METHODOLOGY FOR ASSIGNING CORPORATE CREDIT RATINGS (NON-FINANCIAL NON-HOLDING COMPANIES) – SHORT PUBLIC VERSION

The Methodology presented is a short public version.

1. General definitions

This methodology describes a system of factors and weights used in the process of assigning credit ratings to corporates.

Final international credit rating of a company represents the opinion of Rating-Agentur Expert RA GmbH on the ability of the company to fulfill its financial liabilities to the full extent and in a timely manner, *taking into account external stress- and support-factors and adjustments for country and industry risk*.

Stand alone credit rating of a company represents the opinion of Rating-Agentur Expert RA GmbH on the ability of the company to fulfill its financial liabilities to the full extent and in a timely manner, *without taking into account external stress and support-factors, adjustments for country and industry risks etc.*

This methodology is used to assign ratings to **non-financial non-holding companies** (by defining in which creditworthiness class the company belongs to).

The level of creditworthiness of the company must be assessed as equal to the level of creditworthiness of another entity[1] in the following cases:

- The company's creditworthiness must be assessed based on the financial statements of the parent company, if the following conditions are satisfied:

    - the company raises funds in the bond market where the parent company is located

    - the parent company is a guarantor of the rated company's obligations

- The company's creditworthiness must be assessed based on the financial statements of the subsidiary company, if the following conditions are satisfied:

    - the company does not carry out operating activity

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[1] In exceptional cases, the rating can be assigned on the basis of the company's own financial statement even if indicated conditions are satisfied.

- the company owns stocks or shares in the authorized capital of only one subsidiary "operating" company, and its share in the ownership structure exceeds 95%

- consolidated financial statements are not prepared

- the amount of debt not translated to the level of the subsidiary, does not exceed 10% of the equity

The main users of the rating are creditors. Other users are investors and counterparties of the company whose interest is focused on the possibility of full and timely fulfillment of the company's liabilities, as well as the company's prospects for fulfillment of new liabilities (taking into account possible changes in the economic environment).

The rating assessment of the company can be used for organizing and conducting tenders.

The rating is also useful for managers of the company and its founders as an indicator of the management performance.

2. Sources of information

2.1 While assigning a rating score, the following sources of information are used:

- Standard questionnaire

- Forms of financial statements № 1, 2, 3, 4, 5 (according to RAS) for three completed years

- Forms of financial statements № 1, 2 (according to RAS) as of the last reporting date

- Consolidated financial statements according to IFRS or US GAAP with auditor reports for the last three completed years, and as of the last reporting date (if any)

- Market researches for the key markets for the rated company prepared for the last 12 months (if any)

- Description of the organizational structure in form of a chart

- Officially approved company's development strategy or excerpt from this document with key quantitative and qualitative indicators

- Forecasted cash flow for the next 2 years, broken down by quarters

- Appraiser's report on the value of fixed assets, portfolio of securities and other assets, prepared not earlier than 3 years ago

2.2 The Rating Agency does not control the correctness of accounting and statistical forms, and the reliability of information included in these forms.

2.3 The Agency shall contact the company for an explanation of the indicators provided in the financial statements and questionnaire. If differences between internal statements and official reporting forms are found, the Agency shall prioritize the analysis of the internal statements. The presence of these differences is considered as an additional risk factor.

2.4 The Agency has the right to use other sources of information in case of data incompleteness.

3. Structure of the rating analysis

3.1 The creditworthiness analysis of the company has several levels. The **final international credit rating** is obtained by adjusting the **credit rating of the company** by the Country and Industry Risk (CIR). The **credit rating of the company** is the assessment of the company's creditworthiness taking into account support- and stress-factors, which have external nature. The **stand alone credit rating** is based on the analysis of company's **financial stability** taking into account only support- and stress-factors, which have internal nature.

3.2 The analysis of the company's **financial stability** includes analysis of three sections: business risk analysis (1), financial risk analysis (2) and corporate risk analysis (3). Each section is divided into several large integral factors.

