GOVERNMENT AGENCIES

OVERVIEW

The rating process of government support entities depends on the level of integration with the government. The main factor here is whether the government is a guarantor for the loan being undertaken, as this greatly reduces the risk arising from possible defaults on the loan. The two main ways in which an agency can be thought to be supported by the government are high integration with the government and government guarantees.

High Integration with the Government

These agencies are most closely tied with the government and include government ministries and departments, as well as state-owned businesses. The operations of these agencies are very intricately related to government operations and the risk weight given here is 20%. When the issuing agency is one that has that has a pre-determined role in the government, such as a government department or ministry, the rating is equated with that of the government. However, a stand-alone rating, an analysis based on the organization's financial and business risks is also provided. Other entities that are highly integrated with the government include government departments and regulatory bodies.

Government Guarantees

These are agencies that are not highly integrated but receive a set amount of loans as a government guarantee. The portion guaranteed by the government receives a government equated rating. The rating for the issuer as a whole, however, depends on stand-alone ratings it will receive on the basis of its business and financial risks, as well as the agencies current relationship with the government.

Aside from agencies that are highly integrated with the government, other relationships between the government and government support entities include public-policy institutions, probable support and supportive institutions. Public policy institutes are those that enjoy a favorable attitude from the government as well as financial help in situations of financial distress. Other factors taken into account for public policy institutions include the entities' importance to the government, the uniqueness of the service i.e. the likelihood that a private sector company provides the same services as the public policy entity, as well as the government's policy of support with regards to these entities where a past history of support is taken as indication that the government will help again. The "probable support" situation is one where government support is likely, thus reducing risks, but without much certainty in which case the risk-analysis will focus mainly on the organization as a stand alone. The "Supportive Government" situation is one where the government is not the final guarantor of the loan but rather take steps, through policies, to mitigate and reduce risk for the entity. The risk weight given to a government guarantee is 40%.

The following factors will be used to provide a stand-alone analysis of the entity:
-operation and maintenance risk
-business risk
-financial risk
-management and other qualitative factors
-issue structure

Operations and Maintenance Risk

This aspect of ECRL's analysis looks at the company's operational efficiency. The rating factors that are covered here will differ according to the industry, but the objective of the analysis is to assess the ratee's operational efficiency and effectiveness, and corresponding implications for cost efficiency, profitability and relative competitive position. A manufacturer could have a more favorable cost structure compared to its peers on the basis of manufacturing efficiency, which may or may not have anything to do with size. The age of plant and equipment in use, together with the quality of systems and processes, will often be the more telling explanation for differences in performance. The ability of the ratee to roll out a competitive offering in a timely and efficient manner, ahead of its rivals, has an important bearing on the strength of its business position and its growth potential.

Business Risk

The industry assessment aspect of ECRL's business risk analysis considers the operating environment of the ratee, its industry structure, the relative market share of industry participants and trends in those shares, industry growth rates, the competitive environment as well as the regulatory environment.

Assessment of the current and long-term industry fundamentals of the industry or key industry sectors in which the ratee operates include consideration of pricing power, product or service substitution in addition to barriers to entry and exit. Industries also exhibit distinct attributes over their lifecycle .ECRL also considers the predictability of the regulatory environment and the extent to which regulation influences the competitive environment of the ratee

A rate which belongs to an industry or industries with less favorable industry characteristics will require more conservative financial profiles/policies to achieve the same rating level as firms operating in industries with more favorable industry characteristics. An industry with declining growth rates creates uncertainty about the reliability of earnings and cashflow.

The competitive position aspect of ECRL's analysis covers the ratee's business model, its looks at an organization's strengths and weaknesses relative to its peers. Size can be an advantage if it translates into economies of scale, purchasing power, or pricing advantages. Geographic diversity is usually viewed positively in that it may promote a balance between slower and higher growth markets

Net operating margin is the universal measure of performance on which firms in the same industry can be compared. It relates profits before interest expense and taxes to sales revenue.

Financial Risk

ECRL considers the ratee's operational profitability, typically over a five-year period to assess the volatility of operating margins and its record of earnings generation. This allows us to incorporate the impact of cyclical demand on earnings and to be able to rate through the cycle as far as possible. Isolated from other credit considerations, ratees that are able to demonstrate consistent earnings generation are likely to warrant higher ratings. These ratees also tend to have better access to capital, more financial flexibility and resources to make capital investments. High revenue volatility through cycles and narrow profit margins

will result in periods of low returns on assets. Because our ratings are forward looking, determination of the main drivers underpinning revenue and operating margin trends are fundamental to our assessment of the sustainability of the ratee's earnings generation and its ability to withstand downturns in its business environment. Return measures which relate profits to assets, permanent capital or equity provide an indication of a ratee's ability to generate sufficient return to enable continuous access to equity and debt funding. Return on assets is computed both before and after taxes and measures the productivity of all assets. Return on permanent capital is a slightly narrower measure which relates profits to the "permanent" funding providing by debt and equity capital, principally excluding trade financing and other current liabilities. Return on equity is the narrowest of the return computations and the outcome of the calculation is influenced by the capital structure of the rite.

