FitchRatings

# UK Whole Business Securitisation Rating Criteria

### Sector-Specific

## Scope

These criteria apply to structured new and existing corporate financings in the UK, known as whole business securitisations (WBS). They are typically used for long-term, fully amortising financings of operating assets in industries with stable cash flows and low obsolescence risk. Fitch Ratings' WBS ratings are assigned to individual debt instruments and do not incorporate recovery prospects following a payment default.

The criteria combine corporate and structured finance analysis to determine a rating and may be used in conjunction with related criteria. Fitch applies corporate finance principles to establish key drivers for free cash flow (FCF) forecasts. It then applies structured finance analysis to the WBS framework, under which an administrative receiver can be appointed for the benefit of secured creditors with covenants, asset-specific security and structural protections.

The ratings address the likelihood of receiving payments in accordance with the terms and conditions of the rated notes. In a WBS tranched into multiple note classes, the subordinated notes can feature deferrable debt service, so non-payment may not be classified as a default. In such cases, Fitch's rating addresses the repayment of ultimate principal and deferred note interest payments by note legal final maturity, in line with rating definitions.

## Key Rating Drivers

Ratings are determined by assessing a WBS's key rating drivers (KRDs). However, there is no formula to link KRD assessments to a rating. Fitch considers attributes based on their materiality to performance. When an attribute is significantly weaker than others, it may carry a greater weight. Investment-grade ratings feature midrange and stronger attributes. The table below outlines the qualitative attributes consistent with the assessment of the KRDs.

**Industry Profile:** Fitch evaluates the company's industry. An industry in decline, or one that is highly competitive, cyclical or volatile is inherently riskier than a stable industry with few competitors, high barriers to entry and predictable demand. Industry risks may result in a WBS ratings cap.

**Company Profile:** Fitch uses financial data to assess trends in revenues, costs and capex. Limited historical volatility should support the assumption of sustainable future FCF. Fitch also considers the entity's competitive position, as well as operational and strategic strength.

**Debt Structure:** Fitch separately evaluates each rated debt tranche. Debt structure analysis includes priority of payments, amortisation, maturity, floating-rate exposure and hedging, liquidity facilities, reserves, financial covenants and cash lockup/cash sweep triggers in the context of industry and company profile.

**Cash Flow Analysis:** FCF forecasts based on industry and company risk profiles are used to estimate capacity to meet debt service obligations, taking into account structural features (e.g. liquidity facility) and the priority of payments as defined in the documentation. Fitch uses its rating and stress cases to assess operational vulnerability and debt structural enhancements. Fitch uses its debt service coverage ratio and leverage metrics to evaluate debt repayment capacity.

**Global Infrastructure & Project Finance**
Whole Business Securitisations
**UK**

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This report updates and replaces that published on 3 July 2020 under the same name.

### Related Criteria

Infrastructure and Project Finance Rating Criteria (March 2020)

Corporate Rating Criteria (December 2020)

Structured Finance and Covered Bonds Counterparty Rating Criteria (January 2020)

Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum (January 2020)

Global Structured Finance Rating Criteria (March 2021)

### Analysts


Radim Radkovsky
+44 20 3530 1254
radim.radkovsky@fitchratings.com

Christiane Kuti
+44 20 3530 1396
christiane.kuti@fitchratings.com

George Abbatt
+44 203 3530 1576
george.abbatt@fitchratings.com

## KRD Assessments for UK WBS

| KRD | Sub-KRD | Stronger | Midrange | Weaker |
|---|---|---|---|---|
| Industry profile | Operating environment | Mature and non-cyclical sector<br>Limited exposure to discretionary spending<br>Monopolistic or oligopolistic structure<br>External macro factors (e.g. commodities) not likely to affect industry<br>Stable regulatory framework; limited reliance on individual regulatory barriers<br>Little price and volume risk | Mature sector with some cyclicality<br>Exposure to discretionary spending<br>Competitive industry structure<br>External macro factors likely to affect industry to some extent<br>Mainly stable regulatory framework; Some reliance on few regulatory barriers<br>Moderate price and/or volume risk | Non-mature and/or cyclical sector<br>Significant exposure to discretionary spending<br>Highly competitive industry structure<br>External macro factors likely to considerably affect industry<br>Regulatory framework with uncertainties; Material reliance on few regulatory barriers<br>Significant price and/or volume risk |
| | Barriers to entry | Strict licensing law and regulations<br>Scarcity of alternative locations/physical assets; stringent planning permission process; highly capital intensive<br>Switching costs high | Established licensing law and regulations<br>Limited availability of alternative locations/physical assets; standard planning permission process; capital intensive<br>Switching costs moderate | Light regulations not deterring entrants<br>Many available alternative locations / physical assets; loose planning permission process; non-capital intensive<br>Switching costs low |
| | Sector sustainability | Industry fundamental changes expected to be limited (e.g. low technology/disruption risk, limited threat of substitutes)<br>Industry with mainly favourable macro trends (e.g. long-term demographics) | Industry fundamental changes possible in the long-term (e.g. some technology/disruption risk, threat of partial substitutes)<br>Industry with some favourable macro trends | Industry fundamental changes likely in the medium- to long-term (e.g. material technology/disruption and/or substitution risk)<br>Industry with unfavourable macro trends (e.g. sector in structural decline) |
| Company profile | Financial performance | Around 10 years of stable trading history; proven resilience through an economic cycle<br>Immaterial pension or other liabilities | Around five years of relatively stable trading history; some vulnerability to downturns<br>Limited pension or other liabilities | Limited or poor trading history; significant vulnerability to downturns<br>Material pension or other liabilities |
| | Company operations | Strong/stable management; no key-man risk; good corporate governance practices<br>Very experienced sponsors with long-term horizon<br>Wide range of products or ability to capture a wide range of market segments; strong brands; price-maker<br>Long-term contracts with creditworthy clients/suppliers; low concentration risk<br>Large-sized/leading operator; good economies of scale; low operating leverage<br>Strong logistics/IT and operational track record; well-structured operational covenants | Experienced and committed sponsors<br>Some range in products or ability to capture different market segments; established brands<br>Medium-term contracts with creditworthy clients/suppliers; some concentration risk<br>Medium-sized operator; some economies of scale; moderate operating leverage<br>Adequate logistics/IT and operational track record; standard operational covenants | Frequent or recent management changes; key man risk; corporate governance issues<br>Sponsors with limited experience; evidently weak/unclear financials<br>Narrow range of products with focus only on one or two market segments; no brands or weak branding; price-taker<br>Short-term contracts with weak clients/suppliers; significant concentration risk<br>Small operator; minimal or no economies of scale; high operating leverage<br>Logistics/IT and operational record with past issues; loose/no operational covenants |
| | Transparency | Self-operated business; ability to adapt to industry changes<br>Information provided ensures full insight into underlying profitability<br>Operations with low complexity | Primarily self-operated business; some ability to adapt to industry changes<br>Information provided ensures some insight into underlying profitability<br>Operations entail some complexity | Assets operated mainly by a third party; limited ability to adapt to industry changes<br>Information provided gives little or no insight into underlying profitability<br>Operations with high complexity |
| | Dependence on operator | Multiple alternative operators available; easy to replace operator<br>No operational or financial commingling with non-securitised group | Some alternative operators available<br>Replacement of operator possible<br>Limited operational or finanical commingling with non-securitised group | Few alternative operators available; specialty operator required<br>Material operational or financial commingling with non-securitised group |

