Corporate Methodology Framework

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1   Introduction

1.1   Scope of Criteria

This document presents the methodology applied by Sovereign Africa Ratings (SAR), for assigning short-term and long-term issuer credit ratings to non-financial corporate entities. The purpose of this document is to provide an overarching framework for the analytical process applied by SAR. This includes an overview of the key pillars assessed by the rating agency, as well as the qualitative factors taken into consideration when determining a credit rating.

The Corporate rating methodology will be applied together with industry/sector-specific methodology applicable to the entity which is the subject of the rating analysis. For example, some of the metrics assessed in the rating analysis of a consumer retail entity e.g. sales and stock turnover, will not be relevant when assessing the creditworthiness of a property fund where investment property value and rental income are more pertinent. In each case, SAR will specify all relevant methodologies and related research utilized in its analysis when publishing the final ratings. Should any conflict arise between this criteria document and any industry-specific methodology subsequently published, then the industry-specific methodology will prevail.

2   Overview

The corporate rating methodology is intended to provide a guideline for the analytical steps involved in the relative ranking of issuers in the market. To achieve this, SAR will assign a score to each relevant variable detailed in this methodology, as well as in the industry-specific methodology applicable to each rated entity as a measure of the risk assessed for that variable. In each case, the variable that is assessed and scored as part of the rating process is considered a relevant attribute of the issuer that can provide a relative indication of their ability to repay their debt obligations.

The analytical team will rely on publicly available information together with detailed insights provided by the rated entity, making adjustments where necessary. This will include but is not limited to the annual financial statements, budgets, verbal representations, and regulatory submissions. SAR reserves the right to determine whether the amount of information at its disposal is sufficient to conduct an analysis and assign a credit rating.

SAR's corporate rating methodology comprises four main pillars, each weighted according to the significance it bears on the overall creditworthiness of an issuer. The individual pillars are listed below:

Pillars	Attributes
Operating context	Country Risk
	Industry Risk
	Regulatory Compliance
	Competitive Advantage
Business performance	Environmental, Social, and Governance
	Financial Standing
	Factor 1: Revenue generation and profitability
	Factor 2: Cash flow and liquidity
	Factor 3: Resources and capital structure
Credit profile	Debt Burden
	Debt Service
Peer review & Adjustments	

Beneath each pillar are several attributes that will be assessed and individually scored in accordance with the applicable criteria, including but not limited to the industry-specific criteria applicable to each issuer. Ultimately, the score assigned to each variable under the relevant attribute contributes to SAR's overall opinion on the ability of each issuer to repay their debt obligations. SAR has developed industry-specific models where appropriate weights are assigned to each variable. Once the overall score has been determined, a rating committee will discuss and determine the appropriate issuer rating assigned to the issuer based on SAR's conversion table illustrated in Appendix 1.

2.1   Pillar 1: Operating Context

This Corporate methodology details the principles and analytical approach used by SAR to assign issuer credit ratings to entities that are registered to conduct business according to the rules applicable in the relevant jurisdiction of operation. The ratings provide an opinion regarding the relative ability of an issuer to repay their debt obligations thereby creating a ranking of creditworthiness. The foundation for this opinion is formed by assessing the environment in which the entity operates, thereby capturing the risks associated with the robustness and efficiency of legislative, political, and economic risks expected to impact all market participants where the rated entity conducts its business. This creates a common floor for the score that can be assigned to entities whose operations are limited within the same jurisdiction (i.e. having the same sovereign government).

Attribute 1 Country risk

Each rated entity will initially be assigned a country risk score based on the creditworthiness of the country where the entity has significant operations. This will extend to a combined analysis of any sovereign-related risks that may arise if the entity has exposure to multiple countries either through recorded income or asset holdings. For corporate entities, SAR will consider the contributions to the overall country risk score based on the scores assigned to each country where the entity has an exposure, weighted by the relative size of asset holdings or revenue generated from each country. The relevant measure used to determine the weighting of the scores in each case will be disclosed in the credit rating report.

SAR will rely on its assigned sovereign credit rating for any country forming the subject of an issuer's rating analysis. However, if no such rating is assigned for a particular country, the analyst(s) will perform an assessment and present a recommended score for that country as part of the analysis.

