Rating Methodology

Corporate Rating Methodology

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Contacts:

Thiti Karoonyanont, Ph.D., CFA
thiti@trisrating.com

Jutamas Bunyawanichkul
jutamas@trisrating.com

Pramuansap Phonprasert
pramuansap@trisrating.com

Sermwit Sriyotha
sermwit@trisrating.com

Sasiporn Vajarodaya
sasiporn@trisrating.com

Monthian Chantarklam
monthian@trisrating.com

Wiyada Pratoomsuwan, CFA
wiyada@trisrating.com

Suchada Pantu, Ph.D.
suchada@trisrating.com

WWW.TRISRATING.COM

SCOPE OF THE CRITERIA

The criteria describe the methodology TRIS Rating uses to determine an issuer rating or a company rating for a corporate entity or a general non-financial company. The criteria are not applicable to project finance companies, investment holding companies, and special purpose entities. This article supersedes the "Corporate Rating Methodology," published by TRIS Rating on 26 July 2019.

SUMMARY

The corporate rating framework is built upon two fundamental aspects of credit analysis. The first is the analysis of the business risk of a corporate entity, and the second is the analysis of financial risk. The result of business risk assessment, "business risk profile" (BRP), and financial risk assessment, "financial risk profile" (FRP), are then combined to derive an anchor rating.

The business risk analysis starts with an evaluation of the relevant industry risk, country risk, followed by an analysis of the competitive position and profitability of the entity. An entity's competitive position is determined based on its competitive advantage, scale, scope and diversity of the range of products/services offered, and operating efficiency. The profitability assessment is a combination of the level of profitability and volatility of profitability of that entity compared with those of its peers in the same industry.

For an entity which has operations or assets outside Thailand, we also assess country risk as a factor affecting the issuer rating. In our view, an entity is exposed to risks specific to the country if it has assets or operations in that country. Country risk assessment is different from the sovereign rating assessment which focus on the ability and willingness of a sovereign obligor to pay its debt on time and in full. The country risk analysis will focus on the impact of economic risk, institutional risk, financial system risk, and regulatory risk on the operating performance of the company. While country risk is built in our assessment of BRP, the issuer rating on a corporate entity could be constrained by the relevant sovereign rating and the transferability and convertibility (T&C) assessment.

In assessing an entity's FRP, we focus on financial ratios in relation to cash flow and financial leverage. Generally, we analyze the ratios derived from the historical financials of the past two years, and projected financials of current year and the next two years.

The anchor rating, derived from combining the BRP and FRP, may be adjusted to reflect other credit considerations that have not been captured in the BRP and FRP assessments. These additional considerations could be negative factors such as issues related to corporate governance and liquidity risk, or positive factors such as benefits from financial flexibility, or significant business diversification, etc. The resulted rating, after these additional considerations, is a rating that reflects the standalone credit profile (SACP) of a corporate entity.

In most cases, the SACP is taken as the issuer credit rating (ICR). However, if the rated entity is closely related to a larger business group, an assessment of Group Credit Profile (GCP) of the relevant business group and its potential support or negative intervention to the rated entity will be necessary. The ICR on the rated entity could be the result of a rating enhancement or capped by the GCP, unless we believe the rated entity is insulated from the group.

CORPORATE RATING METHODOLOGY

RATING FRAMEWORK

<table>
<tr><td>Country Risk</td><td rowspan="2">Corporate Industry and Country Risk Assessment (CICRA)</td><td rowspan="4">Business Risk Profile (BRP)</td><td rowspan="7">Anchor Rating</td><td rowspan="7">+/-</td><td>Other Credit Considerations (OCC)</td><td rowspan="7">=</td><td rowspan="7">Stand-alone Credit Profile (SACP)</td></tr>
<tr><td>Industry Risk</td><td>- Management & Governance</td></tr>
<tr><td>Competitive Position</td><td rowspan="2">Overall Competitive Position</td><td>- Liquidity</td></tr>
<tr><td>Profitability</td><td>- Financial flexibility</td></tr>
<tr><td colspan="2" rowspan="3">Cash Flow & Leverage</td><td rowspan="3">Financial Risk Profile (FRP)</td><td>- Diversification</td></tr>
<tr><td>- Peer comparison</td></tr>
<tr><td>- Others</td></tr>
</table>

