

**Standard & Poor's Request for Comment  
regarding General and Corporate Criteria**

## 1 General Remarks

Deutsches Aktieninstitut<sup>1</sup> welcomes the objective of the Request for Comment (RfC) to provide issuers with better transparency and comparability about the rating process.

However, there are certain general aspects which we observe with concern:

- Methodological changes in the rating process should not increase the debt position used for rating purposes systematically. Otherwise, the ability of companies to raise capital on the debt markets will decrease. In particular the proposed surplus cash adjustments will contribute to this development.
- The proposed methodology is very static and hardly able to properly reflect the specifics of an individual company. In order to adequately capture these specifics professional analytical judgment should be a key part of the rating process. The integration of the proposed criteria should not limit analytical freedom in the rating process inappropriately.
- In the rating approach proposed more emphasis is laid on S&P's forecasts (especially regarding the Financial Risk Profile): Up to 75 % of the indicative ratio calculation shall depend on forecasts for the current and the following two years. This bears a considerable risk for false estimation on the development of a company's credit ratios. It is very likely that this approach leads to inappropriate rating actions. Therefore, we are very sceptical that this approach will work. At least, for reasons of clarity and comprehensibility the forecasts should be made transparent to the respective issuer and it should be openly communicated when and how often these forecasts are adjusted.
- Especially regarding the forecasts the problem of confidentiality should be addressed. Market participants are aware of the fact that S&P has a deeper insight and probably access to non-public information. As a con-

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<sup>1</sup> Deutsches Aktieninstitut e.V. (DAI, [www.dai.de](http://www.dai.de)) is the association of German exchange-listed stock corporations and other companies and institutions which are engaged in the capital markets development.

sequence markets will be much more sensitive on any forecasts and projections provided by S&P. As the information provided by the issuer is commercially sensitive in many cases it should be treated confidential and not made public in the rating reports or in any other S&P's publications.

- Regarding the industry risk and the competitive position it is essential to have a classification in place which takes appropriately into account the specifics of the companies. Otherwise, apples are compared with oranges.
- In order to conclusively assess the appropriateness of the proposed changes of the rating methodology it is essential that the issuer is able to calculate the impact of the changes on the rating to be issued. Although S&P provides a large degree of transparency, some details necessary for a proper assessment are missing. In particular individual country risk assessments and many Key Credit Factors are not available so far which hinders issuers to evaluate the impact of the country and the industry risk on their own rating.

Our comments below focus on various aspects of the proposed rating methodology.



## 2 Comments on Specific Issues

### Ratios and Adjustments

Our main concern is related to the document “Corporate Criteria: Ratios and Adjustments” and in particular to the method of calculating *surplus cash* (p. 6). The three haircuts proposed to determine the surplus cash contradict a prudent management of cash reserves available for unforeseeable liquidity needs. In essence, the haircut-approach will heavily increase the companies’ net debt positions. For some companies this could result in a low to mid single-digit billion Euro increase in net debt. This will incentivise companies to limit their cash and liquidity reserves to a minimum which will in turn reduce capabilities to cover unexpected liquidity needs. Overall, we seriously doubt the assumption of S&P that the proposed ratios and adjustments will not result in rating changes.

We question for the following reasons that the proposed methodology on surplus cash is appropriate. Therefore, it would be better to assess the restricted cash for every company individually taking into account the respective reporting obligation according to IFRS and the analytical judgement of the analyst.

We deem the first haircut which calculates the gross available cash as not suitable. First, the impact of severe working capital swings is already incorporated in the analysis of the modifier “liquidity”. To insert an additional analysis in this section of the rating process would produce a redundancy. Second, rating ratios should reflect the underlying economic truth (substance over form). Therefore, extreme events should not be used by the rating analysts. We cannot see any reason why this approach should change regarding working capital. It would be better to refer to the average. Third, we do not think that it is methodologically correct to base this calculation on figures which are determined on two different dates – the *year-end* liquidity and the peak *intra-year* working capital. Such a procedure would compare apples with oranges as the year-end liquidity differs from the cash surplus effectively available on the intra-year peak.

Overall, the current proposal to deduct the amount required to fund seasonal working capital peaks from surplus cash will unfairly penalize those

companies that chose to hold cash to finance their seasonality needs as opposed to those that e.g. draw under bank lines.

Compare two extreme examples of companies with the same 1,000 year end net debt balance and similar 1,500 seasonal working capital needs. Company A finances its working capital needs via maintaining a large cash balance whilst Company B uses its bank lines instead, all of which are repaid by year end. The new proposed methodology will massively penalize Company A versus Company B simply for erroneously using year end gross debt balances as a starting point.

|  | Company A | Company B |
|--|-----------|-----------|
| Cash Balance at Year End                           | 2.000     | 200       |
| Gross Debt at Year End                             | 3.000     | 1.200     |
| Net Debt at Year End                               | 1.000     | 1.000     |
|  |           |           |
| Committed Undrawn Bank Line                        | 0         | 1.800     |
| Peak Seasonal Working Capital Needs                | 1.500     | 1.500     |
| S&P's proposed Net Debt post subtracting W/C Needs | 2.500     | 1.200     |

The second 25 % haircut on gross available cash is overly conservative and does not reflect appropriately corporate practice. Although we understand that the approach allows the adjustment of the haircut individually against the background of the reasons listed on p. 7, we do not think that the 25 % haircut is a good starting point for the discussion with the rating analyst. Therefore, this requirement should be abandoned.

