Article Title: ARCHIVE | Guidance | Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities Data: (EDITOR'S NOTE: —This article is no longer current. We moved its contents to the criteria "The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities" without any substantive changes.) Overview And Scope This guidance document provides additional information and guidance relating to our criteria article, "The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities," published April 29, 2014. It is intended to be read in conjunction with that criteria. Specifically, this guidance focuses on how S&P; Global Ratings analyzes prepayment clauses, ownership changes, and stapling. It also provides additional information on what we mean by "strong contractual or intercreditor provisions." For further explanation of guidance documents, please see the description at the end of this document. Key Publication Information Original publication date: April 30, 2018 This article is related to "The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities," published April 29, 2014. We may revise this guidance from time to time. Guidance Here, we answer questions to provide guidance for our treatment of non-common equity financing criteria. Can a non-common equity financing that includes prepayment clauses be excluded from leverage and coverage calculations? An important focus of our assessment of prepayment/repurchase clauses is to what extent they undermine the principle that financing provided by controlling shareholders will be outstanding and would act as subordinated loss-absorbing capital if the company experiences credit stress. If shareholder loans include terms that enable prepayment at the borrowers' (or shareholder parents') absolute discretion without any offsetting constraints, we do not exclude the loans from our leverage and coverage calculations. The same applies to preferred shares whose terms and conditions include mechanisms that allow for those securities to be bought back without any offsetting constraints. However, if strong contractual or intercreditor provisions exist, we may take the view that the prepayment option is neutralized. For example, this may happen if the payments are seen as similar to dividends by virtue of being variable, linked to a level of company profitability, or if senior lender approval is required to make any prepayment. Importantly, if we are forecasting a shareholder loan prepayment, we expect that the majority portion of the shareholder loan would remain in the capital structure until after the point of the longest debt maturity. This would be consistent with the principle in the criteria that the effective maturity date of the shareholder loan is beyond all other debt and the loan could be excluded from our leverage and coverage calculations. For financial sponsors that typically have shorter-term ownership horizons, we require that they record their intention to meet this condition at all times in the documentation. On the other hand, relatively uniform or non-variable (re)payment profiles that are not dependent on the issuer's financial performance would be considered more akin to servicing a debt-like obligation than being a voluntary dividend-like payment based on the company's financial performance. Likewise, if the senior debtholders provide a blanket advance approval, then the instrument would not be excluded from the debt calculations. What constitutes "strong contractual or intercreditor provisions"? There is a wide variation in shareholder financing terms; however, the more debate and judgment that are needed to interpret the strength of the provisions, the less likely it is that a rating committee would consider the provisions "strong." Typically, what would support us considering provisions "strong" is a clear statement that acts as a constraint to discretionary prepayments (that are significant and not tied to performance). As a result, we would have greater confidence that the financing will function as loss-absorbing capital because the financing is subordinated and its effective maturity date is beyond all other debt. Examples of constraints that we may consider supportive include: No ability to repay shareholder loans or repurchase preferred stocks while senior debt may be outstanding; Requirement for senior lender approval of any shareholder loan repayment or preferred stock repurchases; and Maturity clauses that mean shareholder loans must remain outstanding if senior debt is outstanding. Examples of weak terms include: Financial covenants that do not preserve creditworthiness, but rather give the borrower flexibility that could lead to weakening credit quality, while being set at a high enough level that there would still be value in the business. Management's intent included only in financial policy statements. The strength of financial policies may vary over time depending on the company's capital structure relative to its financial performance and the risk tolerance of its owners. Consequently, the risk objectives of the company's board and management may also change. How do ownership changes, including through an IPO, affect the treatment of shareholder financing? If the seller holds a minority ownership interest or the prior management team continues to hold some of its shareholder financings, can these financings continue to be excluded from our leverage and coverage calculations? Following any ownership change, a key consideration in our analysis is whether and to what extent the alignment of economic incentives between common equity and non-common equity holders is maintained. Notwithstanding a change in ownership structure, when a seller retains equity in the entity, it's important in our analysis that we are almost certain there is no adverse impact on the seller's commitment to the business. For example, a partial sale of equity and ownership change could be considered neutral if the sale partially monetizes an investment but the owner retains control, or if a new shareholder is brought into the business to raise capital or provide expertise or other benefits that will improve the company's financial performance, as long as we believe that the economic incentives between the common equity and the non-common equity financing remain aligned and the conditions in paragraphs 12 and 13 of the criteria continue to be met. In such a case, we would believe that the owners would not exercise any creditor rights associated with the non-common equity financing because doing so could jeopardize their control of the company. If they do not retain effective control, we would treat the financing as debt. If an IPO is used to monetize a minority interest by a strategic owner, and the owner maintains control, then we may continue to exclude the shareholder financing from our leverage and coverage calculations, subject to paragraph 16 of the criteria being met, which includes the condition that "the investment is a long-term holding; and the owner has the resources and