SACP +/- **Group Credit Profile (GCP)** = **Issuer or Company Rating**

KEY RATING FACTORS

1) BUSINESS RISK PROFILE (BRP)

The business risk profile (BRP) assesses the country risk, industry risk, competitive position of an entity in comparison with industry peers, and the ability of an entity to generate and maintain its profitability. The competitive position is mainly derived from competitive advantage, scale, scope and diversity of products/services offered, and operating efficiency. The profitability assessment is a combination of the level of profitability and volatility of profitability of that entity compared with those of its peers in the same industry.

1.1. Country risk

We consider country risk as a factor affecting the BRP of an entity. In our view, an entity that has assets or operations in one or several countries could be exposed to at least one of these four risk factors: 1) economic risk, 2) institutional risk, 3) financial system risk, or 4) regulatory risk in those countries. In addition, the issuer rating could be constrained by the relevant sovereign rating and the T&C of currency of that country.

TRIS Rating ranks the risk levels of each factor in a scale of '1' to '6'. The country risk level is determined by finding the simple average of these four factors and ranking the risk level from '1' (very low risk) to '6' (very high risk).

For an entity that has exposure in several countries, we use the weighted-average approach to calculate aggregate country risk exposure. The weight assigned to each country could be based on the exposure of that entity to that country in terms of assets, revenues, or earnings.

1.2. Industry risk

Currently, an industry risk assessment is categorized into one of five risk levels: '1' (very low), '2' (low), '3' (intermediate), '4' (moderately high), and '5' (high). The levels are based on the volatilities of revenues and earnings of companies in a specific industry, industry growth trends, and the degree of competition. For an entity involved in several industries, we will consider the industry that contributes at least 20% of its assets, revenues, or earnings. The aggregate industry risk score is then calculated based on the weighted-average score of each industry.

For details of industry risk assessment, please refer to our latest report on "Industry Risk Analysis Criteria for Corporate Ratings".

1.3. Competitive position

To derive the overall competitive position of an entity, we combine the competitive position assessment with the profitability assessment. The competitive position is derived from a combination of three key factors: competitive advantage; scale, scope and diversity of products/services; and operating efficiency.

- **Competitive advantage**

  We evaluate the competitive advantages of an entity based on several dimensions, including market share, brand equity, ability to command premium prices, as well as the strength and durability of relationships with key customers and/or suppliers. An entity will receive a good assessment on this factor if it is able to gain sizable market share while maintaining satisfactory profitability. A proven record of its ability to adapt its business strategy to capture growth opportunities or its resilience during downturns is also a plus for the assessment.

  The competitive advantage of a regulated utility company, like a power producer or water supplier, depends more on the sale and purchase agreements the entity has. For instance, most companies in the power sector in Thailand have long-term power purchase agreements (PPA) with reliable state-owned enterprises. The competitive advantage of each company depends largely on the structure of the PPA since the PPA is the major factor determining the risk, return, and cash flow of each company.

- **Scale, scope and diversity of products/services**

  Scale is often correlated with the degree of competitiveness. Normally, large companies will have a competitive edge in terms of bargaining power, production costs, and distribution channels. Smaller companies normally suffer more during contractions in market size or after the loss of a few major customers. However, small size does not always translate into a weaker competitive position. A smaller company might have a competitive advantage over larger companies in terms of product differentiation, niche market serving, or superior technology.

  Depending on the circumstances in a specific industry, diversity in terms of products, price points, geography, and customer base can be a materially favorable factor in relation to an entity's BRP. The measurements used to determine the degree of diversification could be the number and locations of cash-generating assets, product mix, and the revenue contributions from different product lines or customer groups. A more diversified company usually receives a better score than an entity that relies on one or just a few products or a group of customers.

