



R&I's Analytical Approach to Syndicated Loans

(This report is an English translation of the original report in Japanese.)

Rating Approach-Evaluation of Covenants

Loans traditionally more advantageous than bonds from a recovery perspective, but not reflected in rating differences

When determining ratings for individual obligations such as bonds, R&I first gauges the probability of an issuer defaulting or otherwise failing. In its analysis of default risk R&I determines the Issuer Rating. R&I then measures the probability of recovery of the obligation following default, by examining the details of the covenants and conditions for establishing collateral, and reflects the results in its rating of the individual debt. This approach is the same when rating bonds and when rating loans and private placement bonds.

R&I is frequently asked whether it judges there to be a difference between unsecured bonds and unsecured loans in the probability of recovery after default? R&I has traditionally held to the recognition there is a possibility loans will have seniority over bonds, and studied whether to notch down a bond depending on the weight of potential senior obligations. There is a vast asymmetry between banks and general bondholders in the quantity of information held, and banks also possess strong bargaining capabilities. Moreover, when considered based on conventional banking transaction agreements, banks also have much greater advantages in strengthening their preservation provisions.

Banking transaction agreements have been revised recently, however, and even syndicated loan agreement templates cannot necessarily be said to be particularly advantageous for banks. Mitsubishi Corporation's syndicated loan agreement, for example, adopts wording that gives pari-passu consideration to corporate bonds. And although it represents a more qualitative judgment, when the financial support provided to firms struggling with excessive borrowing through measures such as abandonment of claims is considered, there also are opinions questioning whether banks loans are not senior debt at all but are really subordinated obligations,.

R&I does not conclude that loans always exhibit differences with unsecured bonds that it must reflect in notching. R&I can state, however, that compared with other bonds or obligations, loans for which preservation provisions are strengthened when specific conditions exist, or that are redeemed before maturity based on covenants such as those described below, do have a higher level of seniority.

Loans with flexible establishment of covenants

As the standardization and homogenization of covenant provisions for publicly offered corporate bonds advances, financial covenants (restrictive financial covenants) in the form of

maintenance of profits or maintenance of net assets, which once were common, are being seen with less frequency (Note 1).

Providing covenants is the norm, on the other hand, in the world of syndicated loans. For firms with strong creditworthiness that enables them to also issue bonds, syndicated loans are only one option among various alternatives for raising funds, and consequently covenants are a mere formality if they exist at all. On the other hand, however, for projects such as exit financing (financing for rapid completion of a reorganization plan) for firms in reorganization, or financing related to an LBO (leveraged buy-out = acquisition using a loan secured by the assets of the acquired entity) that are considered to have a high degree of normal credit risk, not only are restrictions set on the borrower's financial values, provisions to constrain the borrower's management policies are also fixed, based on the credit management guidelines of the lending institutions.

Because a loan will be redeemed or measures to strengthen the protection of the claim such as provision of collateral will be taken at the stage when signs have appeared that should raise a concern, provided the covenants function effectively, R&I can expect the loan to be in an advantageous position vis-à-vis the other obligations. Moreover, even if such actions do not result, the borrower's management will be aware of the covenants and can eliminate dangerous activities that could violate the covenants or curtail adventurous management risks.

Will R&I change a rating based on the covenants?

Can R&I upgrade an Issuer Rating when covenants have been established?

If restrictive financial covenants are established appropriately, and incorporate provisions such as a prohibition against going into other businesses or restrictions or prohibitions on acquisitions or the sale of important subsidiaries, business risk will decrease to some extent. It is impossible to avoid deterioration of the management environment itself, however, and if the loan subject to the covenants is redeemed or the loan agreement is revised, the effects of the covenants will be lost. Therefore R&I believes it is difficult normally, based on covenants, to upgrade an Issuer Rating it has assigned while viewing a firm three to five years into the future as a going concern.

For an individual loan rating, on the other hand, R&I does believe it is possible to assign a rating that is higher than Issuer Rating.

Taking the scheme described above in which “the loan will be repaid if certain events occur” as an example, the key to redemption of the loan in question lies in whether refinancing can be accomplished readily. Creditworthiness tends to fall during the phase when a borrower appears likely to violate its financial covenants, however, and typically the borrower cannot always procure the repayment funds smoothly. Rather, default becomes a real possibility simply because the covenants are in place.

One scheme organized to address such a defect was the syndicated loan for Maruha Group Co., Ltd. that R&I rated in March 2005. This involved a term loan and a commitment line that

was established simultaneously, which Maruha could draw down under certain conditions provided it used the funds to redeem the loan. Based on this credit enhancement from Mizuho Corporate Bank, Ltd. in the form of a commitment line, R&I assigned a rating that was higher than the acknowledged creditworthiness of the borrower firm.

