RATING CRITERIA

# Consultation Report: Criteria for Rating Non-Financial Corporates

1 August 2018

The expiration date for the consultation period is 1 September 2018. Please submit any comments or feedback on the proposed criteria to the following email address: consultation@dagongeurope.com

During the consultation period, the existing criteria (published on 10 July 2017) will be applied to outstanding ratings and to new rating assignments. Received comments (including details of the respondents such as name, institution, country of domicile etc) and Dagong's responses thereto will be published on Dagong's website after the end of the consultation period, except in cases where confidentiality is requested by the respondent.

Under this updated Criteria for Rating Non-Financial Corporates, Dagong does not expect any impact on outstanding ratings assigned.

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Related publications

Consultation Report: General Rating Framework (9 July 2018)

Accounting Adjustments to Financial Statements of Non-Financial Corporates (1 August 2018)

Changes compared to the previous version:

1. Incorporation of ‘Corporate Strategy’, ‘Planning’ and “Sustainability’ as new items to the analytical building block ‘Development Strategy’ within the Corporate Governance and Development Strategy Analysis.
2. Incorporation of ‘Relative Size’ as new item to the analytical building block ‘Diversification and Dependencies’ within the Operations and Competition Analysis.
3. Incorporation of ‘Operational management of Business Functions’ as new analytical building block within the Operations and Competition Analysis.
4. Incorporation of ‘Liquidity’ as analytical building block within the Financial Analysis.
5. Incorporation of the description of the External Support Analysis (ESA) in this criteria document including the three types of potential external support (parental, governmental, third-party) and additional details on the assessment of the ‘Likelihood of Support’ and the ‘Level of Support’. The separate criteria complement External Support Assessment for Non-Financial Corporates will no longer be published.
6. Incorporation of the Peer Group Analysis as analytical step including the comparisons of the respective business profiles, financial profiles and external support profiles.
7. Incorporation of the description of the Issuance Analysis for the rating of corporate debt obligations reflecting the relative seniority of the debt instrument, external support or credit enhancement, related collateral and collateral type and other factors included in the analytical building block ‘Issuance Characteristics’.
8. Generic guidance for each category of the 7-category scale for all qualitative rating factors.
9. Incorporation of a more forward-looking approach for the compilation of the Standalone Credit Assessment (SACA) and the credit rating based on historic and forecasted data, standard and individual stress assumptions and the use of a 5-year time-weight vector.

## OVERVIEW

The key analytical highlights of Dagong's rating criteria are the overall emphasis on the long-term sustainability of a rated entity's business model, the broadened scope of analytical perimeters over environment analysis and the strong focus on qualitative rating indicators.

Dagong believes that a profound understanding of the factors and drivers underpinning an entity's business strategy is fundamental to build a robust credit analysis and to thoroughly interpret the financial performance of an entity. A financial analysis, which is detached from the fundamentals of an entity's long-term strategies, goals and plans, does not provide sufficient analytical rationale to comprehend the trends behind entity's financial performance and its ability to mitigate future environmental challenges and opportunities. The emphasis on qualitative rating factors and long-term view allows Dagong to conduct a thorough assessment of the rated entity, and its capability to retain a strong financial profile through adverse economic cycles, to maintain sustainable performance in the long-run and to achieve the desired strategic and financial goals. To facilitate a forward-looking assessment, Dagong pays special attention to financial projections and forecasts to formulate an expected case which will be stress-tested using macroeconomic, industry- and entity-specific rating factors.

The analysis of the external operational environment and its consequent impact on the rated entity is primarily considered within the Operational Environment Analysis, which represents the first analytical step of Dagong's rating criteria. This analytical step provides a larger-than-usual perimeter for the rating analysis, facilitating the comparison of entities operating in different macroeconomic contexts, industries and jurisdictions. Dagong's rating criteria do not vary by industry. The Operational Environment Analysis focuses on (i) macroeconomic environment, (ii) industry environment and (iii) legal and regulatory environment. Dagong thoroughly assesses the correlation between an entity's business proposition and its local and macro conditions, including sovereign risk, to understand the overall impact on the entity's operating and financial performance. Environmental, Social and Governance (ESG) related rating factors (e.g. climate changes or demographic dynamics) are also taken into consideration, as they are gaining in importance and could present potential challenges in the future. Dagong's rating criteria put the accent on the long-term sustainability of entities' business models as they aspire to assess the counter-cyclical character of their business propositions. To achieve this target, a close, open and stable communication flow between Dagong's analytical team and the rated entity is required, to map the rated entity appropriately according to Dagong's rating criteria and to position it within the relevant peer group.

## I SCOPE

Dagong has developed a unique analytical framework for rating non-financial corporates. This framework facilitates the credit analysis process and provides a solid base for understanding the credit ratings assigned by Dagong. The rating criteria are applicable across a diverse range of industries and include the fundamental rating factors that, in Dagong's view, sit behind a robust corporate credit analysis. Additional rating factors are presented in the following chapter - 'Other Considerations for Non-Financial Corporates' Credit Ratings'. Any further industry- or entity-specific peculiarities will be analysed by the rating committee on a case-by-case basis and always disclosed within 'Dagong's Credit View'.

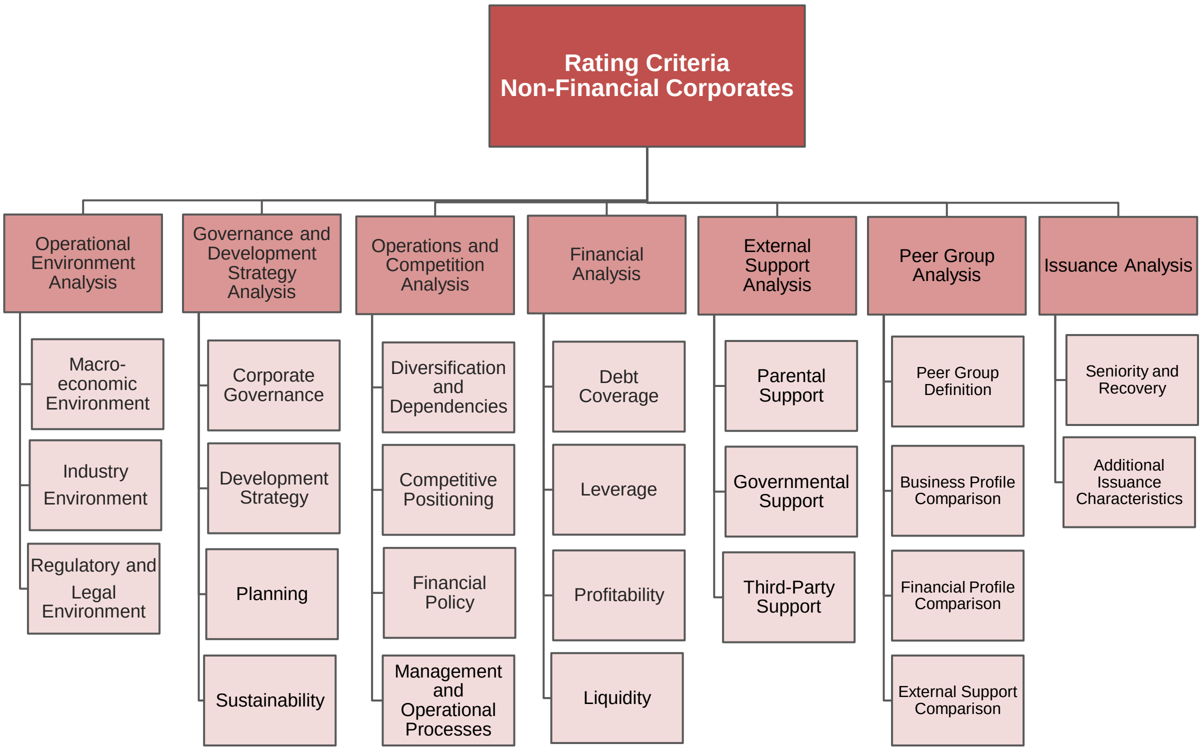
The criteria is not applicable to special purpose vehicles and companies in the financial service industry (e.g. leasing).

The criteria is used to assign new ratings and monitor existing ratings.

The analytical approach described in the criteria is implemented via Dagong's proprietary rating model.

All Dagong's rating criteria and associated models are subject to regular validation and review in accordance with Dagong's internal procedures and regulatory requirements.

**Exhibit 1: Dagong's Rating Criteria Structure**




Source: Dagong

## II SUMMARY

The rating criteria developed by Dagong cover the key areas of the fundamental corporate analysis, ranging from a broad assessment of environmental issues to specific characteristics at the microeconomic and entity level. The condensed analysis of various rating factors included within the analytical building blocks of the rating criteria provides a view on an entity's credit strength and weaknesses and represents the foundation for the rating process and the rating committee discussions. The impact from any potential external support is also taken into consideration using the External Support Analysis (ESA) framework that evaluates such impact of potential external support on the assessed creditworthiness.

In order to prepare the Standalone Credit Assessment (SACA) of an entity, the rating criteria provide a thorough analysis of the relevant operational environment, business risk profile of the entity and its financial performance through four analytical steps:

A Operational Environment Analysis

B Corporate Governance and Development Strategy Analysis

C Operations and Competition Analysis

D Financial Analysis

To support a balanced and unbiased final assessment, each analytical building block within the analytical steps uses as much as possible both qualitative rating factors (of both exogenous and endogenous nature) and quantitative rating factors standardised financial metrics or other ratios respectively).

Dagong’s rating criteria uses a seven category scale ranging from ‘Excellent’ to ‘Very Weak’ (Excellent, Very Strong, Strong, Satisfactory, Moderate, Weak and Very Weak which correspond for any subsequent aggregation and calculation of results to a score value of 22, 19.5, 15.5, 11.5, 7.5, 3.5 and 1) for each qualitative and quantitative rating factor. The final result - for each analytical building block, the intermediate result per analytical step as well as for the SACA - is calculated as a weighted average of each individual rating factor’s score and its weight within the framework provided by the rating criteria. The total result translates into an indication for the SACA and the credit rating. Since the rating criteria is not intended to provide an exhaustive overview of the comprehensive rating analysis, it is the rating committee’s competency to consider and assess any relevant issues concerning environment, regional or segment developments or to apply any industry or entity-specific peculiarities, also if not specifically defined within the rating criteria.

## III ANALYTICAL STEPS

### III.1 Operational Environment Analysis

The analysis of the external operational environment and its potential influence on the entity’s rating is primarily taken into consideration within this analytical step, which represents one of the fundamental pillars of the rating criteria. The domestic and international macroeconomic environment, industry dynamics, level of market development and regulatory and legal framework are crucial when assessing the risk profile of an entity.

Broader aspects like global environmental developments, climate changes or demographic dynamics are also assessed within this section, as they could present significant future risks. As the scope and scale of their impact remain ambiguous and difficult to quantify, the rating criteria provide a base for qualitative discussion on those topics and restrain from introducing any specific quantitative measures or scores.

Sovereign risks are also incorporated as a reference factor within the Operational Environment Analysis. Dagong identifies the key aspects that highly correlate with both short- and long-term operating and financial performance of the rated entity, i.e. fiscal policies, infrastructure developments, public concessions, labour markets reforms, capital flows, etc.

### III.1.1 Macroeconomic Environment

The analytical building block ‘Macroeconomic Environment’ is aimed at evaluating changes in general economic conditions (including political and financial stability within a country or region, government policies etc.) and its impact on the entity’s credit risk. Governments may implement expansive, moderate or tight fiscal policies which directly and indirectly influence the economic environment where an entity operates, creating a profound impact on the entity’s overall business risk profile. Macroeconomic policies may have a direct influence on industries like energy, infrastructure, transportation and construction. As for other industries, the government influence may be indirect, but the correlation to national or wider regional economic policies remaining strong.

Dagong assesses international and domestic macroeconomic trends using the following key indicators of broad economic conditions within its rating criteria:

- Real Gross Domestic Product (GDP) change against the previous year (using the most recent data available), which represents market attractiveness in terms of economic growth and potential;
- Consumer Price Index (CPI) (using the most recent average data available) which represents the price of money and provides an indication of the cost structure stability;
- Unemployment Rate (using the most recent data available), which mirrors the prospective strength of the economy in terms of potential purchasing power and the size of the population with disposable incomes.

In case of geographically diversified businesses, GDP, CPI and Unemployment Rate are computed as weighted averages of all the countries (or regions, where applicable) in which the rated entity operates. In general, weightings are assigned on the basis of the entity’s annual revenues generated in each country or region. Other appropriate measures can be used in case regional revenue information is not available.

Macroeconomic data used by Dagong are sourced from the publicly available International Monetary Fund (IMF) database and the database provided by International Labour Organization (ILO). The data selection follows the same geographical segmentation structure as disclosed by the rated entity. For regions not defined by the IMF or ILO, Dagong provides estimates based upon the size of a single country’s total GDP.