## KRD Assessments for UK WBS (Cont.)

| KRD | Sub-KRD | Stronger | Midrange | Weaker |
|---|---|---|---|---|
| | Asset quality | Assets well-maintained; well-located (e.g. in affluent regions); low concentration risk<br>Maintenance needs well defined<br>Minimum maintenance capex covenants set at levels perceived to be above what is required to support current asset quality<br>Assets mainly on freehold<br>Liquid and established secondary market; disposals on an individual or multi-asset going concern or alternative use basis<br>Strong alternative use value potential | Assets generally well-maintained; mostly well-located; some concentration risk<br>Maintenance needs defined but with some uncertainty in timing/funding<br>Minimum maintenance capex covenants set at levels supportive of current asset quality<br>Assets mainly on a combination of freehold and long leasehold<br>Functioning secondary market; disposals on an individual or multi-asset going concern or alternative use basis<br>Some alternative use value potential | Assets not well-maintained; poorly located; material concentration risk<br>Maintenance needs not well defined with timing/funding unclear<br>Minimum maintenance capex covenants set at levels that are not supportive of current asset quality<br>Significant portion of assets on short leasehold<br>Limited secondary market with disposals mainly on a going concern basis<br>No or limited alternative use value potential |
| Debt structure (tranche level) | Debt profile | Fully amortising on a fixed schedule; flat (or decreasing) debt profile commensurate with industry/company risk profile<br>Immaterial interest-only; concurrent amortisation periods with sub-debt<br>Interest/principal deferral on sub-debt<br>Fixed or fully hedged floating rate<br>Immaterial derivatives or other financial liabilities | Refinancing risk mitigated by cash sweep; debt profile broadly commensurate with industry/company risk profile<br>Limited interest-only; concurrent amortisation periods with sub-debt<br>Largely fixed or hedged floating rate<br>Derivatives or other financial liabilities present, but unlikely to materialise | Not fully amortising; highly sculpted/backdated debt profile not commensurate with industry/company risk profile<br>Prolonged interest-only; concurrent amortisation periods with sub-debt<br>No sub-debt interest/principal deferral<br>Material floating-rate exposure<br>Substantial derivatives or other financial liabilities at risk of materialising |
| | Security package | Senior-ranking; controlling creditor<br>Strong security package; full suite of first ranking fixed/qualifying floating charges | Adequate security package; ability to enforce somewhat constrained | Junior-ranking; non-controlling creditor<br>Weak security package; no first ranking security; ability to enforce constrained |
| | Structural features | Comprehensive and non-ambivalent set of covenants; stringent 'cure' rights<br>High RPC[a] – with effective dividend lockout – and appropriate default covenant levels relative to industry/company risk profile<br>Issuer's liquidity reserves/facility covering at least 18 months of peak debt service<br>Highly rated financial counterparties and adequate downgrade language<br>Clean orphan issuer SPV ensuring full legal separateness from the borrower group | Non-ambivalent set of covenants; some 'cure' rights<br>Moderate RPC[a] – with effective dividend lockout – and default covenant levels relative to industry/company risk profile<br>Issuer's liquidity reserves/facility covering at least 12 months of peak debt service<br>Highly rated financial counterparties but lack of adequate downgrade language<br>Non-orphan SPV but with strong contractual mitigants | Incomprehensive and ambivalent set of covenants; substantial 'cure' rights<br>Low RPC[a] – with cash leakage – and default covenant levels relative to industry/company risk profile<br>Issuer's liquidity reserves/facility covering less than 12 months of peak debt service<br>Weak financial counterparties; lack of adequate downgrade language<br>Non-orphan SPV combined with limited contractual provisions |

[a] Restricted payment condition
Source: Fitch Ratings

## Key Rating Drivers

KRDs include industry and company profiles, and debt structure. The industry and company risk profiles, consistent with Fitch's corporate principles, are used to help assess these factors. Sector specialists from Fitch's corporate finance group are involved when necessary. Elements of this analysis also drive the cash flow analysis used to forecast debt service coverage ratios (DSCRs) over the transaction life.

## KRD – Industry Profile

### Ratings Anchored to Industry Assessment

The starting point of the analysis is the industry assessment. The ratings of issued notes are determined in the context of industry fundamentals. There is a range of possible ratings linked to the industry risk profile, with lower risk industries able to support higher ratings subject to the assessment of the other KRDs. The company risk profile, debt structure, cash flow analysis and credit metrics allow a refinement of the rating to notch-specific levels. Industry analysis and discussions with company management help to determine drivers of potential performance volatility. Industries that are in decline, highly competitive, capital intensive, cyclical or volatile, are inherently riskier than stable industries with few competitors, high barriers to entry, market dominance and predictable demand.

### Industry Caps May Be Applied

Higher volatility of the underlying business and industry may limit the benefit of the WBS structure, meaning strong credit metrics can only partially mitigate constraints from weak industry and company profiles. Industry risk factors such as cyclicality or obsolescence risk may therefore result in an industry rating cap for higher-risk industries. The notes are also unlikely to receive high investment-grade ratings ('A' or above), irrespective of the transaction's financial profile or debt structure (e.g. DSCR, leverage, debt tranching). Equally, reflecting differences in debt structure, financial, corporate and asset risk profile, not all notes in low-risk industries will achieve high investment-grade ratings. The following highlights the key factors for assessing industry risk, while recognising that unique characteristics of a WBS can affect ratings.

