Article Title: ARCHIVE | General Criteria: Standard & Poor's Canadian Stability Ratings Criteria Update Data: The purpose of this article is to provide an updated overview of the analytical criteria underlying stability ratings assigned by Standard & Poor's Ratings Services to income funds participating in the Canadian market place. This overview sets out the basic components of the stability rating methodology, in addition to certain refinements and improvements that are being incorporated in this framework. These refinements are prompted by experiences in the past five years of analyzing an expanding universe of income funds operating in constantly evolving business and financial market environments. Stability ratings are current opinions on the prospective relative stability of distributable cash flow generation of Canadian income funds. Stability ratings refer specifically to the prospective relative sustainability and variability of an income fund's distributable cash flows, which underpin cash distributions. Stability ratings do not comment on an income fund's net asset value, share price, yield, or return on capital. In addition, stability ratings are not a recommendation to buy, sell, or hold a particular income fund, nor do they comment on the suitability of any investment for a given investor. Investors may find that stability ratings provide a useful supplement to their own efforts to understand and compare the risk profiles of different income funds, particularly as this measure of relative risk is not subject to the ebb and flow of market valuations or sentiments. Canadian stability ratings have been in use since 1999, and in a report titled "Canadian Stability Ratings: Methodological Framework" published in September 2002 on RatingsDirect, Standard & Poor's outlined its approach to analyzing income funds' cash flow generation stability. Income fund market dynamics have tested Standard & Poor's stability ratings criteria fundamentals rigorously. This article explains the resulting criteria refinements and elaborates on key analytical steps that will enable users to understand the methodology better and contribute to the transparency and openness of Standard & Poor's stability rating process. Income fund is a generic term for a category of publicly traded securities, including various structures such as royalty trusts, income trusts, limited partnerships, and real estate investment trusts. Overview Of Key Criteria Refinements Standard & Poor's stability ratings are current opinions on the prospective relative stability of distributable cash flow generation of Canadian income funds on a scale running from 'SR-1' to 'SR-7'. The substantive core of the stability rating methodology remains unchanged from the methodology set out in 2002.The overall stability rating continues to incorporate analyses of the same primary building blocks: (i) structure and governance; (ii) business risk profile; and (iii) financial risk profile, which includes the analysis of distributable cash flows and distribution policy. Two notable refinements from the 2002 framework have occurred: The analytical process highlights more prominently the interrelated concepts of sustainability and variability of an income fund. These two concepts provide the link between an income fund's business and financial profile, and its ultimate stability rating level. The formal introduction of Standard & Poor's characterization of an income fund's distribution profile as a third component of the stability rating opinion, in addition to the stability rating level and outlook components. This characterization was previously embedded in the stability ratings level. The updated methodology underscores sustainability and variability of distributable cash flows to allow investors to understand whether the stability rating level on a particular income fund is more influenced by limitations arising from one or the other of these two key dimensions. The sustainability component evaluates an income fund's long-term business prospects, while variability addresses the potential shocks to distributable cash flow generation from year-to-year. It is important to reiterate that stability rating levels reflect the relative risks to distributable cash flow generation, but not the target unit price, yield, or net asset value of an income fund. Chart 1 illustrates the schematic position of sustainability and variability factors as the intermediate stage between the fundamental elements of this analysis and the final stability rating level. The stability rating methodological framework is being disaggregated to explicitly indicate a standardized characterization of a fund's distribution profile. The distribution profile considers an income fund's distribution policy in the context of its cash flow dynamics, and comments on the ability of a fund to maintain a given level of distributions, expressed on a seven-step scale, ranging from very conservative to very aggressive. The distribution profile assessment takes into account, among other factors, how aggressive or conservative the income fund's distribution policy is relative to the variability of its distributable cash flow generation. The purpose of this refinement is to clearly differentiate between the fundamental stability of an income fund and risks to its distributions taking into account its distribution policy specifically. The likelihood of a change in distributions in the short to medium term will be signaled through the distribution profile, while the stability rating level will be adjusted when there are changes to prospective distributable cash flow generation viewed from a medium- to long-term perspective. For example, while the initial methodology assigned an 'SR-6' or 'SR-7' stability