- **Operating efficiency**

  Operating efficiency measures the company's ability to maximize revenues and profits by improving the utilization of its assets, maintaining an adequate level of inventory, and reducing unnecessary expenses. In addition, the company's ability to pass along increases in input costs to its customers or lower its production and overhead costs to sustain profitability during economic downturns will be a plus for the assessment.

  Operating efficiency could come from the production technology employed, the ability to secure raw materials at lower costs, and prudent working capital management. Operating efficiency is important in some industries that are more commoditized and require a minimum scale of operations, such as petrochemicals, petroleum products, cement, and sugar. However, operating efficiency may not be as important in industries in which customers choose products or services based on quality rather than price, such as the healthcare service, media and entertainment, and restaurant industries.

1.4. Profitability

For the profitability analysis, we focus on both the level and volatility of the profit margin of a company relative to peers in the industry. A profitability ratio higher than the industry average may imply a competitive advantage over peers and/or the ability to control costs better than peers. A higher profit margin also gives a company more room to adjust prices when needed. A decline in profitability may imply either increasing competition due to excess supply or declining demand. Some companies may use a price-based strategy to gain market share.

In such cases, revenues may increase but profits may not move in the same direction. In our view, entities that have stable profit margins are preferred to entities that have higher yet more volatile profit margins.

The financial ratios used to assess profitability include the EBIT margin (earnings before interest and tax to revenues), the EBITDA margin (earnings before interest, taxes, depreciation, and amortization to revenues), and the return on permanent capital (ROPC). Profitability is categorized into three levels: 'above average', 'average', and 'below average'.

For the volatility of profitability, we measure the standard error of regression of EBITDA, EBITDA margin or ROPC of an entity compared with the industry average, using at least seven years of historical data. We may adjust the result upwards or downwards if we believe that historical information may understate or overstate expected future volatility, or if we believe that the volatility is distorted by exceptional events or there was a structural change in the company. In the case that the entity does not have enough historical data, we may assume a conservative volatility assessment.

2) FINANCIAL RISK PROFILE (FRP)

For the financial risk profile (FRP) assessment, we take into consideration both qualitative and quantitative aspects. Audited and/or reviewed financial statements serve as the primary source of financial information for our analysis. We expect an entity's financial statements to be audited and/or reviewed by an accounting firm on the list of approved auditors put forth by the Securities and Exchange Commission (SEC) of Thailand. In cases where the auditor expresses no opinion or has a qualified opinion on some material aspects of an entity's financial statements, we will take a very conservative view in assigning the rating, or we may not be able to assign a rating to the entity at all.

We typically base our analysis on consolidated financial statements, rather than company-only financial statements. Consolidated financial statements give a whole picture of the company and its subsidiaries and ensure the net effects of inter-company transactions are presented. In addition, we typically make some adjustments to the financial ratios to better reflect an entity's financial condition and to be able to make consistent financial comparisons among the rated peers. All ratios used in the analysis are adjusted ratios, prepared by using the standard adjustments as described in our latest report on "Key Financial Ratios and Adjustments for Corporate Issuers".

Our FRP assessment is focused mainly on the company's ability to generate cash to service its debt obligations. For property-related industries like homebuilders and real estate for rent companies, we also consider traditional financial leverage ratios like the debt to capitalization ratio. We generally analyze the ratios derived from historical financials of the past two years, the projected financials of the current year and the next two years. The weight applied are typically 10% for year t-2, 15% for year t-1, and 25% each for the current and two subsequent forecast years. However, the weighting could be changed if we believe that the historical financial ratios are no longer relevant to the company's future FRP.

Below are the key financial ratios that we typically use to assess an entity's financial leverage.