For the mapping of the macroeconomic indicators to the 7 category scale the following mapping table will be applied:

**Exhibit 2: Mapping Table for Macroeconomic Indicators**

| | Excellent | | Very Strong | | Strong | | Satisfactory | | Moderate | | Weak | | Very weak | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **GDP** | > | 3.50% | 2.50% | 3.50% | 1.50% | 2.50% | 0.50% | 1.50% | -0.50% | 0.50% | -1.00% | -0.50% | <= | -1.00% |
| **CPI** | < | 1.50% | 1.50% | 2.30% | 2.30% | 3.20% | 3.20% | 4.00% | 4.00% | 4.70% | 4.70% | 5.50% | >= | 5.50% |
| **Unemployment Rate** | < | 4.00% | 4.00% | 6.50% | 6.50% | 8.50% | 8.50% | 11.00% | 11.00% | 14.00% | 14.00% | 18.00% | >= | 18.00% |

Source: Dagong

### III.1.2 Industry Environment

An entity is exposed to both risks related to the stage of development of its own business model and the characteristics and the development of the industry in which it operates. Industry cyclicity (e.g. capital-intensity), industry dynamics (e.g. technological, organisational, financial), industry constitution (e.g. maturity, growth potential), political awareness, and barriers to entry are factors used by Dagong to identify the relevant competitive environment and its competitive intensity and the resulting challenges and opportunities of an industry.

## Growth Potential

Growing markets or economies offer the potential for organic growth, especially to entities driven by technological change. It should be noted that these entities require high investments that can pose significant execution risks, especially in the case of long investment break-even horizons. During the expansionary phase of an industry, the marketplace is large and growing and entities compete to gain market share. Price competition in these circumstances is less intense if compared to mature industries. Conversely, in regions or periods of stagnating or recessionary macroeconomic conditions, mergers and acquisitions (M&A), rather than organic growth, play a significant role in management's strategy for achieving growth.

Although the rating aims to be consistent throughout the economic cycle, it cannot exactly reflect the entity's cyclical highs or lows. In general, entities subject to cyclicality have a higher inherent business risk, which is factored by Dagong within the analytical building block ‘Industry Environment’.

## Capital-, Labour- and Technology-Intensive Industries

In capital-intensive industries, the greater demand for capital requires strong ability to generate cash flows and unrestricted access to financing sources. The need to invest heavily in fixed assets prolongs the time required to reach break-even point and generally leads to higher leverage than those of non-capital-intensive industries.

Capital-intensive industries with a high degree of cyclicality such as shipping, automotive, metals and mining, are sensitive to capacity fluctuations. Often, many capital-intensive industry players tend to over-expand their capacity during growth periods. Conversely, they find themselves in difficulties during a downturn, when surplus capacity and strong price competition increase risks of margin erosion and higher borrowing costs as their financing needs are often significant and long-term.

In labour-intensive industries, profit margins are usually thinner and profitability is mainly dependent on an efficient management of labour costs and overall labour market conditions. The strength of trade unions can play an important role in labour-intensive industries, posing significant risk that prevents entities to adjust quickly and adequately to market cycles or trends.

In technology-intensive industries, an entity's profitability is primarily dependent on technological innovation, successful research and development (R&D) and efficient application to production. Profit margins are usually large in technology-intensive industries, but carry high investment risks.

## Barriers to Entry and Exit

Players in an industry might have periods of good profitability and limited rivalry if the thread of new competitors entering the market is low based on barriers to entry being high. The level of barriers to entry is negatively correlated with the competition in an industry, i.e. if the barriers to entry are high, an industry will not attract new competitors effectively joining the industry even in periods of high profitability. The existing market participants thus can maintain their competitive advantage, which they would lose otherwise very soon.

Barriers to entry are influenced by an entity's ability to take advantage of economies of scale, dominant access to natural resources, capillary distribution channels, capital intensity, proprietary intellectual property, level of switching costs for costumers, established brand identity, permitting requirements, industry standards and level of transparency regarding laws and regulations. Although industries with high barriers to entry allow their dominant entities to obtain strong profits, they may be subject to regulation reviews and government interventions that can significantly alter market conditions and the business risk profile of their players.

On the other hand, opposed to barriers to entry industries show a certain level of barriers to exit. Companies stay active within an industry even though their cost of capital is higher than their current earnings. There are many different reasons behind high barriers to exit, for example high amounts of capital tied up in production facilities, plants or highly-specialised equipment and machinery, other specific assets and hardly reusable specialised skills, regulatory hurdles, long-term obligations or by company owners, that do not primarily focus financial targets. In an industry with high barriers to exit less efficient competitors depress industry profitability.

The qualitative assessment of the Industry Environment uses the 7 category scale with the following general meaning:

**Exhibit 3: Industry Environment Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very high industry cyclicity<br>- Insufficient industry dynamics<br>- Very poor industry constitution<br>- Unclear political awareness<br>- Very high competitive intensity<br>- Very vulnerable cost structure |
| Weak | - High industry cyclicity<br>- Inadequate industry dynamics<br>- Poor industry constitution<br>- Inconsistent political awareness<br>- High competitive intensity<br>- Vulnerable cost structure |
| Moderate | - Elevated industry cyclicity<br>- Unsatisfactory industry dynamics<br>- Improvable industry constitution<br>- Improvable political awareness<br>- Elevated competitive intensity<br>- Improvable cost structure |
| Satisfactory | - Notable industry cyclicity<br>- Satisfactory industry dynamics<br>- Satisfactory industry constitution<br>- Acceptable political awareness<br>- Notable competitive intensity<br>- Acceptable cost structure |
| Strong | - Moderate industry cyclicity<br>- Reasonable industry dynamics<br>- Adequate industry constitution<br>- Elevated political awareness<br>- Moderate competitive intensity<br>- Reasonable balanced cost structure |
| Very strong | - Low industry cyclicity<br>- Extensive industry dynamics<br>- Good industry constitution<br>- High political awareness<br>- Low competitive intensity<br>- Balanced cost structure |
| Excellent | - Very low industry cyclicity<br>- Very extensive industry dynamics<br>- Very good industry constitution<br>- Very high political awareness<br>- Very low competitive intensity<br>- Very balanced cost structure |

Source: Dagong

### III.1.3 Regulatory and Legal Environment

The assessment of the stability, transparency and consistency of the regulatory and legal environment focuses on a successful track record of consistent decision-making processes. Fully developed and highly transparent regulatory and legal frameworks with a long track record of consistent, predictable and independent decisions, with no history of hostile or politically influenced actions, would score highly within the Dagong Regulatory and Legal Environment analytical building block. Conversely, poorly defined frameworks, strong political interference, a history of inconsistent or hostile decisions and frameworks that do not cover all or the majority of competitors, would score lower and constrain the assessment. The potential risk of litigation resulting in high financial penalties is also evaluated within this analytical building block as it may have a large impact in specific cases.

The regulatory environment assessment is particularly important in industries with significant entrance barriers, high capital-intensity or other monopolistic preconditions. An evaluation of how comprehensive, stable, predictable, independent and supportive a regulatory regime is, significantly influences Dagong's assessment of a regulated entity. Moreover, the consistency and transparency of regulations can impact profoundly the ability of regulated entities to recover operating and investment costs and preserve solid credit profiles.

The assessment of the support provided by a regulatory framework focuses on the extent to which the regulatory mechanism supports cost recovery by a regulated entity and balances the allocation of risks between the regulated entity and its final customers. Regulatory regimes that enable regulated entities to timely cover their capital investments and operating costs and to pass volatility onto customers, limit the business risk profile of the regulated entity and strongly support its credit rating. Regimes with a track record of inability or delays in coverage of costs, a history of unfavourable price reviews or a highly uncertain cost recovery environment would score low within the analytical building block 'Regulatory and Legal Environment', with a potentially negative impact on the entity's final credit rating.

Dagong also considers the importance of industry-specific legislations, the incentives that encourage the use of sector-specific legislations and the fit of sector-specific legislation and general legislation. Furthermore, Dagong monitors the acceptance of regulation and legislation by market participants, associations etc. which is often a result of the valuation of regulation and legislation induced costs compared with the benefits of the respective frameworks.

The qualitative assessment of the Regulatory and Legal Environment uses the 7 category scale with the following general meaning:

**Exhibit 4: Regulatory and Legal Environment Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very weak framework quality<br>- Very weak level of regulatory and legal stability<br>- Very weak level of regulatory predictability<br>- Very weak industry-specific legislations<br>- Very weak acceptance of regulation and legislation<br>- Very weak regulation and legislation induced costs |
| Weak | - Weak framework quality<br>- Weak level of regulatory and legal stability<br>- Weak level of regulatory predictability<br>- Weak industry-specific legislations<br>- Weak acceptance of regulation and legislation<br>- Weak regulation and legislation induced costs |
| Moderate | - Moderate framework quality<br>- Moderate level of regulatory and legal stability<br>- Moderate level of regulatory predictability<br>- Moderate industry-specific legislations<br>- Moderate acceptance of regulation and legislation<br>- Moderate regulation and legislation induced costs |
| Satisfactory | - Satisfactory framework quality<br>- Satisfactory level of regulatory and legal stability<br>- Satisfactory level of regulatory predictability<br>- Satisfactory industry-specific legislations<br>- Satisfactory acceptance of regulation and legislation<br>- Satisfactory regulation and legislation induced costs |
| Strong | - Strong framework quality<br>- Strong level of regulatory and legal stability<br>- Strong level of regulatory predictability<br>- Strong industry-specific legislations<br>- Strong acceptance of regulation and legislation<br>- Strong regulation and legislation induced costs |
| Very strong | - Very strong framework quality<br>- Very strong level of regulatory and legal stability<br>- Very strong level of regulatory predictability<br>- Very strong industry-specific legislations<br>- Very strong acceptance of regulation and legislation<br>- Very strong regulation and legislation induced costs |
| Excellent | - Excellent framework quality<br>- Excellent level of regulatory and legal stability<br>- Excellent level of regulatory predictability<br>- Excellent industry-specific legislations<br>- Excellent acceptance of regulation and legislation<br>- Excellent regulation and legislation induced costs |

Source: Dagong

## III.2 Corporate Governance and Development Strategy Analysis

This analytical step covers the longer-term, non-operational framework set by the corporate planning derived from the corporate's development strategy and integrated into the corporate's sustainability management philosophy. It is effectively the analytical linkage between the operational environment as the basis for external challenges and opportunities and the operational strength and weaknesses of the entity assessed in the Operations and Competition Analysis thereafter.

### III.2.1 Corporate Governance

The analytical building block 'Corporate Governance' is aimed at assessing a broad range of areas related to an entity's relationship with its key stakeholders, i.e. shareholders, creditors, employees, and regulators. The procedures and rules established to govern the behaviour of owners, managers and other stakeholders are fundamental to provide long-term direction to an entity. Complex ownership and legal structures, especially when convoluted off-balance sheet structures are applied, significantly increase the rated entities' risk profile.

The alignment of management compensation with other stakeholders' interests and clear relationship between organisational structure and management strategy, indicate satisfactory corporate governance. Conversely, unbalanced management compensation, high levels of senior staff turnover, poor reporting standards, lack of transparency and legal or regulatory investigations, are all perceived as signs of poorly executed corporate governance principles. The analysis of an entity's management must also focus on assessing its capacity to implement established strategies and goals. The main areas of concern are the composition and the experience of an entity's management team, its duration, and past performance.

Dagong's Corporate Governance analysis also considers the comprehensiveness of the entity's internal control regime, the intensity and effectiveness of the implementation, monitoring procedures and any significant past internal control issues of the entity. For example, frequent changes or favourable application of accounting standards or opaque financial reporting indicate poor corporate governance.

A non-exhaustive list of questions and topics that are usually discussed when evaluating Corporate Governance are detailed below:

- Composition of the board of directors/supervisory board, background and independency.
- Concentration of power of decision making processes.
- Are strategy and objectives communicated within the organisation and are those aligned within the organisational structure?
- Is risk tolerance appetite clearly determined and communicated?
- How is the risk management function structured and managed?
- How experienced is senior management?
- Are internal procedures and practices clearly defined, communicated and applied?
- What has been the outcome of the last inspection by the regulator/central bank?
- Is there any evidence of complexity of the ownership structure?
- Structure of the management compensation packages. Are the incentives for management compensation aligned with a sustainable long-term perspective of the institution?
- Is there any evidence of moral hazard risks?
- Quality of reporting, controls and monitoring of the board to management level.
- Evidence of any legal or regulatory disputes that can affect the reputation of the entity.
- Any compliance breach, exception, or fine from a regulatory institution.

- Sizable related-party lending.
- Other relevant aspects.

