Treatment of Hybrids in Nonfinancial Corporate and REIT Credit Analysis

Sector-Specific Criteria

This criteria report updates and replaces the previous version, dated September 2012.

Overview of Methodology

Assess and Rate Hybrids: Ind-Ra and Research (Ind-Ra) applies the following guidelines to assess the effects of hybrid securities on the financial leverage or capital adequacy of entities in the corporate and real estate investment trust (REIT) sectors and to rate these instruments.

Three Debt/Equity Categories: Ind-Ra allocates hybrid securities into the following categories: 100% equity, 50% equity and 50% debt, or 100% debt. The decision to use only three categories reflects Ind-Ra's view that the allocation of hybrids and capital securities into debt and equity components is a rough and qualitative approximation, and is not intended to give the impression of precision.

Key Equity Credit and Rating Drivers

Preserving Ongoing Viability Focus: Hybrids are evaluated, in determining equity credit, as to the extent they contribute to financial flexibility and support the ongoing viability of an organization. It is essential to achieve any equity allocation that the terms of the instrument avoid mandatory payments, covenant defaults, or events of default (EODs) that could trigger a general corporate default or liquidity need. Structural features that constrain a company's ability to activate the equity-like features of a hybrid make an instrument more debt like.

Mandatory Conversion: Instruments with mandatory conversion into equity can fulfil many of these equity-like features by reducing interest and principal payment obligations, avoiding covenants and EODs, or absorbing loss. Mandatory convertible securities may receive a maximum 100% equity credit (see the Mandatory Convertible Securities section on page 10).

Meanwhile, optional convertible securities (whether the option is with the issuer, instrument holder, or both) would typically receive no equity credit, except to the extent justified by other features of the instrument.

Issue Ratings Notched from IR: Hybrid instruments with going-concern loss absorption are typically deeply subordinated instruments with very low recovery prospects in liquidation or bankruptcy. Such an instrument will therefore be treated as being highly loss absorbing and rated lower than the issuer rating (IR) for most corporate issuers.

Wider Notching: Ind-Ra regards permanent write-down of principal as a particularly aggressive measure. Ind-Ra will generally rate these instruments at least three notches lower than an issuer's IR. As with other hybrids, wider notching is likely to be deployed if the write-down trigger is viewed as being easily activated.

Scope and Limitations

The terms "hybrid instruments," "hybrid securities," and "capital securities" are applied interchangeably. Ind-Ra's definition encompasses all instruments that are neither common stock nor ordinary debt.

The criteria outlined in this report are directed toward hybrid instruments purchased by unaffiliated investors that are expected to exercise all available remedies. Ind-Ra notes that in most instances in the recent past, hybrid instruments have been issued by an issuing company to a single strategic investor.

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Strategic investors recapitalizing a distressed company or companies injecting capital into a subsidiary frequently use hybrid structures to increase the tax efficiency of their investment. Also, privately issued, single-investor hybrids sometimes include special terms that make the instrument more debt like than it would otherwise appear. In these cases, the implications differ from ordinary capital market instruments, and Ind-Ra's rating committees may apply case-by-case analyses of such hybrids, based on the individual circumstances.

Ind-Ra's method for allocating hybrid instruments into debt and equity components applies across the rating spectrum, for issuers with both investment-grade and speculative-grade IRs. However, in the case of speculative-grade issuers, Ind-Ra frequently considers alternative cases and scenarios, some of which may vary from the pure application of these guidelines.

Rating committees retain flexibility in applying these criteria to specific situations not contemplated in this report.

The general limitations discussed in Ind-Ra's master criteria for corporates, "Corporate Rating Methodology," referenced in the Related Criteria section on page 1 of this report, apply to these criteria as well.

High-Level Principles

Common Equity Is More Versatile than Hybrids

Hybrids can be structured to replicate some of the key features of common equity. However, Ind-Ra views hybrids as less versatile than common equity. Common equity can absorb losses and provide cash flow flexibility with respect to dividend payments. It has no maturity or right for the investor to put the security back to the issuer and lacks any covenants, EODs, or cross-defaults. It has no contractual obligation to make on-going payments. The potential debt-like qualities of hybrid securities include the following:

- The management may feel obligated to continue making scheduled periodic hybrid payments during a period of distress, despite the existence of provisions that permit deferral.
- Many hybrids have either a contractual or an implied maturity, in the case of nominally perpetual instruments issued with an implied expectation of redemption.
- Many hybrids are structured to take advantage of tax regulations, and the issuer may suffer some economic consequences from changes in the tax regime.
- Drag along rights of the strategic investor in hybrid securities, which allow for sale of full or part equity stake of the original promoters to the strategic investor in the event that the company is unable to provide the minimum return on investment guaranteed to the strategic investor. The inclusion of drag along rights would push the issuer to pay coupon interest/dividend even though the issuer may have the flexibility to defer the same.

In addition, many hybrids, including preferred and preference shares, lack going-concern loss absorption features and rank ahead of common equity in liquidation. This reduces valuations for common shareholders, and could hamper the ability of a financially distressed issuer to raise new common equity or hybrid securities in order to avoid bankruptcy. Coupon deferral on cumulative issues would increase the amount of obligations to be paid ahead of new common equity investors in the event of liquidation.

A capital structure with a large reliance on hybrid securities could reduce the issuer's flexibility under the preceding circumstances.

No Limit on Equity Credit from Hybrid Securities in Ind-Ra's Credit Analysis

There is no explicit limit on the amount of equity allocated from hybrid instruments relative to the equity capital of a corporate. Instead, rating committees will review the amount of hybrid equity eligible for inclusion in ratio analysis only in exceptional cases in which the committee considers the issuer's use of hybrid capital unusually great and likely to reduce the flexibility of the capital structure.