ECRL believes that shareholder friendly financial policies often act as a constraint on improvements in credit measures and balance sheet strength over time. To assess the rates retention of earnings and internal capital formation, ECRL looks at its dividend payout ratio and the retained earnings ratio. The dividend payout ratio considers the portion of earnings paid out as dividends on common stock. A high dividend payout ratio usually translates into reduced ability to internally fund its working capital and capital investment requirements. The retained earnings ratio indicates the extent to which profits reinvested in the business (i.e. Retained earnings) have contributed to the funding of the company's assets since inception.

The trend of the ratio is analyzed. A rising ratio usually indicates increasing reliance on internally generated funds to fund asset growth. Rapid asset growth through acquisitions and/or organic growth could pressure the rates credit quality, as will active share repurchase programs. ECRL will also consider the related issue of the ratee's willingness to issue equity to improve its capital structure where the issue of ability does not arise.

The interest coverage ratio measures the number of times operating profit before interest and taxes covers the gross interest expense. By gross interest expense we are referring to interest before subtracting interest income and capitalized interest. Variations in results among companies in the same industry can be attributable either to differences in profitability or to levels of interest expense. Interest coverage is a useful measure for drawing credit quality distinctions among companies in all different industries.

Management and Other Qualitative Factors

ECRL's assessment of management quality encompasses the track record of management, in particular its performance through different phases of the economic cycle and relative to industry peers as well as execution of its long-term and short-term strategic plans. Additional evidence of management quality is provided by the ratee's past performance. .Also considered are management's growth ambitions, its appetite for risk, and its ability to assimilate acquisitions successfully where the ratee has a history of M&A transactions. The ratee's financial strategy and policies as they provide a guide as its prospective financial risk profile. Key issues addressed are leverage, management's willingness to support the company's share price through share repurchases and its commitment to maintaining a sound credit profile. Well-run institutions are generally characterized by a deep and stable management structure.

Corporate governance represents an important analytic element of management quality. A 'stakeholder' model of corporate governance which promotes the alignment of interests of management, shareholders and other stakeholders (bondholders included) is viewed positively by ECRL. We believe that good corporate governance has positive implications for a ratee's franchise value and lessens the risk of adverse regulatory intervention.

The management evaluation also needs to be conducted with due consideration given to the actual and potential influence of significant shareholders. Ownership concentration increases the likelihood that shareholders' interests may be pursued at the expense of bondholders, other capital providers, employees and creditors. The ratee's owners may foreseeably have a positive, neutral or negative impact on the rating outcome in instances where a controlling shareholder seeks to access the financial strength of the ratee to support its own credit profile. It is important to establish that there is a congruence of goals of such shareholders with those espoused by management to the rating agency.

Issue Structure

Where an issue-specific rating is undertaken, ECRL undertakes an evaluation of issue's principal terms and conditions. Analysis will focus on the proposed utilization of the proceeds from debt to be issued and implications of the proposed issue on the ratee's debt maturity profile, debt servicing burden and covenant headroom. Short-term liquidity and rollover risk are important considerations, particularly if there is heavy reliance on short-term debt to fund longer term assets. Structure includes such characteristics as priority for repayment in a liquidation, security, sinking funds, call features, refunding provisions, reserve funds, payment terms and maturity.. To determine whether the senior secured debt rating should be higher than that of the ratee's unsecured debt rating, ECRL examines the adequacy of the collateral securing the debt, liquidity of the collateral and the likely time frame for the disposal of the collateral and debt recovery. When rating hybrid securities which possess both characteristic of equity and debt, ECRL will typically notch down from the ratee's issuer rating with regard to the priority of hybrid security holders' claims relative to senior obligations, the likelihood of deferral of interest or dividend payments and the extent to which the issuer possesses discretion to suspend dividend or interest payments.

ECRL is also sensitive to the structural subordination of parent company debt to debt at its operating companies and the presence of mitigating features intended to limit the impact of structural subordination such as subsidiary debt limitation and upstream guarantees. ECRL also recognizes that tax authorities and possibly other government bodies may rank higher in the ratee's hierarchy of the creditors.

Reserve Funds or Special Accounts for Assignments of Revenue may in certain instances add confidence that cash will be available for debt service on a timely basis. The covenants the rating analyst would prefer to see (even if the issue being rated is expected to be bank guaranteed) are the following:

Limits on additional debt – The covenant can be phrased in a couple of different ways, either as an absolute amount of debt than can be issued, usually with some caveats, or as an interest coverage test.

Limits on distributions – Such a covenant places some controls on dividends, advances or loans upstream or downstream and sales or dispositions of subsidiaries and uses of proceeds thereon..

Negative pledge – If a holding company is the issuer of the debt, but the earning power and cash flow generation capability is at the subsidiary level, a guarantee of the debt by the subsidiary would make the holding company debt equal in terms of priority to the subsidiary's unsecured debt.

Events of default. The most critical item is the cross default provision, which would state that a default on any obligation represents a default on all obligations. Of course, a firm's agreement to abide by indenture covenants does not necessarily mean that it will be able to do so. Covenants which are so tight that only a small variation from plan would cause an event of default are viewed with concern.