

Rating Debt Instruments in Corporate Finance: Structural Considerations

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Preface

The purpose of this methodology is to explain and elaborate Midroog's approach to the examination of structural considerations when rating issuers and debt instruments in the field of corporate finance that could affect the creditworthiness of the issuers and debt instruments or mitigate expected loss given default (LGD). Structural considerations of this type could include collateral backing debt instruments, guarantees, external support for the issuer or debt instrument, and other extraordinary structural terms that could characterize debt instruments. This report was designed to reflect the main qualitative and quantitative considerations that Midroog employs when examining the influence of structural considerations on the rating of issuers and debt instruments, and can serve companies, investors and other interested parties in the market as a tool to understand how quantitative and qualitative elements can influence the rating of debt instruments and companies. This methodology applies exclusively to corporate ratings, not to finance companies or debt instruments they issue. We note that in Midroog's view, rating subordinate debt in the field of corporate finance (including hybrid instruments and preferred shares) is described in the designated methodology¹. Also, Midroog's approach to rating subordinate debt of banks and insurance companies is described in the relevant methodology for the type of assets underlying the rating. The report does not include a thorough discussion of all the elements embodied in the rating, but is designed to enable the reader to understand the qualitative considerations, the information and the financial ratios that are usually significant and of the utmost importance when examining structural considerations when rating issuers or debt instruments issued by nonfinance companies. In the course of the rating process, individual business and financial parameters of each and every issuer and debt instrument are examined, based on their specific characteristics. Therefore, the rating of a specific issuer or debt instrument may be influenced by other parameters and assessment methods that cannot be anticipated in advance.

The Issuer Rating as an anchor for rating the specific liabilities of the issuer

Midroog's ratings for debt instruments and corporates reflect Midroog's assessment of the creditworthiness of these debt instruments or issuers, which can be presented as the multiple of the probability of default and LGD. That said, Midroog's credit ratings are not intended to represent a cardinal scale of probability of default and LGD. In its ratings, Midroog aspires to reflect the expected credit losses using a (relative) ordinal ranking, meaning that the EL at lower ratings will be higher than the EL at higher ratings. In compliance with Midroog's rating definitions, an Issuer Rating is Midroog's assessment of the issuer's ability to meet its unsecured preferred senior financial liabilities (hereinafter: "**Issuer Rating**" or "**senior unsecured debt**"). As such, the Issuer Rating is designed to reflect the creditworthiness of the issuer compared to other local issuers, without distinction of the structural characteristics of specific debt instruments. The rating methodology for rating issuers in the various industries is described in the relevant rating methodology reports.

¹ See "Rating Subordinate Debts, Hybrid Debts and Preferred Shares in Corporate Finance", Methodology Report, June 2017.

An Issuer Rating may reflect considerations of external support, to the extent that it applies to all the issuer's liabilities.

When debt instruments issued by the issuer have characteristics that Midroog believes may significantly reduce or significantly increase the creditworthiness of the debt instrument relative to the issuer's creditworthiness, or, specifically, to the EL upon default, relative to the EL of senior unsecured debt, Midroog may decide to notch up or notch down the rating of the specific debt instrument relative to the Issuer Rating/rating of the unsecured senior debt, which is the anchor rating of all of the company's liabilities, based on quantitative and qualitative considerations that Midroog shall consider, as elaborated below. Note in this context that the considerations for a rating distinction between debt instruments of issuers defined by Midroog as being in default are described separately in the methodology for rating corporations and debt instruments in default².