Applicable Criteria

Corporate Rating Methodology (January 2017)

For REITs, no threshold exists above which hybrid securities would be treated as debt.

Hybrids Issued by Operating Subsidiaries

Equity Credit (EC) assigned to an operating subsidiary's hybrid is not automatically applied to the parent's ratios. Ind-Ra applies the principles of equity recognition to evaluate whether the equity-like features of a subsidiary's hybrid also benefit the parent. For example, EC will not be applied at the parent level if the subsidiary's hybrid structurally subordinates senior debt at the parent company, or if the deferral of the subsidiary hybrid coupon results in the subsidiary's inability to pay dividends to the parent, thereby reducing going-concern loss absorption for the parent.

Core Analytical Features of Equity like Hybrids

In Ind-Ra's view, a security's equity credit is derived from the financial flexibility provided by the following core features:

- Liquidity flexibility/preservation, e.g. provisions for coupon payment omission or deferral, and no mandatory payments of principal within the rating horizon. An unconstrained ability to defer or omit payments of coupons at the issuer's discretion for at least five years is a prerequisite for equity recognition. Ind-Ra believes that cumulative hybrids wherein deferred coupons accumulate and will have to be paid later are less equity-like than non-cumulative hybrids, which allow omission of coupons.
- Limited or no covenants.
- No EODs or acceleration that could trigger a general corporate default or cross-default that would spread to more senior corporate obligations.
- No maturity, investor put rights, or other features that would force repayment of principal within five years.
- Loss absorption after a general corporate default either by means of deep subordination or principal write-down.
- In case of mandatory convertibles, the earlier the date of conversion, the more likely it is that Ind-Ra will consider the hybrid to be equity-like. This is because the conversion increases the issuer's financial flexibility and does not result in an obligation to repay the principal.

Loss absorption on a going-concern basis (principal write-down or conversion to a more junior form of capital) can enhance the equity-like features of a hybrid, but it is not a required feature for equity credit.

These features may be present in preferred and preference shares and in deferrable coupon subordinated debt hybrids. Instruments with mandatory conversion into equity can fulfill many of these equity-like features by reducing interest and principal payment obligations, avoiding covenants and EODs, or absorbing loss. Mandatory convertible securities may receive a maximum 100% equity credit (see the Mandatory Convertible Securities section). Meanwhile, optional convertible securities (whether the option is with the issuer, instrument holder, or both) would typically receive no equity credit, except to the extent justified by other features of the instrument. For example, a debt-based hybrid security that meets all the criteria to achieve 50% equity credit may have an optional conversion mechanism as an additional feature attached to it. This would neither positively nor negatively influence the equity credit of the overall instrument based on its other features.

Ind-Ra-Defined Equity Credit

Equity credit is an analytical concept that expresses the extent to which Ind-Ra views a security as containing debt like or equity-like qualities when evaluating an issuer's capital structure and financial leverage in support of Ind-Ra's assignment of an IR to the issuer. Hybrid securities are evaluated in terms of their likely effect on the viability of the issuer, and on the issuer's obligations, under the condition of financial stress, regardless of the probability that such financial distress will occur.

Corporates and REITs Entities Differ from Other Hybrid Issuers

Entities in the corporate and REIT sectors are not subject to regulation of their capital adequacy or solvency, which sets them apart from financial institutions and insurers that are more prolific issuers of hybrids. Corporates and REITs are not as confidence sensitive as banks and insurers, and thus, are generally less vulnerable to signaling risk than those sectors.

Measures of debt leverage in the corporates and REIT sectors, such as the ratio of debt to EBITDA or debt to cash flow from operations, are primary credit ratios. The ratio of equity capital to assets is not employed, and debt-to-equity ratios are considered secondary measures. Thus, the focus of the analytical review of hybrids in the corporates and REIT sectors is whether a hybrid security is included in total debt and to what extent.

Another important distinction is the use of forward cash flow-based financial projections in the corporates and REIT sectors as a primary credit analysis tool. Ind-Ra models future debt issuance on retirement and transactions expected to alter debt leverage or capital structure in future years. For a corporate issuer, convertible instruments that will result in future issuance of common equity at a known price and date can play a meaningful role in the projected future financial condition, even in the case of some instruments that qualify for low or no explicit equity credit. See the Mandatory Convertible Securities section for further discussion.

Objective of Hybrid Securities Issuance

Corporates and REITs entities issue hybrid securities in order to access cost-effective financing that provides the added benefit of minimising the risk of default as a going concern during periods of financial distress. Some hybrids are designed to provide a more tax-efficient alternative to traditional equity. The avoidance of default can be achieved by eliminating or delaying the necessity to make any fixed payments, eliminating covenants and EODs, or forcing conversion into equity securities. Secondarily, hybrid instruments are typically deeply subordinated to senior debt and do not dilute the expected recoveries of senior creditors.

Ind-Ra Allocation May Vary from Accounting Standards

Ind-Ra’s decision to allocate part or all of a corporate or REIT issuer’s hybrid instrument to equity or debt is not driven by accounting rules or the classification of the instrument in the issuer’s financial statements.

Ind-Ra’s Analytical Approach for Assigning Equity Credit

In India, the last few years have seen substantial investment from equity funds, most of which are in the form of convertible securities. Such instruments are privately issued, usually single-investor hybrids that sometimes include special terms that make the instrument more debt-like than it would otherwise appear. While many instruments are called ‘Compulsorily Convertible’, the special terms revolve around providing an exit to the investors.

