Investment Holding Companies Rating Methodology Feedback Report

Scope Ratings would like to thank market participants for their feedback on its new Investment Holding Companies Rating Methodology published on 19 May 2023. This report addresses comments received confidentially during the request-for-comments period ended 04 April 2023

Market participants' comments on weighting total cost cover[1]

First comment:

Overall, the total cost cover (TCC) metric in Scope's Investment Holding Companies Rating Methodology seems to be the 'dominant' rating factor. However, considering that there are other factors that could be equally important for investment holding companies (loan-to-value, debt coverage, portfolio credit quality and transparency, financial policy, investment/transaction track record, etc.), we feel that too much weight and emphasis is put on this metric in the overall credit assessment.

Second comment:

Reduce the weight of your total cost cover as this ratio has limited use from my point of view. This ratio clearly favors mature investments (with high dividend payout) versus growth investment (with low dividend payout). Therefore, investments in companies which have many projects with positive net present value (and require capital for growth) are punished even though the investment holding can simply generate its own dividend by selling shares in the investment.

Scope's answer

We take into account all relevant credit factors for investment holding companies and make a balanced evaluation based on the specific circumstances of each company/business model.

The TCC is an important factor in the overall credit assessment, and we recognise that the weight and emphasis placed on TCC may vary depending on the specific circumstances of each company. For example, we have assigned overall ratings of BBB to some companies with a TCC rating of BB (i.e. three notches higher). This demonstrates that the TCC metric does not outweigh other considerations.

Furthermore, mature investments that provide dividends upstream, i.e. at the holding level, allow the holding to service its debt and other recurring costs through regular recurring cash flows. As such, the holding is much less exposed to the cyclicality and availability of capital markets, market timing and demand, than a holding investing in growth companies.

Market participant comment on shareholder remuneration[1]

Discretionary dividend should also be considered differently when calculating the TCC metric compared to regular dividend. If a company is operating with a highly flexible dividend policy, and thus will only distribute discretionary dividends if financial conditions would allow for such distribution (e.g. other important credit metrics are not negatively impacted by such distribution), this should be given a greater deal of consideration and measured up against the company's financial policy of protecting and maintaining key credit metrics (solid loan-to-value, debt coverage, etc.) within invstment grade metrics.

[1] Comment edited for clarity

Analysts

Zurab Zedelashvili
+49 69 6677389-47
z.zedelashvili@scoperatings.com

Thomas Faeh
+47 9305 3140
t.faeh@scoperatings.com

Sebastian Zank, CFA
+49 30 27891-225
s.zank@scoperatings.com

Olaf Tölke
+49 69 6677389-11
o.toelke@scoperatings.com

Related Report

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Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891-0
Fax +49 30 27891-100

info@scoperatings.com
www.scoperatings.com

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Consequently, as the discretionary part of a company’s dividend is not certain, this should be given less weight than regular dividend in the TCC metric.

Scope’s answer

We acknowledge that discretionary dividend payments should be evaluated differently to regular dividend payments when assessing a company's financial policy of protecting and maintaining key credit metrics. In cases where a company has a highly flexible dividend policy and only distributes discretionary dividends if financial conditions allow it, we give greater consideration to protecting and maintaining key credit metrics within investment grade metrics (in such instances, we also model credit metrics to remain at investment grade levels by reducing discretionary dividends, in case our base case assumes lower income than the company's case).

As there may be differing opinions or subjective views on the discretionary portion of a company's dividend payout, we prefer to retain analytical flexibility in deciding whether a dividend payment policy is flexible.

Market participant comment on sales proceeds inclusion in total cost cover calculation[1]

Investment Holding Companies will from time to time make periodic sales which is a natural part of the underlying upstream cash flow (equally important as upstream dividends). Thus, the cash flow generated from disposals, which may not be as regular as dividend received, should also be accounted for in the TCC. Cash flow generated from a sale of a portfolio company is merely the net present value of the dividend received. Thus, if an investment holding company has a track record of doing successful transactions, such cash flow generating activity should also be considered in the TCC as this is a key part of investment holding companies’ way of generating cash flows. Although difficult to forecast such transactions going forward, one solution would be to look at the company’s track record and make some estimation of an average cash flow stream when calculating the TCC.

Scope’s answer

We agree that periodic sales of assets can generate cash flow and are an important part of the upstream cash flow for investment holding companies. We also acknowledge that these cash flows may not be as regular as dividend payments and can be more difficult to forecast.

To account for this, our business risk assessment factors in the portfolio value development and investment policy, which captures the investment holding company's ability to divest. This involves evaluating the company's track record of successful transactions, internal rate of return or generated multiples, and the profitability of the overall portfolio.

Additionally, if an investment holding company invests in close-end funds where the visibility of potential cash inflows is higher, we may take into consideration as an additional support to TCC going forward.

Overall, we recognise the importance of cash proceeds from periodic sales of assets and will continue to assess each investment holding company on a case-by-case basis, taking into account all relevant factors, including the company's track record, investment philosophy and/or TCC.

Changes to the Rating Methodology after the call for comment

No analytical changes have been made as a result of comments received. We have published the updated methodology as proposed. The final version of the Investment Holding Companies Rating Methodology is available on www.scoperatings.com.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891-0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris
10 avenue de Messine
FR-75008 Paris

Phone +33 6 6289 3512

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

Madrid
Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London
52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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