rating to income funds with suspended distribution, the refined methodology evaluates the causes of suspension and factors them into the stability rating based on fundamental sustainability and variability trends. The distribution profile of an income fund with suspended distribution would state "Suspended". Standard & Poor's expects that this modification of the framework will lead to more transparent connections between developments relating to an income fund, and associated changes to the rating, the outlook, or the distribution profile. Stability Ratings Scale A stability rating opinion is expressed through three key components: the rating, the outlook, and the distribution profile assessment. The rating level, which represents Standard & Poor's current opinion on the prospective relative stability of distributable cash flow generation of a Canadian income fund by its components of sustainability and variability. The outlook, which indicates the expected short- to medium-term stability ratings trend; a stable, negative, positive, or developing outlook expresses which way the rating might change if current trends continue over a one- to three-year horizon. In addition, StabilityWatch indicates a special surveillance period. The distribution profile, which considers an income fund's distribution policy in the context of its cash flow dynamics with implications for the likelihood of a prospective change in its distributions. The stability rating level is expressed on a scale from 'SR-1' to 'SR-7'. A rating of 'SR-1' signifies Standard & Poor's opinion as to the highest level of expected stability in an income fund's distributable cash flow generation relative to other Canadian income funds. Conversely, a rating of 'SR-7' indicates Standard & Poor's opinion as to the lowest degree of expected stability. Stability ratings factor in the analysis of sustainability and variability of distributable cash flow generation, with sustainability having a direct and variability having an inverse relationship with the stability rating level. The outlook is expressed either as 'stable', 'positive', 'negative', 'developing', or in special circumstances as StabilityWatch. Standard & Poor's recognizes that a fund's future performance represents the realization of one of several potential outcomes. To this extent, outlooks and StabilityWatch focus on potential scenarios that could lead to a change in stability ratings. In general, StabilityWatch indicates a special surveillance period to ascertain the impact of a specific event(s) that may require additional information. Some examples include acquisitions, mergers, regulatory actions, and unexpected operating developments. Outlooks tend to have a longer time frame than StabilityWatch listings, typically one to three years, and indicate an expected stability ratings trend. The distribution profile is expressed on a seven-step scale from very conservative to very aggressive. Through the characterization of an income fund's distribution profile Standard & Poor's indicates its opinion of the likelihood that an income fund may alter its current distribution pattern over a one to three year time horizon. An income fund's distribution profile is determined by its distribution policy in light of cash flow generation and other industry and operating characteristics. Standard & Poor's opinion on an income fund's distribution profile considers numerous factors such as distribution coverage (the inverse of payout ratio), the cyclical nature of cash flows and capital spending, and structural features such as cash reserves, the existence of convertible debentures or subordinate units within the capital structure. Analytical Time Horizon Considerations Stability ratings incorporate a wide range of pertinent information, adjusted for relative certainty and time horizon. The essential question of which income funds may be expected to thrive for long or indefinite time-spans, and which ones may decline or fail outright, whether sooner or later, is greatly influenced by the time horizon under consideration. Thus, stability ratings differentiate between income funds on the basis of expected life span. The analysis incorporates an assumption that a fund might persist indefinitely (notwithstanding the possible effect of trust provisions to wind up a fund at the unitholders' discretion) and seeks to understand the combination of events and factors that might cause an income fund to decline, fail or prosper. The expected longevity of an income fund in light of these events and factors is reflected directly in the rating. (Stability ratings on income funds with finite lives (and no analytical basis for contemplating subsequent life extensions) are subject to future stability ratings criteria elaboration. For example, an income fund supporting steady cash generation but with a structurally finite life may exhibit high sustainability and low variability throughout its existence (warranting a higher stability rating) but with a short remaining life (warranting a lower stability rating from a time horizon perspective of sustainability). The most appropriate rating treatment of such a hypothetical structure remains to be defined.) In general, the stability rating analysis considers a time horizon of 15 years or more, with greatest emphasis on the business and financial prospects for the next five years. Within this horizon, Standard & Poor's seeks to understand the impacts of reasonably foreseeable eventualities on the income fund. Detailed financial projections and related sensitivities covering the five-year time-horizon are considered as part of the ratings process. Highly rated income funds should have a sustainability profile reflecting clearly visible prospects for long-term