EthiFinance Ratings

Corporate Rating Methodology - Investment Holding

1. Framework & Rating Scale

This document provides an overview of the approach taken by EthiFinance Ratings (EFR) when assigning long-term ratings to investment holding companies.

This methodology incorporates a scorecard with details on the analytical factors and the weights given to them.

This methodology covers investment holding companies. We define an investment holding company as a legal entity with the primary purpose of owning a portfolio of investments, generally composed of equity stakes in companies which are typically not related to one another. In that sense, it is different from a conglomerate, which is a company with stakes in a number of companies acting with a defined global strategy, synergies, and financial links, which are characteristic of consolidated groups.

The purpose of a holding entity can vary, for example family wealth management or to be a platform for financial investments.

2. Investment Holding Companies Rating Methodology

2.1 Methodology approach and scorecard

Our methodology is primarily based on the investment holding's financial accounts (i.e., accounts of the holding company or a group of holding entities, not consolidated accounts) in order to have a pure holding view. An investment holding's consolidated accounts may indeed provide a distorted view of the economic and legal situation. In addition, the debt issued by the entities in which the investment holding has an equity stake is typically without any recourse to the investment holding entity, or any guarantee given by the investment holding entity.

Ratings assigned by EthiFinance Ratings are based on the analysis of both qualitative factors (business risk profile, investment strategy etc) and quantitative factors (historical and projected credit metrics, liquidity etc). More specifically, a rating is the weighted average of an issuer's business risk profile and its financial risk profile as reflected by the following scorecard.

		AAA	AA	A	BBB	BB	B	CCC
BUSINESS RISK PROFILE								
Investment policy								
Investment policy	10.0%	Very prudent clearly stated policy within a structured organization. Very strong track record of execution.		Prudent policy with strong track record.	Adequate policy and track record.	Mildly agressive policy.	Limited disclosure on investment policy. Aggressive policy with some issues on execution.	No investment policy disclosed at all. Very aggressive policy, cyclical industries, management change, weak execution.
Portfolio of investments								
		AAA	AA	A	BBB	BB	B	CCC
Diversification by value of the assets	5.0%	See Table 1						
Diversification by industry	5.0%	See Table 2						
Diversification by geography	5.0%	See Table 3						
		AAA	AA	A	BBB	BB	B	CCC
Liquidity of the assets	10.0%	P* > 80% with the majority of stakes below 20%.		70% < P ≤ 80% Majority of stakes below 35%.	60% < P ≤ 70% Majority of stakes below 35%.	50% < P ≤ 60% Majority of stakes below 35%.	50% ≥ P > 40%	P ≤ 40%
		AAA	AA	A	BBB	BB	B	CCC
Credit quality of the assets	15.0%	AA		A	BBB	BB	B	CCC
Total	**50.0%**							
FINANCIAL RISK PROFILE								
Financial policy								
Financial policy	10%	Very prudent clearly stated policy within a structured organization. Very strong track record/adherence to it.		Prudent policy with strong track record/adherence to it.	Adequate policy and track record/adherence.	Mildly agressive policy.	Limited disclosure on financial policy and weak adherence to it. Agressive policy with reliance on debt.	No financial policy disclosed at all. Very aggressive with high reliance on debt.
Leverage & coverage								
Interest coverage	10.0%	R > 6.0x		6.0x ≥ R > 4.0x	4.0x ≥ R > 3.0x	3.0x ≥ R > 2.0x	2.0x ≥ R > 1.0x	R ≤ 1.0x
Loan to value	30.0%	0% < LTV < 20%		20% ≤ LTV < 30%	30% ≤ LTV < 40%	40% ≤ LTV < 50%	50% ≤ LTV < 70%	LTV ≥ 70%
Total	**50.0%**							

* P = the proportion of listed companies within the portfolio

2.2 Rating factors: Business risk profile

The business risk profile is assessed with regard to the investment policy and the features of the investment portfolio. We assess the investment portfolio in terms of diversification by the value of each investment within the portfolio, by industry, and by geography. We also take into consideration the liquidity of the assets in the portfolio and the respective business and financial strengths of each asset (i.e., the credit quality).