Dagong considers adequate corporate governance as a prerequisite for a sustainable, long-term corporate development. The result of this analytical building block itself does not enhance a corporate credit profile. Good governance could not recover a weak business or financial profile, but it does contribute to the protection of an already strong credit profile. For this reason, assessments of the Corporate Governance will be used for a Corporate Governance-related notching, i.e. assessments which are Excellent to Satisfactory have a neutral impact on the SACA, assessments of Moderate a negative impact (minus one notch to the SACA) and assessments of Weak or Very Weak a very negative impact (minus two notches to the SACA).

The qualitative assessment of the Corporate Governance uses the 7 category scale with the following general meaning:

**Exhibit 5: Corporate Governance Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very poor implementation level of existing corporate governance<br>- Insufficient rights and treatment of shareholders<br>- Very poor interests of other stakeholders<br>- Unclear role and responsibilities of the board and senior management<br>- Deficient integrity and ethical behaviour<br>- Unclear disclosure and transparency |
| Weak | - Poor implementation level of existing corporate governance<br>- Inadequate rights and treatment of shareholders<br>- Poor interests of other stakeholders<br>- Inconsistent role and responsibilities of the board and senior management<br>- Inconsistent integrity and ethical behaviour<br>- Inconsistent disclosure and transparency |
| Moderate | - Improvable implementation level of existing corporate governance<br>- Unsatisfactory rights and treatment of shareholders<br>- Improvable interests of other stakeholders<br>- Improvable role and responsibilities of the board and senior management<br>- Improvable integrity and ethical behaviour<br>- Improvable disclosure and transparency |
| Satisfactory | - Acceptable implementation level of existing corporate governance<br>- Satisfactory rights and treatment of shareholders<br>- Satisfactory interests of other stakeholders<br>- Acceptable role and responsibilities of the board and senior management<br>- Adequate integrity and ethical behaviour<br>- Acceptable disclosure and transparency |
| Strong | - Adequate implementation level of existing corporate governance<br>- Reasonable rights and treatment of shareholders<br>- Adequate interests of other stakeholders<br>- Reasonable role and responsibilities of the board and senior management<br>- Strong integrity and ethical behaviour<br>- Reasonable disclosure and transparency |
| Very strong | - High implementation level of existing corporate governance<br>- Extensive rights and treatment of shareholders<br>- Good interests of other stakeholders<br>- Very strong role and responsibilities of the board and senior management<br>- Advanced integrity and ethical behaviour<br>- Extensive disclosure and transparency |
| Excellent | - Very high implementation level of existing corporate governance<br>- Very extensive rights and treatment of shareholders<br>- Very good interests of other stakeholders<br>- Excellent role and responsibilities of the board and senior management<br>- Well advanced integrity and ethical behaviour<br>- Very extensive disclosure and transparency |

Source: Dagong

### III.2.2 Development Strategy

Business philosophy and strategy play a fundamental role in determining an entity's long-term objectives and risks that it is willing to take. It is important that management provides realistic strategies that reflect the competitive advantages the entity has and challenges and opportunities the entity may face. Unrealistic expansionary strategies may lead to an unsustainable level of corporate borrowings, thus increasing credit risk. Conversely, an overly conservative strategy may result in missed opportunities, loss of competitive advantages and market share erosion.

The consistency and credibility of an entity's management team are assessed by Dagong through a detailed overview of the entity's growth strategy, complemented with a clear indication of expected impact on earnings and cash flows. Increase of shareholder value in the long-term, via organic growth or acquisitions, is fundamental while a lack of indicated earnings growth potential is considered as a weakness.

External growth often plays a pivotal role in corporate strategies, even if M&A bear significant execution and integration risks. Well-executed acquisitions make strategic sense and create synergistic effects only if they fulfil the objectives such as developing economies of scale, creating diversification, gaining market share or improving brand awareness while maintaining a well-balanced financial policy. The approach to and the plans for business units that perform poorly or lose strategic interest, indicate another relevant area for investigation. Objective appraisals of business units and a disciplined approach to dealing with under-performers via divestiture, restructuring, discontinuing activities, etc., are viewed positively.

Entities with well-defined business strategies and goals that are aligned with their core business competencies and market developments would receive a higher score in the Development Strategy analysis. A strong track record of exceeding strategic goals and targets, accompanied by a history of well-executed and synergistic M&A or successful organic growth, utilising market opportunities and mitigating risks, would further support the scoring. Poorly defined or unrealistic business strategies that are not aligned with corporate or market development, accompanied by a track record of consistent under-performance would result in a weaker score. Furthermore, an aggressive M&A or organic growth strategy which involves significant uncertainties and risks, will both constrain scoring within the Development Strategy analysis and the Financial Policy analysis (see later in this rating criteria).

The qualitative assessment of the Development Strategy uses the 7 category scale with the following general meaning:

**Exhibit 6: Development Strategy Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very poor formal strategy quality<br>- Very low strategy strength, consistency and stability<br>- Very weak process of strategy formulation<br>- Very poor implementation level of strategy as management function/tool<br>- Very poor partial strategies<br>- Very weak strategic analysis and assessment |
| Weak | - Poor formal strategy quality<br>- Low strategy strength, consistency and stability<br>- Weak process of strategy formulation<br>- Poor implementation level of strategy as management function/tool<br>- Poor partial strategies<br>- Weak strategic analysis and assessment |
| Moderate | - Improvable formal strategy quality<br>- Moderate strategy strength, consistency and stability<br>- Moderate process of strategy formulation<br>- Improvable implementation level of strategy as management function/tool<br>- Improvable partial strategies<br>- Moderate strategic analysis and assessment |
| Satisfactory | - Satisfactory formal strategy quality<br>- Satisfactory strategy strength, consistency and stability<br>- Satisfactory process of strategy formulation<br>- Satisfactory implementation level of strategy as management function/tool<br>- Satisfactory partial strategies<br>- Satisfactory strategic analysis and assessment |
| Strong | - Adequate formal strategy quality<br>- High strategy strength, consistency and stability<br>- Strong process of strategy formulation<br>- Adequate implementation level of strategy as management function/tool<br>- Adequate partial strategies<br>- Strong strategic analysis and assessment |
| Very strong | - Good formal strategy quality<br>- Very high strategy strength, consistency and stability<br>- Very strong process of strategy formulation<br>- Good implementation level of strategy as management function/tool<br>- Good partial strategies<br>- Very strong strategic analysis and assessment |
| Excellent | - Very good formal strategy quality<br>- Excellent strategy strength, consistency and stability<br>- Excellent process of strategy formulation<br>- Very good implementation level of strategy as management function/tool<br>- Very good partial strategies<br>- Excellent strategic analysis and assessment |

Source: Dagong

### III.2.3 Planning

The analytical building block ‘Planning’ tries to cover all aspects of the corporate planning which breaks down on a regular basis all aspects and strategic thrusts identified and determined in the corporate development strategy and the sustainability management. The idea behind the analysis is, that Dagong believes that the successful break down of the long-term goals and strategic guidelines defined by the corporate strategy and the sustainability management and finally the management performance heavily depends on the adequateness of the corporate planning and the ability of the senior management to use it as a powerful but also flexible management tool.

Therefore, Dagong analyses the current planning quality focusing on formal aspects of the planning result, e.g. the completeness, coverage, adequateness in detail, up-to-datedness, reproducibility, traceability and transparency of the corporate planning, i.e. the business plan. Another focus is on planning consistency and stability, assessing the time horizon covered with the business plan, the historical planning quality and recent disruptive planning revisions.

In addition, Dagong tries to evaluate the planning process including the existing and pre-defined process structure, the integration of relevant internal resources and senior management, the documentation of the planning results, the approval process and the in-house communication of the plan.

Dagong focuses as well on the implementation level of corporate planning as management function and tool set looking at the dedicated organisational structures and responsibilities, the concreteness and break-down of formulated plans, the execution of regular gap analysis and historic actions of plan adjustments. Dagong also looks at existing partial plans, their level of preparation and their fit to the overall corporate business plan.

Finally, Dagong assess the methodological and data foundation of the planning and monitoring process to understand the adequateness of the used data, the assumptions and the methodologies for gap analysis, projections and forecasts.

The qualitative assessment of the Planning uses the 7 category scale with the following general meaning:

**Exhibit 7: Planning Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very weak planning quality<br>- Very weak planning consistency and stability<br>- Very weak planning process<br>- Very weak implementation level of planning as management function/tool<br>- Very weak partial plans<br>- Very weak methodological and data foundation of planning and monitoring |
| Weak | - Weak planning quality<br>- Weak planning consistency and stability<br>- Weak planning process<br>- Weak implementation level of planning as management function/tool<br>- Weak partial plans<br>- Weak methodological and data foundation of planning and monitoring |
| Moderate | - Moderate planning quality<br>- Moderate planning consistency and stability<br>- Moderate planning process<br>- Moderate implementation level of planning as management function/tool<br>- Moderate partial plans<br>- Moderate methodological and data foundation of planning and monitoring |
| Satisfactory | - Satisfactory planning quality<br>- Satisfactory planning consistency and stability<br>- Satisfactory planning process<br>- Satisfactory implementation level of planning as management function/tool<br>- Satisfactory partial plans<br>- Satisfactory methodological and data foundation of planning and monitoring |
| Strong | - Strong planning quality<br>- Strong planning consistency and stability<br>- Strong planning process<br>- Strong implementation level of planning as management function/tool<br>- Strong partial plans<br>- Strong methodological and data foundation of planning and monitoring |
| Very strong | - Very strong planning quality<br>- Very strong planning consistency and stability<br>- Very strong planning process<br>- Very strong implementation level of planning as management function/tool<br>- Very strong partial plans<br>- Very strong methodological and data foundation of planning and monitoring |
| Excellent | - Excellent planning quality<br>- Excellent planning consistency and stability<br>- Excellent planning process<br>- Excellent implementation level of planning as management function/tool<br>- Excellent partial plans<br>- Excellent methodological and data foundation of planning and monitoring |

Source: Dagong

### III.2.4 Sustainability Management

In recent years, based on experienced external shocks systemic environmental, social and governance (EDS) factors have been increasingly incorporated into the corporate strategy, the business plan formulation and lastly in the analysis of the business and financial profile of companies. Concerning this matter, sustainable economic performance requires in the coming years proactive and comprehensive actions from companies and investors likewise. Dagong believes that a company's management of ESG factors, as well as a company's leadership on sustainable development, are at the core of business today, since ESG factors can be financially material and hurt or enhance the long-term and sustainable company value as well as the credit profile.

From Dagong's perspective, leading and successful global companies are those that provide goods and services and reach new customers in ways that address the world's major challenges referred to with the ESG factors, e.g. including poverty, climate change, resource depletion, globalization and demographic shifts etc.

The financial performance of a company can be positively and negatively impacted on the long run by any of the ESG factors. Even though the portfolio of relevant ESG factors in an industry still might not be valued completely by a company's management and its investor base, a minimum of observation and consideration of fundamental ESG factors should be ensured in each company. Still today, many investors do not systematically and routinely integrate ESG factor assessments in their investment or credit analysis. Therefore, the risk of under or overvaluation of the long-term intrinsic value of a company based on its sustainable credit profile is present in business decisions.

Even though the expertise about the systemic link between ESG factors and financial performance has been enhanced in recent years, discussions about the financial materiality of different manifestations of individual ESG factors are still very intense. ESG does not only affect the company's reputation and branding and is not only related to corporate governance issues. But, companies who aim to be successful have to know how and why specific ESG factors could substantially increase their overall risk profile. However, even if these companies have expertise in these ESG matters, access to this information by external parties is still somehow difficult. Also the information contained in sustainability reports is still difficult to use for the purposes of valuing a company or to assess its effects on the medium to long-term credit profile.

Therefore, the analytical building block 'Sustainability Management' covers only Sustainability Management, i.e. the formal way of integrating these issues in the strategy process and the corporate planning. It covers the link between individual ESG factors, the structuring and arrangement of the corporate strategy, the achieved financial performance as well as the disclosure and public communication of the related sustainability issues to the investor community. It includes the background for our assessment regarding the materiality of the ESG issue and the relative management performance regarding ESG compared to relevant competitors.

If individual ESG/sustainability issues are already impacting factors covered in the Operations and Competition Analysis or the Financial Analysis, then these issues will be reflected in the respective assessments.

Dagong analyses if a company focuses on just one element (E, S or G - predominantly on climate change or governance issues) or if a company bundles ESG factors only in the context of reputation and brand issues, but does not manage ESG factors and sustainability in the context of their financial materiality.

Dagong also assesses if a company set up specific corporate roles engaged in sustainability issues like corporate sustainability managers. These roles can – if equipped with sufficient expertise and included properly in the corporate communication process - bridge important knowledge gaps between IR managers, Senior Management and investors in the financial community.

As part of an entity's corporate strategy, sustainability should be firmly established at Board level. Responsibility for the entity's sustainable orientation should lie with a Board of Management member responsible for sustainability maybe in his role as Chief Sustainability Officer, and with a Sustainable Development Committee (SDC) under the auspices of a specialised sustainability function. A SDC sets targets and draws up initiatives, management systems and corporate policies, and is responsible for their implementation.