Notching up liabilities backed by collateral

Notching up financial liabilities backed by collateral will be examined based on our assessment of the strength of the collateral and the extent to which it could mitigate Expected Loss (EL) for the liability holder in the event of default, relative to the EL of the issuer's senior unsecured debt. Notching up secured liabilities issued by issuers at relatively higher ratings shall be considered based on stringent criteria relative to secured financial liabilities issued by issuers at lower ratings, given that issuers at higher ratings are assessed by Midroog as being highly creditworthy, and in any case are farther from circumstances of default. Therefore, the degree of confidence regarding the structure of these issuers' assets and liabilities upon default remains low (and with it, the ability to assess LGD). Also, Midroog believes that the degree of improvement to the rating, arising from collateral alone, to the Issuer Rating/unsecured senior debt should be limited. Midroog therefore caps notching for secured financial liabilities in the case of issuers/unsecured senior debt at A2.il (inclusive). Issuers with ratings higher than that generally will not be notched up for liabilities secured by collateral. If Midroog believes, based on the criteria set forth in this methodology, that the characteristics of the collateral do not supply the strength required to warrant notching up the debt instrument backed by this collateral, it will apply the Issuer Rating to the debt instrument. Also, as described above, the Issuer Rating represents the credit risk of all the issuer's liabilities, as though they were a single thing, without distinguishing the structural characteristics of the various liabilities. As such, when Midroog rates a financial instrument similar in its structural characteristics to most of the company's debt instruments, this instrument will not be notched up: its rating will be identical to the Issuer Rating. For example, when most of the issuer's financial debt is backed by a similar type of collateral (for instance in industries where borrowing is normally contingent on collateral alone), the rating of a specific financial instrument will not be notched up because of the collateral, and Midroog will apply the Issuer Rating to it.

Notching down a rating because of structural subordination

On the other hand, when debt instruments have characteristics that make them structurally subordinate to the issuer's senior unsecured liabilities, Midroog may consider notching down relative to the Issuer

² See "Rating Debt Instruments in Default and Impaired Debt Instruments", Methodology Report, July 2017.

Rating/senior unsecured debt, to create an appropriate distinction regarding higher EL for the debt instrument relative to the issuer's senior unsecured liabilities. The considerations for rating subordinate debt in corporate finance, including rating hybrid debts and preferred shares, are described in a separate methodology³. Also, the considerations when rating subordinate debts issued by banks or insurance companies are presented in the relevant rating methodology for those entities.

External support as a factor mitigating credit risk

Another structural characteristic for which Midroog may consider notching up is the existence of external support for the issuer, which could mitigate the issuer's credit risk. In contrast to structural characteristics of a specific debt instrument that could bear influence, for better or worse, on the recovery rate of the debt instrument in the event of default, external support is usually taken as a factor that could mitigate the default risk of the supported issuer or specific debt instrument, and in extreme cases, isolate the issuer from its inherent risks. Expressions of support mechanisms could include a full legal guarantee, partial guarantee, statement of support, or even tacit support. In such and other cases, Midroog will consider the influence of the external support on the Issuer Rating and/or the rating of the debt instruments issued by it based on its assessment of the probability of support, going by the criteria set forth in this methodology. The external support may influence the issuer's rating and all the debt instruments it issues, or a specific debt instrument, depending on its characteristics and terms. In the case of rating banks or government related issuers, support for the rated corporation or debt instrument – by the state or a parent company (in the case of banks owned by a parent company if it is a financial institution) – is examined using methodologies based on the Joint Default Analysis model, which is a model designated for these corporations, and which is separate from this methodology. For elaboration, see the methodology reports "Model for Joint Default Analysis and its Application to Rating the Banks" (March 2016), and "Rating a Government-Related Issuer" (March 2015).

Notching up for financial liabilities backed by collateral

Table 1 below shows the height of notching up that Midroog may determine for a secured debt instrument relative to the Issuer Rating (hereinafter: including senior unsecured liabilities), depending on the rating level of the issuer. For rising levels of Issuer Ratings, the table shows a rising minimum threshold (from right to left) of the recovery ratio and collateral quality as estimated and assessed by Midroog. We stress that the parameters and ranges are just guidelines, not rigid definitions. The considerations described in the table for the various parameters (qualitative and quantitative) relate to notching by one notch. As shown in Table 1, at relatively low rating levels, notching for collateral may be greater than one notch, and in such cases, the required threshold for the different parameters may be higher. The table also shows the main considerations when examination notching for the collateral, as also elaborated below, but not all the considerations that Midroog may make when setting a rating. There may be special circumstances associated with specific characteristics of the collateral, or other

³ See "Rating Subordinate Debts, Hybrid Debts and Preferred Shares, Corporate Finance", Methodology Report, July 2017.

terms of the debt instrument that will be examined on a case by case basis, at the discretion of the rating committee.