2.2.1 Investment policy

The investment policy relates to the guidelines that have been set, communicated, and followed (or not). These guidelines are in relation to the current portfolio (and past), and its evolution in terms of new investments and disposals.

Typically, we will see less risk in a policy of investing in a portfolio of listed, diversified and established businesses generating positive free cashflow with stable dividend payment rather than in concentrated high-growth, private businesses generating negative free cashflow with the need for frequent capital injection. Therefore, we review the stated investment policy (if any) and compare it to the existing portfolio to determine if the actual track record matches the policy. We also review the dynamics of the portfolio, including the actual rotation of the investments, and the value-creation approach (i.e., long-term growth of the business, turnaround of the company).

	AAA AA	A	BBB	BB	B	CCC
Investment policy 10.0%	Very prudent clearly stated policy within a structured organization. Very strong track record of execution.	Prudent policy with strong track record.	Adequate policy and track record.	Mildly agressive policy.	Limited disclosure on investment policy. Aggressive policy with some issues on execution.	No investment policy disclosed at all. Very aggressive policy, cyclical industries, management change, weak execution.

2.2.2 Portfolio of investments

The holding company's investment portfolio is the most important element in the determination of the credit rating. The purpose of the investment holding company is to build a portfolio of assets and to manage it. The assessment of the portfolio is a core part of the analysis process as the portfolio represents all the assets and the value of the rated entity.

The first step is to evaluate the value of each individual asset in the investment portfolio. Our valuation is based on the market value of listed investments and our estimate when the investments are not listed. Typically, our assessment of unlisted investments will be based (by general order of interest) on third-party valuations (i.e., property valuation for real estate investment trust, third-party valuation realised for an equity-related transaction), peer multiples (from listed peers or recent M&A transactions), and net book value.

Then we assess the five following criteria:

2.2.2.1 Diversification by value of each investment

From the valuation of assets, we can derive the portfolio diversification by asset value (i.e., the respective weight of each investment in the portfolio). For the calculation, we take into account if there is a large cash balance in the investment holding entity resulting from a rotation of the portfolio. If we believe that the cash is most likely to be reinvested, then we consider the cash as being part of the portfolio valuation - and therefore, not included to reduce the investment holding's debt used to calculate the loan-to-value ratio. If the cash is not likely to be reinvested, we consider it outside of the portfolio value and include it in to reduce the investment holding's net debt.

Table 1: Diversification by value

Diversification by VALUE	0%-10%	10%-20%	20%-30%	30%-40%	40%-50%	50%-60%	60%-70%	70%-80%	80%-90%	90%-100%	Size of top 3
0%-10%	AAA	AAA	AA								
10%-20%		AA	A	A	BBB	BBB					
20%-30%			A	BBB	BBB	BB	BB	BB	B		
30%-40%				BBB	BB	BB	BB	B	CCC	CCC	
40%-50%					BB	BB	B	CCC	CCC	CCC	
50%-60%						B	CCC	CCC	CCC	CCC	
60%-70%							CCC	CCC	CCC	CCC	
70%-80%								CCC	CCC	CCC	
80%-90%									CCC	CCC	
90%-100%										CCC	
Size of top 1											

Typically, we prefer a large diversification by asset value as this underlines a low concentration in any given investment in the portfolio. As a result, a material negative change in the value of a single investment would have only a limited adverse impact on the portfolio's total value. This also reduces the likelihood of the investment holding company having to provide a material financial support to any single investment.

2.2.2.2 Diversification by industry

Based on the individual valuation of each of the portfolio investments, we assess the diversification by industry, by aggregating the valuation of each investment in individual industries. We view a broadly equal-weight split of a portfolio across a large number of industries as positive. We also analyse the correlation between industries, i.e., if they react in a similar way in the event of market changes or if they tend to offset each other. The specific industries are also analysed to assess their underlying earnings and dividend capacity.

