

## CROSS-SECTOR RATING METHODOLOGY

# Debt and Equity Treatment for Hybrid Instruments of Speculative-Grade Nonfinancial Companies

### Table of Contents:

SUMMARY	1
THE APPROACH	2
CORPORATE CREDIT ANALYSIS VERSUS REPORTED METRICS	2
PREFERRED STOCK AND OTHER EQUITY INSTRUMENTS	3
SHAREHOLDER LOANS	3
MOODY'S RELATED RESEARCH	6

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### Summary

While Moody's Hybrid Tool Kit provides a rigorous framework for assessing the relative debt and equity characteristics of hybrid instruments issued by investment-grade companies, the approach is less suited for assessing the characteristics of hybrid instruments issued by speculative-grade nonfinancial companies.<sup>1</sup> Relative to investment-grade nonfinancial companies, speculative-grade nonfinancial companies are materially closer to default, have shorter dated and more complex capital structures, as well as debt with more covenants. Additionally, speculative-grade nonfinancial companies often opt to cease cash distributions associated with preferred stock and other hybrid instruments because such actions are contractually allowable without triggering a debt default.

Given these characteristics, our approach to assessing the debt and equity characteristics of hybrid instruments of speculative-grade companies with a corporate family rating (CFR) or senior unsecured rating of Ba1 and below is to closely follow the legal treatment we expect these instruments would receive in a bankruptcy scenario. Instruments with a debt claim as set out herein, other than shareholder loans meeting defined criteria, receive 100% debt treatment while equity instruments, such as preferred stock, with no such debt claim receive 100% equity treatment.<sup>2,3,4</sup> This approach, as outlined in this methodology, reflects the heightened risk of default and bankruptcy for speculative-grade companies relative to investment-grade companies and provides for consistency with the application of Moody's LGD model used to help assign debt ratings of speculative-grade companies. Additionally, the approach provides for consistency with Moody's definition of default in which only debt instruments can default.

Very few rating changes are expected as a result of the publication of this methodology.

<sup>1</sup> For more detail, see [Revisions to Moody's Hybrid Tool Kit](#) (July 2010).

<sup>2</sup> If a company moves from investment-grade to speculative-grade status with hybrid instruments outstanding, this methodology will apply instead of Moody's Hybrid Tool Kit. Conversely, if a company moves from speculative-grade to investment-grade status, Moody's Hybrid Tool Kit will apply. The debt/equity treatment for those instruments may change as a result of the different approaches used for speculative-grade and investment-grade companies. For instance, instruments which are considered equivalent to preferred stock under Moody's Hybrid Tool Kit but have a debt claim in bankruptcy would receive 100% debt treatment under this methodology. As discussed below, the only exception is for certain deeply subordinated debt instruments held by a company's common stock holders, often referred to as shareholder loans, which meet a set of specific criteria effectively making them function as equivalent to equity from a credit perspective.

<sup>3</sup> In contrast to non-financial corporates, financial institutions, such as banks and insurance companies, are highly influenced by regulatory imperatives in their desire to issue deeply subordinated hybrid instruments and in the design of the instruments they issue. Impairments of hybrid instruments issued by financial institutions, resulting from coupon suspension, conversion to equity, and/or principal write-downs, are often driven by regulatory action. We believe our existing hybrid equity credit framework aligns well with the benefits derived for more senior creditor classes from deeply subordinated hybrids issued by financial institutions and will continue to follow our existing guidance for financial institutions.

<sup>4</sup> The guidance in this methodology does not apply to project finance and other infrastructure issuers that are rated using metrics derived from deal-specific cash flow models and/or bespoke covenant, inter-creditor and security arrangements. However, the analytical approach applied to those issuers with respect to hybrid instruments is similar, though the relevant financial and legal structures would typically be different.

## The Approach

The approach applies globally and is relatively straightforward: 1) preferred stock and other similar equity instruments with no debt claim are treated as 100% equity in calculating a company's adjusted financial metrics and are excluded from Moody's LGD model debt waterfall and 2) all instruments with a debt claim are treated as 100% debt in calculating a company's adjusted financial metrics and are included in Moody's LGD model debt waterfall.<sup>5, 6</sup>

The only exception is to 2) above for certain deeply subordinated debt instruments held by the owners of the common stock, often referred to as shareholder loans, which meet specific criteria effectively making them function equivalent to equity from a credit standpoint; that is, with no ability to influence the probability of default and loss given default on the more senior debt of a company. If these instruments meet all of the criteria, we treat them as similar to equity from a credit perspective. That is, such shareholder loans receive 100% equity treatment for the purposes of calculating a company's adjusted financial metrics and are excluded from Moody's LGD model debt waterfall. Otherwise, if all of the required criteria are not met, we treat them as 100% debt and they are included in the LGD model debt waterfall.