Non-financial targets and key performance indicators along the major parts of the value chain should support the operational implementation. The design of corporate policies should also help to establish sustainability principles in all business operations and to implement them in relevant management systems, committee procedures and business processes. The continuous improvement of the management systems and the alignment with all relevant internal and external requirements should be guaranteed by regular reviews and internal audits.

On the long run companies could destroy company value if they do not manage in a structured and responsible way material ESG factors already identified. They can either not take advantage of new market opportunities resulting from market demand related to global sustainability issues or they are not able to mitigate negative financial impacts arising out of them. Therefore, Dagong also assesses the attempts to specify the timing and to quantify the magnitude of impacts from material ESG factors.

The qualitative assessment of the Sustainability Management uses the 7 category scale with the following general meaning:

**Exhibit 8: Sustainability Management Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very low sustainability commitment<br>- Very low implementation level of sustainability management<br>- Very low elaboration level of ESG analysis for opportunities and threats identification |
| Weak | - Low sustainability commitment<br>- Low implementation level of sustainability management<br>- Low elaboration level of ESG analysis for opportunities and threats identification |
| Moderate | - Moderate sustainability commitment<br>- Moderate implementation level of sustainability management<br>- Moderate elaboration level of ESG analysis for opportunities and threats identification |
| Satisfactory | - Satisfactory sustainability commitment<br>- Satisfactory implementation level of sustainability management<br>- Satisfactory elaboration level of ESG analysis for opportunities and threats identification |
| Strong | - High sustainability commitment<br>- High implementation level of sustainability management<br>- High elaboration level of ESG analysis for opportunities and threats identification |
| Very strong | - Very high sustainability commitment<br>- Very high implementation level of sustainability management<br>- Very high elaboration level of ESG analysis for opportunities and threats identification |
| Excellent | - Extremely high sustainability commitment<br>- Extremely high implementation level of sustainability management<br>- Extremely high elaboration level of ESG analysis for opportunities and threats identification |

Source: Dagong

## III.3 Operations and Competition Analysis

The relationship among the operational capacity, competitive position and business strategy is crucial to the rating assessment as it drives the long-term operational success, hence the credit strength of an entity. Dagong assesses the competitive advantages and position of a rated entity by comparing its business scope, product portfolio diversification, distribution networks and key customer and supplier relationships with those of its competitors. The analysis of the financial policy is also included in the assessment, in order to evaluate management appetite to undertake risks within business strategies and balance them with expected gains and opportunities.

Risks involved in different businesses and development strategies vary, depending on the focus, scope and breadth of the envisaged transformations. The focus on maximising the utilisation of existing resources and improving efficiency contains risks, but limits rapid market share expansion. To achieve significant market share or competitive position enhancement, an entity must focus on structurally adjusting its corporate resources, executing product restructuring, increasing diversification or gaining technological advantages. In evaluating an entity's operations and competitive strengths, Dagong takes into consideration the following three analytical building blocks: (i) Diversification and Dependencies; (ii) Competitive Position (iii) Operational Management of Business Functions and (iv) Financial Policy.

This analytical step focuses on the stability, strength and weaknesses of an entity's business profile and supports the evaluation of an entity's ability to withstand adverse external developments while preserving a solid and stable financial profile.

### III.3.1 Diversification and Dependencies

The first item considered in this analytical building block is the entity's size. Small or modest entity size is considered an adverse factor within the rating criteria. Dagong, however, does not exclude that modest-size entities can enjoy a significant competitive advantage if they manage to build defendable market positions in niche segments. On the other hand, smaller entities tend to be more concentrated in terms of geography, product, supplier and customer base. Diversification helps entities to protect themselves against the negative impact of industry's cyclicality, adverse regional economic developments, and hostile regulatory or legislative actions. Having a diverse range of products, customers, and suppliers, helps entities to protect themselves against such adversities. In addition, ample geographical spread usually provides a degree of protection against adverse changes in regional markets and economies, if the markets are not completely correlated. Furthermore, the large size is often positively correlated with stronger bargaining power. Economies of scale in purchasing, manufacturing and distribution can provide large entities with better cash flows, which is of particular importance at the low point of the cycle.

The analytical building block 'Diversification and Dependencies' uses absolute revenue for the first rating factor 'Size'. Additionally, Dagong takes into consideration various market share and relative-size-to-peers estimations for the second rating factor 'Relative Size' for scoring entities within its competitive environment, as it determines its market position, the extent of diversification and potential financial flexibility.

The third rating factor covers 'Diversification'. In cases where an entity operates in more than one unrelated industry, Dagong analyses each business segment separately. The separate assessments are subsequently combined, factoring in each element according to its weight within the overall organisation, preferably based on estimated earnings contribution if available (or revenues alternatively). Having a solid competitive position in several industries is considered as a positive credit factor. The business profile of an entity which is solidly positioned in an array of cash-generative businesses with different industrial cycles, is stronger in terms of credit quality than each of its best-ranked standalone competitors.

Dagong assesses the benefits of diversification looking at several overlapping dimensions of diversification, i.e. with respect to geographical market coverage, client types, products and services (segments), lifecycle, price segments and distribution channels and supplier. It should be noted that extra caution is required to assess the benefits of diversification, with respect to weaker competitive positions, segments or covered regional markets with a difficult operational environment.

Entities with broad geographical market coverage, comprehensive product offerings and without major customer or supplier concentration would score highly within the rating factor ‘Diversification’. High concentration in peripheral or under-performing regions, particularly if accompanied by a high share of commodity-type products in the portfolio and significant customer or supplier concentration would constrain the assessment under this rating factor.

The qualitative assessment of the Diversification and Dependencies uses the 7 category scale with the following general meaning:

**Exhibit 9: Diversification and Dependencies Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very low diversification by geographical market coverage<br>- Very low diversification by client types<br>- Very low diversification by products and services (segments)<br>- Very low diversification by lifecycle status of products and services<br>- Very low diversification by price segments and distribution channels<br>- Extremely high supplier dependency |
| Weak | - Low diversification by geographical market coverage<br>- Low diversification by client types<br>- Low diversification by products and services (segments)<br>- Low diversification by lifecycle status of products and services<br>- Low diversification by price segments and distribution channels<br>- Very High supplier dependency |
| Moderate | - Moderate diversification by geographical market coverage<br>- Moderate diversification by client types<br>- Moderate diversification by products and services (segments)<br>- Moderate diversification by lifecycle status of products and services<br>- Moderate diversification by price segments and distribution channels<br>- High supplier dependency |
| Satisfactory | - Satisfactory by diversification by geographical market coverage<br>- Satisfactory by diversification by client types<br>- Satisfactory by diversification by products and services (segments)<br>- Satisfactory by diversification by lifecycle status of products and services<br>- Satisfactory by diversification by price segments and distribution channels<br>- Satisfactory by supplier dependency |
| Strong | - High diversification by geographical market coverage<br>- High diversification by client types<br>- High diversification by products and services (segments)<br>- High diversification by lifecycle status of products and services<br>- High diversification by price segments and distribution channels<br>- Moderate supplier dependency |
| Very strong | - Very High diversification by geographical market coverage<br>- Very High diversification by client types<br>- Very High diversification by products and services (segments)<br>- Very High diversification by lifecycle status of products and services<br>- Very High diversification by price segments and distribution channels<br>- Low supplier dependency |
| Excellent | - Extremely high diversification by geographical market coverage<br>- Extremely high diversification by client types<br>- Extremely high diversification by products and services (segments)<br>- Extremely high diversification by lifecycle status of products and services<br>- Extremely high diversification by price segments and distribution channels<br>- Very low supplier dependency |

Source: Dagong

## III.3.2 Competitive Position

The industry environment (whether highly competitive, oligopolistic or monopolistic) strongly influences its players’ risk profiles. Changes in an entity’s competitive position can explain the revision of its credit standing.

A strong business profile must be accompanied by a strong competitive positioning. A weak competitive positioning, even in a highly favourable industry environment, is unlikely to result in a strong credit profile. In a monopolistic industry, where one entity controls all significant levels of production and distribution, government regulations, policies, and requirements may represent additional risk elements that need to be considered.

The quality of an entity's product offering needs to be benchmarked against the industry standards and competitors' offerings. Also, the diversity of an entity's existing product portfolio and its commitment to develop new products, should be compared with its competitors.

Support from upstream and downstream counterparties helps an entity to increase its competitiveness. Dagong's analysis focuses on understanding the strength of an entity's relationship with its main suppliers, in addition to the stability of the client base. The quality of an entity's business network and channel diversification play an important role in converting products into profits. The analysis of logistic models, as supporting tools for promoting successful business network development, is also essential to judge the validity and the efficiency of the distribution network.

The operational analysis further focuses on technology, and whether advanced technology can bring benefit to product cost and quality when compared to peers. Significant weight is also given to the entity's attitude towards investment in R&D. In more fragmented markets, a reputable and well-known brand represents a competitive advantage. A strong competitive position also supports an entity's cash flow generation stability and ability to service debt. Entities with leading market positions supported by a comprehensive product portfolio and strong brand recognition would score high within Dagong's rating factor 'Competitive Positioning'. Entities with limited shares in regional markets, that face high competition with low brand awareness or weak pricing power, would score lower. Niche market players would need to possess strong protection from competitors in order to achieve higher-than-modest score within this rating factor.

The qualitative assessment of the Competitive Position uses the 7 category scale with the following general meaning:

**Exhibit 10: Competitive Position Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very weak competitive position regarding quality of products and services<br>- Very weak competitive position regarding product portfolio diversity (i.e. existing portfolio and commitment for new product development)<br>- Very weak competitive position regarding business relationship with key suppliers<br>- Very weak competitive position regarding business network, logistic model, client base and channel occupation<br>- Very weak competitive position regarding use of advanced technology and R&D to improve product cost and quality<br>- Very weak competitive position regarding reputation and brand recognition compared to industry-wide brand awareness and pricing power |
| Weak | - Weak competitive position regarding quality of products and services<br>- Weak competitive position regarding product portfolio diversity (i.e. existing portfolio and commitment for new product development)<br>- Weak competitive position regarding business relationship with key suppliers<br>- Weak competitive position regarding business network, logistic model, client base and channel occupation<br>- Weak competitive position regarding use of advanced technology and R&D to improve product cost and quality<br>- Weak competitive position regarding reputation and brand recognition compared to industry-wide brand awareness and pricing power |
| Moderate | - Moderate competitive position regarding quality of products and services<br>- Moderate competitive position regarding product portfolio diversity (i.e. existing portfolio and commitment for new product development)<br>- Moderate competitive position regarding business relationship with key suppliers<br>- Moderate competitive position regarding business network, logistic model, client base and channel occupation<br>- Moderate competitive position regarding use of advanced technology and R&D to improve product cost and quality<br>- Moderate competitive position regarding reputation and brand recognition compared to industry-wide brand awareness and pricing power |
| Satisfactory | - Satisfactory competitive position regarding quality of products and services<br>- Satisfactory competitive position regarding product portfolio diversity (i.e. existing portfolio and commitment for new product development)<br>- Satisfactory competitive position regarding business relationship with key suppliers<br>- Satisfactory competitive position regarding business network, logistic model, client base and channel occupation<br>- Satisfactory competitive position regarding use of advanced technology and R&D to improve product cost and quality<br>- Satisfactory competitive position regarding reputation and brand recognition compared to industry-wide brand awareness and pricing power |
| Strong | - Strong competitive position regarding quality of products and services<br>- Strong competitive position regarding product portfolio diversity (i.e. existing portfolio and commitment for new product development)<br>- Strong competitive position regarding business relationship with key suppliers<br>- Strong competitive position regarding business network, logistic model, client base and channel occupation<br>- Strong competitive position regarding use of advanced technology and R&D to improve product cost and quality<br>- Strong competitive position regarding reputation and brand recognition compared to industry-wide brand awareness and pricing power |
| Very strong | - Very strong competitive position regarding quality of products and services<br>- Very strong competitive position regarding product portfolio diversity (i.e. existing portfolio and commitment for new product development)<br>- Very strong competitive position regarding business relationship with key suppliers<br>- Very strong competitive position regarding business network, logistic model, client base and channel occupation<br>- Very strong competitive position regarding use of advanced technology and R&D to improve product cost and quality<br>- Very strong competitive position regarding reputation and brand recognition compared to industry-wide brand awareness and pricing power |
| Excellent | - Excellent competitive position regarding quality of products and services<br>- Excellent competitive position regarding product portfolio diversity (i.e. existing portfolio and commitment for new product development)<br>- Excellent competitive position regarding business relationship with key suppliers<br>- Excellent competitive position regarding business network, logistic model, client base and channel occupation<br>- Excellent competitive position regarding use of advanced technology and R&D to improve product cost and quality<br>- Excellent competitive position regarding reputation and brand recognition compared to industry-wide brand awareness and pricing power |

Source: Dagong

### III.3.3. Operational Management of business functions

The rating factor ‘Operational Management of business functions’ focuses on the day-to-day management quality shown by the entity’s management team with respect to the set-up of basic business functions within the company. Dagong concentrates on three selective business functions which are common for all industries and where a comparison across industries might make sense:

- Human Resources
- IT
- Controlling

Dagong believes, that each of these basic business functions need to support a successful and robust business profile making relevant business processes in particular scalable, predictable, verifiable and independent from key personnel. Therefore aspects like the existence of an appropriate process set-up, an adequate organisational set-up including staffing by number and qualification, a comprehensive process documentation and an active board support are assessed.