3.3 Several indicators are assessed within the framework of the analysis of each integral factor. Indicators within each integral factor may be equal to one of the following values:

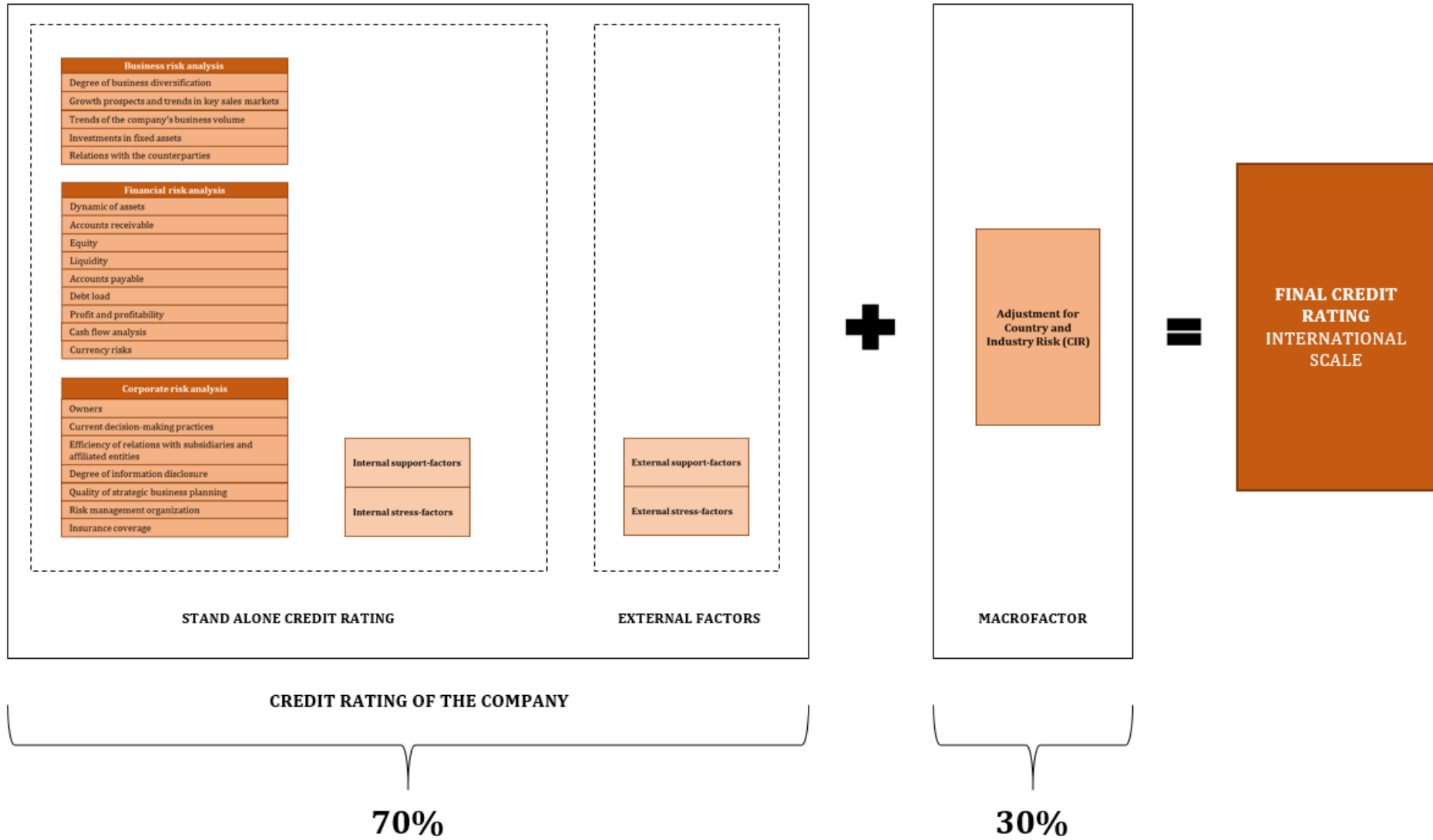| 1	The factor (indicator) has a positive influence on the creditworthiness level
0,5	The factor (indicator) has moderately positive influence on the creditworthiness level
0	The factor (indicator) has neutral influence on the creditworthiness level
-0,5	The factor (indicator) has moderately negative influence on the creditworthiness level
-1	The factor (indicator) has a negative influence on the creditworthiness level

3.4 The score for each integral factor is determined as a sum of scores for separate indicators within a group being weighted in a certain manner. Weights of each section are provided in the **List of indicators and corresponding weights** (see Annex 2).