or open-ended performance in distributable cash flow generation. Income funds that are rated lower, due to sustainability considerations, would likely exhibit some combination of naturally limited business position, very opaque or doubtful out-year business prospects, and/or challenges associated with renewing a fund's assets or business franchise beyond the medium term. Note, however, that an income fund could have strong sustainability but relatively high variability, which offset sustainability considerations and could result in an overall lower stability rating. Depending on time horizon considerations, known risk factors are incorporated in the ratings analysis to varying degrees. The weighting placed on potential events that that could affect an income fund depends on the: Time proximity of the event; Likelihood of an eventuality occurring; Certainty surrounding the potential impact on the income fund; and Ability of management to take steps to control or mitigate the impact. If some event (assuming reasonable likelihood, known impact, and mitigated as it may be) is likely to occur within five years, the current rating is set to incorporate the eventuality's expected impact on the income fund. If the expected time frame for the eventuality is 10 years in the future, or 15 years or beyond, the weighting would be diminished accordingly, particularly if the likelihood and nature of the impact is unclear. Events that are only likely to occur well outside a 15-year horizon are typically noted in the analysis, rather than factored into the stability rating specifically. As the possible occurrence of a particular event draws nearer, and as its impact and likelihood become more evident, the eventuality receives increasingly specific emphasis within the stability rating analysis. Stability Rating Methodology Overview The analytical framework for stability ratings is divided into several categories and stages to ensure that relevant structural, qualitative and quantitative issues are considered. The income fund universe can be divided into several sub groups, such as power generation, energy, pipeline, real estate, business, structured, and portfolio of funds. This document provides an outline of the methodology applicable to income funds in general; relevant sector-specific criteria elaborations may be published where needed and updated on an ongoing basis to address sector-specific analytical issues. The stability rating methodology has a fundamental orientation. The final stability rating depends on the assigned sustainability and variability scores, which in turn are the composite of the three fundamental building blocks: Structure and governance, Business profile, and Financial profile. Based on an analysis encompassing the three fundamental risk categories, Standard & Poor's assesses sustainability and variability of distributable cash flows of an income fund to determine its stability rating opinion. This multistep process facilitates analytical discipline and consistency. There is no simple mechanical formula, however, for combining sustainability and variability scores to arrive at a final stability rating level, which is ultimately an opinion and captures nuances beyond specific scores. Pertinent elements of the fundamental analysis are also drawn on to support an appropriate rating outlook and distribution profile assessment. Structure And Governance Analysis The goal of structural and governance analysis is to determine weaknesses and vulnerabilities that could hinder the fund's ability to generate and deliver distributable cash flows. There are a variety of income fund structures in use, many of which are quite complex in order to achieve taxation primarily at the unitholder level. Standard & Poor's does not view any one structure as nominally good or bad, nor does it hold the view that there is a single correct structure for all income funds. The structural and governance analysis tends to be a qualitative assessment and most queries are not unique to income funds. Nevertheless, there are key structural elements that are common across various funds as having been established by the market. These factors include: Composition and independence of board of trustees and board of directors at the trust and operating company level, respectively, and in various functional committees (audit and compensation); Separation and protection of the income fund's assets from its corporate sponsor's credit risk, if applicable; Rights of retained interest holders such as board representations (usually a sliding scale), board committees and approval rights in case of mergers, acquisitions, asset sales, and debt or equity issuance; Structure of management team and details of management contracts, particularly if externally managed; and Alignment of management's performance and incentive plans with unitholders interests. The ultimate evaluation of the structure and governance is done on a case-by-case basis and takes into consideration universal qualities such as history of acquisitions or corporate culture, and other factors that are specific to the income fund or its industry. Some factors, such as external management or related party transactions, could be a source of potential conflict for a particular income fund, while it might provide valuable synergies for another fund. Business Risk Profile Analysis Stability ratings, not unlike credit ratings, consider a common set of factors that determine a company's inherent ability to achieve success and avoid pitfalls in its business. Furthermore, business risk factors do not generally differ between companies organized as income funds, and those with a conventional corporate structure. Accordingly, the business profile analysis for income funds