### Sub-KRD: Operating Environment

In the analysis of a sector, Fitch will focus on:

- Macro factors such as demographics, interest rates, energy and raw material costs; for example, long-term favourable demographics could lead to more predictable revenues;
- Sector growth phase; a mature sector, as opposed to a declining one, is expected to generate more stable cash flows;
- The sector's cyclicality and exposure to GDP or discretionary spending to assess industry volatility;
- Competitive strengths/opportunities/threats/weaknesses of the key players, industry concentration, horizontal/vertical integration and potential substitute products.

### Sub-KRD: Barriers to Entry

As barriers to entry protect incumbent firms and restrict market competition, they can protect market share and reduce price volatility. This is relevant for a WBS, as debt is often long-term. Fitch has identified three key barriers to entry:

- Sectors with infrastructure-like features, such as local monopolies with natural product demand; assets that are difficult to replicate without significant investment; assets protected by their strategic location; or those in a regulated industry;
- Sectors requiring hard-to-obtain licences or planning permission, for example hospitals and crematoria. A transparent and developed regulatory framework can limit downside risk for regulated companies;

- To a lesser extent, sectors in which incumbents already have a dominant market share and benefit from significant economies of scale as a result. It would be difficult for a new entrant to replicate such a market position without significant investment.

### Sub-KRD: Sector Sustainability

Projected cash flow for the life of the bonds is a significant factor in Fitch's analysis. To evaluate this, Fitch identifies sector drivers and takes a view as to whether these could change. Technological changes, growth phases, potential new competition, substitute products, and macroeconomic, demographic or cultural trends could affect sector fundamentals. Fitch does not rate debt instruments with a debt profile beyond asset economic life or industry visibility.

## KRD – Company Profile

### Sub-KRD: Financial Performance

Fitch considers the key drivers and volatility of performance to determine future cash flows. The underlying business of a WBS should demonstrate stable trading performance through at least one business cycle and for over five years to support a sustainable cash flow assumption. If there is a significant lack of historical trading data, Fitch would not be in a position to assign ratings to the transaction. Sector developments, for example due to changing consumer behaviour or regulation, could render historical performance less relevant.

#### *Pension Risk*

The UK pension regulator has the ability to require parties connected with an employer that is running a defined benefit pension scheme to make up shortfalls in that scheme. The issuer or borrower could, as a result, be called upon to meet potential pension liabilities of the borrower or a company in the borrower group. Pension risk may thus affect entities that have no employees, but derive a benefit from affiliates that are members of a pension scheme, even if only through a service contract with its affiliate.

Fitch views the payment of pension contributions as senior operational expenses affecting FCF. The pension deficit is a form of financial obligation that a WBS would be required to service from its cash flows. While the pension deficit typically ranks behind fixed charge-holders who can still enforce security over the charged assets, it may affect the realisable asset value if the business was sold on a going concern basis.

### Sub-KRD: Company Operations

Several factors can enable an issuer to mitigate competitive or other macro pressures. These include its: position in key markets, product diversity, brand strength, ability to influence price, diversification of customers and suppliers, logistics and comparative cost position. Long-term contracts with creditworthy customers can also contribute significantly to stability of cash flows. The following factors are also taken into account:

#### *Sound Corporate Governance*

Fitch looks for good corporate governance with suitable controls for ensuring sound policies and procedures in boardroom effectiveness, board independence, management compensation, related-party transactions, and integrity of accounting and audit. This translates into a stable management structure with good second tier and local management. Prospective WBS candidates usually demonstrate well-administered operations backed by established procedures that are not over-reliant on a small group of specialised or irreplaceable managers.

#### *Ownership*

Fitch considers the sponsor's sector experience and its long-term commitment to its investment. Although most WBS should be structurally insulated from ownership change, such an event, which may occur during the 20- to 30-year lifespan of a WBS, could trigger a change in strategy or performance. New management could focus on maximising short-term returns by reducing investment or scaling down operations and hence affect borrower performance.

#### *Long-Term Strategy Aligned with Capital Structure*

The long-term strategy for WBS businesses are usually aligned with its capital structure. It is credit-positive for the business not to pursue risky paths such as major acquisitions or extensive development activity within the securitisation group[1]. The ring-fenced structure of the business over which security is given can allow business elements outside this group to pursue equity-risk strategies, which are not detrimental to the securitisation group.

### *Restrictions on Activities*

Restrictions controlling transfers or disposals of assets out of the securitisation group help to lower the risk of deterioration in credit quality of the ring-fenced entity. These operational covenants can ensure that cash flows are less likely to fluctuate significantly. Restrictions in the following areas are considered credit positive:

- Acquisitions restricted to assets within the current line of business (“permitted business”).
- Disposals subject to a cap with a proportion of proceeds required to be applied to acquire replacement assets, carry out enhancement capital expenditure or redeem a greater proportion of allocated debt. These actions are to retain group value or reduce leverage.
- Operating contracts, in standard form and on market terms, governing the relationship between the operators and the secured assets. Provisions for operator replacement in adverse circumstances may also be included.

## Sub-KRD: Transparency of Business Model

To assess business and FCF sustainability, Fitch assesses the profitability of the production/distribution chain. If the borrower is not integrated, it is more difficult to assess FCF sustainability. The typical tenanted/leased pub business model is one example of a weaker assessment, which acts as a constraint to the rating. Disclosure, and therefore the insight into the profitability of the tenants operating the pubs, is limited. If rents charged by the pubco are unsustainably high, the pubco’s cash flow may be temporarily enhanced, but at the expense of failing tenants in the future.

Another factor is whether the operator can adapt its business to respond to a changing industry (e.g. consumer behaviour, regulatory). Entities that operate cash-generating assets themselves have an advantage, as they have more strategic control. Fitch also considers business complexity. Simpler operations reduce the likelihood of strategy and risk management errors.

## Sub-KRD: Dependence on Operator

### *Availability of Alternative Operators and Ease of Replacement*

The value of administrative receivership is diminished if few specialised operators are available to run the securitised assets. Availability of multiple alternative operators is viewed as credit positive, as it reduces operating company dependency.

### *Operational and Financial Commingling*

A low degree of both operational and financial commingling between the securitised group and any other operating assets that sit outside this group which are managed by the same operating company is considered a stronger attribute. This reduces execution risk and related costs in case of a potential insolvency of the operating company.

## Sub-KRD: Asset Quality

High quality cash-flow generating assets are important to ensure stability of the operation’s FCF. Covenants stipulating minimum capex investments are typical in WBS. Fitch assesses the quality of the assets by considering their profitability, size, location and geographical diversification, as well as historical performance stability.

