PEFINDO's Approach Towards Debt Restructuring

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PEFINDO has seen a company's credit profile weaken significantly over the past three years, majority of which we observed was due to Covid-19 pandemic. As a result, many companies that we rated have sought loan restructuring to navigate financial difficulties through the pandemic, taking advantage of the government-initiated debt payment moratoria and loan forbearance. Before the pandemic, PEFINDO generally see a debt restructuring as credit negative, as this indicates a company's inability to service its financial obligation under the loan's original terms. Because of the severe economic fallout brought by the pandemic, the Financial Services Authority *Otoritas Jasa Keuangan* or *OJK*) has provided relief to the financial services sector through its regulation No.11/POJK.03/2020, allowing banks to engage in a credit restructuring for affected debtors, including by reducing bank interest rates, deferral of interest payment, and extending credit terms. With the economy reopening and all Covid-19-related restrictions rescinded, we expect less debt restructurings to occur over the near to medium term, as PEFINDO anticipates operating environments across sectors to normalize and earnings to recover.

This article will explain our approach in assessing debt restructuring and its impact on the credit rating, which we have conducted over the past three years and from which we expect will remain relevant going forward.

In identifying whether a debt restructuring will have a negative credit impact or neutral, it is important to identify the root cause that eventually led to a debt restructuring. PEFINDO has divided the root cause for a debt restructuring into:

- Economic, which is a debt restructuring undertaken due to a significant dropped in economic activities which led to severe earnings loss.
- Issuer-specific, a debt restructuring undertaken due to past aggressive business and/or financial policy decisions.

Economic

A significant loss in earnings because of Covid-19 related restrictions, including movement and activity restrictions, falls under this category. Airports, leisure and tourism, railways, retail, restaurants, and toll roads, are sectors that are heavily affected by the pandemic. If a debt restructuring occurs from these sectors, PEFINDO will generally affirm the business rating only if the company is considered a sector leader and the service or product it offers are irreplaceable. However, we will reassess the financial rating components (whichever is relevant to the company) to reflect the debt restructuring, such as:

1. Reassessment of financial policy, most of which will remain neutral in line with our reassessment of the capital structure and, cash flow protection & liquidity.
2. Reassessment of capital structure and cash flow protection & liquidity, most of which will remain neutral because of the significant cash relief as the financial obligation will align with the cash flow recovery from its operation.
3. Reassessment of financial flexibility, including how much-unused credit facilities are available to the company, the number of unencumbered assets it may be used to secure new external funding, and the company's standing in the credit market.

Nonetheless, we may lower the rating and/or revise the outlook if there is an indication of sustain liquidity pressure and strong expectation of a missed payment due in the near future.

Issuer-specific

If a debt restructuring occurs because of a company's aggressive business and/or financial decisions in the past, PEFINDO will reassess the key success factors of the business rating, such as market position, operating management, or diversification, that eventually led to a debt restructuring. Companies with an aggressive financial track record before the pandemic (having persistently high leverage and weak cashflow protection ratios) saw its financial ratios deteriorating significantly and liquidity diminishing, triggering an imminent debt restructuring to stay afloat. The reassessment of the business rating will also be followed by a reassessment of the financial rating, which includes:

1. Reassessment of financial policy mostly will be lowered in line with our reassessment of the capital structure, cashflow protection & liquidity.
2. Reassessment of capital structure and cash flow protection & liquidity mostly lowered to reflect the rising liquidity risk because of the unsustainable capital structure and cash flow pressure as well as weaker standing in the credit market.
3. Reassessment of financial flexibility mostly lowered because of the debt restructuring.

Regardless of the root cause that led to a debt restructuring, the timing of when the restructuring proposal is finalized by creditors (including bondholders in the case of a bond restructuring) is a critical factor in determining the final impact on the credit rating as the restructuring process may take some time; thus, the procedural delays cannot be ruled out. We may lower the rating to $_{id}$CCC if the restructuring is not yet agreed upon by creditors or, under a worse scenario, is rejected and a missed payment is imminent. On the other hand, PEFINDO may not recognize default as per the original contractual terms if the lenders approve or are expected to approve the restructuring proposal. However, it should be clear that the restructuring proposal must be made before the due date.