Table 2: Diversification by industry

Diversification by INDUSTRY	>=10	9	8	7	6	5	4	3	2	1	Nb industry
0%-10%	AAA										
10%-20%	AA	AA	AA	A	A	A					
20%-30%	AA	AA	A	A	BBB	BBB	BBB				
30%-40%	A	A	BBB	BBB	BB	BB	BB	B			
40%-50%	BBB	BBB	BB	BB	B	B	B	B			
50%-60%	BB	BB	BB	B	B	B	B	B	B		
60%-70%	B	B	B	B	B	B	B	B	CCC		
70%-80%	B	B	B	B	B	CCC	CCC	CCC	CCC		
80%-90%	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC		
90%-100%	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	
Size of top 1											

2.2.2.3 Diversification by geography

The approach is similar to the diversification by industry, aggregating individual valuation into geographies. We take into account the absolute size of the geographic area as well as the degree of correlation between the areas.

Table 3: Diversification by geography

Geographical diversification. Presence in geographical areas / concentration per geographical area	4 geographical areas	3 geographical areas	2 geographical areas	1 geographical area
25% ≤ Largest geographical area < 30%	AAA	AA+		
30% ≤ Largest geographical area < 40%	AA	AA-		
40% ≤ Largest geographical area < 60%	A	BBB+	BB+	B+
60% ≤ Largest geographical area < 80%		BB+	BB-	B
80% ≤ Largest geographical area ≤ 100%			B	B-

Note 1: To be present in a geographical area is to have at least 15% of total asset value from that area. The four geographical areas are Americas, Africa & Middle East, Asia-Pacific, and Europe & Russia.

Note 2: If Africa/Middle East is > 30% of total asset value, automatic two-notches below the grid because of increased political and economic risks.

Note 3: Diversification in countries within one geographical area, or cities within one country, can entail up to two notches up or down with respect to the grid.

2.2.2.4 Liquidity of the assets

The liquidity of an asset will be higher for a listed entity. It can also depend on the cyclical phase of the industry, or the country of the asset and possible related legal restrictions. The place of listing and the amount of security traded are also important drivers. A non-controlling stake in a listed company can be easier to sell compared to full ownership. As such, the table below indicates the categories for the liquidity of assets based on the proportion (P) of listed companies within the portfolio.

		AAA AA	A	BBB	BB	B	CCC
Liquidity of the assets	10.0%	P* > 80% with the majority of stakes below 20%.	70% < P ≤ 80% Majority of stakes below 35%.	60% < P ≤ 70% Majority of stakes below 35%.	50% < P ≤ 60% Majority of stakes below 35%.	40% < P ≤ 50%	P ≤ 40%

2.2.2.5 Credit quality of the assets

The financial strength relates to the respective credit quality. The average credit quality of the portfolio is the average credit quality of each investment weighted by the value of each asset, not on the dividend stream of the portfolio of assets. We will typically assess the credit quality of assets representing individually more than 10% of the portfolio of assets' value. We evaluate the credit quality of the individual asset using our corporate rating grid assessment as a reference. A low credit quality will likely result in a higher volatility of the equity value of the investment and can lead to challenges regarding access to the capital markets. An asset with a low credit quality can also be less resilient in the event of a downturn in its business and may require financial support from the investment holding entity.

	AAA AA	A	BBB	BB	B	CCC
Credit quality of the assets 15.0%	AA	A	BBB	BB	B	CCC

2.3 Rating factors: Financial risk profile

The financial risk profile is dependent on the financial policy and the leverage and coverage ratios. We specifically analyse the investment holding entity on a standalone basis (or group of holding entities), not on a consolidated basis with the investment portfolio. Therefore, our assessment is based on the investment holding company's individual financial statements, unless some of the investment portfolio debt has been granted a guarantee from the holding, which is rather unusual. Nevertheless, the investment holding company's financial statements perimeter can incorporate several holding entities forming the investment holding group (i.e., holding A, owning sub-holdings B, C, and D, used for the purposes of holding investment stakes; in this case, the holding's perimeter is A, consolidated with B, C, and D).

2.3.1 Financial policy

The financial policy relates to the financial situation of the investment holding company. We assess the financing structure of past investments and what is intended for future investments. A conservative approach will have a large proportion put on the equity funding while a more aggressive approach will choose higher debt funding resulting in higher interest expenses and debt load. The adherence to a set policy can be evaluated with regard to the actual financial profile (from the loan-to-value ratio) and an understanding of the historical evolution (i.e., a high loan-to-value ratio can result either from a drop in the investments' value or aggressive financing from day one).