While analysing hybrid instruments, Ind-Ra focuses on the key characteristics of common equity, including the fact that common equity has no maturity or put rights. Many hybrids have either a contractual or an implied expectation of maturity, while being nominally perpetual instruments. Instruments with potential maturity, investor put rights, or other features that would force repayment of principal within the next five years, will not receive any equity credit. For the purpose of the criteria, the first potential maturity date will be considered as the effective maturity date.

Some features that make such hybrid instruments more debt-like can be a ‘put option’ post conversion, which dilute the equity character of these instruments even after conversion. This can be in the form of put option on the issuer, or on the major shareholders of the company, or both. Such conditions normally result in stress to refinance the instrument, often with more onerous terms that can lead to an increase in leverage. Ind-Ra will evaluate the impact of potential exercise of these put options on the operating entity.

Ind-Ra will study the salient features of the term sheet pertaining to the investment in hybrid instruments for first hand understanding of the terms of the instrument and to enable an understanding of the risk absorption nature of the instrument before considering any equity credit. In the event that access to the salient features of the term sheet or relevant documentation of the hybrid instrument is not made available, the agency will desist from assigning any equity credit for the hybrid instrument in its analysis.

Equity credit may not be applied when an event such as a deferral of an IPO triggers an event that Ind-Ra would view as being sufficiently onerous to create an incentive for the issuer to redeem the security. In such cases, the first date on which the trigger event could occur will be considered as the effective maturity date. Such instruments will be analysed as subordinated debt, and an instrument with a remaining effective maturity of less than five years will not be eligible to receive any equity credit.

Negligible coupon rate by itself is not considered to be an adequate reason for assigning equity credit to a hybrid instrument. Ind-Ra will study the other clauses pertaining to a hybrid to assess debt-like qualities (if any) of the instrument before considering any equity credit.

In case of common equity with a buyback clause/return liability, where the option is exercisable against the shareholders of the issuer and not on the issuer, the agency may treat it as equity. However, if the agency believes that the cash flows of the issuer will be tapped in case the option is exercised, no equity credit will be given.

No Adjustment to Coverage Ratios: Ind-Ra uses the full amount of hybrid interest to calculate interest coverage ratios, despite provisions allowing the deferral or omission of payments.

No Limit on Equity Credit: The amount of adjusted equity that can be derived from hybrid instruments is not subject to an explicit cap.

Not Highly Confidence Sensitive: The nonfinancial corporate and REITs sectors are not highly confidence sensitive. Activating the equity-like features of an instrument is unlikely to trigger an entity's financial collapse due to signaling.

Similarities/Differences in Analysis: The credit of both sectors (corporate and REIT) is analyzed with a focus on cash flow measures and projections of an entity's financial condition and liquidity. However, the REIT sector also employs a risk-adjusted capital adequacy measure that is not applied to corporates.

Ratings Assigned to Hybrid Instruments – Notching Relative to Issuer Rating

Ind-Ra normally does not assign ratings to mandatorily convertible instruments or similar instruments that are exclusively redeemable into shares (although equity credit for the same is considered in the analysis).

Hybrid securities are typically notched down from the company's IR. The notches represent the incremental risk relative to the IR, which is a function of increased loss severity due to subordination and heightened risk of non-performance relative to other (senior) obligations. Hybrid instruments that qualify for equity credit are deeply subordinated and typically rated at least two notches below the IR. Those instruments where the going-concern loss absorption features can be easily activated, or those entailing high loss absorption features, including permanent write-down of capital, would be rated at least three notches below the issuer rating. Hybrid instruments that do not combine at least a subordinated ranking in the capital structure and a deferability of interest payments do not receive any equity credit. For example, an instrument that ranks pari passu with other senior debt obligations, but which has a coupon deferral option would not be given any equity credit and be rated at least one notch below the issuer rating. The following table illustrates the notch-down from the IR based on the features of the hybrid instrument

Features of the hybrid instrument	Level of notching below IR
Issuer rated IND A- or above	
Instrument has a coupon deferral option.	One notch below the IR
Instrument has a cumulative nature of coupon payment.	One notch below the IR
Instrument has a non-cumulative nature of coupon payment.	Two notches below the IR
Entails high loss-absorption features, including permanent write-down of capital. The loss-absorption features could be easily triggered.	Three notches below the IR
Issuers rated below IND A-	
The extent of notching would be one notch more than in the above cases to reflect greater risk of default, given the weaker credit profiles of the issuers.	

Application of Equity Credit to Hybrid Instruments

Ind-Ra makes pro forma adjustments to an issuer's financial leverage (gearing) ratios based on the allocation of hybrid securities into debt and equity components. Instruments that are reported as debt or as equity on an issuer's balance sheet may be reallocated from that category and classified as entirely debt, entirely equity, or 50% debt and 50% equity for Ind-Ra's ratio analysis. Ind-Ra uses the resultant adjusted leverage ratios in its fundamental analysis of an issuer.

Figure 1

Allocation of Corporates and REITs Hybrids to Equity and Debt

(% Equity)	Corporates FLR	REITs FLR
Preferred and Preference Shares		
With an Effective Maturity Greater Than Five Years:		
Noncumulative	100	100
Cumulative[b]	50	100
Subordinated Deferrable Debt		
With an Effective Maturity Greater Than Five Years		
Noncumulative Hybrid	100	100
Cumulative Hybrid[b]	50	100
Mandatory Convertible, Deferrable		
Subordinated, Less than Three Years to Exercise	100	100
Subordinated, 3–5 Years to Exercise	50	50
Senior, Less Than One Year to Exercise	50	50

[a] Unless the underlying security would otherwise qualify for higher equity allocation. FLR - Financial leverage ratio. RACR - Risk-adjusted capital ratio.
[b] For cumulative hybrids below 1% coupon will be treated at par with noncumulative hybrids
Note: This is an illustrative summary only, based on typical hybrid features. Please read the full text for further details.
Source: Ind-Ra

Ind-Ra does not make any adjustments to interest or fixed-charge coverage ratios for deferrable and non-deferrable coupon payments because the starting assumption is that the interest on such instruments will be paid. Ind-Ra may use projections or sensitivity cases in calculating coverage ratios for use in rating analysis to assess the flexibility afforded by hybrid instruments.