3.5 The rating score is determined as a weighted sum of scores of all integral factors.

3.6 To determine the **stand alone credit rating of the company,** the rating score must be adjusted taking into account internal support- and stress-factors. To determine the **credit rating of the company,** the rating score for stand alone credit rating must be adjusted taking into account external support- and stress-factors (positive and negative external influence of the owners and the government) (see Part 5).

3.7 The **credit rating of the company** is then adjusted by the CIR in order to obtain the final international credit rating (see logic scheme) Rating-Agentur Expert RA GmbH publishes **only final ratings in accordance with the international scale** (stand alone rating may be published only upon specific request from the rated entity).

Logic scheme:

Business risk analysis
Degree of business diversification
Growth prospects and trends in key sales markets
Trends of the company's business volume
Investments in fixed assets
Relations with the counterparties

Financial risk analysis
Dynamic of assets
Accounts receivable
Equity
Liquidity
Accounts payable
Debt load
Profit and profitability
Cash flow analysis
Currency risks

Corporate risk analysis
Owners
Current decision-making practices
Efficiency of relations with subsidiaries and affiliated entities
Degree of information disclosure
Quality of strategic business planning
Risk management organization
Insurance coverage

Internal support-factors

Internal stress-factors

External support-factors

External stress-factors

Adjustment for Country and Industry Risk (CIR)

+

=

FINAL CREDIT RATING INTERNATIONAL SCALE

STAND ALONE CREDIT RATING

EXTERNAL FACTORS

MACROFACTOR

CREDIT RATING OF THE COMPANY

70%

30%

4. System of Indicators

4.1 Business risk analysis:

- Degree of business diversification

  High sector diversification of products and services produced has a positive impact on the credit rating of a company. If the company is active only in one sector, it is considered to be a risk factor. At the same time, if the sectors, in which the company is represented, are subject to the same set of risk factors, then they are considered to be a single sector. High regional diversification of sales and production facilities allows to minimize economic, political and social risks, which has a positive impact on the rating level. It is considered to be a risk if production facilities as well as product sales are concentrated in a single region. The product sales opportunities through exports has a positive effect on the assessment of its geographical diversification.

- Growth prospects and trends on key sales markets

  The fact that a rating object is primarily focused on growing or operates in non-cyclical sectors, has a positive effect on the rating level of the company. Company's activities in stagnating market segments, is considered to be a risk factor.

- Trends of the company's business volume

  Stable and positive growth rates of actual and projected company's cash flows have a positive impact on the rating level. A slowdown in growth rates or a negative dynamic and volatility of the cash flows negatively affect the rating level.

- Investments in fixed assets

  Substantial investments in fixed assets are considered by the Agency to be a prerequisite for the maintenance of the current level of production and stable cash flows of the company in the future. Lack of investment in fixed assets as well as a high level of depreciation of the fixed assets are considered by the Agency as risk factors.

- Relations with counterparties

A high level of counterparty diversification in the cost of sales and revenue structures reduce the level of company's counterparty dependence, which has a positive impact on the rating level. Also, a high concentration of customers and debtors makes the company dependent on its counterparties' payment discipline and willingness to cooperate, which negatively affects the rating level. Low diversification level of suppliers reduces the potential for the cost control and increases dependence of the manufacturing process on the supplier's reliability.