The qualitative assessment of the Operational Management of business functions uses the 7 category scale with the following general meaning:

**Exhibit 11: Operational Management of business functions Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very Weak human resources<br>- Very Weak IT<br>- Very Weak controlling |
| Weak | - Weak human resources<br>- Weak IT<br>- Weak controlling |
| Moderate | - Moderate human resources<br>- Moderate IT<br>- Moderate controlling |
| Satisfactory | - Satisfactory human resources<br>- Satisfactory IT<br>- Satisfactory controlling |
| Strong | - Strong human resources<br>- Strong IT<br>- Strong controlling |
| Very strong | - Very Strong human resources<br>- Very Strong IT<br>- Very Strong controlling |
| Excellent | - Excellent human resources<br>- Excellent IT<br>- Excellent controlling |

Source: Dagong

### III.3.4 Financial Policy

In general, policies refer to a set of rules, values, beliefs and guiding principles made by an entity which direct the decisions of the organisation. Policies are framed by the top level management to lay down the course of action and to serve as a guideline for current and future operational decision making. They have to be consistently applied over a long period to avoid discrepancies and overlapping. Policies are subordinated to strategies, which are action plans designed with the aim of reaching the organisational goals and objectives, flexible and dynamic in nature and formulated by the top level management and the middle level management (sub-strategies). They are a combination of well-thought intents and actions, a combination of flexibly designed corporate moves.

Therefore, Dagong looks closely at financial policies, which reflect management's philosophies regarding financial risk and are used to regulate the interests of the entity's stakeholders, in order to assess attitudes towards aggressiveness, conservatism, sophistication, and consistency. These differ among entities and can be driven by various factors, including management preferences, business requirements, shareholder value considerations, etc.

Financial policies have to be tested on the basis of realistic possibilities available for the management, in a specific macroeconomic context, industry environment and performance of main competitors. Management's flexibility in adjusting financial policies to reflect an evolving macroeconomic environment, industry cycle and competition, in order to utilise opportunities and effectively respond to envisaged threats, is seen as a positive. Debt usage and shareholder rewards need to be judged in the context of the entity's capability to generate and maintain cash flows and the stability of these cash flows.

Tolerance for risk extends beyond appetite for leverage. The assessment of an entity's financial policy must also focus on the choice, complexity and riskiness of the financial instruments. When assessing financial policies, Dagong considers the balance of long- and short-term debt in relation to the life span of the asset base, the proportion of fixed- and floating-rate debt and the utilisation of natural or financial hedging for foreign currency exposures. Management of a debt maturity profile in accordance with expected future cash flow generation combined with the planned capital investments is also critical.

Entities with a conservative financial policy, which is successfully managed to balance creditors' and shareholders' interests and to generate adequate free cash flow to cover necessary funding, would score high within the rating factor 'Financial Policy'. These entities are generally characterised by high credit profiles (expressed by a strong credit rating) and supported by long-term committed credit lines (without covenants or with ample headroom under covenants). Conversely, financial policies that favour shareholder returns, either via dividends or shares buyback or, that foresee aggressive acquisition strategies not supported by adequate internal cash flow generation and with limited external funding sources, would score lower.

The qualitative assessment of the Financial Policy uses the 7 category scale with the following general meaning:

**Exhibit 12: Financial Policy Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very weak financial strategy<br>- Very weak commitments and guiding principles<br>- Very weak general set-up of procurement of funds<br>- Very weak use of M&A<br>- Very weak dividend policy |
| Weak | - Weak financial strategy<br>- Weak commitments and guiding principles<br>- Weak general set-up of procurement of funds<br>- Weak use of M&A<br>- Weak dividend policy |
| Moderate | - Moderate financial strategy<br>- Moderate commitments and guiding principles<br>- Moderate general set-up of procurement of funds<br>- Moderate use of M&A<br>- Moderate dividend policy |
| Satisfactory | - Satisfactory financial strategy<br>- Satisfactory commitments and guiding principles<br>- Satisfactory general set-up of procurement of funds<br>- Satisfactory use of M&A<br>- Satisfactory dividend policy |
| Strong | - Strong financial strategy<br>- Strong commitments and guiding principles<br>- Strong general set-up of procurement of funds<br>- Strong use of M&A<br>- Strong dividend policy |
| Very strong | - Very strong financial strategy<br>- Very strong commitments and guiding principles<br>- Very strong general set-up of procurement of funds<br>- Very strong use of M&A<br>- Very strong dividend policy |
| Excellent | - Excellent financial strategy<br>- Excellent commitments and guiding principles<br>- Excellent general set-up of procurement of funds<br>- Excellent use of M&A<br>- Excellent dividend policy |

Source: Dagong

## III.4 Financial Analysis

Dagong’s analysis of an entity’s financial strength focuses on its operating profitability, the strength of its balance sheet, its cash flow generation capability and its liquidity profile. Profitability represents the ability of an entity to earn a profit and seen as a relative measure of success of an entity’s business model, and its competitive position among competitors. The balance sheet analysis is focused on an entity’s asset composition and its ability to generate future cash flows. Cash flow analysis involves identifying, understanding and forecasting how cash is generated and spent, distinguishing among operating, investing and financing flows, and understanding potential reasons behind any distortion or future volatility.

The financial analysis is primarily based on the most recent audited financial reports available, including income statement, balance sheet and cash flow statement as well as full sets of notes included within an entity’s annual, semi-annual or quarterly reports. To complete the Financial Analysis Dagong also requires a comprehensive set of other financial documents, including financial plans, forecasts and projections as the rating assessment represents a forward looking view. Although financial projections and forecasts usually begin with assumptions provided by the entity (company case), they are always tested and exposed to plausibility checks and adjustments, assuming different developments impacting an entity's operating and financial performance (due to both endogenous and exogenous factors). Finally, the proposed rating is based on the expected case including any adjustments made by Dagong.

Although financial analysis is primarily quantitative, the interpretation and application of the quantitative financial analysis need to be cross-checked against the applied assumptions and conditions and aligned with the results of the qualitative rating factors pertaining to the operational environment.

The financial profile of an entity includes the analysis of selected ratios from different financial areas. Although an industry may have specific quantitative indicators, the rating criteria focus on a number of commonly-accepted ratios pertaining to the following areas: (i) debt coverage, (ii) financial leverage (iii) operating profitability (iv) liquidity, as the cornerstones of financial analysis and applicable across a wide range of industries.

### Analytical adjustments to financial statements

To ensure accurate representation and consistency of the financial ratios used for comparison amongst competitors, Dagong adjusts entities' reported data by using public information primarily available within their audited financial reports. Through a detailed set of adjustments to each of the three financial statements, Dagong's analysis aspires to reflect more accurately the economic reality behind an entity's financial and operating performance. The adjustments aim to smooth the effects of different accounting policies, to enhance comparison among companies that apply different reporting standards and to remove exceptional items temporarily affecting entities' profitability and cash flow generation. The most common adjustments refer to the following areas: use of third-parties assets, pensions, nuclear liabilities, hybrids, put options, guarantees, restricted cash and exceptional items affecting the income and cash flow statements. For more information please refer to Dagong's Rating Criteria 'Dagong Accounting Adjustments to Financial Statements of Non-Financial Corporates Criteria Complement'.

### III.4.1 Debt Coverage

The analysis of an entity's debt repayment capability assesses the adequacy of its cash flow generation in relation to current debt position and maturity profile. Cash flow generation based ratios, utilised in debt repayment analysis, should reflect the individual characteristics of the rated entity and its sector. In case of financially strong companies operating in stable industries, the analysis could largely rely on operating cash flow and its relationship to the debt burden. Conversely, when considering entities with a weaker position, lower margin propositions or operating in sectors with higher cyclicality, the focus moves to free cash flow generation. The assessment of the future evolution of cash flow generation and debt burden represents a key part of entity's debt repayment capability and its overall credit risk profile.

The underlying concept of a credit rating is based on the assessment of an entity's ability to generate sufficient cash flows to service and repay debts or any other obligations. Although there is generally a strong correlation between operating cash flow and profitability, cash flow analysis is considered more important as income statement profitability, which may be affected by accounting transactions that have a material impact on earnings but not on the actual cash generation.

In the Debt Coverage analysis, Dagong focuses on (i) adjusted Funds From Operations (FFO) Interest Coverage (calculated as FFO plus Interest Expense / Interest Expense), (ii) adjusted Retained Cash Flow (RCF) / Gross Debt, and (iii) Free Cash Flow (FCF) / Gross Debt, which represent the essential group of ratios for assessing an entity's ability to service its debt. An extensive overview of the cash flow ratio definitions is available in the Appendix at the end of this report.

### III.4.2 Leverage

The assessment of the capital structure and definition of debt and equity requires extensive analytical inputs. Determination of debt and equity for the purpose of leverage analysis involves numerous analytical adjustments covering various on- and off-balance sheet liabilities, non-recourse debt structures, hybrid instruments and treatment of cash or cash-like securities.

A well-balanced capital structure, which is defined as the set of external funding resources and their share of the entities' overall funding, is essential for the issuer to achieve its operational performance objectives and to secure a sustainable financial profile in the long-term. A well-conceived capital structure should aim to balance cost benefits and associated risks; as over-leveraging increases risk, under-leveraging may represent potential financial inefficiencies.

Dagong focuses its leverage analysis on (i) adjusted Gearing Ratio (calculated as Total Gross Debt / Total Gross Debt and Equity) and (ii) adjusted Total Gross Debt / EBITDA. In exceptional circumstances, to be analysed on a case-by-case basis, discretion is given to the analyst and to the rating committee to consider Net Debt. An extensive definition of what is considered as 'Debt' by Dagong, is available in the Appendix at the end of this report.

Dagong recognises that EBITDA has limitations relating to potential accounting issues, as it ignores balance sheet movements that impact cash flow. However, the Total Gross Debt / EBITDA ratio has been incorporated into the leverage analysis as it allows broader comparison amongst competitors, is commonly used, and is often available.

### III.4.3 Profitability

In addition to revealing an entity's ability to earn a profit, profitability is also a good indicator of an entity's ability to withstand adverse business developments. Strong operating margins support an entity's ability to generate internal sources, attract external funding, and protect its credit profile. Profitability indicates an entity's overall health and competitive position among competitors. Major ratios in profitability analysis include operating margins, returns on assets and equity. Although operating margin definitions may differ across industries and regions, they generally indicate the overall strength of an entity's operation and how sound its business model is. Dagong identified the adjusted EBIT Margin as the main indicator of profitability as it reflects profit contribution from different layers of operations and is the key in determining core corporate profitability.

Similarly to EBITDA, EBIT also has limitations due to accounting treatments, but it is widely used, always available, and suitable for a wide range of comparisons amongst competitors.

### III.4.4. Liquidity

Dagong complements its financial analysis with an evaluation of an entity's overall liquidity profile (i.e. the capacity of an entity to turn assets into cash, with cash itself (i.e. money) as the most liquid asset) and its current and projected liquidity position. Sufficiency and availability of internal and external financial sources, relative to financial obligations and expected cash uses in the short-to-medium term, represent the pillars of strong liquidity that is fundamental to a sound and viable financial profile.

Liquidity analysis represents a fundamental part of an entity's credit profile. Even companies with a solid business proposition and moderate leverage can experience liquidity problems. Liquidity analysis focuses on the assessment of an entity's ability to withstand, in the short- to medium- term, any adverse external developments such as capital market freezes, restrictions on bank funding or adverse sovereign actions, relying on its own-generated cash flow and committed external resources. The analysis aims to compare the strength, reliability and availability of both internal and external sources of liquidity with anticipated cash outflows that the entity has within the same time horizon. In general, the liquidity analysis tests an entity's ability to cover its upcoming cash outflows in the short-term under a scenario of restricted access to new external financing.

The quality and reliability of an entity's initial cash position and its potential for future cash flow generation are scrutinised. Only headroom under fully committed credit lines without any major availability restrictions should be considered when analysing an entity's sources of liquidity. Restrictive covenants or drawdown conditionality significantly constrains the utilisation of credit facilities and could reduce support to the liquidity profile. Among the main cash outflows are working capital requirements, capital expenditures, planned shareholder returns and upcoming debt maturities. As the liquidity analysis assumes a distressed scenario, all short-term facilities that are coming due should be considered for repayment.