The analytical focus is on FCF from operations as the source of repayment for the WBS notes. However, cash flow from investments, for example by selling assets, may offer another way to repay the outstanding notes as long as there is a liquid and established market with a sufficient number of alternative operators, or there is alternative use value potential. Therefore, Fitch

[1] This refers to the pool of operating assets, which are ring-fenced from the wider operating company, with only WBS creditors having recourse rights against these assets and the possibility of appointing an administrative receiver for their own benefit.

may consider asset valuations in distressed scenarios. Notably, specialised businesses may have assets that cannot be easily disposed of.

## KRD – Debt Structure

### Sub-KRD: Debt Profile

Fitch views a fully amortising debt profile as stronger than alternatives, as it removes refinancing risk. Unmitigated bullet maturities, without a cash sweep mechanism, are viewed as weaker.

#### *Deferability of WBS Subordinated Notes*

The ratings address the likelihood of default of a given debt instrument, when default includes non-payment of either interest or principal in accordance with the terms of that particular debt instrument. In a WBS, debt is tranched into different note classes, the subordinated notes tend to have deferrable debt service – its non-payment on a given payment date may not be classified as a default. However, Fitch is likely to have downgraded the instrument to reflect underlying operational stress if this mechanism has been activated. Deferability may increase the resilience of the senior classes at the expense of the junior deferrable classes in a severe stress case.

#### *Floating Rate Exposure and Interest-Rate Hedging*

WBS notes are typically insulated from changes in interest rates due to the issuance of fixed-rate instruments or floating-rate notes benefiting from interest-rate hedging (typically super senior ranking) until their legal final maturity. The removal of interest-rate risk is another structural positive of a WBS, assuming hedging costs are not unusually high (e.g. through off-market interest rates). Swap notional principal amortisation in line with the notes, leaving no notes un-hedged, is credit positive. This also applies when the swap remains in place despite a borrower default. Since some swaps break when the counterparty is insolvent, an issuer level rather than borrower level swap is a structural positive.

### Sub-KRD: Security Package

WBS bondholders typically have first-ranking fixed and qualifying floating charges over substantially all of the assets of the operating company. The ranking of the rated debt instrument is assessed along with creditor rights. Further details are under Legal Structure.

### Sub-KRD: Structural Features

Key structural features include comprehensive financial and operational covenants, liquidity provisions (e.g. liquidity facilities), dividend lockups and arrangements ensuring the separateness of the WBS issuing SPV from the operating company.

#### *Financial Covenants*

A WBS structure includes financial covenant tests, typically based on EBITDA and/or FCF DSCRs (where FCF is defined as EBITDA less tax and cash maintenance capital expenditure). FCF is a better measure of cash generation for the numerator than EBITDA. If the denominator (debt service) reverts to an interest coverage test upon prepayment of principal, the test could be less effective. Methods allowing the borrower (including sponsor) to remedy a covenant breach are often included, such as depositing cash or adding cash-generative assets. Remedies that provide a long-term solution to the breach that enables the ratings to be preserved are viewed as credit positive.

If the covenant is breached and is not cured within a defined period, an event of default under the secured loan (referred to as a "borrower event of default" or "loan event of default") occurs. In the structures subject to these criteria, such an event of default would enable the security trustee to appoint an administrative receiver, representing the interests of the senior creditors, over the operating entity, but would not result in immediate acceleration against the issuer. DSCR financial covenants set at a level that provides sufficient headroom to meet debt service obligations at the point when an administrative receiver would be appointed are viewed as credit positive. Covenants also limit the borrower's ability to incur additional indebtedness.

### *Control of Business and Financial Activities*

Covenants are included with the aim of limiting the borrower's business activities, to ensure that the business cannot fundamentally change direction, while leaving the borrower enough flexibility to adapt its business to industry changes.

### *Dividend Lockout Triggers*

Cash distributions to shareholders usually through dividends are controlled by restricted payment conditions (RPC). Fitch views cash trapping as a strong protection for WBS secured creditors. However, Fitch carefully considers its effectiveness in protecting cash from leaking out. Fitch also looks at the permitted uses of trapped cash.

### *Liquidity Facility*

A committed liquidity facility is designed to enable the issuer to meet debt service obligations during a period of operating business stress when the borrower is unable to pay its debt service to the issuer. Liquidity facilities that are unlikely to cover the entire period of administration, assumed at around 18 months, are viewed as credit negative. Liquidity facilities only address temporary cash flow shortfalls but do not help in case of a structural decline in the borrower's ability to generate sufficient revenues.

In such a scenario, the senior ranking liability of the drawn liquidity facility could negatively affect the rating. The liquidity facility is usually tranched to prevent the most subordinated notes from fully using it to the detriment of the senior notes. This means that only a portion of the liquidity facility is available for the junior notes Counterparty risk relating to liquidity facility providers and other transaction financial counterparties is assessed using Fitch's *Structured Finance and Covered Bonds Counterparty Rating Criteria*.

### *Bankruptcy-Remote Issuer SPV*

SPVs may be (and in Europe commonly are) orphaned, that is, not legally or beneficially owned or controlled by the sponsor nor by any other enterprise with an interest in those assets or the SPV. In such cases, the beneficial ownership of the SPV is often held in trust for a charity by the immediate legal owner, which is often a professional company specialising in the management of such vehicles and which performs the management duties for a fee.

There may be commercial, tax, structural or legal reasons for an SPV not to be orphaned. This may be the case when there are one or more intermediate SPVs in a structure through which note issuance proceeds and/or asset cash flows pass. In this case, Fitch reviews the safeguards and any aspects that may compromise the separation of the SPV from its parent or sponsor.

When the SPV is part of a group of companies, risks arising from the use of a non-orphan SPV include exposure of the SPV to group tax or employee pension liabilities, or the risk that a court may order the consolidation of the SPV's assets with those of a parent entity in the parent's insolvency proceedings. When there is the risk of such consolidation, Fitch will review an opinion of counsel that the SPV will not be substantively consolidated with its ultimate operating company parent in the event of the bankruptcy of its parent.

Assuming the consolidation issue is dealt with satisfactorily, a non-orphaned SPV may be considered as similar to an orphaned SPV when relevant mitigants, such as noteholder control and strong separateness provisions, are present. These mitigants include undertakings not to act against the interests of noteholders, restrictions of voting rights if the borrower or affiliated parties were to own any notes, as well as disallowing amendments to the documentation without the consent of the security trustee.

For more detail on considerations related to the analysis of SPVs, see *Global Structured Finance Rating Criteria*.

