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Rating Research Services

Archive: TRC Corporate Sector Issue Rating Criteria

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(**Editor's note**: The criteria article is no longer current. It has been superseded by the article also titled "TRC Corporate Sector Issue Rating Criteria," published on Nov. 25, 2014)

1. Taiwan Ratings Corp. (TRC) is refining its issue rating criteria to provide guidelines on the issue ratings for corporate issuers in Taiwan. This article illustrates how TRC assigns issue ratings on its TRC scale. This article is related to a Standard & Poor's Ratings Services criteria article, "2008 Corporate Criteria: Rating Each Issue," published on www.globalcreditportal.com on April 15, 2008.

SCOPE OF THE CRITERIA

2. TRC is refining its issue rating criteria to provide guidelines on issue ratings for corporate sectors in Taiwan. The criteria describes how, for obligations issued by the corporate sector, issue ratings may be equivalent to or notched down or notched up from the corporate credit ratings as a result of various analytical considerations.
3. These criteria are related to only long-term issue ratings on the TRC scale and do not affect any Standard & Poor's global scale ratings assigned to Taiwanese issuers. The notching process will be based from the issuer rating of TRC scale ratings, rather than S&P global scale ratings. Moreover, these criteria do not address short-term ratings or other non-TRC scale ratings.

IMPACT ON OUTSTANDING RATINGS

4. These criteria refinements will not result in rating actions on current outstanding TRC rated corporate bonds.

EFFECTIVE DATE AND TRANSITION

5. These criteria refinements are effective immediately.

METHODOLOGY

Rating Each Issue

6. 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.
7. The corporate rating does not reflect any priority or preference among obligations.
8. 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.
9. 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; Notching Up

10. The practice of differentiating issues in relation to the issuer's fundamental creditworthiness is known as "notching." Issues are notched up or 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. They are notched--up or down--from the corporate credit rating in accordance with established guidelines explained here.
11. 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.
12. 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.
13. 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.
14. Notching guidelines are a function of the bankruptcy law and practice in the legal jurisdiction that governs a specific instrument.

Preferred stock

15. Preferred stock carries greater credit risk than debt in two important ways: The dividend is at the discretion of the issuer, and the preferred represents a deeply subordinated claim in the event of bankruptcy.
16. Accordingly, preferred stock generally is rated below subordinated debt. When the corporate credit rating on a company is 'twBBB-' or above, its preferred stock is rated two notches below the corporate credit rating. For example, if the corporate credit rating is 'twA+', the preferred stock would be rated 'twA-'. (In case of a 'twAAA' corporate credit rating, the preferred stock would be rated 'twAA+'.) When the corporate credit rating is twBB+ or below, the preferred stock is rated at least three notches (one rating category) below the corporate credit rating. Deferrable payment debt is treated identically to preferred stock, given subordination and the right to defer payments of interest.
17. There are situations in which the dividend is especially jeopardized, so notching would exceed the guidelines above. For example, covenants in debt instruments can endanger payment of dividends, even while there is a capacity to pay.
18. In all cases, the risk of deferral of payments is analyzed from a pragmatic, rather than a legal, perspective. If a company defers a payment or passes on a preferred dividend, as permitted under the terms of the issue, the rating is changed to 'twC' once the payment date has passed, if the issuer is not bankrupt or insolvent and our credit rating CCR on the company is not ‘D’ or ‘SD’. We will assign a ‘D’ rating to issues that are in payment default, to issues that have been subject to distressed exchange, or when the issuer has filed for bankruptcy or taken similar action.

Reflecting Recovery In Issue Ratings

19. 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.

20. The weighting of recovery aspects in issue ratings also varies as the potential for default becomes more meaningful, as explained below.

'twBBB-' or above

21. For 'twBBB-' or above companies, 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.
22. Rather, we use a rule-of-thumb approach to identify debt issues with inferior recovery prospects--or, for consideration of adding notches, we use discrete asset valuations if there is collateral (modified somewhat in the case of regulated utilities)

Rating below the corporate credit rating: "Notching down"

23. 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.
24. 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).
25. 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.
26. 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).
27. 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.
28. 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.)
29. 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.

30. 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).
31. 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.
32. 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

33. 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.

Rating above the corporate credit rating: "Notching up"

34. We generally do not perform specific default scenario modeling for 'twBBB-' or above companies, so identifying issues with superior recovery characteristics usually relies on security provisions of a specific issue. Candidates for notching up are secured debt issues, where collateral consists of assets with a well-established track record with respect to recovery, such as first mortgage bonds of regulated utilities.
35. As explained above, the weight given to recovery in assigning issue ratings diminishes as one moves up the rating spectrum. When a rating on a company is in the 'twBBB' category, its well-secured debt is rated one or two notches above the corporate rating, depending on the extent of the collateral coverage. For the 'twA' category, the maximum addition is limited to one notch--and this applies only when full recovery is anticipated. For 'twAAA' and 'twAA' categories, notching-up is phased out entirely.

Structural subordination

36. 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.
37. 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

38. 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 most 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.
39. 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;

    - The legal risk period--ordinarily, one or two years from entering into 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

40. 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

41. 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

42. 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

43. 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

44. 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.

twBB+ or below

45. For twBB+ or below issuers, 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.

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

- **Understanding TRC Rating Definitions**, www.taiwanratings.com, Oct. 29, 2013
- **Taiwan Ratings' Principles Of Credit Ratings**, www.taiwanratings.com, May 19, 2011
- **2008 Corporate Criteria: Rating Each Issue**, April 15, 2008

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