In the event of negligible coupon interest (INR coupon interest rate of 1% per annum or below), Ind-Ra will treat cumulative instruments on par with non-cumulative ones and assign equity credit accordingly.

Perpetual or Dated Preferred or Preference Shares

Corporate Sector

Ind-Ra applies the criteria below to qualify a preferred or preference security as an equity instrument for a corporate issuer.

Subordination

Traditional preferred and preference shares do not have an explicit mechanism for going-concern loss absorption. However, the weak terms and remedies available to preferred and preference shareholders mean that the holders are not assured of principal or coupon recovery either before or after a general corporate default.

Remaining Term

The securities must be perpetual or have an effective or remaining maturity that is not less than five years. An instrument with a remaining effective maturity of less than five years would receive no equity credit.

Call Date Effect on Permanence

A call date will not be deemed an effective maturity date unless it is accompanied with a coupon step up. However, a coupon step up within Ind-Ra's threshold rate of 2% will not cause the call date to be deemed an effective maturity date if the instrument's offering documents used replacement language to disclose the issuer's intent to redeem the instrument at its call date with either the proceeds of a like instrument or equity. The potential scenarios and their effect on permanence are as indicated in the table below.

Figure 2
Call Scenarios

Coupon Step Up	Coupon Step Up Greater Than threshold rate%	Replacement Language	Call Date Is Effective Maturity Date
No	n.a.	n.a.	No
Yes	No	Yes	No
Yes	No	No	Yes
Yes	Yes	Yes or No	Yes

n.a. - Not applicable.
Source: Ind-Ra

Replacement Language

As long as replacement language is in place (i.e. there is a firm commitment from the management that the hybrid security will provide permanent support to the capital structure), the call date will not be treated as the effective maturity date in instances where the coupon step-up is below the threshold rate of 2%. However, if the step-up is higher than the threshold rate, there would be a strong incentive to refinance, due to which the call date would represent the effective maturity date irrespective of other factors.

Since Ind-Ra is focused on the permanence of the capital structure instead of the permanence of the individual instrument, there is no expectation for the replacement language to be in the form of a legally binding covenant. Where a hybrid security is issued within a group of companies and where the replacement language refers to a group entity other than the issuer (as an alternative replacement issuer, eg. the parent), Ind-Ra will decide on a case-by-case basis whether this is sufficient for the call date to not be considered the effective maturity date. It is not possible to provide an exhaustive list of scenarios where this may come into play. As a general guideline, in most cases, Ind-Ra will not consider such replacement language to be satisfactory.

Extension Options

Some hybrid securities provide the issuer with an option to extend the maturity for a number of years beyond the stated maturity date. In such cases, Ind-Ra treats the original maturity date as the effective maturity, and only when exercise of the extension option has taken place will the extended maturity date become the "new" maturity date.

Ability to Defer Dividend Payments

An unconstrained option to defer or omit payments of coupons for at least five years is a prerequisite for equity recognition. Noncumulative preferred shares would be entitled to up to 100% equity credit, and cumulative preferred shares would receive no more than 50% equity credit.

Ind-Ra does not consider a dividend stopper a constraint to defer or omit coupon payments (*see page 15 for the definition of a dividend stopper*). Also, cumulative interest/coupon deferrals that may only be satisfied using common stock are viewed by Ind-Ra to be noncumulative and may be entitled to up to 100% equity credit.

Ind-Ra notes that an aggregate coupon step-up of up to the threshold rate of 2% would not be viewed as a coupon deferral constraint.

Inability to Trigger a Default

Failure to pay a coupon or redeem at a stated redemption date is not a default. The only remedies available to an investor are limited to blocking payment of common distributions or dividends and/or appointment of director seats.

Exceptions to 100% Equity Credit

Equity credit may not be applied when a deferral or nonpayment of principal or dividend, when due, triggers an event that Ind-Ra would view as sufficiently onerous to create an incentive for the issuer to redeem the security. This may include the following:

- Common shareholders lose all voting control.
- Mandatory conversion to common shares that would excessively dilute the exiting shareholders.

REITs Sector

Ind-Ra views perpetual noncumulative preferred and preference shares, with or without optional call provisions, as equity. The rationale for this treatment is that the noncumulative nature of the preferred stock dividend will not impede the payment of common dividends to maintain REIT status. However, the treatment of cumulative preferred or preference shares would depend on the type of credit ratio.

Risk-Adjusted Capitalization Ratios

Ind-Ra will add 50% of the principal of cumulative perpetual preferred or preference share to debt in risk-adjusted capitalisation ratios. The rationale is that the seniority of accumulated and unpaid preferred dividends relative to common distributions, combined with a REIT's requirement to pay out 90% of its taxable income in the form of common dividends to maintain REIT status, makes these hybrids debt like. However, Ind-Ra has observed that certain REITs have deferred their cumulative preferred dividends due to cash flow stress. The issuers probably had net taxable losses and were likely not obligated to make common distributions to maintain REIT status. The ability to defer dividends without triggering default is a source of equity-like flexibility.

Financial Leverage Ratios

In contrast, perpetual preferred or preference securities, whether cumulative or noncumulative, will generally be treated as equity in financial leverage ratios, given the inability of these securities to trigger a default, combined with a lack of maturity or stated redemption date.