Preferred stock, other equity instruments and shareholder loans receiving 100% equity treatment are not eligible for default under Moody's definition of default, although they are eligible for impairment.<sup>7</sup>

## Corporate Credit Analysis Versus Reported Metrics

While this methodology focuses on the debt and equity treatment for hybrid instruments in calculating adjusted financial metrics, we note that such metrics are not the sole basis for assessing the creditworthiness of a company and that many factors, as outlined in Moody's industry rating methodologies, are considered in assigning a company's CFR. Furthermore, corporate credit analysis always inherently involves a large subjective and judgmental component that includes examining the components of leverage and coverage, and the economic incentives for owners and managers regarding decisions on future capital structures and uses of cash. Although this methodology applies a binary approach to debt and equity, importantly, we note that a small difference in an instrument qualifying as 100% equity under this methodology versus qualifying as 100% debt is not analytically equivalent to substituting common equity for senior long-term debt. Or, in other words, 100% debt versus 100% equity for numerical ratios presentation does not imply 100% debt versus 100% equity for fundamental credit analysis.<sup>8</sup>

<sup>5</sup> To classify as an equity instrument similar to preferred stock we require that the instrument has no debt claim in bankruptcy, or prior to bankruptcy, in Moody's view and that non-performance of the instrument cannot directly or indirectly trigger a Moody's default event on any instrument of the issuer. As a result, for example, mandatory convertible instruments with a debt host would not be eligible for equity treatment. For preferred stock (or equivalent equity instruments), the only consequence of not making payments is an inability to make distributions to common equity holders.

<sup>6</sup> Moody's LGD model is used to help assign debt instrument ratings of speculative-grade nonfinancial companies in North America and the EMEA. For more details, see [Loss Given Default for Speculative-Grade Non-Financial Companies in the U.S., Canada and EMEA](#) (June 2009).

<sup>7</sup> See [Moody's Rating Symbols and Definitions](#) for Moody's definitions of default and impairment.

<sup>8</sup> Treating a deeply subordinated debt instrument as debt will, other things equal, typically put downward pressure on the CFR. However, including it in the LGD debt waterfall will provide debt cushion for the more senior debt instruments, putting upward pressure on these instrument ratings relative to the assigned CFR. A different family recovery rate may also be appropriate, where the deeply subordinated debt instrument is considered not to impact PDR or instrument ratings.

## Preferred Stock and Other Equity Instruments

Although preferred stock and other equity instruments have no debt claim in bankruptcy and missed dividend payments do not provide holders with the ability to trigger a debt default, Moody's Hybrid Tool Kit typically attributes partial debt treatment to preferred stock depending on its features. For investment-grade companies, the rationale for this treatment is that such companies almost never miss preferred dividend payments. As a result, for investment grade companies, the cash outflows associated with servicing preferred stock are very similar in nature to the cash outflows associated with servicing debt: both occur regularly with a high degree of confidence. Consequently, treating some portion of preferred stock as debt in calculating a company's adjusted financial metrics assists Moody's in consistently differentiating financial strength and creditworthiness across investment-grade companies.

For speculative-grade companies, however, where the distance to default is potentially much shorter and where companies' capital structures are more complex and dynamic, there is not nearly as strong an expectation that preferred dividends will be made without interruption, especially if a debt default can be avoided by ceasing preferred stock dividends. This follows, of course, because impaired preferred stock and other similar equity securities have no ability to directly trigger a debt default.

Consequently, given speculative-grade companies' greater proximity to default and bankruptcy relative to investment-grade companies, we assign 100% equity treatment to all preferred stock and other similar equity instruments of speculative-grade companies in calculating a company's adjusted financial metrics (see footnote 5). Consistent with current practices, preferred stock and other equity instruments are excluded from Moody's LGD debt waterfall.

## Shareholder Loans

In jurisdictions where the issuance of preferred stock and similar equity instruments by nonfinancial companies is absent or rare due either to a legal basis or well-established market practices, common equity often represents only a small portion of the shareholder funding used to fund leveraged acquisitions and re-capitalizations. Instead, in these jurisdictions, the majority of shareholder funding for such transactions is often made through the issuance of shareholder-owned deeply subordinated debt instruments. In many countries in Europe, for example, these instruments often go by the name of "shareholder loans" or "preferred equity certificates." The terms of these instruments are often drafted such that, from the perspective of the company's other creditors, they imply that the shareholder loan behaves equivalent to equity from a credit perspective; and, therefore, that the probability of default and loss-given-default on the more senior debt are unaffected by the proportions of equity and the shareholder loan in the company's capital structure.

As a result, for speculative-grade non-financial companies rated Ba1 or below, we provide deeply subordinated shareholder-owned debt instruments with 100% equity treatment and exclude them from the LGD model debt waterfall if they meet all of the required conditions outlined below; otherwise, we treat them as 100% debt and include them in the LGD model debt waterfall.<sup>9,10</sup> The approach is to examine all of the credit documentation holistically, analyzing the terms of the shareholder loan and its interaction with other credit documents pertaining to the rated group of entities, including the loan, bond and inter-creditor agreements.