incentives to support the investment." Conversely, if we believe that a sell down or IPO by either a strategic owner or financial sponsor presages its near-term exit from the company, we would question the commitment of the strategic owner/financial sponsor and whether the economic incentives between the common equity and the non-common equity financing remain aligned. In such a scenario, and if documents allow it, we would likely expect the exiting owner to request repayment of its portion of the shareholder financing, and therefore we likely would view its shareholder financing as debt-like, regardless of the strength of documentary protection. Similarly, notwithstanding ownership changes, if the prior management team continues to hold shareholder financing, it is more likely we will consider this a temporary holding rather than reflective of any intent to remain as a long-term investor in the company. This scenario is more likely to occur following an exit by a financial sponsor when management held shares as part of its incentive structure. Accordingly, we would generally consider this shareholder financing as debt-like, irrespective of documentary protection. Can a shareholder financing held by financial sponsors be excluded from our leverage and coverage calculations if it is not stapled to common equity but sales to third parties are prohibited? One of the main considerations to exclude shareholder financing from our leverage and coverage calculations is the extent to which we can expect that the economic interests of the common and non-common equity (i.e., the shareholder financing) will remain aligned. To maintain this alignment, we expect, as stated in paragraph 10 of the criteria, that the financing documents either prohibit the transfer of the shareholder financing outside of the controlling group or mandate the non-common equity financing and common equity be owned and sold together (sometimes called "stapling"). However, in the absence of stapling, even with the prohibition to transfer the shareholder financing to third parties, we also consider the risk that one (or a small group of) shareholder could end up with a grossly disproportionate holding of the shareholder financing relative to its equity holdings so that the incentives for one and the other begin to diverge. In these cases, the decision as to whether the documentation--including, for example, the shareholder agreement--is strong enough to mitigate the potential misalignment and whether the shareholder financing should be excluded from leverage and coverage calculations would be a matter for rating committee judgement. For example, when a 10% equityholder, which is part of a controlling group, holds 90% of the shareholder financing, the value of the loan may approximate or even exceed the value of the equity. If the company's economic performance materially weakens or becomes distressed such that the equity value diminishes, the larger value of the shareholder financing holdings compared with the equity can create a misalignment of economic interests, notwithstanding the prohibition of sales of shareholder financings to third parties. This scenario would raise concerns that equityholders and holders of the shareholder financing are subject to different behavioral incentives. Under such circumstances, as per paragraph 14 of the criteria, we consider financial policies and how these could influence the company's leverage and coverage ratios. In general, the lower the control a shareholder has and the greater the value of shareholder financings relative to equity, the more likely it is that the shareholder financings will be treated as debt. If a company owned by a financial sponsor undertakes a proportional stapling of a shareholder financing to equity, does the stapled portion of debt satisfy the requirements relating to the alignment of economic incentives and therefore support the exclusion of the shareholder financing from our leverage and coverage calculations? No. In general, if a company owned by a financial sponsor undertakes a proportional stapling of a shareholder financing to equity--for example 50% of the financing is stapled and 50% is not stapled--we would not consider the debt stapled to equity as having sufficient equity-like characteristics to exclude this financing and its interest payments from our adjusted financial metrics. For the purposes of the criteria, we typically think of a shareholder financing with uniform terms and conditions that is intended to mimic equity as a single unit, rather than an instrument that could be sliced and diced, which could lead to different treatments for different "slices." We view such a proportionate stapling structure as potentially undermining the alignment of economic interests (see paragraph 10 of the criteria article). How do we treat shareholder financing partially owned by a controlling shareholder and partially owned by a non-controlling shareholder? If the financing is provided through one security and the documents give the controlling shareholder the ability to make decisions that bind all of the lenders, then we could exclude the full financing from our leverage and coverage calculations if all other conditions are met. If the financing is provided through more than one instrument, or through one instrument where the lenders can act independently, then we would only exclude from our leverage and coverage calculations the portion held by the controlling shareholders, provided all other conditions are met. If the financing is provided by several shareholders that exercise control jointly, such as a joint venture, our treatment would depend on whether we view the shareholders' goals and strategy to be aligned, provided all other conditions in the criteria are met. Related Criteria The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014 Related Research Criteria And Guidance: Understanding The Difference, Dec. 15, 2017 This article is a guidance document for Criteria (Guidance Document). Guidance Documents are not Criteria, as they do not establish a methodological framework for determining Credit Ratings. Guidance Documents provide guidance on various matters, including: articulating how we may apply specific aspects of Criteria; describing variables or considerations related to Criteria that may change over time; providing additional information on non-fundamental factors that our analysts may consider in the application of Criteria; and/or providing additional guidance on the exercise of analytical judgment under our Criteria. Our analysts consider Guidance Documents as they apply Criteria and exercise analytical judgment in the analysis and determination of Credit Ratings. However, in applying Criteria and the exercise of analytic judgment to a specific issuer or issue, analysts may determine that it is suitable to follow an approach that differs from one described in the Guidance Document. Where appropriate, the rating rationale will highlight that a different approach was taken.