Attribute 2 Industry risk

Similarly, conditions of the local industry in which an entity operates also contribute to its credit risk profile. SAR will assign an industry risk score based on the industry sector that best describes the nature of the entity's day-to-day business or service delivery. Some issuers will have exposure to multiple industries and SAR will calculate the weighted industry risk score based on contributions to the overall business from each industry. The metric used to determine the weightings for each industry will be disclosed in the rating report.

The industry risk score assigned by SAR captures the dynamics and reflects the strengths and weaknesses of the issuer's specific industry of operation. It will also account for the relative size and stability of the industry by assessing its contribution to national gross domestic product (GDP), barriers to entry, business cyclicality, and prevailing trends, as well as the presence of any correlation with macroeconomic indicators. SAR will periodically review the industry risk scores its assigns, based on the latest available information and to reflect prevailing market conditions over time. An industry such as healthcare which is characterised by stringent regulation, high barriers to entry and relatively inelastic goods/services will have a higher industry risk score when compared to an industry with high cyclicality, discretionary demand, and high execution risk such as construction.

Based on SAR's framework-driven approach, issuers that operate in the same industry and out of the same jurisdiction will have equal country and industry risk scores reflecting the same exogenous risks associated with their operating environment. The industry risk score for a particular sector will vary from one country to the next depending on the individual characteristics of each market including the stability of the economy, the sophistication, and effectiveness of the judicial system, as well as the level of technological advancement.

Attribute 3 Regulatory compliance

Regulatory compliance is the first entity-specific attribute that can either add to the issuer's cumulative risk score or result in a negative adjustment. SAR will consider whether the issuer is obligated to confirm any form of compliance, over and above the minimum requirements to operate as a going concern, that serves to eliminate business risk(s). This will range from requiring specialised licensing or undergoing periodic independent reviews, to honouring specific reporting requirements or following industry best practices. In each case, SAR will assess the entity's compliance with applicable regulation to the extent that this does not overlap with other attributes (i.e. where an entity is required to report its leverage metrics, the leverage assessment will be undertaken as part of the credit profile review and not in this section).

Scoring for this attribute may be positive where there is sufficient evidence that the entity is required to comply with risk-mitigating measures (failure of which would not necessarily jeopardise their status as a going concern). A negative score would be assigned where such compliance was breached, or if an entity opts not to comply with industry best practices that are deemed essential for mitigating prevalent risks. Where no compliance is required or there is no regulation in place, the compliance score will be neutral.

As an example, where two entities require the same annual renewal of operating licenses, Company A will have a better compliance risk profile than Company B if Company A has managed to successfully comply with the annual license renewal, while Company B has periods where it did not comply with the license renewal requirement. Furthermore, if Company A opts to subscribe for a special designation granted by a recognised industry regulator to entities who undertake to provide specific reporting based on distinguishable criteria aimed at mitigating risk, this may qualify them for a positive adjustment to their regulatory compliance score.

Attribute 4 Competitive advantage

The last attribute of the Operating Context relates to the issuer's competitiveness within the markets where it operates. This attribute will have a high score where the entity has an obvious competitive advantage such as owning patents or operating as a monopoly. In addition to that, SAR will consider other factors (or lack thereof) which add to the entity's competitive advantage, thereby providing additional mitigation against a deterioration in the ability to repay debt in the event of an industry-wide downturn. The competitive advantage score assigned is not a reflection of any one characteristic of the issuer, rather it provides a holistic view of the position occupied by the entity in the market, relative to peers and other market participants.

SAR will assess the diversity of operational lines and stability of income from each stream when determining the competitive advantage score. For entities with diverse operations, each significant business line will first be assessed on a standalone basis relative to peers in the market and based on its historical performance. Competitive divisions with a strong customer base and stable high profits will support a high competitive advantage score,

whereas having multiple business lines that are relatively weak compared to their peers and that have poor historical performance will result in a low score. Vertically integrated entities that have strong and stable divisions which create synergies within the group and lead to the retention of profits will be positively considered.

