

PERPETUAL BOND RATING METHODOLOGY

INTRODUCTION

Perpetual bond was created out of the need to have an instrument that can act both as a debt and an equity. It addresses the problem of having cost-efficient funding in form of liability without having to add any financial pressure nor reducing financial flexibility of the Company. The Company may also expect to enhance its capital structure profile by substituting its debt with perpetual bond. The subordinated nature of the instrument will result in higher interest rate. This may entice higher yield-seeking type of investors to take up the instrument. However, this situation may result in additional cash flow burden for the issuer. As equity credit indicates how closely perpetual bond resembles common equity, the credit rating agency must assess how much equity credit must be given and subsequently at how many notch down must be given to the instrument.

The methodology is drawn up to explain our opinion and our assessment specifically to assign a rating to perpetual bond. As the name implies, perpetual bond has no due and several of its added features make it eligible to qualify as quasi-equity.

ASSESSMENT

PEFINDO analyses characteristics of the perpetual bond before coming up with any measure on how much equity credit must be given and at what point that the perpetual bond will lie in the debt-equity continuum. The economic impact of the perpetual bond is more relevant than its nomenclature. Any perpetual bond can be regarded as equity in accounting, tax, or regulatory point of view but may still be considered as pure debt in rating assessment, and vice versa.

From the credit perspective, the perpetual bond has several characteristics that mimics common equity such as:

1. Perpetuity, as it has no maturity, hence no requirement for principal repayment,
2. Permanence of capital, as it is expected to be permanent in the company's capital structure or having a high precipitation in company's capitalisation,
3. Deferability, with no ongoing payments that can lead to default,
4. Loss absorption, as it provides a cushion for creditors to absorb losses.

PEFINDO assesses the perpetual bond from these four points and how these standpoints will bear any economic effect to the instrument. The assessment will affect our calculation scenario to how the perpetuity bond will impact the issuer's financials. If equity credit can be given to the instrument, we then proceed to assigning notch-downs as the final step of the exercise.

PERPETUITY

Equity has no maturity date and although the Company can distribute dividend related to that equity or buy back their shares, it is not mandatory and fully in management discretion. In contrast, debt must be repaid upon maturity. Aside from incurring pressure on the entity's cashflow, this obligation also introduces the risk of default, cross-default on other debts, and even bankruptcy.

In principle, perpetual bond has no maturity. The perpetual characteristic eliminates the requirement for principal repayment. It will give the company a financial flexibility and replicates the features of ordinary equity in this aspect. To attract investors, the perpetual bond offers issuer's call option with interest step-up. Other than acting as a sweetener, the callable feature also provides the issuer with an opportunity to refinance. Thus, the call option also raises the need to assess the replacement language, where the issuer states whether it will replace the callable instrument with other similar or equity-like instrument. To classify as equity, the call option must be on issuer's side, not investor's. However, the ability to call generally weakens the equity feature as the issuer could refinance the instrument with debt.

We view that the call option must be exercisable after 5-10 years to be given a sufficient equity credit. The magnitude of interest step-up also determines the equity credit, as high interest step-up will implicitly indicate that the instrument will be most likely to be called, thus in actual will bear the characteristic of debt. The introduction of coupon step-ups also could further weaken the equity feature as it will motivate the issuer to replace the instrument at the callable period.

PERMANENCE OF CAPITAL

Being a perpetual by definition, perpetual bond has a high degree of permanence in the capital structure. The introduction of call feature and interest (or coupon) step-up may put the permanency of perpetual bond in question. To address the risk of issuer refinancing the perpetual bond with less equity-like instrument, the issue could incorporate a covenant with replacement language that stipulates that the perpetual bond can be given a meaningful equity credit if any replacing instrument (if the perpetual gets called) is of a similar or more equity-like type. While in practice the legal enforcement could be less effective, the replacement language nevertheless signals the issuer's intent.

DEFERABILITY

The coupon on perpetual bond must be able to be deferred to classify itself as equity. This requirement comes from the equity characteristic where it can skip dividends without triggering an event of default. This feature provides significant financial flexibility to the issuer. The deferral will not constitute a default condition and is allowed under the instrument's terms and conditions.

