LEADING TREASURY PROFESSIONALS

Peter Kernan and Paul Watters
Standard and Poor's Ratings Services
20 Canada Square
Canary Wharf
London, E14 5LH

25 September 2013

Dear Peter and Paul,

Request for Comment: Corporate Criteria

Following our discussion at 20 Canada Square (for which, thank you), I write – a little late as we said we would be – with comments.

As we said at our meeting, we will not comment on the general approach of S&P's methodology that is an important part of its intellectual property.

Broadly, we like the approach taken in clarifying the general criteria and how they are modified by other analysis and judgement. However, as we mentioned, we are somewhat concerned at the apparent intention to over-formalise things and too much to downplay the role of judgement.

More frankness about the role of judgement would be a good thing. To say that companies may be classified into two or three groups based on some criterion related to uncertain reported numbers is importantly saying that judgement will be exercised on those, often many, firms that are close to boundaries. The paper gives the impression that your lawyers have said to make it look as objective as possible as judgements can always be challenged. But maybe you go too far.

We have seen the submission in response to you from the Association Française des Trésoriers d'Entreprises (appended) . We support the AFTE's comments and, as you know, they generally cover the points made in our meeting.

We would add one specific concern. It seems that a company that pre-funds a maturing debt repayment or amortisation and holds the funds in cash and short-term investments meanwhile may be treated as having increased debt from the (advance) funding without offset of the (liquid) assets raised from it. We think this could be unintended or mistaken. We realise that money is fungible and that funds raised for a repayment may be blown on something else. However, if the company has indicated its intentions in on-the-record statements or explained the situation to S&P privately this should be taken at face value and set-off be allowed in looking at the firm's debt and leverage/gearing.

And we wonder if there is an attempt at over-sophistication in the use in looking at variability of profit for a firm of the standard error of regression over seven years – in that seven years is quite short and could cover only a stable period in the economy. Does the apparent sophistication actually improve over a subjective judgement?

To repeat, we welcome the light shone on the process but repeat the comment by the AFTE that credit ratings must not become "credit scoring".

Yours sincerely

John Grout
Policy and Technical Director

The Association of Corporate Treasurers (ACT)

Established by Royal charter, The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

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RESPONSE TO STANDARD & POORS's REQUEST FOR COMMENT ON CORPORATE CRITERIA

19 September 2013

Created in 1976, AFTE represents around 1400 members, including 1000 corporate treasurers or financial managers of approximately 800 industrial and commercial companies. AFTE development is concentrated on five activities: technical committees, representation of corporate treasurers, conferences, publications, training and education.
AFTE sits, as full member, in many French official Boards.
AFTE is a founder member in 1996 of the International Group of Treasury Associations (IGTA) and in 2002 of the EACT (European Association of Corporate Treasurers).

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Introduction

This document has been prepared by AFTE (Association Française des Trésoriers d'Entreprise) in response to Standard & Poor's (S&P) Request for Comment on its proposed new Corporate Criteria.

The French corporate treasurers and their companies, represented by AFTE, welcome S&P's proactive approach to criteria evolution and fully support the objectives outlined by S&P for its rating methodology: transparency, comparability and forward looking.

While we appreciate the consultation process launched by S&P and while we do thank S&P to have accepted our contribution beyond the indicative preset date of 16 September 2013, we do need to mention that our comments have been voluntarily limited due to time constraints only to what we perceived as the major changes brought by this new methodology or some important areas of possible concerns. As the French Treasurer Association we have had numerous exchanges with other interested parties, including rating advisory teams of some of the major French banks and generally share the more detailed comments that these institutions have been contributing to the consultation.

We will therefore limit our comments:

- General comments
- Treatment of Surplus Cash
- Areas which would deserve better clarity
- Implementation Process and Timing

1) General Comments:

- Rating must not become scoring

While we do not believe this is S&P's intention, the proposed new methodology presentation is such that it can give the impression that this new methodology could lead to a rather heavy mechanical approach of the rating. We do strongly feel that a large part of the rating process value comes, beyond the outcome of financial ratios and S&P's views on country or industry risks, from the value of the dialog between each individual company and the lead analyst and, as much as possible, other members of S&P credit committees.

We insist on the fact that this is the only way where S&P can get an intimate understanding of the industrial sector and of the relative positioning of any individual rated company within its sector.

If the very detailed methodology proposed is made to provide greater transparency and possibly accuracy in the rating assessment it must not neglect judgment made possible by an in depth knowledge and understanding of an individual rated entity.

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- **Anchor rating and Modifiers possible impacts**

AFTE believes that there is a contradiction between the objective of transparency and clarity on the ratings and the way, beyond the methodology outcome on the ‘’Anchor Rating’’, the ‘’Modifiers’’ could influence the final rating outcome.

Indeed, while the detailed process to reach the anchor rating, while heavy and complex, is relatively clear, the magnitude of the rating impact that could be induced by the strict use of Modifiers seems quite significant.