The competitive advantage attribute will be viewed positively for large entities that benefit from economies of scale. For relatively smaller entities that cannot rely on scale to mitigate their cost base, SAR will positively consider any special arrangements, concessions, or other forms of risk mitigation employed by the entity, to the extent that these are not conditional and can be relied on over a reasonably foreseeable period. The use of bespoke technological tools that are not readily available to other market participants may also support a strong competitive advantage score. Lastly, some consideration will also be afforded to other non-tangible factors such as the influence of brand ambassadors and general brand strength.

2.2   Pillar 2: Business Performance

After determining the environmental context in which an entity conducts its business, SAR will then examine entity-specific characteristics of the issuer and start to build a view of the issuer's profile. This will be aimed at establishing insights about the issuer's operations and strategic initiatives, to determine their sustainability. A borrowing entity will be expected to have a sustainable business model, that can withstand business cycles and a degree of stress to achieve a high credit rating. Beyond being a going concern, the profitability of an issuer underpins its ability to repay debt obligations, and the attributes scored under this pillar all provide an indication of the issuer's strength as an operating entity.

A qualitative assessment of the sustainability of the business will be centered around their demand capacity and any positive externalities from supply-side relationships. The business should be seen to have strong enough fundamentals to continue operating profitably under stressed scenarios/environment in order to get a strong score. A track record of achieving beneficial strategic initiatives and navigating market cycles with agility will be positively considered.

Attribute 1 Environmental, Social & Governance Factors

As part of the assessment of environmental, social, and governance factors, SAR will focus on the policies that are in place to drive the impact that an entity has on the environment. The ESG score will be supported by entities whose operations are considered 'green' by virtue of them focusing on recycling, utilising renewable energy, or minimising pollution, among other considerations. Conversely, the score will be negatively impacted where it is determined that the business has a significantly negative impact on the environment, e.g. inappropriate disposal of toxic waste. Furthermore, the ESG score will be positively impacted where sufficient evidence can be provided to show that the entity makes a significant contribution to effecting positive social change. This includes but is not limited to pursuing

equitable employment, being a responsible corporate citizen by giving back to the community and screening suppliers to avoid engaging unscrupulous entities.

The governance factor will focus on the leadership team of the issuer as well as the internal policies regarding the management of issues such as board selection, conflicts of interest, and internal audits. As a start, SAR will review the entity's organisational structure, including the composition of its board, and presence of independent directors, and the competence of its executive management team. The assessment will include a review of the qualifications, tenure, and diversity of the leadership team, with a negative view taken for unduly high personnel turnover or apparently ill-equipped management teams. Furthermore, the score will incorporate a view of the entity's data management systems and controls that are in place to ensure compliance with local and international industry best practices, as well as reporting transparency.

Attribute 2 Financial Standing

The second attribute assessed for a rated entity is its financial standing, determined by evaluating financial statements and budgets. SAR will rely on an issuer's latest annual financial statements and will make adjustments in order to gain relevant analytical insights and enhance the comparability of financial statements for entities that may adopt different reporting methods. Further to that, the analysis will incorporate forecast financial performance based on entity-specific budgets, subject to internally generated parameters for expected performance within specific industry segments.

Scoring of this attribute will be based on the perceived risks regarding the fundamental factors supporting business stability and performance, which are key to an entity's ability to service its debt obligations. The analysis will focus on three quantitative factors that SAR will score, namely i) revenue generation and profitability, ii) cash flow and liquidity, and iii) resources and capital structure. Due to the nature of certain businesses, these factors may be further augmented to include additional ratios that describe the well-being of the entity's financial standing, in which case, this will be detailed in the industry-specific criteria.

Attribute 2, Factor 1: Revenue generation and profitability

Revenue generation is assessed from a qualitative and quantitative perspective. The qualitative view will consider the nature and quality of income, as well as the capacity to sustain revenue generation in a stressed environment. Consistent and/or guaranteed lines of revenue (e.g. an agreement to be the exclusive supplier of goods/services) that are not exposed to any exchange rate risks, or arrangements to fix the cost base over a period of time would be positively considered. This is combined with a quantitative analysis of historically observed income statement results, as well as SAR-generated forecast performance. A negative score will indicate poor and/or unstable earning potential or weak margins relative to the industry average, while a positive score is an indication of the capacity to generate high returns consistently, which translates to stable profits.

