Creditreform Rating AG Rating Methodology

Corporate Short-Term Ratings

Sub-Methodology for Performing Short-Term Ratings

DRAFT
Version 1.0

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This document (version 1.0) is the first version of the methodology. With the introduction of this method, Creditreform Rating AG (CRA) will issue short-term ratings for non-financial corporates and small and medium-sized enterprises (SMEs) on an as-needed basis. This will not affect CRA's existing long-term ratings (LTR).

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1 Introduction

1.1 Background of the methodology

In order to enhance the transparency and clarity of Creditreform Rating AG's (CRA) ratings to companies, investors and the general public, the present supplementary rating sub-methodology "Corporate Short-Term Rating" (CSTR) is disclosed. The rating methodology will be updated in case of changes in the applicable methodology. Each CRA rating is based on defined fundamentals and principles (e.g. rating process, principal procedures, defined rating scales and add-ons). This sub-methodology is used in conjunction with the main methodology rating of companies "Corporate Ratings". CRA's sub-methodology, main methodology, credit rating criteria, and definitions, along with our Code of Conduct, are readily accessible to the public via our website, www.creditreform-rating.de.

1.2 Introduction

CRA's Short-term Corporate Ratings provide information on the ability of an economically active company to service its short-term financial instruments. In this context, short-term refers to a horizon of up to one year.

Regarding short-term debt, larger companies often issue commercial paper (CP), which offer flexible means of short-term financing and coverage of working capital requirements and is an alternative to drawing on bank credit lines. Investors in CP are almost exclusively institutional investors, including investment, pension and insurance funds.

Most CP issued in the European market have either a very high or even a top tier short-term credit rating, which is considered a superior creditworthiness for issuers respectively credit quality for bonds. Below there are further rating levels, for short-term credit quality assessments, typically considered as good adequate and speculative, before default levels occur. Under current regulations, Money Market Funds may only invest in bonds with superior respectively exceptional credit quality[1].

2 Scope of application

The Corporate Short-Term Rating (STR) is significant in relation to an economically active company and its financial instruments that are maturing within one year. Essential for the assessment of the short-

[1] Source: Regulation (EU) 2077/1131

term creditworthiness of the issuer, or the credit quality of short-term issues, is the long-term creditworthiness of the issuer, which is expressed in its Long-Term Corporate Issuer Rating (LTR).

For example, an issuer assigned a high LTR would be very likely to have access to the debt capital market even in times of a difficult capital markets and restricted lending. This probability diminishes as the credit rating decreases, especially during periods of stress. Moreover, the LTR already takes into account key factors that are important for a short-term creditworthiness assessment. For these and other reasons, CRA derives the STR from the LTR (standard mapping).

For larger companies, their current liabilities primarily comprise unsecured debt instruments that have a maturity of 365 days or may also include commercial paper (CP) issues. Creditreform Rating undertakes ongoing monitoring of credit ratings, considering factors that are significant for both the long-term rating (LTR) and the STR.

Similar to an LTR, an STR remains valid until any revisions or withdrawals are made. However, it is important to note that not every company receiving an LTR automatically receives an STR from CRA. STRs are explicitly published and require a LTR for the respective company.

The methodology refers to economically active non-financial companies and does not include banks, leasing or insurance companies, sovereigns and supranational corporations and agencies (SSAs), structured finance and asset-based finance (special purpose vehicles, SPVs), or fund companies.

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3 Rating methodology

3.1 Notation and rating scales

The rating scale or notation and the mapping used by CRA for short-term ratings is shown below:

Short-Term Rating	Assessment
L1	Extraordinarily high level of liquidity
L2	High level of liquidity
L3	Adequate level of liquidity
NEL	Inadequate level of liquidity or liquidity at risk
D	Default

In contrast to the LTR scale (see p. 5), which shows 19 rating notations and 2 default levels (SD/D), the STR only shows four notations (L1, L2, L3, NEL) and 2 default levels (SD/D). In principle, there is a predefined relationship (standard mapping) between the assignment of an LTR and an STR. In the case of the

upper rating levels in the LTR, an uplift to the next higher STR level can be justified if the liquidity profile is excellent. With regard to the rating scales applicable to CRA and the meaning of the notations, please refer to the basic paper "Rating Criteria and Definitions", which is available on CRA's website (www.creditreform-rating.de) and which contains further relevant information on CRA's approach and ratings.