Previously, it was commonly accepted that the ‘’softer’’ factors, now called ‘’Modifiers’’, could move the rating up or down by one notch (event risk, strong financial flexibility, etc…) especially for names with a ‘’solid’’ credit profile. It now seems that - potentially -Modifiers could have a much stronger impact with no cap, the Anchor Holding concept becoming therefore questionable.

Moreover, Modifiers seem to introduce more a ‘’Negative Bias’’ on more subjective factors as their individual ‘’notching impact’’ is unbalanced.

AFTE strongly feel that this goes against S&P’s objective of transparency, clarity and comparability of ratings and we would need S&P to be more restrictive on the overall rating impacts of the Modifiers which otherwise, by themselves give a too high analytical ‘’flexibility’’.

Lastly, AFTE fears that the leverage level be counted twice in fact as it is both part of the Anchor Rating through the analysis of the Financial Profile and possibly in the Modifiers when it comes to the judgment on Financial policy.

- **Key Credit Factors ‘’KCF’’**

While you mention under point 7 that ‘’*KCF criteria may supersede certain sections of these criteria’’* (referring to the Request for comment content), KFC are so far unknown for most sectors. It will therefore be of the utmost importance to track any potential KCF publication in the future. We are concerned that these KFC may greatly impact ratings.

2) Surplus cash treatment and calculation

AFTE considers that this specific aspect of the new proposed methodology would seriously damage the credibility of the new criteria if it was not amended in the final version. **This is for AFTE the most important area of concern.**

Surplus cash treatment and calculation has indeed a direct impact on the level of adjusted net debt taken into account to calculate especially the two “core ratios” contributing to the definition of the Financial Risk Profile. Preliminary calculations made by many AFTE members show that the impact on their perceived credit worthiness could be significant.

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Association régie par la loi du 1er juillet 1901 - Journal officiel du 17 novembre 1976 - N° de siret 314 974 338 000 68 - Code Ape 9499z

We agree with S&P's statement: *"Moreover, we consider that surplus cash is available to repay debt, in addition to cash flow generation. Therefore, it would be appropriate to evaluate debt net of surplus cash."*, but we consider the proposed methodology to calculate the surplus cash (in all its 3 steps) absolutely needs to be amended as its current version neither contributes to a proper credit analysis nor respects the objectives outlined by S&P.

Step 1: Under the current proposal an amount "calculated as the difference between year-end working capital and the peak intrayear working capital (PIYWC) needs of the business" must be subtracted from cash and liquid investments available on the balance sheet.

<u>- This Step 1 is for us, inappropriate for Long Term rating analysis:</u>
"Intrayear needs" are by definition linked to a liquidity analysis and not to a Long Term rating analysis.
S&P's liquidity analysis, being performed on a rolling quarterly basis, already captures working capital seasonality and rightly takes it into account to qualify the liquidity of a company.
Therefore Step 1 should never apply if the liquidity level of the company is adequate or better.
Step 1 is even more inappropriate for a Long Term analysis as it is calculating adjusted debt level based on an instantaneous intrayear peak level of the working capital needs. An average need would be more consistent with a Long Term approach.

<u>- Step 1 doesn't respect the comparability objective:</u>
There are 2 ways of addressing intrayear working capital seasonality: you can have more cash when needs are low and less cash when needs are higher, or you can have always a low level of cash but issue more short term debt to cover your seasonal needs.
Economic net debt level needed in both ways is exactly the same, but under the current proposal adjusted net debt would be higher for the company choosing the safer way of relying on more cash available (therefore being less dependant on market availability).
Ratio calculation would penalize companies having the more conservative approach to cover their liquidity needs!

<u>Step 1 doesn't respect the objective of a forward looking analysis:</u>
Under the current proposal PIYWC calculation is based only on a proxy or on "historical evidence".
As companies are managing working capital needs and can define targets, forecasts on PIYWC (if available) should also be taken into account in this calculation, as well as long term trends.
In addition there may be cases such as major scope changes where the Working Capital analysis deserves a very specific attention.

Step 2: "Then take a fixed 25% haircut (deduction) on gross available cash (C) to derive adjusted available cash. Therefore, adjusted available cash (D) = C * 0.75. If available information indicates greater or lesser accessibility to cash and liquid investments, the haircut would be raised or lowered."

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We agree only available cash should be deducted from gross debt, but this step should first define what is considered as inaccessible cash (as already mentioned in the proposed criteria) to be excluded from surplus cash, and only if not enough information is available consider a “by default” haircut.

S&P haircut approach seems to have been – at least partly - dictated by S&P willingness to allow for better comparisons between the US and European companies. It must be very clearly stated that European companies do not suffer at all from any systematic taxation (of around 35% in the US as far as we know) on dividends repatriated at the Holding Company level. There is therefore no reason to apply any systematic haircut on cash, whatever the figure would be, of European based companies.

Lastly, it is worth noting that this haircut also ignores the fact that, in many instances, cash balances at ‘’opco’’ level are usually partly matched with some financial debt locally.