## Financial Analysis

Fitch analyses the key drivers of financial performance. Common elements include:

- revenues;
- operating costs;

- EBITDA;
- central overheads;
- capital expenditure (capex); and
- FCF as defined below.

Fitch uses historical data as a starting point to define scenarios for FCF available for debt service over the term of the transaction. Reports from third-party experts on the industry or on the historical, current and future financial performance are also taken into account.

### *Revenue*

Fitch analyses historical, audited accounts and, when possible, compares them with industry-wide data. Management accounts for the period following the last audited statement can also be factored into the analysis, although with less credit given than audited data. Credit may be given for documented, fixed increases in operating contracts; however, in considering such arrangements, both the enforceability of the contracts as well as the creditworthiness of the counterparty is factored in. The effects of volume, price and product mix on the revenue side are also considered, as well as organic versus non-organic growth.

### *Operating Costs*

Costs are analysed to ascertain which are fundamental to the continuation of the business. Establishing operating leverage is also relevant to the rating process. This is particularly significant in stress scenarios, when operating leverage increases the negative effect of revenue decline on operating profit. Whereas variable costs, by definition, fluctuate with the state of the business, fixed costs should remain constant. Some credit can be given to portions of the fixed-cost base that can be scaled down. If available, Fitch will use independent third-party information or reports on the ability of the business to adjust costs.

Other critical costs include those when accretion might be outside the control of the business, such as fixed uplifts or inflation-linked rents, national minimum wage increases, business rates or utility costs (see Capex).

### *EBITDA*

EBITDA is adjusted to exclude non-recurring and exceptional income and costs, and to include expenses of the securitisation group. For example, some development costs that could have been characterised as one-off capex or capitalised costs, but which are expensed as opex by the company, may be added back. Conversely, some income related to non-core businesses or to disposals is deducted. Identifying those revenues and expenses purely related to the core and restricted operations of the business, as defined in the transaction documents (under restricted activities), helps to determine the recurring operating profit level in the WBS.

### *Central Overheads*

The overheads incurred by the company are deducted and analysed and compared with peers. When looking at profit generation for an individual asset (e.g. a pub, hospital or nursing home), assumed central overheads are sometimes added back when the rent coverage the property could bear is measured, regardless of the size of the total operator.

### *Capex*

Fitch identifies the level of capex historically required for the assets to support an ongoing level of profitability. Maintenance capex is the spend required to maintain the quality of the assets and support existing EBITDA levels based on historical and industry data, while development capex is the amount invested for growth.

Typically, the transaction documentation requires the company to spend an annual amount at least equal to maintenance capex. Some comfort can be taken from the inclusion of covenanted minimum maintenance capex requirements stated in the transaction documentation, although these are often below Fitch's estimated minimum capex. If a borrower incurs significant operating expenses already deducted at the EBITDA level, which could qualify as maintenance capex, FCF is adjusted to avoid any double-counting.

The notion of maintenance capex for non-standard assets is less straightforward and would be subject to additional analysis. Although development capex is more discretionary by nature, any annual committed amounts are also deducted from EBITDA to derive FCF.

#### *Free Cash Flow*

FCF is defined as operating cash flow available for debt service. Typically, FCF would be equal to EBITDA less maintenance capex and other cash flow relevant items, such as corporate tax payable and pension contributions. FCF usually excludes changes in working capital, as long as there are no ongoing significant working capital cash inflows/outflows and working capital facilities are sufficient to cope with expected fluctuations and avoid liquidity issues.

#### *Debt Service*

For a given debt tranche within the WBS structure, all interest and principal payments due which rank senior and pari passu to it are accounted for. Senior costs, such as liquidity facility commitment fees, swap payments, financial guarantees and fees are also included.

### Cash Flow Projections and Stress Testing

#### *Rating Case*

The analytical team creates a scenario, the Fitch rating case, reflecting its view of the transaction's long-term sustainable performance. The Fitch rating case is also used as a starting point for stress analysis and it constitutes the base line for surveillance over the debt's life. Given the long-term nature of WBS debt and the challenge in making forecasts far into the future, the assumptions are cautious and may deviate significantly from the management case.

Certain adjustments are made to the sponsor's projections when appropriate, using the main revenue and fixed and variable cost drivers of the securitised business as key inputs. Adjustments are typically based on Fitch's experience in a given sector, historic revenue and cost volatility, correlations to macroeconomic factors such as GDP growth, inflation and death rates, third-party reports when available, as well as the agency's view on the sector's outlook. Fitch reviews the flexibility to manage businesses through cost-cutting exercises or cost deferrals during difficult periods, or the possibility to adapt to a changing operating environment over the long term.

#### *Downside, Breakeven and Sensitivity Analysis*

Fitch designs downside and breakeven scenarios to test the ability of stressed cash flows to fully pay interest and principal of each class of notes using the WBS structural enhancements such as cash-trapping and drawing on the liquidity facility. These scenarios also allow Fitch to differentiate the operational vulnerability of different WBS. However, ratings are not assigned merely on the basis that some classes of debt could pass a stress scenario. Stresses are discretionary, theoretical and only represent one part of the rating analysis.

### Credit Metrics

Based on the rating and downside cases, projected FCF DSCRs (FCF divided by debt service) are analysed for amortising transactions at the tranche level. Fitch focuses on projected DSCRs as opposed to projected leverage due to the limited refinancing risk. DSCR analysis is more appropriate as it focuses on the capacity of operating assets to repay debt via securitised cash flows. However, FCF and EBITDA leverage is also considered with lower leverage often associated with higher ratings. Fitch does not derive ratings purely based on credit metrics, as they may be affected by other more qualitative aspects of the credit analysis.

Transactions with identical credit metrics could differ in terms of risk profile simply due to the operational facets of the borrower, such as operating leverage (e.g. increased by rental payments). Such differences are better assessed in the downside cases when transactions with higher operating leverage would not sustain the same stresses on revenues or costs.

#### *Fitch Rating Case DSCR*

For each debt tranche, Fitch focuses on the lower of the average or median projected FCF DSCRs under its rating case. This metric shows the level at which the DSCRs are expected to fluctuate based on the analytical team's long-term view of the transaction's performance. It also aims to avoid any misrepresentations. The average, for instance, can potentially give too much weight to any DSCR outliers. In practice, analysts review the FCF DSCR distribution profile over the life of the transaction to understand when and why periods with higher exposure to default risk may occur.

The higher the rating case DSCR is, for a given debt tranche, the less exposed it is to default. This approach is possible because a WBS has one cash waterfall for both senior and subordinated tranches. Each tranche can therefore be isolated in the DSCR analysis as interest and principal of the senior tranches are paid before the junior tranches with the junior debt service usually deferrable without triggering a note event of default.