CRA Corporate Long-term vs. Short-term Rating scale (Mapping)

LTR Class	LTR	STR			
AAA	AAA				L1
	AA+				L1
AA	AA				L1
	AA-				L1
	A+			L2	L1
A	A			L2	L1
	A-			L2	
	BBB+		L3	L2	
BBB	BBB		L3	L2	
	BBB-		L3		
	BB+	NEL	L3		
BB	BB	NEL			
	BB-	NEL			
	B+	NEL			
B	B	NEL			
	B-	NEL			
	CCC	NEL			
C	CC	NEL			
	C	NEL			
SD/D	SD/D	SD/D			

*Standard Mapping *Exceptional Mapping

Even though the probability of default on the rating scale increases considerably, especially with the beginning of the speculative range (BB+) downwards, the short-term rating scale of CRA consists of only four rating grades. This is because short-term investors generally avoid investments in (highly) risky unsecured assets, and for this reason, a differentiation of the lowest rating classes appears to be less meaningful. In the context of the LTR, it is prudent to differentiate, as Creditreform Rating AG (CRA) considers liquidity to be a crucial factor, one that takes on an even greater significance as creditworthiness deteriorates.

3.2 Mapping between Long-Term and Short-Term Ratings

Various fundamentals of short- and long-term credit risk are very similar, which is why the short-term credit risk profile is already adequately taken into account when assigning a Corporate LTR. Failure to repay upcoming financial obligations can also lead to insolvency and cessation of operations in the short term, which must be considered in the LTR. Conversely, the long-term credit quality of issuers also influences the willingness of investors to roll over short-term debt instruments, making them appear to be a reliable source of external financing for the company.

In times of crisis or high economic uncertainty, the correlation between the short- and long-term credit risk curves strengthens, as long-term investors tend to become more cautious. At the same time, we have observed that in times of crisis, many companies with higher credit ratings tend to use their opportunities to increase their liquidity headroom, which also supports their LTRs. Overall, in CRA's opinion, a high degree of differentiation of creditworthiness in many rating notations is not meaningful in the short term, which is why CRA distinguishes "only" 4 grades here.

According to the above explanations, there should initially be no significant differences between STRs and LTRs according to the above mapping of the scales. In other words, companies with low liquidity should in principle not receive a higher LTR[2]. However, companies with good to excellent liquidity may receive a low LTR. This could be the case, for example, if the liquidity situation of a company is currently good to excellent, but the medium to long-term business outlook is deteriorating.

CRA will nevertheless look to the LTR in determining the STR in the standard mapping. This means, for example, that a Class "A" LTR is generally assigned to STR Class "L2" and Class "BBB" LTRs are generally assigned to STR Class "L3." For clarification, the mapping of the STR is initially based on the LTR. In addition to the standard mapping, this system also includes the possibility of an uplift of STRs to the next higher STR level, according to Exceptional Mapping, for companies with an excellent liquidity situation and very good capital market access and/or very good banking relationships. According to standard mapping, a rating assigned with a LTR of "BBB+", for example, would initially be assigned to STR level "L3". In case of excellent results in the liquidity analysis, an uplift to STR level "L2" would still be possible. In the fundamental opinion of CRA, the STR may be upgraded by a maximum of one rating level in the STR scale.

[2] Exceptions to the rule are possible in justified cases. This may be justified, for example, in the case of companies with a close relationship to a state.