Table 1: Guidelines for Notching Debt Instruments Backed by Collateral

Issuer Rating/senior unsecured debt		A2.il	A3.il	Baa1.il	Baa2.il	Baa3.il	Ba1.il	Ba2.il	Ba3.il and below
Collateral characteristics:	Collateral quality*	High			Moderate and above				Moderate**
	LTV	<50%	<55%	<60%	<65%	<70%	<75%	<80%	<90%
Estimated effect on EL	Recovery ratio***	>1.7		>1.6			>1.5		>1.4
Notching up Issuer /senior unsecured debt rating		+1					+1-2		+1-3

* According to Table 2 below.

** In some cases, weak collateral may also suffice.

*** Recovery ratio as defined below.

**** Under special circumstances related to the special characteristics of the collateral, additional considerations may be made, at the discretion of the rating committee.

The rating of the issuer/senior unsecured liabilities as an anchor for notching for collateral

As described above, the Issuer Rating reflects Midroog's assessment of the issuer's ability to meet all its liabilities as though they were one thing, without dependence on the structural characteristics of the various types of liabilities, and usually, the rating of senior unsecured liabilities will be identical to the Issuer Rating. The Issuer Rating therefore constitutes an anchor for rating the issuer's senior unsecured debt instruments, and the point of origin for notching secured debt.

Issuers with high ratings are characterized, in Midroog's view, as being highly creditworthy relative to issuers at lower ratings, and as such, default is accorded low probability. Accordingly, the required threshold for notching for a secured debt instrument will be higher for issuers with higher ratings. Moreover, Midroog limits the degree of notching at higher ratings to one notch, and usually avoids notching at relatively high rating levels (A1.il and up). This consideration stems, among other things, from the degree of confidence regarding the structure of the assets and liabilities of relatively highly rated issuers, upon default, still being low (and with it, the ability to estimate LGD).

In the context of Issuer Ratings, note that attaching assets as collateral for financial assets may impair the issuer's financial flexibility, and if the extent of attached assets is large relative to the issuer's total debt, the issuer's credit risk increases.

Assessing the quality of the collateral as a cushion for secured debt

Providing collateral to back financial assets is designed to supply investors with a designated safety cushion, aspiring for it to mitigate expected LGD. Assessment of collateral quality as a parameter when examining notching up secured debt is meant to examine the stability of the collateral over time as a source on which the debt-holders can rely. Table 2 below shows the main parameters by which Midroog assesses collateral quality, in three categories: "strong" quality, "medium" quality and "weak quality. When examining collateral quality, Midroog uses considerations related to the characteristics of the

asset itself, such as the strength of the cash flow it produces, the stability of its value, and its tradability. Midroog also uses considerations related to the characteristics of the asset's economic, business and legal environment.

Table 2: Main Parameters in Assessing Collateral Quality

Strong	Medium	Weak
Generates strong, stability cash flow	Generates relatively weak, fluctuating cash flow	Generates no cash flow
Asset value is relatively stable	Asset value likely to undergo moderate fluctuation	Asset value is highly volatile
Asset has a high level of tradability/sellability in a relatively short period of time	Asset has a medium level of tradability/sellability over a medium period of time	The asset's tradability is low and selling it will take a long time
Economic environment is relatively stable	Economic environment is moderately stable	Stability of the economic environment is low
Very stable legal environment, legal system's actions can be anticipated with high confidence	The stability of the legal environment is moderate, medium confidence in anticipating the legal system's actions	Low level of stability in the legal environment, low confidence in anticipating the legal system's actions
The legal structure of the collateral is strong (e.g., first lien) and the complexity of the debt instrument's terms is low	The legal structure of the collateral is at the second level of subordination and the complexity of the debt instrument's terms is relatively moderate	The legal structure of the collateral is at a high level of subordination, constituting deferred debt from the collateral cash flow and the terms of the instrument are highly complex
Existing rights to the collateral cannot be changed	"Degradation" of the rights to the collection at a medium level of confidence	"Degradation" of the rights to the collection at a high level of confidence