The coupons can be deferred by either management option or compulsory requirement. Management can choose to defer coupons at any time if criteria are met. There is a link to dividend payment in which the issuer's ability to pay dividends is linked to coupon payments. This could take the form of making coupons compulsory following dividend payment in the last one year (called a "dividend pusher"), or preventing dividends if coupons are deferred (called a "dividend stopper"). Coupons deferred may be cumulative, and sometimes also compounding.

We distinguish the deferral into (1) optional deferral and (2) mandatory deferral. In optional deferral, the management entitles to suspend/cancel distributions without triggering a legal default. We assume that the issuer has a degree of reluctance to exercise given reputation risk. Mandatory deferral refers to the requirement to suspend payments at breach of pre-determined triggers. It is typically linked to financial parameters. Deferral that triggered by any regulatory trigger will also be classified as mandatory deferral. Typically for issues with optional deferral, where deferral risk is relatively remote (but still material in terms of economic effect), one notch-down on top of a notch-down of subordination (two notch-downs of issuer's rating) will be applied. If there are increasing concerns that the issuer may defer, the gap between issuer's rating and issue rating will be increased. The combinations of different forms of deferral may increase deferral risk. The deferral must not exceed the callable period.

LOSS ABSORPTION

PEFINDO expects that in order for the perpetual bond to get a meaningful equity credit, it has to rank junior to all other creditors, cannot default or cross default and has no rights in bankruptcy. All these are required to mimic the loss absorbing characteristic of equity.

These four factors will be a combined input to our assessment on how the perpetuity bond will fall on debt-equity continuum and given a certain degree of equity credit. PEFINDO expects the instrument to not be able to default or cross-default, having no right in bankruptcy, and to rank junior to all other creditors.

The equity characteristics of having no ongoing payments and no maturity will be viewed as primary consideration above subordination feature. Thus, a deeply subordinated instrument may be regarded as debt-like if it does not have the ability to defer coupon payments and/or has a very short maturity.

For internal purpose, we project how the perpetuity bond affect the issuer’s financial statement and measure the impact of the instrument. If enough equity credit is given, we expect that the instrument is less likely to significantly put an additional financial pressure and proceed to assign notch-down as laid out in the following section.

NOTCHING CRITERIA

Perpetuity bond would be typically notched down from the issuer’s rating. The amount of notch down reflects the relative loss severity and/or incremental non-performance risk relative to that indicated by the issuer’s rating. In case of perpetuity bond, we breakdown the notching down by looking into how deep the subordination will be, how will the coupon be deferred, and how those two combined with the loss severity and non-performance risk. We assigned at least 1 notch-down for the loss severity issue, being that perpetuity bond is subordinated. The maximum of the notch-down would be 2 for the deeply subordinated bond with full discretion in coupon omission.

For the non-performance risk relative to issuer’s rating, the notch-down that we assigned is of wider range. We assigned at least 1 notch-down for the coupon deferral feature of perpetuity bond. We regard the mandatory deferral to have higher risk, considering that there is a breach in one or several safety ratios that trigger the coupon deferral rather than the management discretion.

As a general guideline we provide below table in assigning our notch-down to a perpetuity bond.

	idBBB- rating and above		idBB+ rating and below	
	Optional Deferral	Mandatory deferral	Optional Deferral	Mandatory deferral
Subordination	1	1	2	2
Deferral	1	Typically 2*	1	Typically 2*
Total notches	2	3	3	4

*If there is a mandatory trigger and the issuer states that it will make best efforts to settle with common shares and the risk of the trigger being breached is relatively remote, the notch-down can only be “1”. However, if there is high likelihood that the trigger will be breached, the notch-down can be greater than “2”.

CONCLUSION

Perpetuity bond is one form of hybrid instruments which in practice take advantage of both debt and equity features. The instrument is also of higher credit risk and usually compensates the advantage with higher coupon and other investor-friendly features embedded.

The assessment forks into two processes: (1) assessing the equity credit (or equity content) of the bond in order to make sure that the bond has enough equity credit to keep the debt servicing capability of the issuer intact, (2) assigning notch-down to the perpetuity bond, factoring in all the clauses in its terms and conditions.

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