draws on Standard & Poor's credit rating criteria framework, particularly for industrials and utilities. Standard & Poor's has developed and published numerous criteria articles on the nuances of analytics for the credit rating of various industries, which are also utilized by the stability rating process. Standard analytical subcomponents of business risk evaluation include: Industry characteristics Competitive position Asset quality Profitability and peer group comparisons Operational management The business profile analysis begins with the general overview of the income fund's industry prospects and competitive and regulatory factors affecting its industry. Patterns and impacts of business cycles, whether industry or economic, are factored into the business profile assessment. Given limitations posed by industry risk characteristics, the income fund's ultimate business profile is determined by its competitive position such as market share, pricing power and cost position, and by the quality of its assets, including factors such as diversification, age and remaining life and operating flexibility. Profitability analysis and peer comparisons provide further insights in the income fund's competitive position. In addition, the management team is assessed for their role in determining and affecting the income fund's operational success. Conclusions of business risk profile analysis are important inputs for evaluating sustainability of distributable cash flow generation. The business risk profile of an income fund also affects risk tolerance from a financial perspective, to the extent that a solid business position implies greater potential staying power. In addition, a clear understanding of factors that drive revenue and cost cycles is critical for variability considerations. Financial Profile Analysis The financial profile assessment of income funds includes qualitative components, although quantitative measures, particularly financial ratios, are essential analytical considerations. Financial ratio calculations for stability ratings incorporate Standard & Poor's customary credit rating adjustments to financial statements such as the inclusion of off-balance-sheet items to facilitate comparability across the income fund sector and with other industry participants, whether structured as an income fund or not. The analytical subcomponents of financial risk evaluation include: Accounting and financial policy, including distribution policy; Cash flow adequacy and distributable cash flow; Capital structure; and Liquidity, financial flexibility, and short-term factors. Although fundamental financial analysis is not primarily driven by organizational structure, income funds do have common financial characteristics stemming from their structure and 'raison d'être'. For example, income funds typically retain little of their distributable cash flows and generally have limited scope to smooth distributions in the face of prolonged adverse performance, thereby constraining their financial flexibility. Another common feature of income fund structures is the large amount of internal debt that is used to eliminate operating company taxes through interest deductibles. Given the alignment of economic incentives with equity stakeholders, Standard & Poor's does not consider this internal debt as part of leverage. In addition, distributable cash flow and distribution policy analyses call for particular analytical attention from a stability rating perspective by providing essential information for evaluating an income fund's variability and distribution profile. Distributable cash flow Distributable cash flow analysis is focused on potential shocks and not on predictable seasonal patterns of cash flow generation. Seasonal fluctuations are an important consideration for evaluating liquidity in relation to the income fund's cash requirements. Distributable cash flow analysis, on the other hand, concentrates on cash flow patterns throughout the operating cycle and quantitatively and qualitatively takes into account factors that affect cash flow available to unitholders. There are several definitions of distributable cash flow in the market place. Standard & Poor's key reference definitions are adjusted funds from operations (AFFO) and cash available for distribution (CAD). AFFO is defined as operating cash flow before working capital changes (or funds from operations; FFO) less imputed maintenance capital expenditures. CAD is defined as AFFO net of changes in working capital. Although the above definitions do not incorporate growth capital spending and changes in debt position, these considerations are also important to round out the understanding of cash flow patterns. Imputed maintenance capital expenditures are critical in determining AFFO. The concept of maintenance capital expenditures is certainly not unique to income funds. In fact, any cash flow analysis considers the nature of capital expenditures from the perspective of sufficiency to maintain an ongoing business, while liquidity analysis employs a timing and financial flexibility perspective. However, in considering distributable cash flows of an income fund, the separation of maintenance and growth capital and determination of replacement capital spending is useful. Imputed maintenance capital spending represents expenditures that are necessary to maintain current distributable cash flows, while growth spending represents an investment in future cash flow expansion. Standard & Poor's imputed maintenance capital expenditures calculation, in addition to sustaining spending attributable to the income fund, includes the estimated replacement value of annual depletion/shrinking of its asset base. For example, the cost of replacing a year's production for