RATING CRITERIA

General Rating Framework

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Related publications

Criteria for Rating Financial Institutions (25.07.18)

Criteria for Rating Insurance Companies (10.07.17)

Consultation Report: Criteria for Rating Non-Financial Corporates (01.08.18)

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I SCOPE

This criteria report lays out the general principles followed by Dagong Global when assigning credit ratings. The report describes in broad high-level terms the main concepts underlying Dagong's analysis of an entity's credit quality. The report should be read and applied in conjunction with the sector-specific criteria reports, which contain a detailed description of the rating methodology for the individual sectors covered by Dagong.

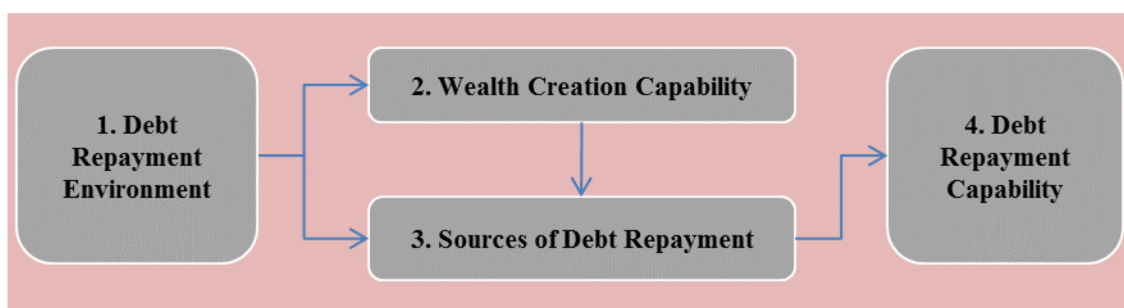
The criteria is used to assign new ratings and monitor existing ratings.

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

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.

II SUMMARY

Dagong's general rating approach is based, inter alia, on the following key principles:



Source: Dagong

III DEBT REPAYMENT ENVIRONMENT

Debt repayment environment focuses on the issuer's operational environment that affects its creditworthiness and capability to service debt. Operational environment encompasses the macroeconomic situation, regulatory and legal landscape, as well as the conditions in the specific industry of the issuer.

III.1 Macroeconomic environment

The health of a country's economy, as reflected by GDP growth, inflation and unemployment, typically sets the tone for the performance of economic agents. The analysis of the macroeconomic environment is aimed at evaluating changes in general economic conditions (including political and financial stability in a country or region, government policies etc) and their impact on an issuer's credit risk. Governments may implement expansive, moderate or tight fiscal policies, which directly and indirectly influence the economic environment where an entity operates, and thus impact an entity's overall business risk profile.

III.2 Legal and regulatory environment

The level of transparency, reliability and predictability of the regulatory framework impacts the financial decision making of market participants. The robustness of the legal framework, clarity of legal procedures and ability to enforce contracts is vital for their smooth operations.

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 receive a high score in Dagong's rating methodology. Conversely, poorly defined frameworks, strong political interference, a history of inconsistent or hostile decisions would score lower and potentially constrain the assessment outcome.

III.3 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 cyclicality, dynamics, maturity, growth potential and barriers to entry are factors used by Dagong to assess the relevant competitive environment and the resulting challenges and opportunities of an industry.

IV WEALTH CREATION CAPABILITY

Wealth creation capability focuses on the issuer's competitive position and ability to generate profits, which drive the issuer's long-term operational success and credit strength.

IV.1 Competitive position

Dagong assesses the competitive advantages and position of an entity by comparing its business scope, product portfolio diversification, distribution networks and key customer and supplier relationships with those of its competitors. 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.

The competition structure of an industry (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 should 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 efficiency of the distribution network.

Dagong's 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 in Dagong's assessment. 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 a higher-than-modest score.

Small or modest entity size is considered an adverse factor in the rating analysis. 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 an 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.

IV.2 Profitability

Profitability represents the ability of an entity to earn profits and is seen as a relative measure of success of an entity's business model. In addition, 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. Main 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.

The ability of an entity to generate and maintain strong, sustainable and stable earnings is key to the continuity of the operation and long-term solvency. A detailed analysis of profitability, including key business activities, sources and composition, allows to identify the stability and predictability of earnings. Depending on the business model, core earnings are identified and analysed. Dagong places particular attention on entities with business models that lead to volatile earnings. A business model that lacks stable core earnings is more exposed to market and economic volatilities and therefore compares poorly with peers with more stable core earnings. A deviation from the defined business model, to obtain 'one-off' earnings or to take advantage of market momentum is viewed as negative in the profitability analysis.

V SOURCES OF DEBT REPAYMENT

Sources of repayment focus on the issuer's liquidity position and funding sources. Sufficiency and availability of internal and external financial resources, 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.

Even companies with a solid business model 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.

For non-financial corporates, the quality and reliability of an entity's initial cash position and its potential for future cash flow generation are analysed. 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.

Furthermore, Dagong analyses the bank and credit relationships of an entity focusing for example on the number, type and length of business relations, as well as the bank concentration to assess the stability and reliability of existing relationships in 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 capital market access in the home market of the entity, capital market experience and reputation, capital market appetite for the level of credit risk associated with the entity and the availability and acceptance of appropriate collateral for any sort of secured funding.

For financial institutions, solvency is highly correlated with liquidity and funding risks, including the concept of market contagion that could result from the financial instability of even a small and isolated entity affecting larger and more solid franchises. Dagong expects entities to demonstrate their ability to manage liquidity and funding shortfalls under stressed economic scenarios.

Dagong gives special attention to the liquidity management framework (promoted by Basel III), including not only a qualitative analysis of liquidity plans (under contingency and normal scenarios), but also gaining an understanding of the historical liquidity dynamics that an entity has faced during economic cycles.

In addition, it is important to identify regulatory measures put in place to prevent financial institutions (particularly banks) facing uncontrolled liquidity stresses. The analysis includes the differentiation and special conditions available (central bank funding) for specific entities (banks in most cases) and for other non-bank institutions. Also, the availability of

liquidity measures like the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) provides additional information to assess liquidity and funding risks.

The access to central bank funding or any other liquidity sources is analysed in the context of economic conditions. For Dagong, sound liquidity management is supported by a reasonable and balanced funding structure, with no overdependence on specific funding sources.

To complement the assessment, Dagong also considers the structure of funding and how an entity maintains on-going renewal. The analysis is focused on reviewing the deposit base, inter-bank loans, capital market funding, central bank funding and any other sources of funding available, if relevant.

VI DEBT REPAYMENT CAPABILITY

The analysis of an entity's debt repayment capability assesses the adequacy of its cash flow or income generation in relation to its current liability structure and maturity profile. Ratios based on cash flow generation, utilised in debt repayment analysis, should reflect the individual characteristics of the rated entity and its sector.

For non-financial corporates, in case of financially strong companies operating in stable industries the analysis largely relies on operating cash flow and its relation to the debt burden. Conversely, when considering entities with a weaker position, lower margins or operating in sectors with higher cyclicality, the focus moves to free cash flow generation.

For financial institutions in general, the analysis relies on the ability to match the maturity of assets and liabilities, together with the management of liquidity resources to support any short-term debt burden. The assessment of the future evolution of cash flow and income generation, as well as financial obligations (including debt and any type of counterparty obligation) represent a key part of an entity's debt repayment capability and therefore its credit risk profile.

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

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