next layer of debt also is important. If the next layer is especially large--in relation to the assets assumed to remain after satisfying the more senior layers--then coverage is impaired. There are numerous LBOs financed with outsized issues just below the senior layers. Although the priority debt may be small (below the threshold levels), it poses a real disadvantage for junior issues: given the paucity of coverage remaining, the junior debt should be notched down.

Application of guidelines

- In applying the guidelines above, lease obligations--whether capitalized in the company's financial reporting or kept off balance sheet as operating leases as priority

debt--and the related assets are included on the asset side. Similarly, sold trade receivables and securitized assets are added back, along with an equal amount of priority debt. Other creditors are just as disadvantaged by such financing arrangements as by secured debt. In considering the surplus cash and marketable securities of companies that presently are financially healthy, we assume neither that the cash will remain available in the default scenario, nor that it will be totally dissipated, but rather that, over time, this cash will be reinvested in operating assets that mirror the company's current asset base, subject to erosion in value of the same magnitude.

Structural subordination

- At times, a parent and its affiliate group have distinct default risks. The difference in risk may arise from covenant restrictions, regulatory oversight, or other considerations. This is the norm for holding companies of insurance operating companies and banks. In such situations, there are no fixed limits governing the gaps between corporate credit ratings of the parent and its subsidiaries. The holding company has higher default risk, apart from post default recovery distinctions. If such a holding company issued both senior and junior debt, its junior obligations would be notched relative to the holding company's corporate credit rating by one or two notches.
- Often, however, a parent holding company with one or more operating companies is viewed as a single economic entity. When the default risk is considered the same for the parent and its principal subsidiaries, they are assigned the same corporate credit rating. Yet, in a liquidation, holding-company creditors are entitled only to the residual net worth of the operating companies remaining after all operating company obligations have been satisfied. Parent-level debt issues are notched down to reflect structural subordination when the priority liabilities create a material disadvantage for the parent's creditors, after taking into account all mitigating factors. In considering the appropriate rating for a specific issue of parent-level debt, priority liabilities encompass all third-party liabilities (not just debt) of the subsidiaries--including trade payables, pension and retiree medical liabilities, and environmental liabilities--and any relatively better positioned parent-level liabilities. (For example, parent-level borrowings collateralized by the stock of the subsidiaries would be disadvantaged relative to subsidiary liabilities, but would rank ahead of unsecured parent-level debt.) Potential mitigating factors include:

Guarantees

- Guarantees by the subsidiaries of parent-level debt (i.e., upstream guarantees) may overcome structural subordination by putting the claims of parent company creditors on a pari passu basis with those of operating company creditors. Such guarantees have to be enforceable under the relevant national legal system(s), and there must be no undue concern regarding potential allegations of fraudulent conveyance. Although joint and several guarantees from all subsidiaries provide the most significant protection, several guarantees by subsidiaries accounting for a major portion of total assets would be sufficient to avoid notching of parent debt issues in most cases.
- The legal analysis outcome depends on the specific fact pattern, not legal documentation--so one cannot standardize the determination. But, if either the guarantor company received value or was solvent for a sufficiently long period subsequent to issuing the guarantee, the upstream guarantee should be valid. Accordingly, we consider upstream guarantees valid if any of these conditions are met:

- The proceeds of the guaranteed obligation are provided (downstreamed) to guarantor. It does not matter whether the issuer downstreams the money as an equity infusion or as a loan. Either way, the financing benefits the operations of the subsidiary which justifies the guarantee;
- Any legal risk period from entering the guarantee has passed;
- There is a specific analytical conclusion that there is little default risk during the period that the guarantee validity is at risk.

Operating assets at the parent

- If the parent is not a pure holding company, but rather also directly owns certain operating assets, this gives the parent's creditors a priority claim to the parent-level assets. This offsets, at least partially, the disadvantage that pertains to being structurally subordinated with respect to the assets owned by the subsidiaries.

Diversity

- When the parent owns multiple operating companies, more liberal notching guidelines may be applied to reflect the benefit the diversity of assets might provide. The threshold guidelines are relaxed (but not eliminated) to correspond with the extent of business and/or geographic diversification of the subsidiaries. For bankrupt companies that own multiple, separate business units, the prospects for residual value remaining for holding company creditors improve as individual units wind up with shortfalls and surpluses. Also, holding companies with diverse businesses--in terms of product or geography--have greater opportunities for dispositions, asset transfers, or recapitalization of subsidiaries. If, however, the subsidiaries are operationally integrated, economically correlated, or regulated, the company's flexibility to reconfigure is more limited.