an oil and gas trust, or the finite life asset portfolio of a financial business trust. The calculation of imputed maintenance capital spending is an important distinction that may vary from the income fund's own reported maintenance capital expenditures, and correspondingly from publicly stated distributable cash flows. It is worthwhile to note that income funds have an incentive to minimize sustaining capital expenditures reported to maximize distributable cash flow numbers. Maintenance capital spending can be at times deferred a few quarters without affecting operations and cash flows, but inadequate spending is likely to result in distributable cash flow volatility later on. After all, these expenditures are required for the sustainability of distributable cash flow generation. In addition to the revenue and cost cycles and capital spending, distributable cash flows could also be affected by debt indentures, particularly covenant patterns. It is critical to understand what restrictions, if any, these agreements contain on distributable cash flows. For example, distributions can be restricted or eliminated under certain conditions, even if the fund is well within its financial covenants. Distribution profile The sensitivity analysis of distributable cash flows is the background for evaluating an income fund's distribution policy. The distribution profile analysis considers the income fund's distributions to unitholders in light of management's strategies and current and anticipated cash flow patterns. An income fund's distributions to unitholders are akin to dividends of corporations. Distributions are only moral obligations of an income fund, just as dividends are of corporations. Although most funds are reluctant to lower or suspend distributions there is no legal obligation to pay distributions. In addition, while income fund units are often likened to high yield debt, they are equity instruments. There is no event of default if distributions are lowered or suspended. There is limited potential for structuring to substantially improve an income fund's inherent cash flow generation; however, some income funds employ policies and structural features, which may incrementally strengthen their financial profiles. These include cash reserves, or the issuance of units (typically held by the sponsor of the funds and not publicly listed) that are subordinated in rights of cash distributions to another class of units (typically the publicly traded units of the income fund). The overall impact of any cash reserves depends on the size of reserves relative to potential periodic cash demands on reserves and the fundamental risk profile of the fund, and the potential that these reserves can be replenished over the financial performance cycle. Reserves do not mitigate or protect against fundamental business deterioration since their effect is temporary in such situations. The positive impact of subordination on an income fund's distribution profile depends on the various subordination features. A number of income funds have subordination features, in which the sponsor of the fund subordinates its distributions or part of its distributions entitlement to public unitholders for a period of time or until certain conditions are met, if distributions were to fall below a predetermined level. Features assessed include, among others, the percentage of units subordinated, which determines the cash flow cushion provided to priority unitholders; expiry of subordination, which can depend on time or certain performance metrics; terms of subordination, such as the distribution level at which subordinated unitholders are entitled to distributions; and accrual of unpaid distribution and whether the fund is allowed to borrow to make distributions. Stability Rating Determination The final stability rating opinion is expressed through the stability rating level, the outlook and the distribution profile. The stability rating level is a composite of the income fund's sustainability and variability assessments, which in turn depend on conclusions of structure and governance, business, and financial profile analyses. Sustainability gives an opinion on the likelihood that an income fund will remain an ongoing entity that generates cash flows. The sustainability assessment of an income fund draws heavily on the business and some components of financial risk assessments. As an example, an income fund with a predictable or solid business risk profile and modest-to-average financial risk position is likely to receive a relatively strong sustainability assessment. Sustainability also incorporates the conclusions of the structure and governance analysis, which has either a neutral or, if found lacking, a negative implication. Sustainability is gauged relative to the universe of known income funds, to other industry players (including those not organized as income funds), and theoretical constructs representing upper and lower bounds for potential business risk. Variability provides an opinion on the level, trend, and patterns of distributable cash flow generation, relying heavily on the distributable cash flow and distribution components of the financial risk profile assessment. Variability considers, among other factors, the volatility, trend, and the likelihood of a material drop and magnitude of potential decreases in distributable cash flow generation, including potential worst-case scenario. As an example, an income fund with minimal volatility and a stable or positive trend to its distributable cash flow generation is likely to receive an assessment of relatively low variability. Although the variability assessment of an income fund is largely based on quantitative measures, qualitative factors such as Standard & Poor's