The quantitative analysis will first focus on the entity's top-line performance, assessing the entity's earnings relative to its peers in the market. The earnings before interest, taxes, depreciation, and amortisation (EBITDA) ratio will be used as a measure of the strength of an entity's earning potential. In some cases, the nature of an issuer's business will render this ratio less insightful; however, in which cases, an alternative measure such as the operating profit or net income ratio will be utilised instead. Furthermore, gross and net profit margins are expected to be competitive and stable in order to support a high score for this attribute. In each case, the analysis will consider the historical average, the most recent results, and the forecast level relative to the sector average. Similarly, the entity's cost base will be assessed for efficiency, stability, and the prevalence of exceptional or non-cash items that can fluctuate reported profitability and potentially be over- or understated to counter other macroeconomic factors.

To achieve a strong score, an entity will typically exhibit stable revenue flows through the business cycle, with well-contained and cash-based costs that support margins at a level higher than the industry average. Income that is recurring and originates from a diversified customer base would also be positively considered. From a cost perspective, a low proportion of fixed overhead costs coupled with minimal non-cash expenditure that is highly predictable would support a strong score.

Attribute 2, Factor 2: Cash flow and liquidity

When analysing the cash flows of an entity, SAR will determine the quantum of cash generated and whether that is sufficient to meet the cash outlays required to sustain the business. This will include an assessment of whether cash is deployed appropriately for investing, financing, and operational purposes. An entity's operating cash flow will be expected to be stable and potentially exhibit a positive trend in order to support a positive score for this factor. As a measure of the cash-generating power of an entity, SAR will calculate the ratio of operating cash flow to total cash income over time. This is used as a measure of the robustness of cash generation from core operations, albeit positive cash flow from investments and financing activities will be positively considered as an indication that the business does not rely on a single source of cash income.

Investment and financing cash flows are generally expected to exhibit volatility on account of the potential for single large cash movements at points in time when significant acquisitions/disposals are undertaken. As such, the cash-generating power ratio will be calculated over at least 3 years, or the relevant horizon applicable to the entity when determining core returns. This will account for the expected volatility in investment and financing activity over the short term. Looking at these cash flows over time will also allow SAR to establish trends in respect of cash deployed for these purposes, whether positive or negative returns are prevalent for the entity.

The amount of available cash is the cornerstone of the liquidity analysis. Nonetheless, any other highly liquid instruments will be taken into account when determining the issuer's

capacity to meet upcoming obligations. A haircut may be applied for instruments whose value is dependent on market dynamics, such as share price, or for instruments that are not deemed to be easily liquidated. SAR will calculate the coverage provided by available cash resources against all debt principal and interest repayments, contingent liabilities, operational expenses, and potential investment outlays (including dividends). This liquidity coverage ratio is expected to be a minimum for entities with sufficient liquidity. When the ratio is less than one for a particular entity, this indicates significant liquidity risk and the potential for at least one upcoming obligation to not be met timeously.

Attribute 2, Factor 3: Resources and capital structure

The resources and capital structure analysis will focus on the entity's balance sheet and the impact that the positional statements have on the long- and short-term capacity of the issuer to repay its debt obligations. The resources available to the entity, quantified by the total assets, provide a benchmark for the relative scale of operations, while further insight may be gained by assessing the proportion of long-term and short-term assets relative to long-term and short-term liabilities, respectively. Depending on the underlying business of the entity, having a significant asset base is considered beneficial as it is likely to bring about economies of scale in an industry such as manufacturing, or it may be a direct indicator of value, as would be the case for a real estate investment trust (REIT).

SAR will ascertain the efficiency of an entity's capital structure by analysing the composition of capital, the protection against losses at a senior unsecured level, and the enforceability of legal rights in favour of or against senior unsecured lenders. Typically, any subordinated instruments (including equity) provide a cushion against losses for senior unsecured debt in the business, albeit very high levels of equity funding will come at a significant cost. The scoring for this factor will be supported by a well-managed weighted average cost of capital (WACC), together with a diversified pool of capital that eliminates any concentration risk in respect of funding sources. Qualitative adjustments may be applicable to the score depending on the risk policies applied in respect of capital (e.g. hedging or the lack thereof), the presence of cross-default clauses, and contingent liabilities from subsidiaries or guarantees, among others, which will be assessed on a case-by-case basis.