- Funds from operation (FFO) to debt ratio
- Debt to EBITDA ratio
- EBITDA interest coverage ratio
- Debt to capitalization ratio

3) OTHER CREDIT CONSIDERATIONS

The anchor rating may be adjusted by some other credit considerations not captured in the BRP and the FRP. These additional credit considerations could be related to management and governance, liquidity profile, financial flexibility, diversification, or other factors (if any).

- **Management & Governance**

Management plays a crucial role in the success or failure of a company. To evaluate the management team's capabilities, TRIS Rating focuses on the team's track record, past successes and failures, vision, credibility, and managerial style in terms of transparency, teamwork, delegation of authority, and succession plan.

Even though the analysis is largely subjective, certain objective measurements are also taken into consideration. We look at the past performance, growth rate, the ability of the management team to cope with crises, team continuity, and the financial policies of the company. The assessment of management quality is partly justified through interviews with the management team, the audit committee, and comparisons with industry peers.

- **Liquidity**

For the liquidity analysis, we focus mainly on the sufficiency of the sources of funds to cover the uses of funds, especially over the next 12-24 months. For a company that has a significant amount of debt due in any given year, we emphasize the issuer's ability to refinance the debts and other possible sources of funds. The rating could be negatively impacted should the entity have a significant amount of short-dated debt relative to liquidity. However, the liquidity profile will be considered in conjunction with operating performance, relationships with financial institutions, and the entity's ability to access the capital market.

- **Financial flexibility**

Companies that have a portfolio of investments in unconsolidated equity affiliates and/or other non-core assets that can be liquidated during tough times are considered to have more financial flexibility than other companies. These investments should have a market value and could be monetized over an intermediate timeframe. Generally, we do not include these investments in the evaluation of the BRP and the FRP of the company. In addition, these investments must be considered as nonstrategic investments. The divestments of these securities or assets should not affect the entity's existing operations or competitive position. Moreover, the proceeds from the divestment could be used to repay debt and reduce leverage significantly.

- **Diversification**

A company may have diverse core business lines under its umbrella. These lines of business may or may not be related. Generally, the benefits of diversification are low if the lines of business are highly correlated. For diversification to be beneficial, it is crucial that the management team can manage more than one business at the same time and the diversification should help reduce the volatility of revenues and earnings. In addition, any new ventures should not weaken the existing lines of business. In many cases, a company chooses to diversify into unfamiliar or unrelated businesses and later finds itself unable to compete, resulting in the failures of both the existing business and the new businesses. TRIS Rating takes a conservative view when a company enters a new business.

- **Peer comparison**

In addition to the factors mentioned above, the SACP will be compared across the entire portfolio of entities rated by TRIS Rating. The SACP could be adjusted upward or downward based on the final decision of the rating committee. However, the adjustment, if any, will be by no more than one notch.

- **Others (if any)**

Other credit considerations that could lead to a positive or negative assessment include industry or macroeconomic trends, a short operating track record, exposure to litigation risk or contingent liabilities, or an entity in transition after a significant change of business policy or financial structure.

4) GROUP CREDIT PROFILE (GCP)

If the rated entity is part of a larger business group (the Group), an assessment of the risk profile of the relevant business group may be necessary if the rated entity's business operation and financial health are closely related to the group. In that case, the final issuer rating of an entity will depend on the evaluation of the GCP and the status of the entity in the group.

We may assign a weak subsidiary of a strong business group an issuer rating higher than its SACP if we assess that the subsidiary has the potential to receive extraordinary financial support from its parent or other group members in a financial distress scenario. In contrast, the issuer rating we assign to a strong subsidiary of a weak business group may be capped by the GCP of the group if we believe that the subsidiary's business operation and financial health could be negatively impacted by its weak parent or other members of the group. Please refer to our latest "Group Rating Methodology", for more details.

TRIS Rating Co., Ltd.
Silom Complex Building, 24th Floor, 191 Silom Road, Bangkok 10500, Thailand. Tel: +66 2 098 3000