Subordinated Debt Hybrids with Coupon Deferral Features

Corporates and REITs Sectors – 50% Equity Credit

Subordination

The security must be subordinated to all senior creditors. The level of subordination must be consistent both before and upon bankruptcy.

Remaining Term

The securities must have an effective, remaining maturity that is not less than five years in the future. An instrument with a remaining effective maturity of less than five years is not eligible to receive any equity credit.

Call Date Effect on Permanence

A call date will not be deemed an effective maturity date unless it is accompanied with a coupon step up, subject to the criteria discussed below.

A coupon step-up that is less than or equal to Ind-Ra's threshold rate will not cause the call date to be deemed an effective maturity date if the instrument's offering documents used replacement language to disclose the issuer's intent to redeem the instrument at its call date with the proceeds of a like instrument or with equity. The table on page 6 illustrates the potential scenarios and their effect on permanence.

In the event that the coupon step-ups are in increments (for example, 0.25% step-up per call date), the call date will be deemed an effective maturity date at the point the cumulative step-up exceeds the threshold rate of 2%.

Where the step-up involves a switch from fixed-to floating-rate, Ind-Ra will review the effective change in spread to the floating index relative to the implied spread to the index rate at the inception of the financing and compare this with its threshold step-up level.

An issuer's options to redeem an instrument on the occurrence of certain events that change the accounting, tax, regulatory, legal, or rating agency treatment of this instrument will not have an effect on the effective maturity date.

The remaining principles described under the section Call Date Effect on Permanence on page 7 (including comments on replacement language) apply to these securities as well.

Ability to Defer Interest Coupon Payments

Debt-based hybrids that allow optional cumulative deferral of coupon payments for at least five years are eligible for up to 50% equity credit.

Full Discretion to Cancel or Defer Coupons for at Least Five Years

Constraints such as look-back/dividend pusher clauses and parity securities language would negate a security's ability to obtain equity credit.

With regard to mandatory deferral mechanisms associated with Subordinated Debt Hybrids, the principles mentioned under Perpetual or Dated Preferred or Preference Shares on page 9 will apply here as well.

Ind-Ra does not consider a dividend stopper a constraint to defer or omit coupon payments (see page 15 for the definition of a dividend stopper). A provision that enables an issuer to pay dividend subject to all outstanding deferred interest being settled is not considered a dividend stopper. In addition, an aggregate coupon step-up of up to the Ind-Ra determined threshold rate would not be viewed as a coupon deferral constraint.

No Covenants and Limited EODs

Material affirmative or negative covenants, cross-defaults, or cross-acceleration to other capital instruments cause the instrument to be allocated entirely to debt.

EODs that are consistent with the 50% equity and 50% debt treatment include the following:

- Events of bankruptcy and liquidation.
- Failure to redeem the securities after the invalidation of the basic structure.
- Failure to pay amounts due after application of all permitted deferrals.

An example of invalidation would be if a security is structured as a preferred note issued by a special-purpose entity that gains its credit support from its parent company's subordinated guarantee. The invalidation of the underlying subordinated guarantee would render the security's basic structure invalid.

Corporates and REITs Sectors – 100% Equity Credit

A debt-based hybrid would have to replicate all features of noncumulative preferred or preference stock in order to achieve 100% equity credit. The features of such an instrument are similar to those listed earlier for treatment as 50% equity and 50% debt, with the modifications outlined in the following sections.

Subordination

The securities must be subordinated to all senior creditors and senior only to common equity.

Noncumulative Deferrals

A noncumulative deferral hybrid permitting omission of coupons for at least 5 years would be eligible for up to 100% equity credit. Cumulative interest/coupon deferrals that may only be satisfied using common stock are viewed by Ind-Ra to be noncumulative and may be entitled to up to 100% equity credit.

EODs

There is no difference from the EODs that are consistent with 50% equity credit.

Exceptions to Equity Credit

An exception would be in the case of a corporation operating in a confidence-sensitive business, whereby the deferral or omission of dividends or failure to redeem or call an instrument could undermine viability. In this case, Ind-Ra may view any call date as an effective maturity date and/or apply either 50% equity credit or no equity credit, depending on the situation and as determined by a committee. Ind-Ra does not expect this to be common in corporates or REITs sectors.

Mandatory Convertible Securities

Corporates and REITs Sectors

IRs in the corporates and REITs sectors are determined by an analysis that focuses on forward projections of the issuer’s financial condition and cash flow. Thus, equity credit for hybrids is not the sole means of reflecting the effects of hybrid instruments on capital. Using the financial projection model, Ind-Ra can model the exercise of mandatory convertible securities or synthetic equity units if these instruments are present in the capital structure. Instruments of this type are used to some extent in the corporates sector but are uncommon in REITs.

100% Equity Credit

Conversion or Exercise

Conversion or exercise has been established at a predetermined date and does not hinge on a trigger event.

Resulting Instrument

Instruments must convert to common equity, preferred or preference shares, or a hybrid instrument that would receive 100% equity credit under this criteria report.

Conversion Date

Instruments subordinated to all senior creditors must convert within three years of issuance or have remaining tenure of three years.

Exchange Price or Ratio Fixed

The conversion rate or ratio is fixed at issuance or has limited flexibility within a predetermined band.

An issuer should have authorization or capacity to issue the required number of shares to complete any conversion. Equity credit may be reduced to 50% or to zero if Ind-Ra has concerns that the exchange terms might create significant incentives to take actions that would weaken an issuer’s credit quality in order to avoid excessive dilution (e.g. securities repurchase or asset sales).

