Short-term Rating Methodology

Published on:

04 March 2022

This document provides an overview of the approach taken by EthiFinance Ratings (EFR) when assigning short-term ratings.

With this updated methodology, we present further refinements and clarifications in order to provide additional transparency and clarity regarding our methodology. Among other areas, this update gives further details on the following items:

- The transition matrix between long-term and short-term ratings is disclosed and explained throughout the methodology for further transparency.
- We made some minor editorial changes in order to give further details on our methodology and we provided examples for how some specific cases are treated under this methodology.
- Notably, we replaced the notion of 'credit outlook' by the notion of 'credit metrics expected evolution (CMEE)', to avoid any confusion with the notion of 'rating outlook'.
- We separated the rating process from the rating methodology

None of the above modifications changes any of EthiFinance Ratings' existing short-term ratings.

We also introduced the notion of 'ratings under review'. This is not expected to impact our existing short-term ratings.

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1 Framework and rating scale

1.1 Short-term rating

EthiFinance Ratings' short-term ratings are a measure of an issuer's ability to fulfill its debt-related payments over the next 15 months.

More specifically, EthiFinance Ratings' short-term ratings are usually used to assess the risk of short-term instruments that are mostly unsecured and have a maturity less than 15 months. Such instruments include commercial paper, short-term notes, or long-term notes close to maturity.

Although long-term ratings give an overall assessment of the credit quality of the issuer, they are not necessarily able to capture specific short-term risks.

In some cases, issuers with high long-term ratings may have a greater short-term risk vis-a-vis long-term lower rated issuers for various reasons. The main reason is that large and well-known issuers may be used to funding themselves in the short-term market when market confidence allows them to achieve lower interest rates through the issuance of rolling short-term instruments. On the flipside, long-term, lower rated companies may attempt to fund themselves on a longer-term basis when they know that the capital markets or banks will not always be open to lend them money. Moreover, short-term ratings are linked to the level of cash set aside as an operating cash flow buffer, amounts which may differ widely across sectors.

EthiFinance Ratings has identified three important parameters impacting short-term ratings:

- the long-term rating which is covered by a specific methodology

https://files.qivalio.net/documents/compliance/long-term-methodology-04March2022.pdf

- the liquidity risk (see definition below);
- the credit metrics expected evolution (CMEE).

EthiFinance Ratings' short-term ratings are assigned assuming a single corporate entity and a single class of debt, regardless of structural or contractual considerations. Consequently, EF's ratings apply to consolidated groups for which audited consolidated accounts are available for the ultimate consolidating holding company. Debt located at the holding level (e.g. PIK), above the consolidated group, may be factored in on a case-by-case basis depending upon the degree of protection offered by group covenants against cash leakage to service such debt.

1.2 Instrument rating

Unless subject to specific conditions, all short-term instruments have the same short-term rating, which is assumed to be similar to the corporate short-term rating. As such, when EthiFinance Ratings assigns a short-term rating to an instrument, such as a NEU CP program, it usually does not specify the short-term corporate rating.

1.3 Rating scale

Our short-term ratings are split using the following grid:

Rating	Description	Category
SR0	Very low short-term risk, and very strong ability to reimburse short-term debt.	Low risk
SR1	Low short-term risk linked to the issuer's ability to anticipate short-term funding risks.	
SR2	Moderate short-term risk linked to potential external risks.	
SR3	Medium short-term risk. The issuer's ability to reimburse its short-term debt may be hampered by external or specific risks.	
SR4	High short-term risk.	High-risk
SR5	Very high risk /In or out-of-court restructuring.	
SRD	Defaut on the short-term debt.	

EthiFinance Ratings defines a default as either i) a missed payment (post-grace period) on a coupon or the debt principal, ii) an in-court restructuring with a failure to fulfill financial obligations, or iii) a liquidation.

2 Liquidity analysis

Liquidity is key for an issuer to operate both in good times and even more importantly in times of stress.

EthiFinance Ratings' liquidity analysis results in a score of 0, 1, 2 or 3, based on the result of a combination of both quantitative and qualitative analysis as illustrated by the table below.

		Liquidity analysis stressed scenario			
		3 years	2 years	1 year	0 year
Refinancing profile	Solid financial profile / Virtually no issues expected to refinance	3	3	3	1
	Medium financial profile / Refinancing not expected to be an issue but may depend on the conditions in financial markets at the time of refinancing	3	2	2	1
	Low financial profile / refinancing may be challenging or at a very expensive conditions	3	2	1	0

2.1 The quantitative driver: the liquidity analysis - stressed scenario

The quantitative analysis is a measure of how long an issuer can finance its operations assuming that access to both equity and debt capital markets is closed. It is measured on a scale of '0' to '3' years, and one on the refinancing profile:

- 0 year: the issuer has insufficient liquidity to face its debt obligations in the coming years, and/or may run out of liquidity due to cash burn or covenant breach deriving from an issuer-related situation and not a macro-economic situation;
- 1 year: the issuer can meet its debt obligations for the coming year;
- 2 years: the issuer can meet its debt obligations for the coming two years;
- 3 years: the issuer can meet its debt obligations for at least the coming three years.

The liquidity analysis is based on EthiFinance Ratings' own forward-looking covenant computations and financial forecasts which enable us to assess the balance between an issuer's projected sources and uses of funds.