Companies simply need liquidity for working capital purposes, so traditionally they borrow that liquidity from a bank. But, companies themselves also generate liquidity in their day-to-day operations so they look at how this can be used efficiently. Furthermore, companies are continuously questioning why they actually need that amount of liquidity, trying to determine ways to reduce the liquidity requirement itself. Today, companies are looking at all three aspects rather than just tapping the banking market for further liquidity. They are proactively trying to ensure that they have the appropriate liquidity profile in order to run their day-to-day operations. And when surplus cash is available, they are looking at investing this in primarily short-term instruments. In addition to that, they try to take a proactive approach to short-term cash management and aim to increase visibility - and mobility - of cash worldwide as much as possible. They also place a focus on cash forecasting which they consider the core of corporate treasury, are extending its supply chain finance products in order to reduce the cash consumption for working capital etc. Finally, there is already some level of cash awareness in the overall business, but advanced techniques of Liquidity Risk Management also help to increase the robustness of the credit profile.

Due to the different aspects and dimensions of liquidity and their importance for the credit profile, the overall assessment of the analytical building block 'Liquidity' is composed of quantitative and qualitative rating factors. The assessment of the rating factors 'Cash Position', 'Internal Liquidity Sources' and 'External Liquidity Sources' are done on a qualitative basis.

This qualitative assessment is supported by a quantitative measure. For an entity accounting liquidity is a measure of ability to pay off debts as they come due. For the assessment of accounting liquidity, liquid assets have to be compared with current liabilities. Depending on the definition of liquid assets, several ratios can be calculated.

The following ratios are used by Dagong to analyse accounting liquidity:

- Current Ratio = Current Assets / Current Liabilities, whereby current assets are those that can reasonably be converted into cash within 12 months
- Quick Ratio = (Cash and Cash Equivalents + Short-Term Investments + Accounts Receivable) / Current Liabilities; excluding inventories and other current assets, which are not as liquid as cash and cash equivalents, accounts receivable and short-term investments
- Cash Ratio = (Cash and Cash Equivalents + Short-Term Investments) / Current Liabilities; excluding accounts receivable, as well as inventories and other current assets.

Based on quarterly data for the next eight quarters Dagong calculates all three ratios and assesses the liquidity position.

Furthermore, Dagong analyses the bank and credit relationships of an entity focusing for example on the number, type and length of business relation as well as the bank concentration to assess the stability and support from the existing relationships with the banking sector to maintain a solid liquidity base.

To assess the alternative way of long-term funding and liquidity via the capital market, Dagong looks at the capital market access in the home market of the entity, the capital market experience and reputation, the capital market appetite for the entity and the availability and acceptance of appropriate collateral for any sort of secured funding.

Finally, Dagong assesses the existing covenants in current loan agreements and capital market issuances of the entity, i.e. terms and conditions that are mandatorily required to be fulfilled by the entity during the tenancy of relevant debt instruments. Covenants are designed to protect investors and typically require the entity to meet certain conditions or refrain from undertaking certain actions over the life of the respective debt instrument. Covenants can therefore reduce credit risk by giving the entity less room to manoeuvre and clarifying the status of lenders in the event of insolvency. From a liquidity perspective, covenants can directly impact the liquidity position of the entity, for example through a liquidity covenant or a minimum liquidity covenant according to which the entity shall, at all times, maintain unrestricted cash and cash equivalents in one or more deposit accounts in an aggregate amount equal to or greater than a certain sum. On the other hand, covenant breaches of whatever type of covenant can lead to a redirection of liquidity or a limitation of pay-outs. Therefore, Dagong also evaluates how close the entity is to any liquidity relevant covenant breach.

The qualitative assessment of the Liquidity uses the 7 category scale with the following general meaning:

**Exhibit 13: Liquidity Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very Weak cash position<br>- Very Weak internal liquidity sources and uses<br>- Very Weak external liquidity sources<br>- Very Weak covenants<br>- Very Weak banking relationships<br>- Very Weak capital market access |
| Weak | - Weak cash position<br>- Weak internal liquidity sources and uses<br>- Weak external liquidity sources<br>- Weak covenants<br>- Weak banking relationships<br>- Weak capital market access |
| Moderate | - Moderate cash position<br>- Moderate internal liquidity sources and uses<br>- Moderate external liquidity sources<br>- Moderate covenants<br>- Moderate banking relationships<br>- Moderate capital market access |
| Satisfactory | - Satisfactory cash position<br>- Satisfactory internal liquidity sources and uses<br>- Satisfactory external liquidity sources<br>- Satisfactory covenants<br>- Satisfactory banking relationships<br>- Satisfactory capital market access |
| Strong | - Strong cash position<br>- Strong internal liquidity sources and uses<br>- Strong external liquidity sources<br>- Strong covenants<br>- Strong banking relationships<br>- Strong capital market access |
| Very strong | - Very Strong cash position<br>- Very Strong internal liquidity sources and uses<br>- Very Strong external liquidity sources<br>- Very Strong covenants<br>- Very Strong banking relationships<br>- Very Strong capital market access |
| Excellent | - Excellent cash position<br>- Excellent internal liquidity sources and uses<br>- Excellent external liquidity sources<br>- Excellent covenants<br>- Excellent banking relationships<br>- Excellent capital market access |

Source: Dagong

## IV COMPILATION OF THE STANDALONE CREDIT ASSESSMENT

After running all analytical steps described above, Dagong determines a Stand-alone Credit Assessment (SACA) for each period by aggregating the analytical results of each analytical step, analytical building block and rating factor. The analytical results, i.e. the calculated figures or ratios of all quantitative rating factors and the expert judgement-based assessments of all qualitative rating factors will be mapped to one category of Dagong's 7-category scale which in each case is equivalent to a numeric score (i.e. either 22, 19.5, 15.5, 11.5, 7.5, 3.5 and 1).

Primarily, Dagong uses static weights in a weighted sum concept as shown in the following table:

**Exhibit 14: Framework of Dagong's Rating Criteria for Non-Financial Corporates**

| Analytical Step | Weight | Analytical Building Block | Weight | Rating Factor (Analytical Building Block) | Weight |
|---|---|---|---|---|---|
| Environment Analysis | 15% | Macro-economic Environment | 6.8% | GDP Growth Rate | 2.3% |
| | | | | CPI | 2.3% |
| | | | | Unemployment Rate | 2.3% |
| | | Industry Environment | 4.5% | Industry Environment | 4.5% |
| | | Regulatory and Legal Environment | 3.8% | Regulatory and Legal Environment | 3.8% |
| Corporate Governance and Development Strategy Analysis Development Strategy | 15% | Corporate Governance | n/a | Corporate Governance | n/a |
| | | Development Strategy | 15.0% | Corporate Strategy | 6.0% |
| | | | | Planning | 5.3% |
| | | | | Sustainability | 3.8% |
| Operations and Competition Analysis | 30% | Diversification and Dependencies | 12.0% | Size | 3.0% |
| | | | | Relative Size | 3.0% |
| | | | | Diversification | 6.0% |
| | | Competitive Position | 6.0% | Competitive Position | 6.0% |
| | | Operational management of business functions | 3.0% | Operational management of business functions | 3.0% |
| | | Financial Policy | 9.0% | Financial Policy | 9.0% |
| Financial Analysis | 40% | Debt Coverage | 16.0% | (FFO+Interest)/Interest | 6.4% |
| | | | | RCF/Debt | 4.8% |
| | | | | FCF/Debt | 4.8% |
| | | Leverage | 12.0% | Debt/(Debt+Equity) | 3.6% |
| | | | | Debt/EBITDA | 8.4% |
| | | Profitability | 8.0% | EBIT Margin | 8.0% |
| | | Liquidity | 4.0% | Liquidity | 4.0% |

In the weighted sum concept the numeric scores and the respective weights are the two types of input factors to calculate all subsequent weighted aggregated results.

In addition, to put more emphasis on weaker assessments and to adopt an asymmetric view on risk when aggregating, Dagong uses a dynamic weight concept, which will be applied for the weights of the analytical steps ('Operational Environment Analysis' to 'Financial Analysis') to give more emphasis on notably negative assessments. In cases in which the result of an analytical step exceeds the related Rating Rank Threshold (e.g. 'B'-category level or below) a pre-determined Reallocation Weight (based on the level of the static weight of the respective analytical step and the weights of all other impacted analytical steps) will be added to the static weight of the respective analytical step. At the same time the static weight of the other three analytical steps will be reduced on a pro rata basis using the static weights as pro-rata parameter (Deduction Weight).

**Exhibit 15: Dynamic Weights**

| Analytical Step | Static Weight | Rating Rank Threshold | Reallocation Weight |
|---|---|---|---|
| Environment Analysis | 15% | B (<9,5 of 22-scale) | 5% |
| Corporate Governance and Development Strategy Analysis | 15% | B (<9,5 of 22-scale) | 5% |
| Operations and Competition Analysis | 30% | B (<9,5 of 22-scale) | 10% |
| Financial Analysis | 40% | B (<9,5 of 22-scale) | 10% |

Therefore, the final dynamic weight of each analytical step is calculated as sum of the static weight of the respective analytical step, the Reallocation Weight and the Deduction Weights for each analytical step according to the following formula:

$\text{Dynamic Weight}_{\text{Analytical Step(1)}} = \text{Static Weight}_{\text{Analytical Step(1)}} + \text{Reallocation Weight}_{\text{Analytical Step(1)}} - (\text{Deduction Weight}_{\text{Analytical Step(2)}} + \text{Deduction Weight}_{\text{Analytical Step(3)}} + \text{Deduction Weight}_{\text{Analytical Step(4)}})$

The same dynamic weight concept will be applied to the analytical building block 'Liquidity' within the analytical step 'Financial Analysis'. The static weight of 'Liquidity' will be increased by 10 percentage points (Reallocation Weight) if the respective result is below the BB-category. The static weight of 'Profitability', 'Debt Coverage' and 'Leverage' will be reduced according to their pro-rata static weights.

## V. EXTERNAL SUPPORT ANALYSIS

The next analytical step refers to the analysis of external support (External Support Analysis, ESA) which has been developed to facilitate Dagong's assessment of

- the probability of an entity to receive external support under a scenario of financial distress (Likelihood of Support); and
- the potential extent of the support to be received (Level of Support).

The outcome of the ESA framework, the External Support Strength expressed in four categories (Low, Moderate, High or Very High), provides a joined indication of Dagong's view on the Likelihood of Support and the Level of Support, both expressed as one category of Dagong's 7-category scale (Excellent to Very Weak). However, the final impact on the rated entity's credit rating is determined by a rating committee.

**Exhibit 16: External Support Strength**

| | | Level of Support | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | Very weak | Weak | Moderate | Satisfactory | Strong | Very Strong | Excellent |
| Likelihood of Support | Excellent | Low | Low | Low | Moderate | High | Very High | Very High |
| | Very Strong | Low | Low | Low | Moderate | High | Very High | Very High |
| | Strong | Low | Low | Low | Moderate | High | High | High |
| | Satisfactory | Low | Low | Low | Moderate | Moderate | Moderate | Moderate |
| | Moderate | Low | Low | Low | Moderate | Moderate | Moderate | Moderate |
| | Weak | Low | Low | Low | Low | Low | Low | Low |
| | Very weak | Low | Low | Low | Low | Low | Low | Low |

Identification of potential External Support Provider

The ESA starts with the identification of potential Support Providers. Dagong defines a Support Provider as either

- a parent company of the rated entity (Parental Support);
- any government (Governmental Support); or
- any other third party related to the entity (Third-Party-Support)

Dagong assesses all three types of external support, but considers in the process of compiling the final credit rating only the most valuable Support Provider and only in cases, where the Support Provider has a stronger credit profile than the rated entity as reflected in the SACA. If Dagong believes that the Support Provider does not have a better credit profile than the subsidiary, than the assessment on the likelihood of support is irrelevant. On the other hand, there may be no notching up even from a higher rated Support Provider if Dagong views that there is remote probability that the entity will be given support during financial distress by the Support Provider.

Parental Support

If the rated entity is as subsidiary part of a group of companies potential parental support is an obvious assumption and the final credit rating of the entity should reflect the entity’s standalone credit strength as well as support given by the party controlling the entity (Parent Company).

Governmental Support

The second option of support refers to entities (Government Related Entities (GRE)) with close relationship to the government. Dagong does not limit its application to entities with direct or indirect government ownership only. The external support evaluation can also be incorporated into the rating assessment of entities that are mandated to manage activities through special agreements with the government, e.g. universal service obligations. Furthermore, as observed during the last years, the provision of government support has expanded also to entities with no direct government relationship.