Full Discretion to Cancel or Defer Coupons for the Remaining Life of the Instrument

Features such as look-back/dividend pusher clauses and parity securities language would negate a security's ability to obtain any equity credit. In addition, cumulative interest/coupon deferrals that may only be satisfied using common stock are viewed by Ind-Ra to be non-cumulative and may be entitled to up to 100% equity credit. Instruments where the issuer has an option to settle via stocks are considered cumulative.

Ind-Ra does not consider a dividend stopper a constraint to defer or omit coupon payments *(see page 15 for the definition of a dividend stopper*). Also, an aggregate coupon step-up of up to the threshold rate would not be viewed as a coupon deferral constraint.

Remedies for Any Event Defaults Are Limited to an Accelerated Conversion

EODs should only trigger an accelerated conversion. The only permitted exception is an event of default triggered by bankruptcy or liquidation. Under this event, remedies do not need to be limited to an accelerated conversion.

50% Equity Credit

The following features modify the list of requirements above for mandatory convertible securities to achieve 50% equity credit.

Resulting Instrument

The instrument must convert to common equity, preferred or preference shares, or a hybrid instrument that would receive at least 50% equity credit under these criteria to achieve equity credit.

Conversion Date

Conversion must take place within five years of issuance if the instrument is subordinated to all senior creditors. Conversion must take place within one year if the instrument is a senior obligation.

Exceptions

Such securities may be treated as 100% debt if Ind-Ra has material concerns about the near-term viability of an entity and there is no automatic conversion to the resulting instrument upon the issuer's bankruptcy.

Equity Units

Synthetic equity units are offerings that combine a fixed-income instrument such as a subordinated hybrid note, a senior note, or more rarely, preferred or preference shares with a forward purchase obligation to purchase equity or similar securities at a known exercise price, so as to simulate the features of a mandatory convertible instrument. The fixed-income instrument serves as collateral for the investor's commitment to the stock purchase agreement.

Ind-Ra will model the exercise of the forward stock purchase commitment on the exercise date in accordance with the terms of the transaction in forward financial projections. New equity is contributed upon exercise of the stock purchase agreement, which is reflected as common equity both in the issuer's financial statements and in Ind-Ra's equity credit analysis.

No Equity Credit

All instruments that do not fall into the categories above will be treated as 100% debt in ratio calculations.

Optional Convertible Securities

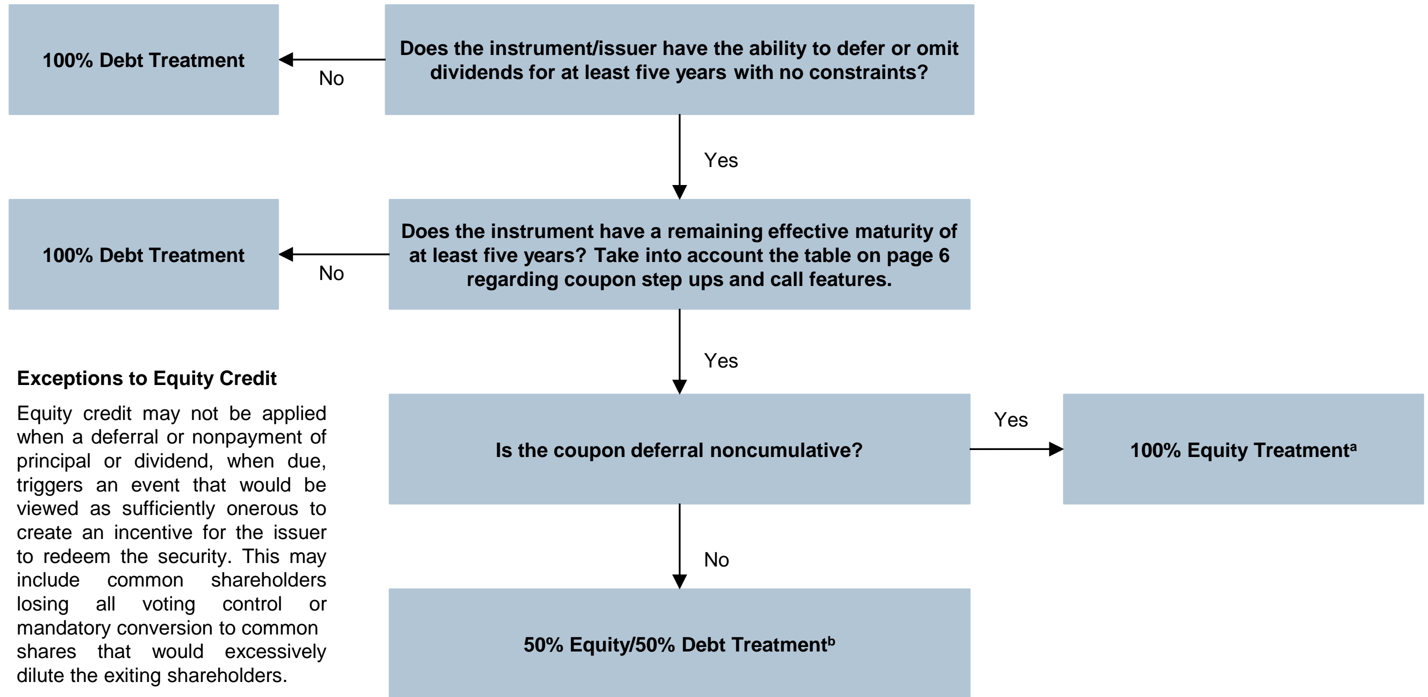
These instruments, whether the option is with the issuer, instrument holder, or both, will be treated as debt in all cases, unless the instrument has other features that would allow it to fit into one of the categories listed above. This reflects Ind-Ra's continued view that optional conversion cannot be relied upon during stressful circumstances, and in many cases, conversion would be viewed as unlikely. If a portion of the principal of optional convertible securities is classified as equity in the issuer's balance sheet, Ind-Ra will reduce equity and allocate the full value of the instrument as debt.