4.2 Financial risks analysis:

- Dynamics of assets

  We consider that a steady positive growth in assets affects the rating in a positive way. If assets show a constant increase in recent years and the potential to keep pace in the following years, it means that the company is growing in general. However, while doing the assessment, we also analyze the main factors contributing to this growth. A positive assessment would generally be that assets' growth is mainly financed by increases in profits and, thus, retained earnings converted into cash or other investments. Nonetheless, asset growth could also be financed by debt, high levels of which could negatively affect company's creditworthiness.

- Accounts receivable

  A low share of accounts receivable in the total amount of assets is positive for the creditworthiness of the company. This means that, combined with a high sales margin, the entity is capable of cashing in or reinvesting most its revenues. Furthermore, a positive diversification of the company's debtors would be shown by low concentration of accounts receivable in one or a small amount of customers. Finally, a high share of short-term receivable is considered positive due to the fact that the company shows no long-term credits to customers.

- Equity

  A steady increase in equity is credit positive for the entity as it means that the company is expanding either by having higher profits (retained earnings) or there is additional paid in capital. Increasing assets through equity as compared to liabilities, is generally a positive factor for the company as it reduces the share of debt in the overall balance sheet and increases the growth prospect of the entity.

- Liquidity

A high degree of coverage of current liabilities of a company adjusted for liquidity by current assets has a positive impact on the rating level. Substantial excess of sources of liquidity over usage of liquidity has a positive impact on the rating level. A possibility of a liquidity gap emergence in a horizon of up to one year (for example, in the case of the large debt payments) negatively affects the rating level. An excess of total assets adjusted for liquidity over total liabilities of a company has a positive impact on the rating level.

- Accounts payable

A small share of accounts payable in the overall liabilities along with a low expenses to sales ratio is positive for the company as it means that it has low obligations with suppliers. In addition, a low short-term expense ratio to current assets means that the company is well protected regarding liquidity in this regard, i.e. any short-term accounts payable could be easily paid in case of any unfavorable conditions.

- Debt load

A high degree of coverage of both and short-term and long-term debt with company's cash flows has a positive impact on the rating level. A lack of sufficient cash flows to cover debt repayments is considered by the agency as a risk factor. A diversified structure of creditors has a positive impact on the assessment of company's debt burden.

- Profit and profitability

A high operating margin as well as an ability of a company to show a high and stable financial result on capital, assets and revenues has a positive impact on the rating level.

- Cash flow analysis

A low turnover of accounts receivable and accounts payable is positive as the company generates constant cash flows and has reduced long term liabilities with suppliers. Furthermore, a high coverage of (interests payable) by the cash flows from operating activities (CFO) shows that the company has enough funds to pay interests after satisfying all the operating expenses have been covered. Finally, we use the ratio

of external debt to cash flow from operating activities (FFO) to analyze how much FFO the company needs in order to payout the full amount of debt.

- <u>Currency risks</u>

Absence of currency disproportionalities in the incoming and outgoing cash flows (natural hedge), as well as in the current assets and liabilities has a positive impact on the rating level of a company. Presence of derivatives that allow to remove currency imbalances in the cash flows of the company, has a positive impact on the rating level.

4.3 Corporate risks analysis:

- <u>Owners</u>

A transparent ownership structure dominated by a controlling shareholder has a positive impact on the rating level. An incomplete disclosure of the beneficiary structure of the company and a non-transparent ownership chain which does not allow to assess the impact of company's shareholders on the company is assessed as a risk factor. Absence of the controlling shareholder increases the risk of corporate conflicts, which has a negative impact on the company's rating level.

- <u>Current decision-making practice</u>

Existence of formal documents regulating activities of the CEO and the board of directors, as well as documenting of the key decisions made, affect the rating level positively, as it enables more in depth evaluation of the decision-making policy in the company.

- <u>Efficiency of relations with subsidiaries and affiliated entities (SAs)</u>

Absence of loss-making SAs, poor financial performance of which requires additional financial injections from a parent company, as well as presence of the parent company representatives in management of SAs, allowing for a greater control of their activities, have a positive effect on the rating level.