Dagong considers governmental Support Provider as any central, regional or local government (sovereigns, regions, provinces, municipalities etc.) with the authority and legal capacity to autonomously deploy funds required to provide financial support to a Non-Financial Corporate. The authority to autonomously manage its financial budget, generally accrued through tax collections, is fundamental to the assessment of Support Provider’s capacity to provide support.

In the case of an entity owned by multiple Support Providers, Dagong assumes that the owner with the largest share will benefit the most from supporting the entity; therefore, the dominant owner is considered the sole Support Provider for the purpose of the ESA application. In cases where two or more Support Providers have similar shareholdings, Dagong will make an estimate of the combined effect from these Support Providers. When ownership is widely spread among a larger number of governmental parties (e.g. municipalities), estimating a combined strength of all parties involved would, in Dagong’s view, lose representativeness. For this reason, limited support will be assigned, unless there is strong evidence or track record of coordinated, timely and effective effort to support the entity (e.g. joint-and-several liability arrangements).

Third-Party Support

The third type of Support Provider is any third-party or a group of third-parties, which is related to the entity (e.g. business community, competitors, owner family), but without any direct legal or contractual support obligation. Even though such situations have been seen in the past in several industries and the format of support can be quite flexible (e.g. ranging from subordinated loans to purchase of production assets or takeover of licenses to generate liquidity) compared to the other two options it is definitely the most exceptional one, needs complex negotiations and the financial resources to give any timely support are limited.

Likelihood of Support Assessment

The likelihood of support depends on the willingness of the Support Provider which is for Dagong closely related to the following items:

(i) The rated entity’s degree of strategic, economic, social and competition-tactical importance to the Support Provider as well as its political influence; and
(ii) Any specific contractual support arrangement or legal commitment between the Support Provider and the rated entity and the level of control that the Support Provider could exercise over the rated entity; and
(iii) The historical track record of providing support to corporate entities in need or governmental economic intervention respectively.

Especially for (i) the assessment and the indicators used may vary depending on the type of Support Provider and entity. For parental support Dagong would look at the subsidiary status of the entity (core subsidiary, strategically important subsidiary, non-strategic subsidiary). In case of the assessment of potential governmental support the importance of an entity to its territory is assessed by Dagong through three main indicators: strategic infrastructure, economic power and political influence.

The ESA framework takes into consideration the nature of the products, services or assets produced or held by the entity. Entities operating in sectors that are essential for the safety or economy of the territory, like infrastructure networks (electricity, gas, water, railroads etc.) or intrinsic services (postal, defence, aerospace) are the most common candidates for receiving a high assessment for the Likelihood of Support.

The economic power measured by revenue size, profit generation, or workforce size reflects the importance of the rated entity for the overall economic environment of the Support Provider. Leading entities with high importance for the overall economy are usually large employers, suppliers of vital natural resources or dominant players in the overall production chain. Failure of such entities could significantly impact the overall macroeconomic environment of their respective territories and add significant risks to future growth. They are often significant tax contributors as well, which further increases their strategic importance to the Support Provider. All those factors positively influence Dagong's assessment of the Likelihood of Support. Conversely, entities operating in fragmented industries, like telecommunication, with strong competition and homogenous product or service offerings would be generally considered to have limited economic power and score low within this sub-factor.

The Political Influence sub-factor aims to assess the potential reputational risk for the Support Provider, in case of the supported entity's financial distress. The exposure to 'political embarrassment' may in some cases incentivise the Support Provider to justify financial costs of a bailout to avoid reputational damage. Furthermore, entities with sizeable workforce and strong unions could exert significant political pressure and secure strong support.

The impact of the Political Influence sub-factor on the overall Likelihood of Support, needs to be carefully evaluated together with the assessment of the previous two factors (Strategic Infrastructure and Economic Importance). The assessment of the overall rated entity's relevance has to be balanced among these three factors, to avoid double counting and overestimating the potential Likelihood of Support - as most of the large, strategically and economically important entities are usually capable of exerting significant political influence.

The factor 'importance' needs to be assessed in the light of specific bankruptcy laws in place and particular connections between the Support Provider and the rated entity. The result of this factor, however, cannot compensate the potential weaknesses in Support Provider's economic and legal capability to provide support.

In case of the assessment of potential governmental support strong legal or regulatory limitations to support provision may reduce the probability of a government's intervention and constrain the assessment of the level of support. The European Union regulation, for example, prohibits preferential support to commercial entities. However, Dagong acknowledged that in some cases, local laws have prevailed or exceptions have been applied to allow the Support Providers' intervention.

The overall weakening of major governments' financial profiles after the financial crisis requires a prudent approach when assessing available financial sources. This makes the assessment of the Likelihood of Support further complex, especially in the case of systems with limited policy transparency, opaque objectives and unclear priorities of the governments.

The assessment of Support Provider's previous track record of economic interventions complements the analysis of the financial strength and legal feasibility to provide support. Dagong believes that the historical track record can help to predict similar actions in the future. Conversely, a track record of the Support Provider's indifference to providing support to distressed important corporates, constrains the Likelihood of Support incorporated into the ESA framework.

Any contractual arrangement between the Support Provider and the rated entity needs to be carefully assessed. Direct, unlimited and unconditional guarantees could lead to a strong assessment of the Likelihood of Support as well as the Level of Support and underpin a profound positive impact on the credit rating. Any contractually weaker forms of support (e.g. letters of comfort, letters of consent, etc.) need to be scrutinised and are not likely to provide significant boost to the External Support Strength.

High ownership levels suggest Support Provider's strong governance or managerial influence over the rated entity and therefore, strong willingness to provide support. The controlling interest factor does not rely solely on the level of direct ownership, but also considers arrangements that allow indirect control, such as public policy mandates or universal services obligation agreements. This factor aims to evaluate Support Provider's overall level of control over the rated entity, which gives the Support Provider the ability to supervise potential bailouts.

Level of Support assessment

The analysis of a Support Provider's legal capacity and economic ability to provide support is a fundamental requirement to determine the Level of Support. It goes beyond the analysis of legal arrangements, scrutinising Support Provider's sources of funds and ability to timely release them. The Level of Support is significantly constrained in cases of Support Providers with weak financial profile, limited resources or complex/unclear regulatory and legal environment.

In Dagong's view, the assessment of the Support Provider has to focus not only on its legal capacity, but primarily on its ability to secure the necessary funds. A history of intensive economic intervention for example in case of governmental support could indicate strong inclination to providing support in the future.

However, the economic capacity of any Support Provider remains crucial and needs to be prudently scrutinised against the size of the entity subject to potential support, and the scale of support required. Dagong strongly emphasises the assessment of the Support Provider's economic ability to provide support within its ESA framework, to reflect fluctuating financial strength in the medium-term.

Support Providers with Weak Credit Profiles

The role of support as a component of the credit rating diminishes when the Support Provider's financial profile is weak, underpinned by deteriorating macroeconomic performance and significant fiscal burden. Financially constrained Support Providers score low within the 'Economic Ability to Provide Support' sub-factor of Dagong's ESA framework, resulting in Low Level of support and no uplift impact on the credit rating of the entity. Therefore, for Dagong, Support Providers with evidently weak credit profiles do constrain the credit rating of any strongly positioned rated entity.

To be rated above the level of the Support Provider, the rated entity needs to demonstrate strong resilience to adverse economic, financing and foreign exchange conditions affecting its domestic territory, through sufficient geographical diversification. Furthermore, the rated entity needs to be able to successfully weather the potentially conflicting governmental, legal or regulatory actions, introduced in an effort to benefit the wider economy that might however, penalise individual entities or industries.

When considering the assignment of rating above the level of the Support Provider, Dagong will specifically focus on the following factors:

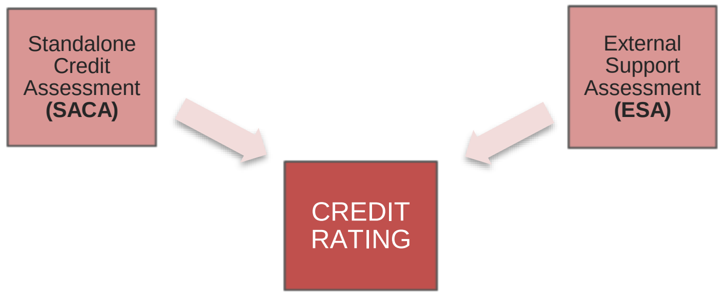
(i) The proportion of the rated entity's revenues, profitability and cash flow coming from non-domestic mature markets;

(ii) Diversification and strength of the available financing banks and entity's access to stable and sophisticated capital markets;
(iii) Track record of resistance to adverse political, legal or regulatory actions and
(iv) Limited exposure to un-hedged foreign-currency risks.

<u>ESA outcome and impact on the credit rating</u>

When the ESA framework is applied, the credit rating assigned to a rated entity reflects the combination of the entity's Standalone Credit Assessment (SACA), and the estimated Level of Support. The SACA is assessed in accordance with the rating criteria explained above and reflects the credit strength of the rated entity on a standalone basis, without considering any external support.

**Exhibit 17: Application of External Support Analysis Framework**




The ESA framework provides an indication of the strength of the potential support (External Support Strength) at four levels:

- Low
- Moderate
- High
- Very High

It is the rating committee's full responsibility to determine the impact of the assessed External Support Strength on the rated entity's credit rating based on the minimum and maximum notches uplift shown in the following table:

**Exhibit 18: External Support Uplift**

| External Support Strength | Min Uplift | Max Uplift |
|---|---|---|
| **Very High** | 2 | 3 |
| **High** | 1 | 2 |
| **Moderate** | 0 | 1 |
| **Low** | 0 | 0 |

An External Support Strength of 'Low' suggests no impact on the credit rating. It usually indicates a combination of Support Provider's constrained economic ability and legal capacity to provide support, a track record of no interventions, missing or undefined contractual agreements and/or limited strategic importance of the rated entity. Conversely, an External Support Strength of 'Very High' suggests high uplift potential to the entity's SACA. To achieve an External Support Strength of 'Very High', a combination of Support Provider's strong financial capacity to provide timely support, together with clear and unconditional guarantee has to be demonstrated.

When the ESA framework is applied, Dagong will disclose the rated entity's SACA and the credit rating. Dagong indicates both SACA and the credit rating according to its standard rating scale system. To avoid confusion, lowercase letters are used to indicate the SACA scale, while the credit rating is always expressed in uppercase letters. Please refer to Dagong's Definitions: Credit Ratings and Other Analytical Products available on www.dagongeurope.com. A detailed rationale behind the main drivers of the External Support Strength and how the outcome has impacted the credit rating will always be provided within the issuer-related research documents published by Dagong.

## VI PEER GROUP ANALYSIS

The credit rating (after applying the External Support Analysis), could change up or down two notches based on the entity's strengths or weaknesses relative to its peer group, as well as other comparably rated companies.

Therefore, the final step in the rating analysis consists of a structured relative comparison of the Business Profile, the Financial Profile and the External Support Profile of the rated entity with those of its most relevant competitors. Dagong uses the most recent full year end scores for each of the above mentioned profiles and compares them with each profile's average score in the peer group to highlight areas for further comparative analysis by identifying outliers on specific rating factors where the entity is notably stronger or weaker than companies at the same rating level.

For each profile Dagong assesses the relative position of the entity using a 7-category scale ranging from 'Extremely above average' to 'Extremely below average' based on the score's variation coefficient. Each category is equivalent to the same Dagong standard score values (1 to 22). The weighted sum of the three scores (Business Profile: 40%, Financial Profile 40%; External Support Profile 20%) provides a guidance for a potential adjustment of the credit rating. Adjustments are limited to up to two notches due to the peer group comparison in case of substantially above or below average profiles.

## VII COMPILATION OF CREDIT RATINGS

Dagong's credit ratings always incorporate a forward-looking view. The final credit rating of an entity is determined by calculating a weighted average of all single period credit ratings using the following time weight vector together with the credit rating equivalent rating ranks (e.g. AAA=1, AA+=2 etc.):

**Exhibit 19: Time Weight Vector**

| Period | Weight |
|---|---|
| $p_{-1}$ | 20% |
| $p_0$ | 20% |
| $p_{+1}$ | 30% |
| $p_{+2}$ | 20% |
| $p_{+3}$ | 10% |

Dagong calculates a SACA and a credit rating for the most recent period for which the necessary historical financial and macroeconomic data is available and - based on the projections and forecasts for all quantitative and qualitative rating factors - also for the current year and 3 subsequent years (single period SACAs, single period ratings). Therefore, period ‘$p_0$’ is the current year, ‘$p_{-1}$’ the previous year with completely available historical financial and macroeconomic data, ‘$p_{+1}$’ to ‘$p_{+3}$’ the three years for which projections and forecasts have been worked out by Dagong. The final credit rating rank will be calculated based on the following formula and then mapped onto the rating scale:

$$Final\ Credit\ Rating\ Rank = \sum_{p=-1}^{3} Single\ Period\ Rating\ Rank\ (p) * Time\ Weight\ (p)$$

## VIII OTHER CONSIDERATIONS FOR NON-FINANCIAL CORPORATES’ CREDIT RATINGS

### Reporting and Information Risk

Dagong’s analysis and credit ratings rely on a wide range of information sources including audited historical financial reports and legal documentation of credit facilities. In addition to these, management information such as preliminary financial data, projections, scenario analyses, liquidity and cash flow figures are also evaluated. Dagong uses an entity’s internal and external data (only if provided by valid publicly available sources of information) to complement and verify validity, consistency and the rationale of the information provided by the entity.