Appendix A

The following three decision trees are intended to help readers and users evaluate instruments using the criteria outlined in this report.

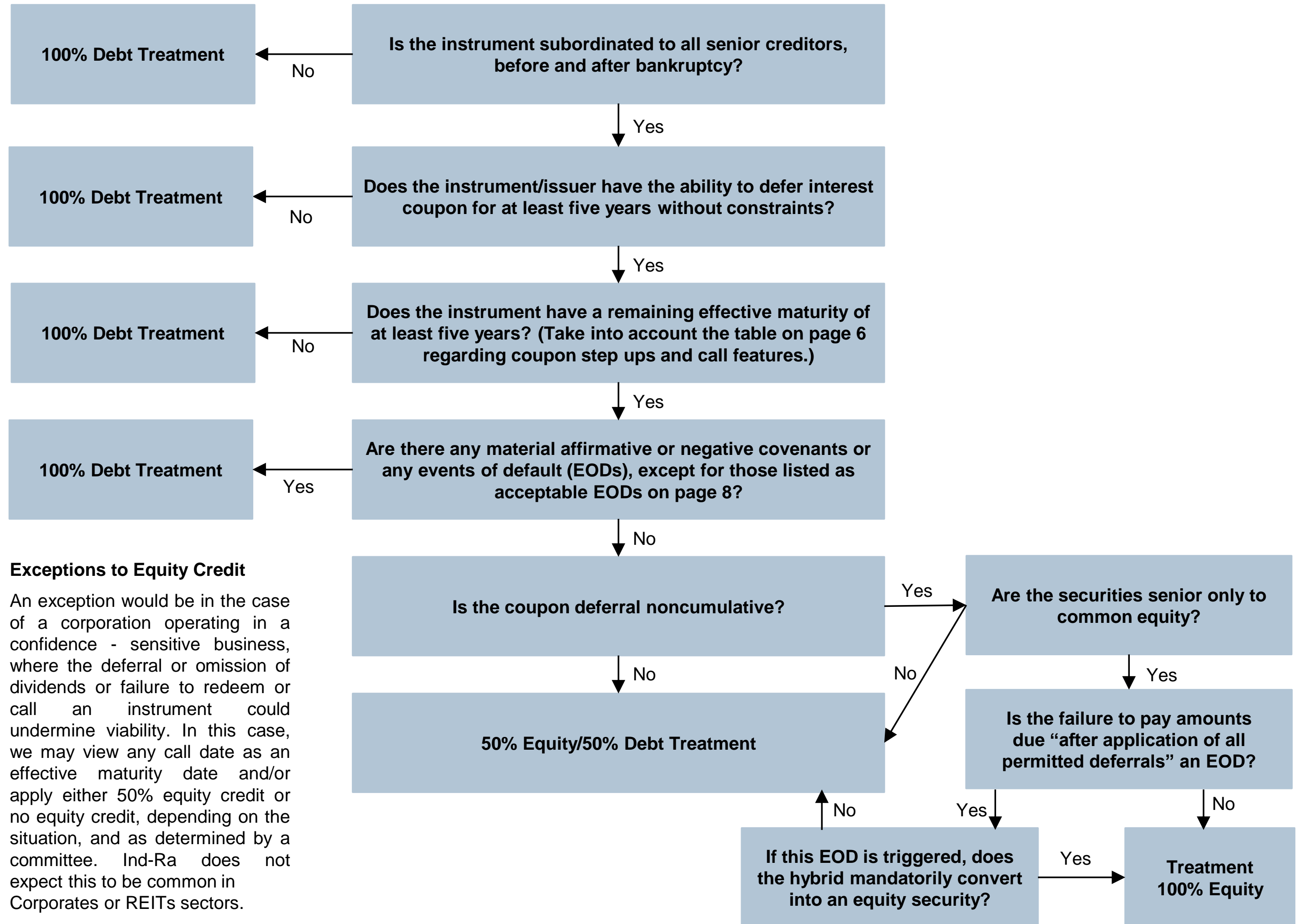
Figure 3

Decision Tree for Corporate and REIT Preferred or Preference Shares



[a] For REIT RACR: 50% equity/50% debt treatment. [b] For REIT FLR: 100% equity treatment. RACR – Risk-adjusted capital ratio. FLR – Financial leverage ratio.
Source: Ind-Ra