evaluation of management's strategies could influence the assessment of variability. Growth, or a positive trend, may counterweigh volatility, leading to an assessment of low variability. As noted earlier, there is no simple mechanical formula for combining sustainability and variability assessments into a final stability rating. In some cases the final stability rating opinion is more or less straightforward, particularly if the sustainability and variability assessments are relatively well aligned. The final stability rating is, however, not simply a saw-off when a fund is assessed as having high variability and weak sustainability, or vice versa. In general, neither sustainability nor variability dominates the stability rating, albeit the sustainability score may have an incrementally greater weight. After all, as long as an income fund remains an ongoing entity there is potential for cash flow generation and distributions. Chart 7 serves as a broad illustration of the correlation of sustainability and variability. The bands indicated by the dotted lines serve as the median expectation of a final stability rating given relatively symmetric sustainability and variability assessments. The shaded areas indicate ranges that are less likely, as variability and sustainability assessments are not wholly uncorrelated. The more asymmetric the assessments are, however, the greater the challenge is in determining the ultimate stability rating. The outlook assigned identifies key factors that are necessary for maintaining the stability rating level of an income fund and various scenarios that could lead to a change. The outlook has a typical time horizon of one to three years. The outlook strives to provide qualitative milestones, in addition to quantitative measures, as warranted, to further the transparency of the stability rating trend anticipated by Standard & Poor's. The distribution profile assessment indicates Standard & Poor's opinion on the income fund's distribution policy in context of its distributable cash flow generation, with implications for the likelihood that an income fund will maintain its current distribution pattern over a one to three year time horizon. An income fund's distribution profile assessment is not determined by a single financial ratio, such as AFFO distribution coverage, but rather considered in light of its business and financial profiles, particularly its distribution policy and variability of distributable cash flows. The distribution coverage consistent with a given distribution profile will vary between issuers and sectors. For a given income fund, a moderate distribution profile will be assigned if distributions are determined to be at the highest level that can be readily sustained across a reasonable range of future scenarios. Increasingly, aggressive profiles will be assigned for income funds where maintaining distributions may be stressed or threatened under foreseeable scenarios. Conservative profiles would be applicable to issuers with some degree of cushion existing between expected and forecast distributable cash flow and the established distribution level. Moreover, the distribution profile for income funds with suspended distribution would indicate "Suspended". The analysis would indicate Standard & Poor's understanding of the causes of suspension and the distribution outlook based on the fundamental analysis of business and financial risk profiles. Rating Changes And Surveillance Surveillance of stability ratings on an income fund is an ongoing process, with stability rating actions driven by changes in characteristics of its primary building blocks: structure and governance, business, and financial profiles. Moreover, stability rating actions consider the degree to which an eventuality is already incorporated in the analytical process. Thus, an event could have varying degrees of consequences, depending on the extent to which its implication was already incorporated in the existing stability rating. An event can have four different outcomes, some of which may occur in combination of the following. No change in the outlook, level, or, distribution profile of the stability rating This could indicate an event that is already fully incorporated in the stability rating; an event that is not significant enough to affect the income fund's profile; or an event that alters Standard & Poor's view of the stability rating opinion, but not sufficiently to warrant change. The outlook on the rating is revised, including StabilityWatch placement Outlook revisions reflect a directional change in stability ratings and generally indicate the conditions under which a stability rating action could materialize. The stability rating level is raised or lowered A change in stability rating level generally reflects a major shift in the income fund's sustainability and variability, thus its fundamental risk profile. The distribution profile is revised A change in the distribution profile reflects Standard & Poor's reassessment of the income fund's distribution policy relative to its cash flow dynamics, particularly the likelihood that it will maintain its current distribution level. It is worthwhile to note that stability ratings are not just a snapshot of a point in time, but rather attempt to anticipate foreseeable ups and downs in business and industry cycles that affect a particular income fund. Thus, stability ratings in general can withstand some cyclical pressures. However, actual pattern and longevity of any given cycle and its potential long-term effects are challenging to predict with a high degree of precision. The stability rating opinion therefore may be revised if the income fund's business or financial profile, and through them the sustainability and