Rating Approach-Probability of Recovery from Collateral

R&I can also apply notching up from an Issuer Rating

After deciding an Issuer Rating, R&I will temper the rating for factors such as agreement terms and conditions and decide the ratings for individual obligations. When there is concern, based on consideration of the degree of recovery after a borrower firm has defaulted, that an obligation will be remarkably subordinated, R&I will assign a rating that is lower than the Issuer Rating (notching down). Conversely, when strong collateral is ensured and there is a strong expectation of recovery, R&I will assign a rating that is higher than the Issuer Rating (notching up).

R&I applies notching down mainly when (1) clear subordination exists under the agreement (subordinated bonds issued by a bank etc., subordinated loan, etc.) or (2) there are many secured obligations or potentially senior obligations and R&I judge the sources of funds for recovery of the rated obligation are remarkably small. Although the meaning is slightly different, R&I will sometimes also apply notching down from the acknowledged creditworthiness of the entire group to the rating of a pure holding company.

This does not, however, mean that R&I will apply notching up to a rating simply because there is collateral. R&I decides the breadth of notching up while tempering its analysis using four parameters, namely the adequacy of the collateral assets compared with the subject obligation, the liquidity of the collateral assets, the degree to which disposal of the collateral will be subject to legal constraints and the period of time until debt recovery is completed (Note 1).

R&I decides the breadth of notching up according to Issuer Rating level and degree of recovery

For collateral asset value, R&I uses the “level that enables the issuer to sufficiently cover principal and interest payments on the target obligation even after a certain amount of stress is applied” as a prerequisite for studying notching up of a rating. In this case, the issuer needs only to be able to recover the nominal value and it is not necessary to adjust the recovery amount to a present value base. The thinking in this approach is that even if the initial amount of the obligation is collected, the recovered amount will be considerably less than the initial claim amount if the claim amount is raised to its present value when a long time is required for collection, but that this is not a problem.

R&I judges the degree of recovery by separately studying the four parameters described above. When a guideline is given for the types of collateral, R&I regards the degree of recovery to be “extremely high” for guarantees, deposits and government bonds that cover the full amount of the principal and interest. For collateral such as bonds and stocks, R&I individually studies

whether to judge the degree of recovery as extremely high, or to assume a lower level, by reviewing creditworthiness and also considering factors such as liquidity and the mechanism for providing additional collateral after applying stress, including price fluctuation risk.

It is difficult to apply notching up for assets with a very high credit correlation. For example, when there is an owner asset management company and control of the stock of a listed subsidiary is in fact its only activity, and assuming the subsidiary company shares are provided as collateral, can there be said to be a credit enhancement effect? Such a conclusion is questionable because the parent company's operating results depend on the performance of the subsidiary, and the asset value of the shares can easily be imagined to fall if circumstances make it necessary to execute the collateral.

In any event, because the degree of recovery is "extremely high," the collateral assets can be converted to cash easily but investors must be able to execute the pledge and recover the loan almost immediately before legal constraints take effect.

In cases it judges to be "high," R&I assumes assets that can be 100% ensured after stress and that appear to have comparatively high liquidity, specifically monetary claims such as loan claims, and negotiable securities not included in the highest rank. If all such assets are of high quality it should be possible for a firm to reorganize quickly and for investors to recover their claim through the reorganization process, or to sell the assets to other companies in the same industry for cash, even if a firm moves to begin civil rehabilitation proceedings. The possibility that security execution will be constrained under the Company Rehabilitation Law and that collection will take considerable time also cannot be overlooked, however, making it necessary to incorporate the probability of such an event into the decision for whatever scenario R&I assumes (Note 2).

Finally, the rank considered as "a little high" includes assets that cannot be considered to be "high" as well as real estate collateral that can be 100% assured after stress. Because real estate possesses strong individual characteristics and its immediate convertibility into cash is limited, however, R&I must ascertain the degree of recovery sufficiently.

For control of the collateral, the agent's role is critical. For assets assumed to exhibit comparatively large fluctuations in collateral value such as equities, for example, a mechanism is required to ensure additional collateral can be secured without delay if a deficiency occurs when the asset is regularly marked-to-market. Depending on the mechanism and the agent's ability, R&I will study responses such as making the weighting severe, or lowering its evaluation of the degree of recovery.

(Note 1) For details, please refer to the press release "R&I Changes Notching Up Policy for Secured Debt" dated February 13, 2006.

(Note 2) Recently it has become possible under the Company Rehabilitation Law to exercise and partial extinguish security without depending on a rehabilitation plan, and procedures to liquidate reorganization security rights from the proceeds of property sales practically also have been established.

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