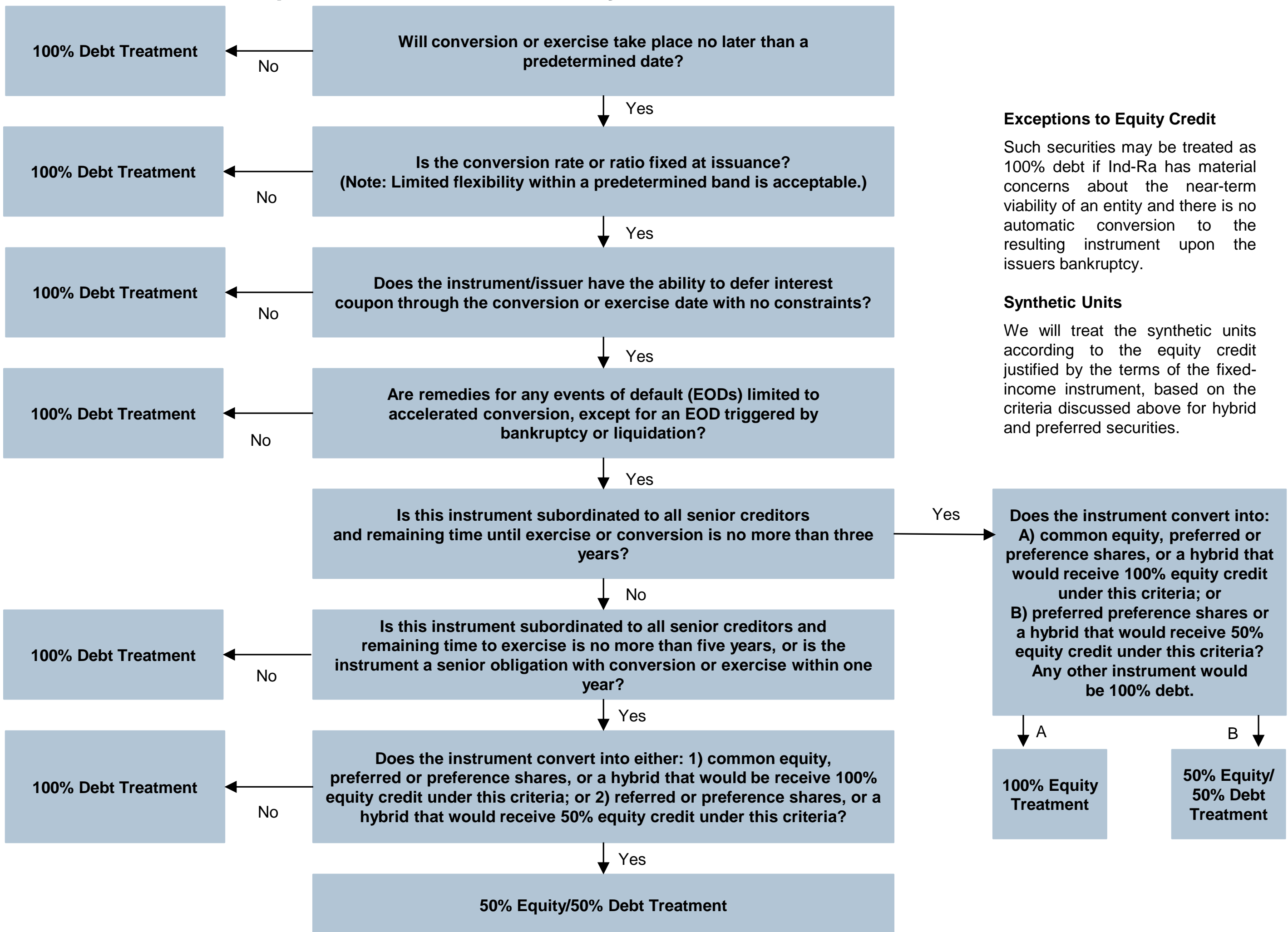
Figure 4
Decision Tree for Corporate and REIT Debt Based Hybrids



Source: Ind-Ra

Figure 5

Decision Tree for Corporate and REIT Mandatory Convertible Securities



Source: Ind-Ra

Appendix B — Glossary of Terms

Constraints on Deferral: Hybrid instruments may include terms that limit or constrain the issuer's right to exercise the option to defer coupon payments. The existence of such constraints will result in an instrument being treated as 100% debt. Constraints include limitations on the deferral period; look-back provisions, also known as dividend pushers (see below); provisions requiring the issuer to attempt to issue equity securities in the market; and use the proceeds to pay the deferred or omitted coupons (alternative settlement mechanism). Ind-Ra does not consider a dividend stopper a constraint to defer or omit coupon payments.

Dividend Stopper: Refers to a clause in the security agreement that if an issuer omits or defers a distribution to hybrid or preferred holders, the issuer is barred from paying distributions or dividends on common shares or more junior classes of capital securities until it resumes or comes current on the hybrid payments.

Dividend Pusher: Another term for a look-back provision. (See below.)

Effective Maturity: Represents Ind-Ra's opinion as to the most likely length of time the instrument or equivalent replacement will remain within the issuer's capital structure. Effective maturity is driven by a number of factors, including the final scheduled maturity, if any; call options and related incentives to call; and replacement language, including replacement capital covenants (see below).

Look-Back Provision: The most common form of deferral constraint is the look-back provision, sometimes referred to as a dividend or coupon pusher. Under a look-back provision, the issuer cannot take advantage of its option to defer its payment obligation to the investors of the hybrid security if a specific reference event (or events) has occurred within a certain time prior to the hybrid payment date.

The most common reference events are the declaration or payment of a dividend to holders of common equity, share repurchases, or any other form of distribution to common shareholders. In some cases, the reference event may include coupon payments on any instruments that are at a parity with or junior to the hybrid instrument in question, rather than just ordinary share capital. A provision of this sort can effectively eliminate the issuer's ability to defer. Such provisions often require prospective planning on management's part to enact a deferral, which is inconsistent with having flexibility to defer or omit the payment on the hybrid instrument. Look-back provisions are sometimes called dividend pushers, since the occurrence of the reference event results in a fixed obligation to pay the hybrid coupon on the required date, eliminating the opportunity for deferral.

Replacement Language (or Replacement Intention): An intentional commitment or legally binding covenant that informs investors of an issuer's intent and commitment not to redeem the hybrid security at the hybrid's optional call date unless the instrument is redeemed using the proceeds of an equally or more equitylike instrument. Clear disclosure to investors in the offering materials is adequate, and Ind-Ra does not require the replacement disclosure to be in the form of a legally binding replacement covenant. Ind-Ra presumes the date of an issuer's call option, in combination with a coupon step-up, is the effective maturity of the hybrid instrument, absent such replacement language (please refer to "Call Date Effect on Permanence" sections for preferred and preference shares and subordinated debt hybrids).

Step-Up: A provision for increasing the hybrid's coupon rate at specified times, or upon certain events.

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