variability of distributable cash flow generation, is permanently altered. An event that is highlighted by the media or reported by the income fund via financial reporting or news releases may or may not have an impact on the ratings opinion. Some examples of typical events and potential rating responses include: Minor or major cut in distributions Circumstances that led to the distribution cut are evaluated with respect to fundamental distributable cash flow generation. If the cut in distributions signals a weakening of the income fund's sustainability or variability prospects over and above what is already incorporated, then the stability rating level could be lowered or the outlook revised. In addition, the distribution cut may also affect the income fund's distribution profile to the extent that lower distributions could signal a moderation in its distribution policy, albeit only if distributable cash flow generation has not changed. Distribution suspension The distribution profile will be revised to "Suspended". In addition, the nature of the suspension, transient or open-ended, is determined, followed by the evaluation of elements already incorporated in the stability rating. For example, a stability rating at the 'SR-6' level might already incorporate a number of probabilities that can lead to a suspension of distributions, while an 'SR-2' stability rating level likely does not. Moreover, a transient suspension, even if not expected and incorporated, is likely to have a less material overall stability ratings consequence. Unexpectedly poor quarterly or annual results Although the operational and/or financial performance is unexpected, some degree of performance variance is in general incorporated, depending on the particular stability rating level. The income fund's overall performance is evaluated in light of general industry dynamics and expected duration of underperformance. If the reported weakness is relatively short in duration and small in magnitude, then the stability rating level might not be lowered. If there is a fundamental deterioration in the income fund's sustainability or variability prospects, however, then the rating level, and/or the outlook could be revised downward. In addition, the distribution profile may be reassessed in light of evolving distributable cash flow dynamics and distribution policy. (Conversely, the opposite is true for unexpectedly strong quarterly or annual results.) Acquisition Evaluation of the effects of an acquisition is a multidimensional exercise, particularly if it is a major acquisition. Minor acquisitions, unless specifically noted otherwise in the rationale on the income fund, do not tend to change the stability rating opinion. Major acquisitions, however, have to be evaluated from the perspective of integration risks, impact on business position, impact on capital structure, and cash flow implications both in the near and long term. The combination and timing of acquisition risks determine whether it is positive, neutral, or negative for the stability rating opinion. An outlook change could also be warranted to indicate directional concerns or positive targets for downgrading or upgrading a particular stability rating level. Moreover, the distribution profile may also be affected by change in distributable cash flow generation, distribution level, and policy. Closing Comments This methodological update is part of an ongoing effort on the part of Standard & Poor's to support the transparency of its rating criteria and processes applicable to stability ratings issued in coverage of the Canadian income fund market. Given the evolving nature of the income fund sector, and consequentially of this framework, it may be appropriate to emphasize certain considerations associated with the use of stability ratings. First, stability ratings seek to opine on the relative risk levels between different income funds with respect to distributable cash flow. In contrast to traditional equity analysis, stability ratings are not buy/sell/hold recommendations, and do not comment on relative value and should not be viewed as sufficient in and of themselves to justify any particular investment decision. For a given investor, the best (or worst) relative value may well be found with an income fund assessed at any point on the stability rating scale. This will depend on the individual investor's perceptions of relative value, risk tolerances, sectoral exposure preferences, unit liquidity concerns, and many other factors that are not encompassed in the stability rating framework. Similarly, different stability ratings should not be viewed as good or bad in their own right, but instead as indicative of lower or higher relative risk levels with respect to distributable cash flow. Likewise, stability ratings do not comment on a fund's net asset value or market value, which will fluctuate with market sentiment in conjunction with other factors. Stability ratings provide investors with an opinion on the future sustainability and variability of distributable cash flows and the likelihood of future payout changes, notwithstanding what value the market may place on the units at any particular point in time. Both issuers and investors should also acknowledge limits on the use of stability ratings. For issuers, stability rating coverage should not to any extent be viewed as a substitute for active and forthright disclosure to the market in general. With respect to investors, stability ratings should not be viewed as a substitute for their own analysis and judgments. An investor should arrive at an opinion on the risk and value relating to a particular investment decision drawing on any and all sources of reliable and relevant information. No particular stability rating