The recovery ratio as a measure of the degree of support for the asset in mitigating LGD relative to the issuer's other liabilities

The recovery ratio as measured by Midroog is designed to constitute an estimate of the degree of support the collateral provides in mitigating LGD, relative to the EL of holders of senior unsecured debt, and consequently, the degree to which the collateral warrants notching. The recovery ratio estimates the asset's coverage ratio against the secured debt compared with the coverage ratio of all the issuer's liabilities. This ratio is supposed to reflect the gap between the existing recovery rate for the financial asset backed by the collateral and the existing recovery rate for unsecured debt. The greater this gap, the higher the expected recovery rate in the ratio between the unsecured debt and the debt backed by collateral and under some circumstances, can create distinctions in risk levels between the different

debt instruments. The recovery ratio is examined under a sensitivity scenario for the value of the collateral, also factoring in that if the state of the issuer deteriorates, it will attest to possible erosion in the value of its assets. The sensitivity scenario will also factor in that selling the asset under circumstances of financial distress may also erode its value.

The recovery ratio is calculated as follows, depending on the sensitivity scenarios elaborated in the rating report:

$$\text{Recovery ratio} = \frac{V/L}{A_{\text{residual}}/L_{\text{Unsecured}}}$$

Where:

V – Value of the collateral after sensitivity

L – Volume of secured debt

A_{residual} – Balance of total assets less debts on them

L_{Unsecured} – Volume of unsecured debt

External support for an issuer or debt instrument

General

In ratings of issuers or debt instruments issued by corporations that are nonbank and not government related issuers, we may check existing support mechanisms for the issuer/debt instrument from external parties to the company, such as the parent company, controlling shareholder, or partners as a factor that mitigates credit risk and improves the rating. In the framework of determining the weighting given in the rating for the external support mechanism for the rated entity, we distinguish between support given by way of legal guarantee and support given by way of other support arrangements, which are usually considered to be of inferior quality to legal guarantees. Beyond examining the nature and strength of the support arrangement, we shall also examine the credit quality of the supporting entity and its willingness to provide support when needed.

External support backed by full legal guarantee

Guarantees are enforcement agreements under law that are designed to prevent default by the guaranteed party and require the guarantor to make payment if the guaranteed party fails to. Assuming that the guarantee is valid throughout the lifetime of the liability it backs, is not conditional and is irrevocable, and on condition that it requires immediate payment to creditors on time and in full before actions of curing and compensation, and is not constrained by any legal protections, the guarantee may constitute a credit substitution. Midroog will examine the strength and quality of the guarantee on a case by case basis, depending on the guarantee's terms and constraints. When Midroog assesses that the guarantee isolates the investors from the issuer's credit risk and thus constitutes a full credit

substitution, the rating of the issuer and/or the debt instrument it issued will usually be determined according to the guarantor's rating, whether or not Midroog rated the issuer on a stand-alone basis. Additional considerations taken into account include the degree to which the support commitment influences the guarantor's rating, and whether this commitment could undermine the guarantor's credit quality. Midroog will also examine the business and financial ties between the guarantor and the guaranteed party, and the degree to which deterioration in the state of the guaranteed party could in and of itself affect the guarantor's credit quality (for instance, when there are strong mutual business relationships between the guarantor and the guaranteed party).

External support not backed by legal guarantee

External support mechanisms may come in different forms and include different types of agreements under which the supporting entity undertakes to supply a specific kind of support, usually limited, to the supported entity. These agreements usually do not require from the supporting entity to supply full payment on time in the stead of the supported entity. In most cases, these support mechanisms do not supply creditors with full cures to enforce debt payments, and the strength of legal enforcement and timing of the payments vary according to the characteristics of each support arrangement. Although some support mechanisms may somewhat improve credit risk, they do not constitute credit substitutes. These support mechanisms are usually provided by parties affiliated with the issuer, such as parent company, controlling shareholder (which may not be an incorporated company) or business partner. The degree of support they provide can vary significantly, from arrangements involving a commitment to maintain certain quantitative financial parameters, such as a commitment to maintain a certain liquidity cushion to service debt, a commitment to maintain minimal net value or support limited by liquidity during the routine course of business, to weaker forms, not necessarily including quantitative parameters for the extent of support, such as general comfort letters and verbal statements including intentions to supply financial support or verbal statements about the strategic importance of the issuer to the supporter. Midroog may also consider notching a rated entity based on a tacit assumption of support. Tacit support need not necessarily be materially weaker than other non-legal support mechanisms, as long as the assumption of support is based on willingness and high ability to provide the support, including based on past experience.