Dagong always relies on audited financial statements and does not implement any further audit or verification of the already-audited financial accounts. Consistency in accounting policies and financial strategies is, however, always assessed in a critical manner. Dagong understands the importance of the information risk as it significantly influences decisions on rating, including assignment, maintenance or withdrawal. In cases where the information risk is so significant that it prevents a meaningful analysis, Dagong will decline to assign a credit rating, or where a credit rating is already assigned, Dagong will withdraw it.

Transparency and thorough reporting standards are fundamental to Dagong’s credit analysis and ratings. Dagong recognises that lengthy reporting delays, material restatements, inconsistencies and related investigations, indicate poor quality of reporting. Close attention must be given to any adverse development such as regulatory challenges, lawsuits, changes in capital markets, or frequent substitution of auditors. Managements’ approach to the resolution of these matters is also a pivotal part of the analysis.

## Rating Holding Companies

The analysis of non-financial corporates generally focuses on consolidated group accounts including a bottom-up credit analysis. Large corporate groups consisting of a relatively small number of majority owned subsidiaries require an analysis of their major subsidiaries on a standalone basis, followed by consolidation of the outcomes into the final rating. In the case of a non-operating holding company, the rating is anchored at operating subsidiary’s level, which is then notched down to reflect a lack of independent earnings generation and dependency on dividends as only income sources. Further notching down might apply, depending on the degree of leverage and lack of financial flexibility of the holding company. The holding company can be rated at the same level as the operating subsidiary if it has additional proven sources of earnings or cash e.g.:

- Significant investment assets that can be easily liquidated and transformed into an immediate source of cash;
- Other important businesses with significant earnings that contribute stable cash flows and allow the holding company to maintain a flexible and healthy financial position without over-dependency on a single subsidiary;
- A direct and unconditional upstream guarantee, provided by the majority of the operating subsidiaries.

## Foreign Currency and Local Currency Ratings

Dagong assigns ‘Foreign Currency’ ratings in cases where an entity issues debt instruments in a currency that is different from the local or domestic currency. These ratings are not independent and are obtained through the ‘Local Currency’ rating. The debt obligations that an issuer commits in a ‘Foreign Currency’ are subject to a ‘notching’ adjustment (up or down) based on the rated entity’s access to the specific foreign currency. Dagong defines notching as ‘the practice of assigning different ratings to the different sets of liabilities included within an entity’s financial statement’. The adjustments also take into account the specific features of the foreign currency issuance and any other factor Dagong would consider to constrain access to the foreign currency and therefore reduce the entity’s ability to fulfil its obligations accordingly.

In addition, a ceiling on a ‘Foreign Currency’ rating will be applied if Dagong believes that the entity’s access to that currency is considerably restricted within its operating country, or if there is a government restriction on foreign currency access in events of financial distress. In these cases, the ‘Foreign Currency’ rating would mostly follow the external restrictions; therefore, would not be in alignment with the ‘Local Currency’ rating in place. The difference in notching is analysed on a case-by-case basis, depending on the rated entity’s strengths and ability to ring-fence the specific ‘Foreign Currency’ debt obligation.

## Hybrid Securities in the Corporate Debt Structure

Although mostly related to banks and financial institutions, Dagong includes hybrid securities in its assessment of corporate debt structure in cases when they are issued by non-financial corporates. In order to evaluate the scope of the debt- or equity-like character of any corporate hybrid issuance, Dagong focuses on the timing and cumulative versus non-cumulative character of coupon suspension, the structural ranking of the hybrid security and its maturity. The proportion of equity versus debt recognised by Dagong within an issuer's capital structure is assessed on a case-by-case basis.

In general, high equity proportion is assigned to deeply subordinated hybrid securities that represent the most junior instrument in the issuer's capital structure. These hybrid securities include strongly protective and non-cumulative coupon suspension conditions, have the inability to default or cross default other debt, and have long (if any) maturity. Hybrid securities with weak loss absorption features, higher priority of claim in liquidation or short maturity (generally less than 30 years) would be treated as debt-like instruments with low or no equity proportion assigned.

Usually hybrid securities issued by non-financial corporates do not represent a significant proportion of their overall debt and their treatment has a marginal impact on an issuer's capital structure and rating. Dagong might, however, decide to limit the equity contribution of hybrid securities to the overall capital structure in cases when the proportion represents a high share of the issuer's overall equity. Hybrid issuers need to make a clear representation of the market on the respective hybrid characteristics otherwise it is classed by Dagong as subordinated debt.

## IX ISSUANCE ANALYSIS FOR CORPORATE DEBT ISSUANCE RATINGS

For the rating of debt instruments issued by non-financial corporates Dagong starts with the determination of the rating for the issuer as described above. In an additional analytical step, the Issuance Analysis, Dagong focuses on the individual debt instrument. The analytical step consists of two Analytical Building Blocks:

- Seniority and Recovery
- Additional Issuance Characteristics

### IX.1 Seniority and Recovery

Dagong follows a notching approach for the determination of the credit rating of a debt instrument issued by a non-financial corporate (Issuance Rating). Therefore, Dagong considers as the most important determinants of post-default recovery rates that investors may realize

- the relative seniority of the debt instrument with regard to the issuer's pool of debt instruments and priority of repayment in the event of default,
- the general corporate recoveries available to service the individual debt instrument in the event of default of the issuing entity (depending on an entity's full set of liabilities and the debt instrument's structural and contractual subordination; estimated at default under a going concern and a liquidation scenario assumption),
- the legal format, type and (dynamic) coverage of existing effective external supports or credit enhancements (e.g. LoC, guarantees, insurance cover, related collateral) available exclusively for the individual debt instrument in the event of default of the issuing entity.

Finally, senior debt will benefit more from general corporate recoveries than junior debt, but an external issuance-specific support or credit enhancement provides a credit risk mitigation for the credit risk associated with an individual debt instrument in case of an event of default independently from the relative seniority.

Dagong uses as a rough guidance for the estimation of instrument-specific recovery rates the following values:

**Exhibit 20: Recovery Rate**

| Seniority/Collateralisation | Recovery Rate (% of nominal amount of debt instrument) |
|---|---|
| Senior Secured Bank Loan | 65% |
| Senior Unsecured Bank Loan | 50% |
| Senior Secured Bond | 55% |
| Senior Unsecured Bond | 40% |
| Senior Subordinated Bond | 35% |
| Subordinated Bond | 30% |
| Junior Subordinated Bond | 20% |

All three aspects will be used to determine the level of the post-default total recovery prospects:

**Exhibit 21: Post Default Total Recovery Prospects**

| Post-Default Total Recovery Prospects | Total Recovery Range |
|---|---|
| Very high | >=70% |
| High | >= 60% and < 70% |
| Medium | >=40% and < 60% |
| Low | >= 25% and < 40% |
| Very low | < 25% |

The above guidance for the post-default total recovery prospects is indicative, and Dagong may deviate from this when for example

- the issuer's characteristics support the assumption that the company value in the event of default could deviate materially from historical levels,
- the company's debt structure is uncommon,
- the amount of prior-ranking debt is notably high,
- industry-specific above or below average recovery prospects are identified (e.g. real estate companies),
- the amortisation profile and a decreased outstanding of relevant debt instruments at default of the debt instruments according to contractual amortisation have to be properly reflected,
- the form of subordination is special (contractual, structural),
- volatility and correlation of collateral values have to considered etc.

and Dagong believes that the rating of the debt instrument requires a different analytical approach.

The following table shows Dagong's guidance for the seniority and recovery notching based on the level of post-default total recovery prospects. The shown ranges for each level of post-default total recovery prospects consider, that it might be necessary to make differences between stronger and weaker issuer credit profiles.

Since weaker entities are closer to default than investment-grade issuers, the likely creditor claims at default are less clear and secured debt is usually immaterial for investment-grade issuers the extent to which the range will be utilised at Dagong differs. Generally, the distance to default of investment-grade issuers is so high and they are sufficiently collateralised relative to their funded debt and other financial obligations that instrument-specific recoveries do not play such an important additional role. Hence the average recovery rates by type of instrument as shown above are used more often than for weaker credit profiles, and in many instances debt instruments will be rated more closely to the respective Issuer Ratings.

**Exhibit 22: Seniority and Recovery Notching Guidance**

| Post-Default Total Recovery Prospects | Notching |
|---|---|
| **Very high** | up to 3 notches uplift above the issuer rating |
| **High** | up to 2 notches uplift above the issuer rating |
| **Medium** | up to 1 notch uplift above the issuer rating |
| **Low** | up to 2 notches lowering below the issuer rating |
| **Very low** | up to 3 notches lowering below the issuer rating |

An intermediate result (the Pre-final Issuance Rating) is calculated combining the Issuer Rating and the respective Seniority and Recovery Notching.

## IX.2 Issuance Characteristics

The last Analytical Building Block, Issuance Characteristics, covers the soundness, robustness and transparency of the debt instrument. Collateral-related information like market value volatility and seniority of the debt instrument are already reflected in the previous analytical building block. Therefore, this analytical building block contains rating factors covering

- Terms and Conditions (incl. currency, interest rate type, term)
- Use of proceeds (incl. priorities and portion of use of proceeds, control and monitoring)
- Covenants and Reporting

The qualitative assessment of the Issuance Characteristics uses the 7 category scale with the following general meaning:

**Exhibit 23: Issuance Characteristics Assessment**

| Assessment | Characteristics |
|---|---|
| Very weak | - Very weak terms and conditions<br>- Very weak use of proceeds<br>- Very weak covenants and reporting |
| Weak | - Weak terms and conditions<br>- Weak use of proceeds<br>- Weak covenants and reporting |
| Moderate | - Moderate terms and conditions<br>- Moderate use of proceeds<br>- Moderate covenants and reporting |
| Satisfactory | - Satisfactory terms and conditions<br>- Satisfactory use of proceeds<br>- Satisfactory covenants and reporting |
| Strong | - Strong terms and conditions<br>- Strong use of proceeds<br>- Strong covenants and reporting |
| Very strong | - Very strong terms and conditions<br>- Very strong use of proceeds<br>- Very strong covenants and reporting |
| Excellent | - Excellent terms and conditions<br>- Excellent use of proceeds<br>- Excellent covenants and reporting |

Source: Dagong

The number of notches uplift or lowering is determined by using a two-dimensional grid (Issuance Characteristics Grid).

Depending on the Pre-final Issuance Rating (CC to AAA) and the Issuance Characteristics Score (1 to 22) an adjustment can be made based on the following table:

**Exhibit 24: Issuance Characteristics Notching**

| Pre-final Issuance Rating | Issuance Characteristics Score | | | | |
|---|---|---|---|---|---|
| | 1 | 7.5 | 11.5 | 15.5 | 22 |
| AAA | 0 | 0 | 0 | 0 | 0 |
| AA+ | 0 | 0 | 0 | -1 | -1 |
| AA | 0 | 0 | 0 | -1 | -2 |
| AA- | 0 | 0 | 0 | -1 | -2 |
| A+ | +1 | 0 | 0 | -1 | -1 |
| A | +1 | 0 | 0 | 0 | -1 |
| A- | +1 | 0 | 0 | 0 | -1 |
| BBB+ | +1 | +1 | 0 | 0 | -1 |
| BBB | +1 | +1 | 0 | 0 | -1 |
| BBB- | +1 | +1 | 0 | 0 | -1 |
| BB+ | +1 | +1 | +1 | 0 | 0 |
| BB | +1 | +1 | +1 | 0 | 0 |
| BB- | +1 | +1 | +1 | 0 | 0 |
| B+ | +2 | +1 | +1 | 0 | 0 |
| B | +2 | +1 | +1 | 0 | 0 |
| B- | +2 | +1 | +1 | 0 | 0 |
| CCC+ | +2 | +2 | +1 | 0 | 0 |
| CCC | +2 | +2 | +1 | 0 | 0 |
| CCC- | +2 | +2 | +1 | 0 | 0 |
| CC | +2 | +2 | +1 | 0 | 0 |

The combination of the Seniority and Recovery Notching and the Issuance Characteristics Notching can lead to a total notching of up to 5 notches (uplift or lowering) for the final Issuance Rating compared to the Issuer Rating.

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