Sources of funds considered by EthiFinance Ratings include unrestricted cash, undrawn committed credit facilities with expiry > 1 year and FCF (FFO post-working capital + capex + lease repayments). EthiFinance Ratings typically excludes from its assessment restricted cash, the minimum level of cash required to run the business (when available, alternatively we may use the historically lowest quarterly cash level exhibited or a percentage of turnover), uncommitted credit facilities, and asset disposals (if already agreed upon). EthiFinance Ratings also factors in new debt issued at the time of the analysis.

Uses of funds considered by EthiFinance Ratings include acquisitions already agreed upon or being part of the company' strategy and therefore probable, dividends, and debt maturities.

The liquidity score is adjusted for the potential impact of a covenant breach.

Until Q3 in a fiscal year; the liquidity score captures the remaining quarters left during that year as well as the two following fiscal years. In Q3, the starting point of the assessment shifts to the beginning of the following fiscal year and captures the three fiscal years thereafter.

The qualitative analysis reflects the issuer's refinancing profile, which is its ability to refinance its debt based on its financial profile, among other things. The refinancing profile assessment is divided into three possible outcomes: i) Very high financial profile / Virtually no issues expected to refinance, ii) Medium financial profile / Refinancing not expected to be an issue but may depend on the conditions in financial markets at the time of refinancing, and iii) Low financial profile / refinancing not guaranteed.

2.2 The qualitative driver: the refinancing profile

By introducing the notion of a refinancing profile, EthiFinance Ratings values companies which have a very high financial profile and virtually no issues to refinance their debt by assigning them a score of 3/3, independently from the liquidity analysis under a stressed scenario, with the exclusion of a score of '0 year' which EthiFinance Ratings believes is not commensurate with a very strong financial profile. Conversely, companies which have a very weak financial profile and therefore no refinancing guaranteed are basically assessed through the stressed scenario only.

3 The credit metrics expected evolution (CMEE)

The credit metrics expected evolution (CMEE) - formerly labelled credit outlook in past methodologies- is EthiFinance Ratings' indication of where the credit metrics of an issuer are heading within a 12-month timeframe. The CMEE can be Positive, Stable or Negative. The CMEE directly derives from EthiFinance Ratings' forecasts used during the financial analysis when assigning ratings.

Please note the CMEE is different and not correlated to the notion of rating outlook, which is a measure of the likelihood of a rating change.

4 The transition matrix between long-term ratings and short-term ratings

The following chart provides an indication of the mapping between different ratings and criteria, although the credit committee remains free not to follow these guidelines under specific circumstances, linked to a lack of information, for instance.

EthiFinance Ratings

EFR LT rating	CMEE	Liquidity index 3	2	1	0
AAA	Stable	SR0			
AAA	Negative				
AA+	Positive				
AA+	Stable				
AA+	Negative				
AA	Positive				
AA	Stable				
AA	Negative				
AA-	Positive				
AA-	Stable				
AA-	Negative				
A+	Positive				
A+	Stable				
A+	Negative				
A	Positive				
A	Stable				
A	Negative	SR1			
A-	Positive				
A-	Stable				
A-	Negative				
BBB+	Positive				
BBB+	Stable				
BBB+	Negative				
BBB	Positive				
BBB	Stable		SR2		
BBB	Negative				
BBB-	Positive				
BBB-	Stable				
BBB-	Negative			SR3	
BB+	Positive				
BB+	Stable				
BB+	Negative				
BB	Positive				
BB	Stable				
BB	Negative				
BB-	Positive				
BB-	Stable				
BB-	Negative				
B+	Positive				
B+	Stable				
B+	Negative	SR4			
B	Positive				
B	Stable				
B	Negative				
B-	Positive				
B-	Stable				
B-	Negative				
CCC+	P/S/N				
CCC	P/S/N				
CCC-	P/S/N				
CC	P/S/N	SR5			
C	P/S/N				
D	P/S/N	SRD			

5 Specific considerations

In some specific cases, EthiFinance Ratings may override the transition matrix if it seems more accurate to do so. For instance, if an issuer has a level of cash more than several times its short-term debt or overall debt, the scorecard of its long-term rating combined with the transition matrix may still place it in the SR1 category. However, the rating committee may decide that the excess cash position is commensurate with an SR0 rating as there is very low short-term risk.

6 Ratings under review

When an event of such nature that it could change the rating of a company occurs, but EthiFinance Ratings lacks information or needs further analysis to review its rating, thereby preventing an immediate reaction, EthiFinance Ratings may decide to put the rating under review. The label 'under review' is a temporary classification by which EthiFinance Ratings may inform stakeholders of a potential upcoming rating action. When a rating is put under review, the current rating remains valid until the next rating action. Ratings can be under review for upgrade, downgrade, or in some rare cases, uncertain. Unlike outlooks, ratings under review will usually result in a rating action from one to 2 months after the review has been announced, but may sometimes last longer when EthiFinance Ratings is expecting further guidance and information in order to assign its ratings. Events which usually trigger such reviews are mergers, acquisitions, disposals of a significant part of a company, significant unforeseen change in the financial situation of a company or its operating environment. Ratings under review may result in an upgrade, a downgrade or no change at all for the rating, based on work performed by EthiFinance Ratings' analysts.