	AAA AA	A	BBB	BB	B	CCC
Financial policy 10%	Very prudent clearly stated policy within a structured organization. Very strong track record/adherence to it.	Prudent policy with strong track record/adherence to it.	Adequate policy and track record/adherence.	Mildly agressive policy.	Limited disclosure on financial policy and weak adherence to it. Agressive policy with reliance on debt.	No financial policy disclosed at all. Very aggressive with high reliance on debt.

2.3.2 Leverage ratios

In contrast to a typical leverage of a corporate entity (usually EFR-adjusted net debt/EFR-adjusted EBITDA or a gearing ratio), we assess an investment holding company's leverage as its net debt divided by the value of the investment portfolio. The investment holding company's net debt is calculated on an unconsolidated basis (to exclude portfolio investments which are consolidated) unless a guarantee is provided by the investment holding entity for the debt (which is unusual). The value of the investment portfolio is the sum of the valuations of each investment (sum of the parts). As we indicated before, valuation is derived from the market value when the investment is a listed company and primarily from third-party valuation or a peer multiple when the investment is private. Book value can also be considered, in the event of a lack of comparable elements or for specific reasons.

We attribute the highest weight to the leverage criteria as it is a key driver of the holding company's ability to either raise financing or pay off its debt if needed. It is also an indicator of the magnitude of asset value volatility that a rated entity could withstand.

Better ratings are assigned to companies with a low LTV ratio whereas companies with a high LTV ratio have lower ratings.

		AAA AA	A	BBB	BB	B	CCC
Loan to value	30.0%	0% < LTV < 20%	20% ≤ LTV < 30%	30% ≤ LTV < 40%	40% ≤ LTV < 50%	50% ≤ LTV < 70%	LTV ≥ 70%

2.3.3 Interest coverage ratio

The funding structure is analysed with regard to the fixed charge coverage of the investment holding and its liquidity profile. The interest coverage can be defined as funds from operations (FFO) relative to interest.

We calculate FFO before interest expenses. It typically consists of dividends, management fees, interest income (often intercompany loan interest income). For the calculation of the ratio, the denominator factors in interest expenses plus required dividends paid by the investment holdings to meet shareholder's needs (i.e., when the ultimate shareholder has debt resulting in the need for a recurrent stream of dividend to be paid by the rated entity). We also evaluate if there is an outsized part of the dividend stream paid by a particular investment in the portfolio.

		AAA AA	A	BBB	BB	B	CCC
Interest coverage	10.0%	R > 6.0x	6.0x ≥ R > 4.0x	4.0x ≥ R > 3.0x	3.0x ≥ R > 2.0x	2.0x ≥ R > 1.0x	R ≤ 1.0x

2. Specific Considerations

After having assessed the business risk profile and the financial risk profile of an issuer, EthiFinance Ratings looks at certain key rating factors the presence of which could cap the final rating at a lower level than that resulting from the risk profile assessments.

This is because such rating factors are either seen as necessary for the company to survive on a going-concern basis, are key to monitor the performance of the issuer (transparency), or expose the issuer to material event risks which are tougher to quantify through a grid and thus cannot be factored in

otherwise (country risk, some ESG risks). This de-notching applied to the rating originally envisaged can be as many as three notches, although it is more usually one or two notches.

2.4 Transparency

EthiFinance Ratings measures the degree of transparency of an issuer based on the quality of the information and the level of details provided to investors, including quarterly financial statements, market data, KPIs, operational and financial guidance etc. Listed companies tend to score higher on this metric relative to privately-owned companies. Transparency is measured by EthiFinance Ratings on a scale of '0' to '5'.

Transparency is key for investors to monitor the operating and financial performance of an issuer. Whilst a high level of transparency may not raise a rating, a material lack of sufficient transparency may cause us to cap a rating at a level lower than normally envisaged to capture the risks associated with poor disclosure, including that of unforeseen events arising. Ultimately, an extremely low level of transparency may not be commensurate with the ability to maintain a public rating, and could cause us to withdraw such a rating (if it is the Rating Committee's decision).