2.3   Pillar 3: Credit Profile

The credit profile scoring reflects how robust the entity's credit support structure and coverage metrics are. The comfort level for leverage is dependent on the industry sector, the nature of debt undertaken, as well as the ability to service outstanding debt from internally generated funds, all of which SAR will analyse. The issuer ratings assigned by SAR are an indication of the likelihood of repayment of senior unsecured debt issued by an entity and so they translate into the issuer's creditworthiness.

Typically, senior unsecured debt is issued as the highest-ranking liability in an entity's capital structure, with mezzanine, junior, and equity instruments available below it to absorb any incurred losses before a loss can materialise at the senior level. Unless specifically structured to differentiate the ranking of senior debt instruments (e.g. senior secured obligations), all senior obligations will rank *pari passu* and carry the credit rating assigned to the issuer. SAR will conduct a separate analysis of secured debt to determine whether any uplift is applicable on account of the additional security supporting such instruments.

Attribute 1 Debt burden

The quantum and type of debt issued by an entity is the first attribute assessed under this pillar. Heavily indebted issuers will inherently carry higher financial risk due to elevated interest costs, refinance risk, as well as limitations on strategic flexibility, particularly where creditors' consent is required to execute significant investments or to secure additional funding. SAR will assess the level of indebtedness of an issuer based on its leverage ratios, subject to the industry sector, business cycle, and strategic initiatives being pursued. The assessment will be based on the ratio of total debt to total assets, as well as the total debt to total equity. Entities that have high leverage ratios relative to their industry average will be considered to be relatively highly indebted, and this will negatively impact the score for this attribute, whereas conservative leverage will support positive scoring.

Furthermore, SAR will establish the entity's debt appetite by calculating the ratio of utilised debt relative to total available debt as a proxy for the issuer's debt capacity. This will also serve the dual purpose of establishing the issuer's available debt facilities at a point in time, which will be expressed relative to the average annual debt consumption for that entity to estimate the potential longevity of the business should it not manage to acquire any additional debt. A strong debt burden score would be supported by having a relatively low debt appetite characterised by a low proportion of utilised available debt facilities. Nevertheless, SAR will not penalise entities that strategically maintain available debt facilities at a minimum due to having a low debt capital requirement, as this will inherently bear the financial benefit of a lower interest expense.

Attribute 2 Debt service

The scoring of this attribute relies on quantitative measures of the issuer's ability to make all relevant payments associated with their outstanding debt, including interest and principal. This will be determined by calculating the debt service coverage ratio of the issuer (adjusted to exclude leases that are recognised as debt under International Financial Reporting Standards (IFRS) 16). A debt service coverage ratio (DSCR) of less than one will be considered weak and result in negative scoring, while a positive score would require a DSCR of at least 1.5x. Further to that, the issuer's interest coverage ratio will be calculated and tracked relative to historical performance and industry averages, with an interest coverage ratio (ICR) of at least 2x required for a positive score.

SAR will also assess ratios that express the total debt relative to measures of income. In particular, the net debt to EBITDA[1] ratio and the net debt to operating cash flow ratio provide an indication of whether income generation is robust enough to support the levels of outstanding debt and enhance the timely repayment of the debt as it matures. To support a positive score, these net debt ratios should be maintained at low levels. Adjustments may be necessary to avoid understating the net debt position due to movements in cash prior to reporting.

Where possible, SAR will assign a risk score to each of the ratios discussed above, however, one or more of these ratios may not be informative or even relevant for some industries. Likewise, entities in other sectors may have their own ratios (not mentioned above) that are tracked or reported to provide insight regarding the servicing of debt. In those circumstances, the relevant ratios will be outlined in the sub-sector-specific criteria. SAR will expect that any debt covenants that are applicable to an issuer will form part of the ratios listed above. If not, the rating analysis will extend to the relevant covenant, and a positive or neutral score will only be achievable if the covenant is not in breach.