3.3 Criteria for a potential uplift in the short-term rating

3.3.1 Basic procedure

As previously stated, the Long-Term Rating (LTR) serves as the foundation for Short-Term Rating (STR) allocation. Under an Exceptional Mapping (refer to STR scale on page 5), an uplift to the next higher STR level may be warranted if both the overall result of the following criteria reaches a certain threshold, and the individual criteria demonstrate a predominantly positive outcome. These criteria are comprised of both quantitative and qualitative elements. To assess a company's liquidity profile, CRA undertakes a comprehensive analysis of its liquidity scope, as well as evaluate its access to capital markets and banking relationships. The rating committee will ultimately decide on whether an uplift in the STR is warranted based on a thorough analysis of the aforementioned factors.

3.3.2 Quantitative criterion: Cash sources/cash uses and sensitivity analysis

CRA generally considers three levels when quantitatively assessing the short-term financial strength of a company. Firstly, the operating cash flow is important for the assessment of the short-term financial strength of a company. This indicates the strength of sustainable liquidity generation. Secondly, the internal liquidity fund, which consists of unrestricted cash, including cash at banks and marketable securities, is added, resulting in the "internal cash sources".

$$Internal\ coverage\ ratio\ cash\ sources\ vs.uses\ I\ (\%)\ = \frac{operating\ cash\ flow}{cash\ uses}\ x\ 100$$

$$Internal\ coverage\ ratio\ cash\ sources\ vs.uses\ II\ (\%)\ = \frac{internal\ cash\ sources}{cash\ uses}\ x\ 100$$

These two levels of cash sources must be contrasted with the use of liquidity. For this part of the methodology, we assume for analytical purposes, that access to the capital market is not available in the short term and that only committed, available credit lines can be used. Banking relationships and access to the capital market are subsequently included in the qualitative analysis part. Capital expenditures (Capex) are added to cash uses for analytical purposes, on the premise that they cannot be externally funded, yet are still undertaken. In addition, financial liabilities due in the short term, interest to be paid, dividend payments and, if necessary, further disbursements (e.g. from share buyback programs) are deducted. Subsequently, we calculate the "Internal Coverage Ratio Cash Sources vs. Uses," which includes Ratios I and II, to ascertain the level of liquidity that is internally available.

$$\boldsymbol{Total\ coverage\ ratio\ cash\ sources\ vs.uses}\ (\%)\ = \frac{\boldsymbol{internal + external\ cash\ sources}}{\boldsymbol{cash\ uses}}\ \boldsymbol{x\ 100}$$

In a further step in the calculation of the liquidity fund, the external cash sources, usually consisting of committed available credit lines and, if applicable, alternative liquidity, such as from already contractually agreed disposals or capital increases, are added.

The above calculations are considered over several years and the development, continuity and volatility are taken into account. The key figure "Total coverage ratio cash sources vs. uses" is considered to be of decisive importance, whereas the key figures "Internal coverage ratio cash sources vs. uses" I and II can be used to supplement the decision on liquidity strength. In order to verify the sustainability of the liquidity strength, the above calculations are stressed in various scenarios for informative purposes.

3.3.3 Qualitative criterion: Capital market access and banking relationships

A company's solvency also depends on its ability to access external financing at any time, which is also largely determined by its capital market access and relationship with credit institutions.

We estimate the latter, for example, based on the number and quality of relationships with established credit institutions and the volume of available credit facilities and whether these are conditional or unconditional. Other indicators may include the extent of covenants, the term of the loan agreements and the utilization rate.

We estimate capital market access by, among other things, issuance frequency, issuance volumes and placement ratios, the existence of emissions programs, issuance places, and financing instruments. The terms of the financings can be included.

Although the government relationship is already generally included in the LTR, CRA also considers it when assessing banking relationships and capital market access, if relevant. In this context, CRA generally assumes that corresponding rating objects that exhibit a certain degree of affiliation to (sub) sovereigns/public sponsors with a higher credit rating will also receive access to the capital and credit market in times of crisis.

3.4 Additional Notes

CRA may deviate from the above criteria and calculation methods, or use other/additional criteria for the assessment of the STR if it is convinced that this will ensure a more plausible rating assessment. This may, for example, be caused by extraordinary events or due to the special intrinsic business of the rating object. CRA will justify this and disclose it in the published documents.

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