should be viewed as providing assurance that an income fund's distributions will not be reduced or suspended at some time. Given the fact that income fund units are equity instruments, investors should recognize the inherent variability of distributions, and the first-loss position of unitholders in an income fund's capital structure. Income fund units should not be viewed as fixed income instruments, and the stability rating scale should not be aligned with the credit rating scale of Standard & Poor's. Finally, users should keep in mind the fundamental nature of stability ratings. While Standard & Poor's presents stability ratings as a useful information source offering analytical insight and predictive value in relation to the relative risk levels of different income funds with respect to distributable cash flow generation, they are ultimately opinions. Stability ratings are not verifiable statements of fact. Users of stability ratings should actively consider which analytical elements contributing to the overall rating opinion they agree with, and which they disagree with, and by considering such other relevant information as is available thereby arrive at their own level of comfort with a Canadian income fund's risk profile. Investors are also encouraged to critically compare the insights derived from rating analyses with the observed performance of rated income funds and the income fund sector over time. Over time Standard & Poor's expects that its methodological framework with respect to stability ratings will continue to be refined to reflect additional experiences in the Canadian income fund market. Sidebar 1: Credit Rating Linkages The fundamental focus of the stability rating methodology is closely related to the credit rating analytical framework refined over many years by Standard & Poor's. Substantial components of the structure and governance, business and financial risk profile analyses are equally important for both corporate credit and stability ratings, resulting in a significant linkage between the processes evaluating creditworthiness and distributable cash flow generation. Both rating perspectives (stability and credit) are primarily concerned with a shortfall from established expectations, whether it is for ongoing distributable cash generation, or timely debt service. For the most part, key factors with credit implications often have directionally similar stability rating implications. Nevertheless, considerations such as financial policy and debt covenants may lead to diverging credit and stability rating conclusions. The closest connection between stability and credit ratings is within the sustainability dimension. The threshold concern for sustainability is the potential for the business to fail or enter bankruptcy, which is the direct concern of credit rating analytics. In light of this connection, an issuer's credit profile will constrain the applicable stability rating. For example, an issuer with a 'B' credit profile would not warrant an 'SR-1' or 'SR-2' stability rating. Since stability ratings are primarily concerned with cash available to equity stakeholders, distributable cash flow and distribution analysis is a critical component of the stability rating financial risk assessments. Accordingly, stability rating analytics differ from credit rating analytics in terms of the greater significance of variability in distributable cash flow, since equity stakeholders are in a residual cash position. Sidebar 2: Portfolio Of Funds Ratings Methodology Stability ratings that are assigned to portfolio of funds (or "fund of funds") also rate to the basic principals of variability and sustainability in cash available for distribution. A key difference with fund of funds ratings versus and individual income fund ratings is that the inherent and managed diversification in a portfolio of funds materially reduces variability and enhances sustainability. In arriving at a fund of funds rating opinion, a thorough review of management qualifications is conducted in addition to the analysis of the portfolio of funds. Sustainability in a fund of funds is assessed by gauging the average life of the distributable cash flow based on the sectoral diversification and underlying rating category diversification attributes of the portfolio. Variability is assessed through a variety of analytic scenarios that test how the total funds available for distribution are affected by changes in distributions of the constituent income funds. Note A stability rating is not a credit rating but reflects Standard & Poor's current opinion on the prospective relative stability of distributable cash flow generation of a Canadian income fund on a scale running from 'SR-1' to 'SR-7'. A stability rating is an opinion and is not a verifiable statement of fact. Stability ratings are based on information provided to Standard & Poor's by an issuer or its agents and Standard & Poor's relies on the issuer, its accountant, counsel and other experts for the accuracy, completeness and timeliness of the information submitted to it in connection with a stability rating. Standard & Poor's does not perform an audit in connection with a stability rating and undertakes no duty of due diligence or independent verification of any information used in the rating process. Standard & Poor's does not and cannot guarantee the accuracy, completeness or timeliness of the information relied on in connection with a stability rating or the results obtained from the use of such information. Standard & Poor's may raise, lower, suspend, place on StabilityWatch or withdraw a stability rating at any time, in Standard & Poor's sole discretion. A stability rating is not a "market" rating nor a recommendation to buy, hold, or sell any security.