2.5 Liquidity

EthiFinance combines the assessments of a firm's level of liquidity with that of its refinancing profile to arrive at a liquidity risk assessment of 'very weak', 'weak', 'adequate' and 'superior' (see Table 4).

Table 4 - Liquidity risk assessment

		Level of liquidity		
		Poor	**Reasonable**	**High**
Refinancing profile	**Weak**	Very weak	Weak	Adequate
	Satisfactory	Weak	Adequate	Superior
	Strong	Weak	Adequate	Superior

2.5.1 Assessing the level of liquidity

To assess a company's level of liquidity, we determine how many years of liquidity a company has. A 'Poor' assessment would be assigned to a company if there is a risk of insufficient liquidity in the coming year; a 'Reasonable' assessment would be given if EthiFinance believes a company has sufficient liquidity between the coming year and the next, and a 'High' assessment if assigned to a company if it is expected to have sufficient liquidity beyond 2 years (see Table 5).

Table 5 - Level of liquidity (years)

Poor	Reasonable	High
<1 year	<1 – 2>	> 2

Level of liquidity is determined by reviewing sources and uses of funds. Sources of funds include unrestricted cash, operating cash flow and undrawn committed lines of credit over one year of maturity; and uses of funds include upcoming debt maturities, capital spending, dividends, and any

commitments that EthiFinance believes have reasonable likelihood of materializing in the period under review.

2.5.2 Assessing the refinancing profile

The assessment of a firm's refinancing profile (Table 6) is closely tied to the assessment of its financial profile and reflects its capacity to access funds from financial markets in a timely manner and at market conditions under moderate stress conditions. We assess the strength of a company's refinancing profile using the following three categories:

Table 6 - Refinancing profile

Weak	Satisfactory	Strong
Firms with a weak financial profile further undermined by capital structure risks such as concentrated debt maturities, currency or interest rate mismatches, restrictive covenants or adverse terms and conditions. We expect that access to refinancing for these firms may be challenging, or at very expensive conditions under even moderate stress conditions	Firms with a satisfactory refinancing profile would have a medium financial profile and no overarching capital structure weaknesses, but their capacity to refinance may depend on market conditions at the time of refinancing.	Firms with a strong financial profile complemented by well spread-out debt maturities, little currency or interest rate risks, and few restrictive debt covenants. We expect these firms to have uninterrupted access to financial markets at market conditions under most circumstances.

We choose to assess refinancing profiles against moderate stress conditions. This is because we observe that all firms, irrespective of their credit quality, may find access to financial markets to be challenging under extreme financial market conditions, such as those seen during the Great Financial crisis.

2.6 Country risk

Country risk represents the risk of doing business in a country. All things equal, a company exposed to significant country risk would have a lower rating than one operating exclusively in stable and favourable jurisdictions. However, the absence of country risk does not contribute to a better rating than the rating indicated by the scorecard.

EthiFinance Ratings looks at many sources of information to assess country risk, including the country risk assessments provided by credit insurers Coface[1] and CESCE[2]. The assessment of country risk considers the macroeconomic and political environment, fiscal and regulatory risks, transfer risk, the application of the rule of law in business (e.g., property rights, contracts, financial distress, insolvency) as well as safety issues.

If a company operates in one country, and all sales are generated there, its rating will be capped to the sovereign rating of that country. If a company operates in several countries, EthiFinance Ratings

[1] https://www.coface.com/Economic-Studies-and-Country-Risks

[2] https://www.cesce.fr/en/w/country-risk

will evaluate the overall country risk proportionately to its business activities in these countries, provided they exceed 10% of the fair value of assets. Generally, operating in risky jurisdictions will severely limit the rating. There may be rare situations where some flexibility could be granted, particularly if a company is highly diversified geographically.

2.7 Other considerations

Other specific considerations may relate to potential M&A operations which may not have been analysed through the financial risk profile. Likewise, financially stressed companies may not always be easily identified through standard credit metrics, which may justify additional denotching. Another significant consideration may relate to ESG criteria.

This document updates the previous version while preserving its original methodological criteria; therefore, all existing ratings remain unchanged. In this version, the format has been updated and includes a higher level of detail.