Ratings are assigned within certain ranges of rating case FCF DSCRs for individual industries. This does not imply that they are assigned solely on this basis.

### *Relationship Between Various Industries' DSCRs for a Given Rating*

The more an industry is at risk of a long-term deterioration in performance, the higher its rating case DSCR attachment point is. While the industry's long-term trend would already be reflected in the rating case FCF projections, higher DSCR ratios are still expected for a riskier sector to compensate for the higher uncertainty about the cash flow projections. Similarly, with increasing performance volatility or a wider array of performance outcomes and asset qualities for a sector, the bandwidth of DSCR ranges is likely to be wider for a given rating.

### *Minimum DSCR*

Any periods of stress when DSCRs are forecast to be depressed are evaluated to assess the risk of payment default. Periods of low coverage could occur either due to an irregular debt profile as a result of past debt prepayments, or a projected decline in performance.

Given the availability of liquidity facilities or cash reserves, short-term or one-off dips in projected DSCR are less of an issue than prolonged depressed periods close to the minimum DSCR. A given class of notes is viewed as more at risk (all other things being equal) if the lowest DSCRs occur towards the end of the transaction's term due to the higher uncertainty about long-term FCF projections. However, periods of tight DSCRs later in time may be mitigated if the transaction has been partially amortised leading to reduced leverage.

### *Annuity-Based DSCR*

Given the usually long-term nature of the rated debt, annuity-based FCF DSCRs based on the assumed run-rate FCF may be taken into consideration. These metrics can provide a sanity check on a debt tranche's credit worthiness while implying a fully amortising annuity payment profile (accounting for senior costs as well as interest and principal paid at the tranche level).

Annuity-based DSCRs are usually based on the remaining life of the tranche until its legal final maturity and the weighted average cost of debt, facilitating comparison with the rating case DSCRs. However, annuity-based DSCRs and rating case DSCRs are likely to differ and a greater weight is assigned to DSCRs based on the actual debt profile. Annuity-based metrics can be useful for comparing transactions that employ a cash sweep mechanism as the only or primary means of principal repayment with more standard structures using scheduled amortisation.

### *Debt Multiples*

Rated debt to EBITDA ratios are evaluated at the various tranched levels. Debt amounts are usually not adjusted for cash balances unless these are escrowed and separated for the benefit of the securitised group. Debt multiples are primarily used in peer-group analysis to compare leverage at a given rating level between similar transactions (in terms of sectors).

While WBS debt multiples are also informed by comparable corporate rating multiples, the WBS structure typically allows for higher leverage at a given rating owing to the various structural enhancements, as well as the fully amortising nature of the debt (while a typical corporate financing may not amortise at all, or only partially). Notably, leverage does become more important analytically the closer a WBS moves towards breaching its financial covenant, as reduced leverage would facilitate a potential full refinancing of the WBS debt.

Although useful, debt multiples do not account for the cost of debt incurred, its affordability or its maturity profile and this limits comparability between transactions. Hence, Fitch considers day one leverage as a secondary metric in the WBS analysis – in particular for fully amortising transactions.

#### *Deleveraging Profile*

There is, however, an added focus on the deleveraging profile of a transaction particularly if the long-term sustainability of the underlying operating assets is less predictable. For instance, such assets could be exposed to long-term changes in consumer behaviour or technological advances, in which case a faster deleveraging would be viewed as a mitigating factor. The deleveraging profile is influenced by the fixed scheduled amortisation profile of the rated debt, the cash sweep features and the forecast FCF.

#### *Others*

Fitch takes into account other transaction-specific characteristics such as:

- Leasehold assets: Credit metrics are adjusted to reflect the level of debt supported by assets held on short leaseholds, which could be terminated upon insolvency or non-payment of rent. For example, the rating case adjusted FCF DSCR is akin to a fixed charge cover with the rent added back to both the numerator and denominator. The seniority of the rent paid to the landlord/long leaseholder in the cash available to service the debt is also reflected, especially in a stress scenario.
- Concurrent amortisation: Notes with various degrees of subordination may amortise at the same time. This is addressed in the transaction's presale and new issue report.

## Models

Fitch may use the following models in the analysis of WBS sector credits: GIG AST Model, Corporate Monitoring & Forecasting Model (Comfort Model), and Third-Party models. The Models section in the *Infrastructure and Project Finance Rating Criteria* provides a description of these models.

## Legal Structure

### Security and Administrative Receivership

The criteria are based on the assumption that the security trustee is able to appoint an admin receiver upon borrower event of default, which allows the operating company to trade through insolvency, as a going concern. This feature, in combination with covenants, asset-specific security and structural protections, limits the scope of the borrower's business and protects the interests of secured creditors if financial performance deteriorates. However, their rating benefits may be limited. Given that the assets or the business are located in the UK, it is crucial to establish whether the capital markets exemption applies to the issued WBS debt instruments, as this would enable the security trustee, on behalf of the WBS noteholders, to appoint an administrative receiver. Together with the WBS structural features, this mitigates the risk of the operator's insolvency.

The ability of the security trustee – as the beneficiary of a qualifying floating charge over all or substantially all of the assets of the operating company in a WBS and the representative of the secured creditors – to appoint an administrative receiver following a borrower event of default or an insolvency of the borrowing company is considered a key structural feature. There are two key aspects of control given to the security trustee on behalf of the secured creditors in case of a borrower event of default:

- The ability of the security trustee on behalf of secured creditors to block any administrator appointed due to another creditor filing to commence an insolvency proceeding in respect of the borrowers. This gives clear and straightforward control to WBS-secured creditors on insolvency process timing, offers choices over the outcome and avoids the potentially longer and more complex route of a court-led administration.
- Contrary to the administrator's mandate to optimise proceeds for all creditors (and to save the legal entity and its business), the administrative receiver acts only for the benefit of the secured creditors and only answers to them. This provides the secured creditors with additional control on the timing of the insolvency process and offers

choices over the outcome of the administrative receivership. The administrative receiver can remove the board, replace the management, sell certain parts of the business, or run the business for cash through insolvency; he can elect a course of action which the secured creditors chose to maximise the proceeds to pay the amounts owed to them.

In conjunction with the issuer/borrower structure, the right to appoint an administrative receiver supports the assumption that the business may sustain greater stresses than would be the case for standard secured debt (when similar stresses would trigger insolvency of the corporate entity and lead to a court-led insolvency process). In WBS, as the performance of the business deteriorates and the financial covenants on the borrowers' loans are breached, it is assumed that the secured creditors would choose to permit the business to be run for cash, using up the trapped cash and the issuer's liquidity facility to service the bonds.