- <u>Degree of information disclosure</u>

A high level of information transparency and notably financial disclosure allows company's counterparties (in particular customers and creditors) for a more in-depth assessment of its risks, which has a positive impact on the rating level.

- Quality of strategic business planning

  Presence of a formal development strategy under condition that the plans specified are achievable taking into account company capabilities and market conditions has a positive impact on the rating level. Insufficient level of strategy disclosure or absence of it as such, is considered to be a risk factor by the agency, as it reduces the quality of the management decision-making.

- Risk management organization

  Evidence of satisfactory risk management practices are positive for the creditworthiness of the company. This is shown by assessing whether or not the entity has a special department dedicated to measure the different types of risks to which the company is exposed.

- Insurance coverage

  It is credit positive for the assessment of the entity when its assets, especially those carrying a high amount of risk, are covered by insurance. Furthermore, we also take into account the quality of the coverage by analyzing the creditworthiness of the insurance companies which provide the service.

4.4 Rating score adjustments

To determine the **stand alone credit rating of the company,** the rating score must be adjusted taking into account internal support- and stress-factors. To determine the **credit rating of the company,** the rating score for **stand alone credit rating** must be adjusted taking into account external support- and stress-factors (positive and negative external influence of the owners and the government).

In case of identifying a moderate internal stress-factor (internal support factor) the rating score can be reduced (increased) by half of a rating level (10 points). In case of a strong internal stress-factor (internal support factor) the rating score can be reduced (increased) by one rating level (20 points). The following internal stress- and support factors are used for rating score adjustments:

Internal stress factors:

- Funds in "troubled" banks[2]

- Effect of non-monetary transactions

- Short period of the company's existence

- Influence by debt burden

- Poor asset quality

- Other stress factors (according to the expert's opinion there are some facts which are not considered in the methodology but which can have a moderate/ strong negative effect on the company's stand alone creditworthiness)

Internal support factors:

- Market position (the company is included in the Ranking "Expert 400" from RAEX (Moscow) (open source[3]) and the company is included in the list of "Strategic Russia enterprises [4]")

External stress-factor (external support factor) is a factor which is not directly connected with the financial condition of the company, but it is able to have a significant negative (positive) impact on the level of the company's creditworthiness. In case of identifying a moderate external stress-factor (external support factor) the rating score can be reduced (increased) by half of a rating level (10 points). In case of an external strong stress-factor (external support factor) the rating score can be reduced (increased) by one rating level (20 points). The following internal stress- and support factors are used for rating score adjustments:

External stress factors:

- Influence by the owners

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[2] Banks which have credit rating at the "B++" level or below according to the national scale from RAEX (Moscow) (or with comparable rating from another rating agency with good reputation), or banks without rating.
[3] http://raexpert.org/related_activities/researches/expert400/
[4] This list was developed by the Government Commission on Sustainable Development of the Russian economy in February 2015. The List includes 199 enterprises. The Organizations included in the list have a priority for government support in case of economic crisis or financial problems.

- Other stress factors (according to the expert's opinion there are some facts which are not considered in the methodology but which can have a moderate / strong negative effect on the company's creditworthiness)

External support factors:

- Support from the government

- Support from the owners

5. System of indicators for the Country and Industry Risk (CIR)

5.1 Section *"Country Score"*

The purpose of this section is to assess the state of the credit environment in the economy (-ies), where the company has its main operations, through a thorough consideration of both the Sovereign Risk and the Banking System Risk (BSR).

5.2 Section *"Industry Score"*

Under this group of factors we analyze the industry (-ies) in which the company has its main operations, through a close assessment of cyclicality and barriers to entry of the respective industry (-ies).