Assessing the probability of support

Midroog will examine the probability of support for the issuer based on the willingness and ability of the supporting entity to provide the support. The main considerations serving Midroog when examining the support probability are: 1) The strength of the supporting entity's incentive to provide the support, according to the strategic importance of the supported entity to it, for instance when the supported entity constitutes a material part of the supporter's asset value, or when risk to joint goodwill is identified, or there is a high business correlation between the activity of the supported entity and the activity of the supporter 2) The existence of a financial incentive for support, in the form of cross-guarantees between the parties, cross-holdings of assets, or joint transactions 3) The supporter's commitment to maintain the supported entity's credit rating and past experience in providing support of various types by the supporter to the supported entity or to other entities it supports 4) The supporter's ability to provide the support as assessed based on the supporter's rating or a credit

assessment of the supporter or an assessment based on the financial strength and financial means available to the supporter. In examination of the supporter's ability to provide support, and in its assessment of the extent of support that will be required and its influence on the supporter's financial strength, Midroog factors in existing correlation between the financial state of the supported entity and that of the supporter, and existing limitations and barriers to providing the support (such as constraints on moving money between countries, regulatory constraints such as antitrust, or other). Midroog also examines the existing degree of liquidity and financial flexibility of the supporter for the purpose of providing support immediately and in a short period of time 5) The degree of correlation between the supporter and the supported entity: At companies with a high degree of business correlation, cases may arise where the supporter suffers from the same economic problems as the supported entity at the very time the company needs support, which could greatly reduce its ability to help exactly when the situation requires it.

Midroog may weight into its assessment scenarios circumstances in which the economic sense of providing support declines, reducing the incentive to provide support, even if it has not materialized yet or when the confidence in the economic sense is not high. Such circumstances may arise when the state of the supported entity has deteriorated significantly, to the point of there being no economic sense warranting continued support, or when the business circumstances have changed and with them, the strategic importance of the supported entity to the supporter.

Applying the external support assumptions when setting the Issuer Rating

When Midroog assesses that the probability of external support for a rated entity is high, based on the willingness and ability of the supporter, it could lead Midroog to notch up relative to the issuer's stand-alone rating. Notching will be done in two stages. First, the Issuer Rating will be determined based on the issuer's stand-alone credit risks, without including an assumption of support. Secondly, the degree of notching relative to the supporter's stand-alone rating will be determined relative to the stand-alone rating of the supporter, based on the degree of probability of support. As said, determining the probability of support will be based, among other things, on the rating or credit assessment of the supporter or an assessment based on the financial strength and financial means available to the supporter. The degree of notching may range from a single notch to applying the supporter's rating to the Issuer Rating, depending also on the supported entity's rating level.

When Midroog assesses that the probability of support is low, notching will not happen. However, in cases where Midroog assesses that there is a probability of support even though it isn't very high, it may be reflected in the stand-alone credit rating of the issuer, in parameters such as liquidity or financial flexibility.

Other structural characteristics

The structural characteristics discussed above do not necessarily exhaust the range of characteristics that may distinguish specific debt relative to other debt instruments and relative to senior unsecured debts. A debt instrument may have specific characteristics that could affect seniority or subordination relative to other debt instruments, unique legal or financial characteristics. If these characteristics affect

the creditworthiness of the debt instrument for its holders relative to other debt instruments, Midroog will examine these characteristics and their effect on the credit rating of the instrument. If there are various types of considerations, they will be elaborated in the relevant rating report.

Related reports

[Midroog Rating Scales and Definitions](#)

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