Concentration of debt

- If a parent has a number of subsidiaries, but the preponderance of subsidiary liabilities are concentrated in one or two of these, e.g., industrial groups having finance or trading units, this concentration of liabilities can limit the disadvantage for parent-company creditors. Although the net worth of the leveraged units could well be eliminated in the bankruptcy scenario, the parent might still obtain recoveries from its relatively unleveraged subsidiaries. In applying the notching guideline in such cases, it may be appropriate to eliminate the assets of the leveraged subsidiary from total assets, and its liabilities from priority liabilities. The analysis then focuses on the assets and liabilities that remain, and the standard notching guideline must be substituted by other judgments regarding recovery prospects.

Downstream loans

- If the parent's investment in a subsidiary is not just an equity interest, but also takes the form of downstream senior loans, this may enhance the standing of parent-level creditors because they would have not only a residual claim on the subsidiary's net worth, but also a debt claim that could be pari passu with other debt claims. However,

most intercompany claims are subject to equitable subordination and/or other elimination in the bankruptcy process. Such assessment of downstream advances must take into account the applicable legal framework. (On the other hand, if the parent has borrowed funds from its subsidiaries, the resulting intercompany parent-level liability could further dilute the recoveries of external parent-level creditors.)

Adjustments

- We eliminate from the notching calculations subsidiaries' deferred tax assets and liabilities and other accounting accruals and provisions that are not likely to have clear economic meaning in a default.

Rating debt issues, for companies with issuer ratings of 'twBB+' or below

- For issuer ratings of 'twBB+' or below, we employ a simple rule-of-thumb approach to identify issues that are junior--and thereby materially disadvantaged with respect to recovery prospects. If claims that come ahead of a given debt issue equal 15% of assets, we would rate the issue one notch lower from the corporate credit rating level; if such priority claims reach the 30% level, we would rate the issue two notches lower. We do not rate issues more than two notches below the corporate credit rating on the basis of inferior recovery considerations.

Rating The Issue: Default And Distress

The issue credit ratings on hybrid capital instruments, or on any debt instrument with a coupon deferral or cancellation feature or principal write-down or deferral feature, are generally lowered to 'D' when payments are deferred or reduced on a permanent basis according to terms of the instrument. This includes: nonpayment of interest or dividends on a non-cumulative instrument (where missed coupons are not repaid in the future); write-down of principal; or conversion to common equity due to a credit event. Here "coupon" refers to periodic distributions, regardless of how they are described under the terms and conditions of the instrument (including such descriptions as "coupons," "interest," or "dividends"). The issue credit ratings on hybrid capital instruments with cumulative deferral provisions (such as cumulative preferred stock), or economically equivalent structures that also allow temporary coupon deferral without interest on deferred interest, will be lowered to 'D' upon deferral. The exception is if we expect that the deferral period: a) will be short term, typically one year or less, and b) will be in accordance with the terms of the instrument.

Rating The Issue: Government Support

Our criteria for rating the hybrid capital securities of government-related entities (GRE) deserve particular mention. When TRC expects the government to support a GRE's debt obligations but has less confidence that the support would be extended to the entity's hybrid capital instruments, then the base off which we apply notching to rate the hybrid capital instrument may not only be the ICR (which factors in our expectations of extraordinary potential government support). The issuer's SACP (which excludes our expectations of extraordinary potential government support) is also a relevant rating factor in these situations.

Our approach would be similar in the case of an entity on which the assigned ICR factored in our expectations of extraordinary potential group support, but where we doubted whether group support would be extended to the subsidiary's hybrid capital instruments.

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as TRC's

assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

Related Criteria And Research

Related Criteria

- **General Criteria: Rating Government-Related Entities: Methodology And Assumptions**, March 25, 2015
- **General Criteria: Principles For Rating Debt Issues Based On Imputed Promises**, Dec. 19, 2014
- **Understanding Taiwan Ratings' Rating Definitions**, www.taiwanratings.com, Nov. 18, 2014
- **General Criteria: National And Regional Scale Credit Ratings,** Sept. 22, 2014
- **General Criteria: Methodology: Use Of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments**, Oct. 24, 2013
- **General Criteria: Principles Of Credit Ratings,** Feb. 16, 2011
- **General: Hybrid Capital Handbook: September 2008 Edition**, Sept. 15, 2008
- **General: 2008 Corporate Criteria: Rating Each Issue**, April 15, 2008

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