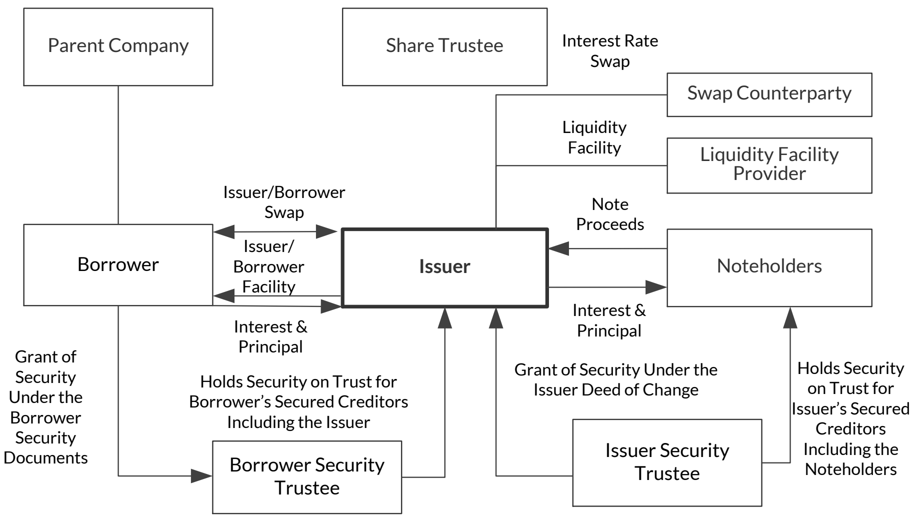
In summary, the security package enables the WBS noteholders to indirectly take control of the cash-flow generating assets of the borrower and operate them through a replacement operator (elected by the administrative receiver), notwithstanding the insolvency of the original operator. However, this replacement also depends on the industry, the availability of alternative operators as well as other operational considerations (e.g. whether an alternative operator can take over quickly or whether close operational links between the borrower and the current operator would prevent a swift take-over of operations).

Although for WBS ratings, the analysis depends on the secured creditors' right to appoint an administrative receiver, it is acknowledged that, in the context of a WBS, this mechanism remains largely untested from an operating perspective. The analysis also assumes that the secured creditors will take necessary and timely action in their own interests to benefit from this legal mechanism (e.g. providing an indemnity to the administrative receiver).

Once the administrative receiver is appointed, the secured creditors can choose to sell the business or any realisable assets and recover proceeds in accordance with the priorities of payments. Under its rating case, Fitch assumes that the administrative receiver or, subsequently, an appointed replacement operator would keep the business in operation allowing the secured creditors to be repaid using cash flows.

While the WBS legal framework is likely to enhance the rating of the most senior debt, it may do so at a cost to potential subordinate tranches, depending on, inter alia, the rights of the senior tranche (often considered the controlling class) compared with the subordinate tranche, the issuer events of default and the priority of payments (in particular in a default). These inter-relations are considered when assigning ratings to both senior and subordinate tranches.

**Structure Diagram**




Source: Fitch Ratings, transaction documents

### *The Secured Loan Structure*

A secured loan structure between the bankruptcy-remote issuing SPV and the operating company granting security on part or all of its operational assets ensures that the insolvency of the operating group does not necessarily lead to an issuer event of default.

The issuing SPV is established to issue notes and lend on the proceeds to an existing operating company by way of a secured loan. The secured loan structure, as illustrated above, is commonly used in UK WBS, as it optimises security for the secured creditors over the whole business being pledged without requiring the assets to sit outside an operating company.

The issuer benefits from first-ranking fixed and floating charges over all, or substantially all, of the assets of the operating company, granted to the security trustee on behalf of the secured creditors. However, certain accounts and assets may only be classified as floating charges to provide the securitisation group with the freedom necessary to operate its business. The issuer is expected to be a bankruptcy remote SPV, ensuring the insolvency of the operating group does not directly affect the solvency status of the issuing entity.

### *Borrower and Issuer Cash Waterfalls*

In contrast to asset backed securitisations – which tend to have separate priority of payment schedules (commonly referred to as cash waterfalls) for principal and interest – WBS has only one cash waterfall for both sets of payments. For the cash flows generated by the business at the borrower level, the priority of payments is defined in three possible states, as follows:

- pre-enforcement;
- post-enforcement, pre-acceleration; and
- post-enforcement, post-acceleration.

At the issuer level, the priority of payments is defined in pre- and post-acceleration.

### Review of Legal Opinions

Basic legal assumptions, on which the UK WBS rating criteria are predicated, are applied in the analysis. For example, the agency assumes that the structure will withstand an insolvency of the borrower and that any security granted will be enforceable against third parties. It is therefore expected that no assumptions about the ongoing solvency of the borrower (or any party) or general bankruptcy carve-outs will be included in the legal opinions.

Fitch assumes that the floating charge granted would qualify for an exemption under the Enterprise Act 2002, as a result of which the security trustee would have the right to appoint an administrative receiver in any insolvency of the Issuer or the borrower. For new assignments, legal opinions would be expected to disclose any deviations from those legal assumptions. The impact of such deviations is reflected in the analysis, supplementing it as warranted, for instance, by applying more punitive assumptions, or declining to assign a rating.

## Surveillance, Taps, Rating Assumption Sensitivity

### Surveillance

Fitch's surveillance involves carrying out comprehensive transaction reviews by applying the same rating approach outlined in these criteria to both new issuance and surveillance, however, the depth of information required for surveillance may be less. To maintain its ratings, regular information reports are typically issued in relation to the rated transaction. These are expected to be timely and sufficient for noteholders. Fitch reviews the overall performance of the borrower and the trustee is expected to ensure compliance with the structure. Over and above this information, commercially sensitive information is also often supplied to Fitch. Information requested at least annually includes:

- profit and loss and cash flow data for the securitisation group;
- reporting on financial covenants (both compliance with and levels);
- capital expenditure details and all cash account balances;
- management commentary on strategy, operational and financial performance; and
- regular interaction with the agency.

### Taps

The rating of a tap issue is approached in the same way as a new transaction. There are two types of taps: asset or value taps. In an asset tap, the issuer seeks to add cash flow-generating assets to the securitised group and raise additional debt from the same issuer supported by the increase in FCF. Fitch assesses the quality and historical performance of the added assets, and their potential credit benefits are weighed against the risk of the extra debt raised.