The proposed third haircut deducts the forecasted discretionary cash flow if it is negative. This implies a double counting of working capital cash flow needs, since the discretionary cash flow is net of changes in working capital, which have already reduced surplus liquidity in step 1. Furthermore, take for example an acquisition in the next forecast year which may, if likely enough, be included in the first forecast year's financial ratios anyway (and is therefore taken into consideration via future financial ratios). Therefore, it is included in the overall rating analysis already and should not also be part of the surplus cash adjustment in the latest historic year.

In addition, we doubt that interest expenses and tax expenses should define the Funds From Operation (FFO) as these ratios are accounting positions which do not reflect the true cash movement. In our view, it makes more sense to maintain a FFO definition based on cash flow statement data and include items such as “change in provisions” or “other non-cash income/expenses” in order to enable S&P to come to a better educated view of the potential to generate cash of the business.

### **Industry Risk**

Our comment refers to the consultation papers on “Methodology: Industry Risk...” and “Corporate Criteria”. We deem the proposed industry classification as too broad. The number of industry classes is insufficient to properly capture specifics of companies belonging to the same industry.

Take for example the class Auto OEM industry which ignores the fact that the automobile market can be split into different segments, e.g. premium car and volume car manufacturers. Therefore, a refined industry classification with more specific industry (sub) classes comprising companies with comparable specifics (e.g. regarding the products) should be introduced. As another example, the specifics of European integrated utilities seem to be ignored. While the 38 industries seem to fit into the broader landscape for US energy companies where integrated utilities basically do not exist, this is not the case for the European energy sector with a large number of integrated utilities. It would therefore in our view be reasonable to simply add an industry risk assessment for integrated utilities. This would prevent S&P from importing US based criteria which do not seem to fit for European companies (we understand that European Integrated Utilities should by default fall into “Merchant Power” basket which seems simply wrong). There should be a separate industry classification also due to the massive amount of (rated) debt outstanding from integrated utilities.

In addition, information regarding the Key Credit Factors (KFCs) is of utmost importance in order to assess properly the proposed methodology. As many KFCs are not released so far there is an extreme uncertainty among market participants what will be the effect of proposed methodology on the ratings to be issued and thus the creditworthiness of individual issuers.

**Country Risk (Corporate Criteria, p. 12 et seq.)**

As many companies in Germany are export-oriented the treatment of country risks in the rating assessment is important. In order to properly evaluate the impact of the proposed methodology regarding country risk information on the individual country risk assessment is necessary. Unfortunately, such information is not available yet.

**Competitive position (Corporate Criteria, p. 15 et seq)**

In general, the approach to determine the competitive position is very complex and difficult to understand. The interplay between the sub factors and the sub-sub factors is unclear. This applies also for the assessment of the volatility of a company's profitability which is based on a standard error of regression (SER) analysis (p. 30). Furthermore, the retrospective nature of the SER analysis with seven years of historic data somehow contradicts the forward-looking character emphasized in other parts of the RfC, especially regarding the Financial Risk Profile.

In addition, we do not understand why S&P explicitly refers to EBITDA distortion from currency fluctuations (p. 30). We assume that "EBITDA" as mentioned in the RfC has the meaning of "EBITDA including all relevant S&P adjustments" (including distortion from currency fluctuations).

We propose to delete the last step of the aggregation of the credit ratio assessment in its entirety as the analysis of company's volatility has already taken place as part of the business profile analysis (p. 38). Furthermore, the analyst can consider if the company is exposed to a significant degree of volatility in various other fields of the analysis (such as business profile analysis, financial policy modifier analysis, peer comparison etc.).

**Modifier (Corporate Criteria, p. 9 et seq. and p. 40 et seq.)**

The assessment of debt maturity profiles should take asset-liability matching into consideration. Furthermore, a captive financing company is part of many corporate groups. It is important to take the banking nature of the business and financing model into account when the debt maturity profile is assessed.

**Thresholds (KFCs for the global regulated utility industry, p. 11)**

We refer to the RfC “Key Credit Factors for the global regulated utility industry” and understand that S&P intends to follow a binary approach when determining whether to apply the low- versus the standard volatility table for benchmark ratios. This means a utility with a share of regulated activities falling by only a few percentage points below the threshold of 33 % would immediately be subject to a significantly higher set of benchmark ratio ranges. We see no sense at all in this binary approach due to the fact that a minor change in the business profile of a company would result in the requirement to heavily improve the financial profile in order to maintain a given rating. There is no analytical justification that two otherwise identical companies with slightly different shares of regulated activities and therefore a similar business risk profile would have completely different benchmark ratio ranges.



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