Request for comments

January 2022

RAEX-Europe invites market participants to provide comments on the proposed changes in the Methodology of assigning corporate credit ratings. During the Methodological Committee Meeting held on the 29th of December 2021 two core proposals in the Methodology were discussed and approved by the independent members of the Advisory board. These proposals will lead to the following changes in the Methodology in the part of the assessment of debt and profitability ratios:

1) **We propose to change the debt ratios in the Methodology for assigning corporate credit ratings:**

- *Total debt load level*

Benchmarks for the indicators of total debt load (continuous assessment for all indicators)

Coefficient	**Benchmarks / score**	
	1	**-1**
FFO leverage*	Less than 2	More than 10
Net FFO leverage*	Less than 2	More than 8
CFO leverage*	Less than 2,5	More than 14,5
FCF to total debt*	More than 10%	Less than 0%
Debt to EBITDA*	Less than 1	More than 7,5
Net debt to EBITDA*	Less than 0,5	More than 7

*Adjusted ratios must be used in case there is a large amount of shareholder loans or other type of quasi-capital.

Formulas for the calculation of debt ratios:

1. **FFO leverage** = *total debt + debt-like leases + guarantees / (Funds from operations (FFO) + net interest + paid dividends);*
2. **Net FFO leverage** = *total debt + debt-like leases + guarantees – cash & cash equivalents / (FFO + net interest + paid dividends);*
3. **CFO leverage** = *total debt + debt-like leases + guarantees / (Cash Flow from Operations (CFO) + net interest + paid dividends);*
4. **FCF to total debt** = *FCF + net interest + paid dividends / (total debt + debt-like leases + guarantees);*
5. **Debt to EBITDA**= *total debt + debt-like leases + guarantees / Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA);*
6. **Net debt to EBITDA**= *total debt + debt-like leases + guarantees – cash & cash equivalents*

/ EBITDA.

Formulas for the calculation of adjusted debt ratios:

1. **Adjusted FFO leverage** *= total debt - quasi-capital + debt-like leases + guarantees / FFO + net interest + paid dividends;*
2. **Adjusted Net FFO leverage** *= total debt - quasi-capital + debt-like leases + guarantees – cash & cash equivalents / FFO + net interest + paid dividends;*
3. **Adjusted CFO leverage** *= total debt - quasi-capital + debt-like leases + guarantees / CFO + net interest + paid dividends;*
4. **Adjusted FCF to total debt** *= FCF + net interest + paid dividends / total debt - quasi-capital + debt-like leases + guarantees;*
5. **Adjusted Debt to EBITDA**= *total debt - quasi-capital + debt-like leases + guarantees / EBITDA;*
6. **Adjusted Net debt to EBITDA**= *total debt - quasi-capital + debt-like leases + guarantees – cash & cash equivalents / EBITDA.*

- *Interest and short-term debt coverage*

Benchmarks for the indicators of current level of the debt load.

Coefficient	Benchmarks / score	
	1	-1
EBITDA-to-interest coverage ratio*	More than 15	Less than 1,5
FFO-to-interest coverage ratio*	More than 10	Less than 1,5
Short-term debt to EBITDA*	Less than 0,5	More than 2
Short-term debt to FFO*	Less than 1,2	More than 5
FCF to total short-term debt*	More than 10%	Less than 0%

*Adjusted ratios must be used in case there is a large amount of shareholder loans or other type of quasi-capital.

Formulas for the calculation of interest and short-term debt coverage ratios:

1. **EBITDA-to-interest coverage ratio** = *EBITDA / financial expenses;*
2. **FFO-to-interest coverage ratio** = *FFO + net interest + paid dividends / financial expenses;*
3. **Short-term debt to EBITDA** = *Short-term debt / EBITDA;*
4. **Short-term debt to FFO** = *Short-term debt / FFO + net interest + paid dividends;*
5. **FCF to total short-term debt** = *FCF + net interest + paid dividends / short-term debt.*

Formulas for the calculation of adjusted interest and short-term debt coverage ratios:

1. **EBITDA-to-adjusted interest coverage ratio** = *EBITDA / financial expenses + interest on quasi-capital;*
2. **FFO-to-adjusted interest coverage ratio** = *FFO + net interest + paid dividends / financial expenses + interest on quasi-capital;*

3. **Adjusted short-term debt to EBITDA** = *short-term debt + short-term quasi-capital / EBITDA;*
4. **Adjusted short-term debt to FFO** = *short-term debt + short-term quasi-capital / FFO + net interest + paid dividends;*
5. **FCF to adjusted short-term debt** = *FCF + net interest + paid dividends / short-term debt + short-term quasi-capital.*

2) **We propose to change the profitability ratios in the Methodology for assigning corporate credit ratings:**

Profitability indicators shall be assessed on the basis of the benchmarks listed in the table below, continuous assessment.

Indicator	**Benchmarks / score**	
	1	**-1**
Return on assets based on the adjusted profit (ROA*), %	More than 5%	Less than -1%
Return on equity based on the adjusted profit (ROE*), %	More than 15%	Less than -3%
FFO Margin	More than 10%	Less than 0%
EBIDTA margin, %	More than 15%	Less than 0%
EBIT margin, %	More than 10%	Less than 0%

If the capitalization ratio[1] of the rated entity as of the reported date is less than 10%; the score for the indicator ROE* shall be equalized to the ROA* for the same period.

Formulas for the calculation of profitability ratios:

1. **Return on assets based on adjusted profit (ROA*)** = *adjusted net profit of the rated entity for the period / average assets at the beginning and end of the correspondent period;*
2. **Return on equity based on adjusted profit (ROE*)** = *adjusted net profit of the rated entity for the period / average equity at the beginning and end of the correspondent period;*
3. **FFO margin** = *FFO for the period / revenues from sales for the period;*
4. **EBITDA margin** = *EBITDA for the period / revenues from sales for the period;*
5. **EBIT margin** = *EBIT for the period / revenues from sales for the period.*

Rationale:

1. Most of the ratios we used in the methodology were outdated and not standard according to what is used by the financial analysts in general. Thus, we decided to change the debt and profitability ratios in order to have the same as other financial analysis firms and, thus, be able to make comparisons.

2. We also decided to add and put more emphasis on more cash flow focused ratios. As a credit rating agency, our priority is to assess the capacity of debt repayment; therefore, our focus should be more on cash flow debt ratios and less on balance sheet debt ratios.

[1] The capitalization ratio is calculated as a ratio of equity of the rated entity to total assets.

3. Weights were reassigned evenly when ratios were split.

4. Benchmarks were recalculated based on a quick calibration on our curr ent ratings. Not much changes in the benchmarks were noted.

Please submit your comments to: info@raexpert.eu or compliance@raexpert.eu by the 11.02.2022. Your response to this consultation will be published unless confidentiality is requested.