Value taps can be defined as taps without new assets. Fitch views these as debt recapitalisation exercises to initial leverage levels (measured by way of debt multiples or DSCR) following either principal repayments or an improving EBITDA profile. In the case of a straightforward recapitalisation at par with the initial levels of debt, the industry, business and financial assumptions are compared with those applied at the initial rating.

An issuer raising a higher amount of debt on the back of an improving EBITDA profile based upon macro or industry benign conditions would be considered a credit negative, as the EBITDA has the potential to revert downwards. Conversely, improving EBITDA based upon asset churn, which improves the quality of the securitisation group, is a credit positive.

### Rating Assumption Sensitivity

#### *Upgrades*

The positive revision of an assessment of KRDs following a change in an industry (e.g. regulation) or company fundamentals (e.g. operations or financial performance), or an improving credit profile as a result of deleveraging or operational outperformance viewed as sustainable, could lead to an upgrade of the notes. When the transaction already has a debt tranche rated at the industry ceiling, upgrades to this class are typically not possible. However, junior notes may be upgraded from their original ratings towards the industry ceiling.

Fitch also factors in tap risk. The issuer is typically entitled to tap the transaction without the noteholders' consent, provided, among other conditions, that the ratings of the existing notes are not adversely affected by the tap issue. When such a ratings test refers to the then-current ratings, Fitch's ability to upgrade the notes will not be constrained. However, if it refers to the original rating, the notes will not be upgraded above the original rating as assigned at transaction closing, as the increased risk of a tap would counterbalance the improving credit profile for existing bondholders (such provision is likely to indicate an intention to periodically re-lever the transaction).

#### *Downgrades*

Performance deterioration below the rating case or key ratios below set triggers will result in the formal rating review of a transaction, which could lead to a downgrade. In reviewing ratings, Fitch considers whether the deterioration has resulted from a permanent rebasing of a company's profitability or from a temporary period of stress. Unless triggers exist that act to impair the credit profile of the rated notes on a financial covenant breach, its breach (or breach of the restricted payment conditions) does not in itself result in a rating action.

## Variations from Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment, and full disclosure via rating commentary strengthens Fitch's rating process while helping market participants to understand the analysis behind our ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating if applicable.

A variation can be approved by a rating committee when the risk, feature or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but when the analysis described in the criteria requires modification to address factors specific to the transaction.

## Limitations

Ratings, including Rating Watches and Outlooks, assigned by Fitch are subject to the limitations specified in Fitch's Ratings Definitions and are available at https://www.fitchratings.com/site/definitions.

## Data Sources

The key rating assumptions for the criteria are informed by Fitch's analysis of UK WBS transaction documents, data received from issuers, arrangers, consultants and other third-parties, and publicly available information. Such information is also used when individual transactions are analysed and ratings assigned.

## Disclosure

Fitch expects to disclose the following items in its rating reports and/or Rating Action Commentaries (RACs):

- key rating drivers and their assessment;
- financial metrics;
- peer analysis;
- main analytical assumptions including key stresses applied;
- rating sensitivities;
- any variations from criteria

## Appendix 1: UK WBS Pub Sector – Industry Analysis

### UK WBS Pub Sector – Differentiation between Operating Models

While the industry profile is applied to the UK pub sector as a whole, Fitch views the managed pubs as more adaptive and transparent than the leased/tenanted pubs due to their full control over the operations. Fitch therefore applies more conservative credit metric thresholds for leased/tenanted pubs for a given rating. Credit metrics of a certain level do not necessarily equate with a certain rating, as other KRDs may also affect the credit risk.

### UK WBS Pub Sector – Rating Case Key Drivers

Based on previous WBS pub transactions (factoring transaction-specific characteristics) and fundamental industry drivers, revenues and costs are stressed with both a short-term view (reflecting the higher visibility) and long-term view (reflecting the increased uncertainty).

- Rent, beer and food sales: Fitch typically stresses annual beer sales growth per pub (-5% to 2.5%) by taking into consideration the price/volume/mix effect, the rental income per pub (-2.5% to 2.5%), food sales per pub (0% to 5%) and other income items per pub (-5% to 5%).
- Costs: Main drivers such as COGS (gross margin), employment costs per pub (0% to 5%), overheads (0% to 5%), utilities (above inflation), rental expenses per pub (depending on contract terms) and business rates are stressed. The shares of the variable and fixed costs, and the effective corporation tax, as well as capex requirements, are also estimated.

The above guidance for key revenue and cost growth assumptions is indicative as Fitch's cases are informed by various sources of information, such as historical performance, issuer projections, third-party expert reports, and Fitch's expectations (including Fitch's macro-economic assumptions).

### UK WBS Pub Sector – Indicative FCF DSCR Rating Guidance (x)

| Assigned notes' ratings | Managed pubs | Tenanted pubs |
|---|---|---|
| A | >1.95 | >2.05 |
| BBB | 1.55-1.75 | 1.6-1.9 |
| BB | 1.25-1.35 | 1.3-1.5 |

Note: The FCF DSCR is the lower of the median and average DSCR measured as actual debt service against Fitch Rating case FCF forecast to bond legal final maturity
Source: Fitch Ratings

### UK WBS Pub Sector – Rating Cap

The UK pub sector's industry profile KRD is assessed as 'Midrange'. This means it is unlikely for even the most senior ranking tranches of UK pub sector WBS to be rated higher than the 'A' rating category. The industry profile sub-KRDs are scored as follows:

#### *Operating Environment: Weaker*

While the pub sector in the UK has a long history, trading performance for some assets has shown significant weakness in the past due to the exposure to reduced discretionary spending in weak economic conditions. Products are typically purchased externally (e.g. from brewers) and sold on and – in the case of leased/tenanted pubs – not to the final consumer. The sector tends to be highly affected by price and volume risk, which makes the projection of future cash flows challenging. This is exacerbated by the reliance on commodity and food prices.

#### *Barriers to Entry: Midrange*

The UK pub sector features reasonably strict licensing laws and regulations (e.g. health and safety) and requires some capital investment. However, individual regulatory changes can potentially have a significant impact on revenues (e.g. smoking ban; alcohol taxation).

### *Sector Sustainability: Midrange*

While the number of pubs has been in decline for several years and is likely to decrease further, Fitch believes in the long-term viability of the industry, albeit on a reduced scale. However, pubs stand in competition with more traditional restaurants and the off-trade. A potential change in consumer behaviour (e.g. cultural trends) is an additional long-term risk factor.