<sup>9</sup> Absent unusual or extenuating circumstances, all of the conditions must be met in order for a shareholder loan to be treated as equity.

<sup>10</sup> In jurisdictions where preferred stock is commonly issued by nonfinancial companies (e.g., North America), we have not observed the issuance of shareholder-owned deeply subordinated debt instruments that would meet the conditions for equity treatment.

Required Conditions:

- (i) The shareholder loan is junior to all liabilities, with the exception of other tranches of shareholder-owned debt that also meet the conditions here for equity treatment

We expect such subordination to be captured in an inter-creditor agreement (or subordination agreement) that also documents enforcement processes and application of recovery proceeds. We also expect that the shareholder loan will be contractually subordinated to all liabilities within the rated group, including non-financial liabilities such as trade creditors, and apply to future liabilities within the rated group.

In certain cases, holders of the shareholder loan may have a claim following an insolvency event. In such cases, we expect the inter-creditor agreement to ensure that any claim is economically junior to all other debt claims – such that the proceeds from any enforcement of collateral are applied first to all other financial and non-financial creditors until those claims have been fully discharged.

- (ii) The documentation needs to eliminate any and all rights of holders of any shareholder loan to directly or indirectly influence a company's default probability, or the position or recovery prospects of any other creditors within the rated group following any form of default or bankruptcy proceeding

The terms of the shareholder loan and the inter-creditor agreement, considered comprehensively, need to document the following:

- » No covenants (other than informational covenants where failure to comply has no consequences), no acceleration rights, no right to declare default or an event of default; or if such rights exist then they are unenforceable until all senior debt has been repaid in full
- » No security encumbrances within the rated group
- » No amortization, redemption or other prepayment allowable prior to maturity of the more senior-ranking instruments in the capital structure; except to the extent that such payment could have been accommodated out of equity distributions in an all-equity structure and is subject to a restricted payments test as further outlined below which is no different than the typical restrictions on purchasing common stock
- » No enforceable put options prior to the maturity of the senior debt even if permitted by a restricted payments test
- » Given the inherent uncertainty over insolvency proceedings in various jurisdictions, the maturity of any shareholder loan should at all times be at least six months beyond the maturity of any other debt within the rated group.

- (iii) We expect the economic interests of the common equity and the shareholder loan to be aligned through “stapling” (i.e., evidence at issuance that the shareholder loan is owned by the common stock holders and, after issuance, restrictions on transferability of the shareholder loan to a party other than a common stock holder that ensure that such alignment is maintained)<sup>11</sup>

<sup>11</sup> Differences in percentage ownership of the common equity and the shareholder loan may arise, for example, to facilitate management incentives. However, we require sufficient overlap in ownership to ensure commonality of interests.

- (iv) Protections are present on cash leakages from the company as a result of interest or principal payments associated with the shareholder loan

While many such shareholder loans are payment-in-kind (PIK) only, some permit cash distributions to shareholders in the form of cash interest or principal payments. Such distributions are generally governed by a restricted payments test. We require that the presence of the shareholder funding does not imply an increase in the amount of cash distributions that could otherwise be made. Hence, the restricted payment test should not differentiate in any way between a dividend payment on common equity and a cash payment made under the shareholder loan.<sup>12</sup>

- (v) Protections for other creditors are present in the event changes are made to the terms of the shareholder loan

Any changes to the financing documentation, including the terms of the shareholder loan or the inter-creditor agreement, that impact any of the conditions outlined in sections i) - v) need majority approval of senior financial creditors, or equivalent protections.<sup>13</sup>

Subsequent to the initial assignment of a company's ratings at the issuance of a shareholder loan meeting the requirements for equity treatment, if we become aware that any of the terms have changed such that the required conditions discussed above are no longer met, we will treat the shareholder loan as 100% debt in calculating a company's adjusted financial metrics, include it in the LGD debt waterfall, and adjust all of the company's ratings as necessary to reflect any changed view we may have regarding the creditworthiness of the company and its more senior debt. Specifically, for many structures, once the senior debt of the company has been refinanced or paid off, the restrictions imposed by the inter-creditor agreement may no longer apply and standard covenants within the shareholder loan may have force, including rights to trigger a default event and acceleration.

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<sup>12</sup> Early distribution of cash in a highly leveraged company is a credit negative that may negatively impact the CFR even in the absence of an explicit debt adjustment. The payment would be included in other metrics that consider cash flow; and would also weigh on financial policy considerations.

<sup>13</sup> Equivalent protections would ensure that permitted changes are solely: (i) of a minor, administrative or technical error; or (ii) not materially less favourable to senior financial creditors as determined by an independent third party.

## Moody's Related Research

### Rating Methodologies:

- » [Revisions to Moody's Hybrid Tool Kit, July 2010 \(125615\)](#)
- » [Loss Given Default for Speculative-Grade Non-Financial Companies in the U.S., Canada and EMEA, June 2009 \(114838\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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