Annex 1. List of factors and corresponding weights for the assessment of the credit rating under international scale

Factor	Weight
I. Business risks analysis	**20,0%**
Degree of business diversification	
Growth prospects and trends on key sales markets	
Trends of the company's business volume	
Investments in fixed assets	
Relations with counterparties	
II. Financial risks analysis	**60,0%**
Dynamics of assets	
Accounts receivable	
Equity	
Liquidity	
Accounts payable	
Debt load	
Profit and profitability	
Cash flow analysis	
Currency risks	
III. Corporate risks analysis	**20,0%**
Owners	
Current decision-making practice	
Efficiency of relations with subsidiaries and affiliated entities (SA)	
Degree of information disclosure	
Quality of strategic business planning	
Risk management organization	
Insurance coverage	
IV. Internal stress-factors*	
Funds in "troubled" banks	
Effect of non-monetary transactions	
Short period of company's existence	
Influence from debt burden	
Poor asset quality	
Other stress factors	
V. Internal support factors*	
Market position	
TOTAL – STAND ALONE CREDIT RATING	
VI. External stress-factors*	
Influence by the owners	
Other stress factors	
VII. External support factors*	
Support from the government	
Support from the owners	
TOTAL – CREDIT RATING OF THE COMPANY	
CIR score adjustment	
TOTAL – FINAL CREDIT RATING IN INTERNATIONAL SCALE	

*See Point 5 "Rating score adjustment" in the description above.

Annex 2. List of factors for the assessment of the Corporate Industry Risk (CIR)

Factor	Weight
Country Risk	0-75%
Industry Risk	25-100%
FINAL CIR SCORE	

Annex 3. List of rating classes

Credit rating assigned by Rating-Agentur Expert RA GmbH is defined on the basis of allocating the company to one of ten rating classes (for both types of ratings – stand alone credit rating and credit rating) (international scale).

AAA - Highest level of creditworthiness

In the short-run the company will ensure timely fulfillment of all its financial liabilities, both current and contingent, with exceptionally high probability. In the mid-run there is a significant probability that the liabilities will be fulfilled even in case of significant unfavorable changes in the macroeconomic and market indicators.

AA - Very high level of creditworthiness

In the short-run the company will ensure timely fulfillment of all its financial liabilities, both current and contingent, with very high probability. In the mid-run there is a significant probability that the liabilities will be fulfilled if the macroeconomic and market indicators remain stable.

A - High level of creditworthiness

In the short-run the company will ensure timely fulfillment of all its financial liabilities, both current and contingent, with high probability. In the mid-run the probability of fulfilling the liabilities requiring significant payments depends greatly on the stability of the macroeconomic and market indicators.

BBB - Moderately high level of creditworthiness

In the short-run the company will ensure timely fulfillment of all its current financial liabilities, as well as small- and medium-sized contingent liabilities with high probability. Probability of financial difficulties in case of incurred contingent liabilities requiring significant lump-sum payments is considered as moderately low. In the mid-run the probability of fulfilling the liabilities depends on the stability of the macroeconomic and market indicators.

BB - Sufficient level of creditworthiness

In the short-run the company will ensure timely fulfillment of all its current financial liabilities, as well as small- and medium-sized contingent liabilities with high probability. Probability of financial difficulties in case of incurred contingent liabilities requiring significant lump-sum payments is considered as moderate. In the mid-run the probability of fulfilling the liabilities depends on the stability of the macroeconomic and market indicators.

B - Moderately low level of creditworthiness

In the short-run the company will ensure timely fulfillment of almost all of its current financial liabilities with high probability. Probability of not fulfilling incurred contingent liabilities requiring large payments is moderately high. In the mid-run the probability of fulfilling the liabilities depends on the stability of the macroeconomic and market indicators.

CCC - Low level of creditworthiness

In the short-run the probability of not fulfilling occurring financial liabilities of the company is high.

CC - Very low level of creditworthiness (close to default)

In the short-run the probability of not fulfilling financial liabilities of the company is very high.

C - Lowest level of creditworthiness (partial default)

The company is not ensuring timely fulfillment of part of its financial liabilities.

D - Default (Bankruptcy)

The company is not ensuring fulfillment of all its financial liabilities / the company is going through the bankruptcy procedure.

One of the above rating levels (the company's creditworthiness and company's stand alone creditworthiness) that can be assigned to the company (excluding AAA and ratings below CCC) may be supplemented with (+) or (-) sign depending on the value of the rating score).