Qualitative Adjustments

All of the abovementioned ratios will be individually scored, and the average will be taken as the base score for the attribute. Several factors in relation to the debt profile will be assessed further and may require negative qualitative adjustments to be made to the score assigned for that attribute. These include:

i)   the concentration of debt provider(s). Issuers should ideally have diversified sources of funding;
ii) lumpy debt maturity profile. Issuers should ideally have minimal bullet maturities or structured solutions to mitigate against refinancing risk;
iii) covenant compliance. Issuers should ideally comply with all relevant covenants;
iv) unhedged exposure. Issuers should ideally mitigate against currency and interest rate risks.

2.4   Pillar 4: Peer Review & Adjustments

The last pillar is a balancing factor that looks at the aggregate of all the assigned scores and incorporates positive or negative adjustments based on entity and industry-specific factors that may not be explicitly reflected in the pillars and attributes discussed above. This will be at the discretion of the analyst(s) performing the rating analysis and subject to the overall committee's decision, and will be documented in the rating announcement and detailed report.

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[1] earnings before interest, taxes, depreciation and amortization

Further, it must be noted that within a particular country, the government is generally considered to be the most secure credit within the local market. This translates into a local government rating being the highest achievable rating and may impact issuers operating in that particular country through the country score attribute. Exceptional circumstances, including significant holdings/revenue from economies with a better credit profile and/or exceptional credit fundamentals, may result in an issuer receiving a higher credit rating than that of its local government, indicating that the rated entity is sufficiently shielded against the local economy. This is due to the fact that SAR's assessments are based on the merits of the rated entity, which may at times result in better credit ratings than those of its home country.

Appendix 1: Converting Scores into Ratings

The SAR methodology generates a score calibrated on a scale given below. The points are from 0 up to 1000 in line with the corresponding credit ratings from D to AAA.

A rating of AAA is assigned for scores of 800 points and above out of 1000, whilst the least rating of D is assigned to scores below 200 points.

The table below is used to convert scores into ratings. Scores from 500 and above are investment grade while scores equal to and lower than 499 are in the speculative grades.

Converting Scores into Ratings

SOVEREIGN AFRICA RATINGS: CONVERTING SCORES INTO RATINGS						
	SAR Tier Grade	Points Allocation		SAR Numeric Rating System (%)	Long Term	Short Term
Investment Grade ≥ 50%	1 - Exceptional (Prime): ≥ 80%	Tier 1: 800+	1	≥80	AAA	A1+
	2 - Very Good (High Grade): 70% - < 80%	Tier 2: 700-799	2	76,7 – 79,9	AA+	A1
			3	73,4 – 76,6	AA	
			4	70 – 73,3	AA-	
	3 - Above Average (Upper Medium Grade): 60% - < 70%	Tier 3: 600-699	5	66,7 – 69,9	A+	A2
			6	63,4 – 66,6	A	
			7	60 – 63,3	A-	
	4 – Average (Low Medium Grade): 50% - < 60%	Tier 4: 500-599	8	56,7 – 59,9	BBB+	A3
			9	53,4 – 56,6	BBB	
			10	50 – 53,3	BBB-	
Speculative Grade < 50%	5 - Below Average: (Non-Investment Grade) 40% - < 50%	Tier 5: 400-499	11	48,4 – 49,9	BB+	B1
			12	46,7 – 48,3	BB	
			13	45,1 – 46,6	BB-	
			14	43,4 – 45,0	B+	B2
			15	41,8 – 43,3	B	
			16	40 – 41,7	B-	
		Tier 6: 300-399	17	36,7 – 39,9	CCC+	C

	6 – Poor (Substantial Risks): 30% - <40%		18	33,4 – 36,6	CCC
			19	30 – 33,3	CCC-
	7 - Very Poor (Extremely Speculative): 20% - < 30%	Tier 7: 200-299	20	26,7 – 29,9	CC+
			21	23,4 – 26,6	CC
			22	20 – 23,3	CC-
	8 - Default: < 20%	Tier 8: 0-199	23	0 – 19,9	D	D