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Spread Research: Investment Holding's Corporate Rating Methodology

INTRODUCTION

The investment holding methodology is derived from our global rating methodology. It is based on the analysis of qualitative and quantitative factors which are influencing both the business and the financial risk profile. In addition, specific considerations are added to determine the ultimate corporate credit rating of the investment holding.

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 that are typically not related to each other. In that sense, it is different from a conglomerate, which is a group of companies acting with a defined global strategy, synergies, and financial links.

The holding entity's purpose can be family wealth management or to be a platform for financial investments.

OVERVIEW OF THE METHODOLOGY

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 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.

We assess the rated entity following the methodological approach on which our global rating methodology is based. The first step is the analysis of the issuer's business risk and financial risk profiles.

BUSINESS RISK PROFILE

The business risk profile relates to the entity's investment policy and analysis of its portfolio of investments. The latter is split into five subsections: diversification by asset value, industry, and geography, liquidity of assets and their credit quality.

FINANCIAL RISK PROFILE

The financial risk profile depends on the financial policy, funding structure, and leverage.

BUSINESS RISK PROFILE

Investment policy
- Investment policy

Portfolio of investments
- Diversification by value
- Diversification by industry
- Diversification by geo-

FINANCIAL RISK PROFILE

Financial policy
- Financial policy

Leverage & coverage
- Interest coverage
- Loan to value

We analyse each segment of the business and financial risk profiles. Some of these key elements can be split into subsections with their own specific weights. The rating is driven by a weighted average rating from all the sections.

Certain specific considerations can also have a significant impact on the rating. It can either cap the rating (i.e. country risk) or influence it. The final decision about the assignment of the investment holding corporate rating remains subject to the Rating Committee's decision based on a case-by-case specific assessment.

SPECIFIC CONSIDERATIONS

- Country risk
- Transparency
- Corporate Social Responsibility
- Off the chart features
- Event risk
- Liquidity

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 value, industry, and 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).

BUSINESS RISK PROFILE

INVESTMENT POLICY
- Investment policy (10%)

PORTFOLIO OF INVESTMENTS
- Diversification by value (5%)
- Diversification by industry (5%)
- Diversification by geography (5%)
- Liquidity (10%)
- Credit quality (15%)

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).

PORTFOLIO OF INVESTMENTS

The holding's investment portfolio is the most important element in the determination of the credit rating. The purpose of the investment holding 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:

Diversification by value. 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 that resulted 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 in the reduction of 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 the reduction of the investment holding's net debt.

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

Diversification by industry. Based on the individual valuation of each of the portfolio investments, we assess the diversification by aggregating by industry the valuation of each investment. We view a broadly equal-weight split of a portfolio in 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.

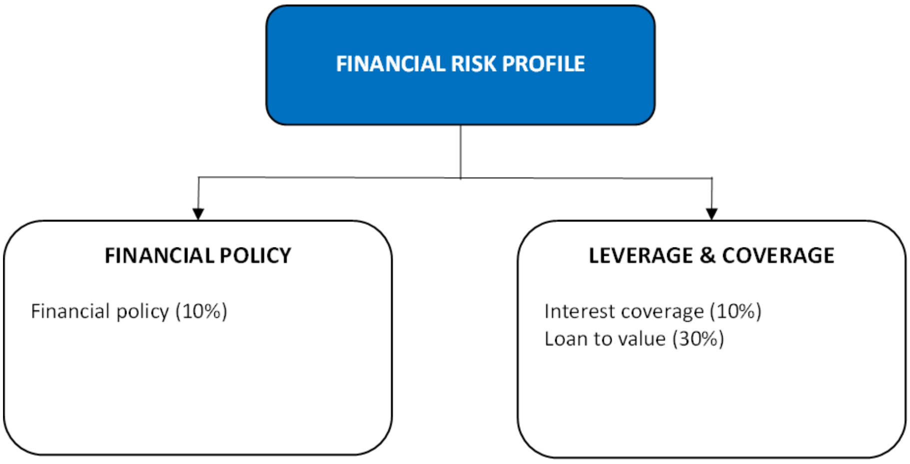
Diversification by geography. The approach is similar to the diversification by industry, aggregating individual valuation into geographies. We take into account the absolute size of the geographic area as well as the degree of correlation between the areas.

Liquidity of 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.

Credit quality of assets. The financial strength relates to the respective credit quality. The average credit quality is calculated based on 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 general corporate rating methodology. 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 activity.

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'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'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).



FINANCIAL POLICY

The financial policy relates to the financial situation of the investment holding. 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) and an understanding of the historical evolution (i.e. a high loan-to-value can result either from a drop in the investments' value or aggressive financing from day one).

FUNDING STRUCTURE

The funding structure is analysed with regard to the fixed charge coverage of the investment holding and its liquidity profile.

<u>Interest coverage</u>: We calculate the fund from operation before interest expenses. It typically consists of dividends, management fees, and intercompany loan interest incomes. For the calculation of the ratio, we add dividends paid by the investment holding to interest expenses if they arise from a need for dividends by the investment holding's shareholders (i.e. when the parent company has debt resulting in the need of 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.

LEVERAGE

In contrast to a typical leverage of a corporate entity (usually net debt/EBITDA or a gearing ratio), we assess an investment holding's leverage as its net debt divided by the value of the investment portfolio. The investment holding'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 to the debt (which is unusual). The value of the investment portfolio is the addition of the valuation 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 peers 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'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.

APPLICATION TO THE RATING GRID AND OTHER DRIVERS OF THE RATING

All the key elements of our analysis presented above are incorporated in our rating grid. From this rating grid we derive an indicative rating. However, specific considerations are also taken into account by the Rating Committee and can result in the rating being substantially different from the rating grid indicative rating.

SPECIFIC CONSIDERATIONS

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Country risk
Transparency
Corporate Social Responsibility
Off the chart features
Event risk
Liquidity

These other considerations are generally more qualitative (i.e. management track record, corporate governance, transparency, country risk, corporate social responsibility) than the key elements, which are by nature more quantitative (except for the investment and financial policy).

This can also be the reflection of a key element that has an 'off-the-chart' feature. In this case, it might warrant having a higher or lower weight than stated in the rating grid for the rating determination. Additionally, it can be a developing special situation, such as a period of liquidity stress that could potentially trigger material negative events (i.e. covenant breach, margin call). More generally, liquidity is taken into account in our assessment.

Ultimately, the decision about the assignment of the corporate rating is the prerogative of the Rating Committee. The decision is based on a specific case-by-case assessment.

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