Step 3: “forecast cash available for debt repayment” which can only be zero or negative (!) could further reduce the surplus cash.

The proposed methodology already includes in the analysis 2 years (beyond the current year) of cash flow forecasts. Any future cash needs are therefore already included in the ratio calculations. Considering these forecasts (only if they are negative) to reduce cash surplus mixes cash and cash flows and considers cash flows twice. This step is clearly inconsistent.

AFTE urges S&P to take into account our comments above to amend accordingly the proposed cash surplus calculation.

3) Areas to benefit from greater clarity:

3.1 Volatility of earnings:

The approach of earnings volatility raises practical concerns:

- There is a concern the way scope changes will be taken into account and/or restated as it does not make sense to study earnings volatility at variable scope. Our view is that this can only be done at constant scope being aware that it does, in some cases, make the exercise much more difficult and therefore suggest a rather in depth dialog with the company

- In addition, as far as the measurement of the earnings volatility is concerned, the choice of the indicator is particularly important and may even depend on the industrial sector. It however seems that for a majority of sectors, the most relevant indicator is the evolution of the EBITDA margin which captures all of the pure operational elements of the performance, including companies reactions to changes in market environments.

- There is also a strong concern of double or even triple ‘’counting’’ of volatility in the proposed methodology: at the industry level, at the company level and in the financial ratio benchmarks. This seems to add cushions on cushions. Limiting volatility measurement and impact at company level through the EBITDA margin evolution should be enough to take into account the level of exposure of a given company to the evolution of its business environment.

- Lastly, SER calculation seems to be a blackbox which can be based on different components and can also be adjusted (see point 84). We would need S&P to give more precise guidance on how it calculates SER.

3.2 Clarity in the communication on restated figures

- This is not a new theme for us and is not in fact directly linked to the proposed new methodology but it was felt that this was another opportunity to request full transparency and, even more, full clarity on the restatements made by S&P on the companies published figures and this as much for the rated entity itself and for the market:

- for the rated entity itself, while it is fair to say that a rated entity can obtain from its S&P analyst restatements performed on its publicly disclosed figures, the restatement tables communicated are far from bringing the appropriate level of clarity. There is clearly a need to progress and systematically provide the issuer with a clear, complete and exhaustive restatement file allowing for a perfect understanding of the adjusted figures. This should be provided in such a way that the company can perform a line by line reconciliation with its published figures.

- for the investor community, to allow them, at least for the major adjusted elements such as but not limited to Net Debt and FFO figures, where they come from. Such clear and easily readable table should be provided with all S&P releases as part of its transparency and clarity commitment to the market.

- This requirement is all the more important with the proposed new methodology where additional adjusted financial ratios will be considered.

3.3 Assessment of Preliminary Competitive Position

Referring to your point 68, the weighting of the different criteria can be questionable, especially for National Industries and Utilities, especially for those which are ‘’de facto’’ quasi local monopolies (‘’Competitive Advantage’’).

More generally, the nuances brought in the weightings may not be all justified. AFTE wonders why a simpler approach of a one third weighting for each of the indicator would not be as efficient and possibly less controversial.

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3.4 Definition of EBITDA and FFO

The definitions are quite sensible. However, we understand that the FFO calculation will be mainly based on P&L figures rather than the Cash Flow statement which is also very much questionable given credit analysis objectives.

4) Timing / process

AFTE had mentioned mid July that the consultation period was not ideally placed in July and August and therefore that the 16 September deadline, while seeming generous on paper, was in reality a tight deadline! The methodology presentation was indeed planned in Paris for September 5th which was much later than for a number of other financial places. In addition, S&P itself has not been able to provide all the information in time. For example, country risks list was published late, most of Key Credit factors are not yet known, …

That being recalled and given the areas of concerns which have been raised thanks to the consultation process that S&P has organised, AFTE believes that two steps would be needed prior to the publication of the ''final' New Methodology:

a) A second draft document should be circulated after analysis of the comments received and clarification needed on the methodology. This second document may not open a second round of consultation but it will allow market participants to refine their understanding and their appreciation of the possible consequences of S&P new methodology.
b) This ''second round'' should be used by S&P analyst community to answer to any question that individual rated companies may have on the application of the new methodology to their case. The objective is to make sure people will be able to supply the right level of information and understand the way the methodology will work in their individual cases. AFTE is not requiring individual ''new'' ratings to be given during that second round. AFTE would however expect S&P to communicate to companies their new adjusted figures with a full reconciliation with the companies's published figures, before actual changes are implemented.
c) Formal Publication of the New Methodology should take place at the end of this second round.
d) This ''end of second round'' date is key for us as S&P objective should be to avoid creating market turmoil. With that objective, AFTE would strongly advise for S&P to use the end of the year period to make its market announcements. Financial markets are virtually closed between mid December and the first week of January leaving, in our view, time to resolve the possible sensitive cases with the right level of mobilisation of S&P analytical teams.

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