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Frequently Asked Questions: How Does GCR View State Owned Entities Within the Context of Existing Criteria?

Scope

This Frequently Asked Questions ("FAQ") publication on State Owned Entities ("SOEs") applies to issuer credit ratings and issue credit ratings (on both national and international scales) which have a meaningful component of Government interest, either directly through shareholding or indirectly by licensing and regulation. SOEs are considered to be a subset within a broader industry. As such ratings for SOEs and other National Government-controlled companies are conducted under the Criteria for Rating Corporate Entities. State-owned banks, finance companies and insurers would be assessed under the Criteria for Rating Financial Institutions, Criteria for Rating Financial Services Companies, and Criteria for Rating Insurance Companies respectively.

This FAQ publication is not separate criteria and should be read in conjunction with Criteria for the GCR Rating Framework, and GCR's Rating Scales, Symbols and Definition, as well as the above referenced sector criteria, all of which are available on our website. GCR has published this research to clarify for users of our ratings (both Issuers and Investors) how we account for the unique and often conflicting characteristics within the broader sector Criteria.

Frequently Asked Questions

Why do SOEs exist?

SOEs can be established in almost any sector of the economy, but tend to be concentrated in industries that provide critical public services, and dovetail with the core responsibilities of the Government. SOEs are also common in sectors where a very long-term investment horizon, or a protected market position, is necessary. Therefore, in many parts of the world, utility companies (electricity, water or telecoms) tend to be SOEs, as well as companies that develop and operate fixed infrastructure (rail and roads networks, airports, and harbors). In many jurisdictions SOEs also operate across the transport value chain (public bus services, trains and airlines).

SOEs in the financial Sector are generally set up to provide financial support to sectors or projects where funding from private sector financial institutions may not be available or may be prohibitively expensive. Most often this applies to industries with a strategic role in the broader economic context (even if returns in the sector would not be sufficient to attract meaningful investment), or to industries that play a critical social role (such as support for farming). In addition, SOEs may serve to reduce funding risk for start-up investments, or in support of other social objectives.

What makes SOEs a unique subset within the rating criteria?

SOEs exhibit a unique mix of both private and public sector institution characteristics. On the one hand, SOEs are usually partially or wholly owned by the national government of a particular country, or fall under some regional jurisdiction within a country. Even where the entity may have been privatised, the provision of services and the pricing thereof tends to be highly regulated. On the other hand, SOEs tend to operate as corporatised legal entities, with a distinct Board of Directors and a management structure similar to that of private sector entities.

Another distinction from more common private sector companies is that SOEs are often required to deliver on a dual and sometimes conflicting mandate. They are tasked with providing a critical social service, while also returning a profit to the national government (or at least avoiding losses). However, in many cases the fees that can be charged for service provision are not sufficient to cover the cost of provision, even though there are clear social benefits that cannot be fully quantified. This gives rise to a unique set of challenges that general companies, whose primary motivation is profitability, do not experience. On the other hand, SOEs may enjoy the benefits of government ownership, monopoly positions, access to policy makers and preferential funding, which can all strengthen their corporate profile.

GCR will always weigh these strengths and weaknesses with reference to the particular entity under assessment. Generally, the greater the regulation in an industry is, and the more reliant an SOE is on the national government for financial support, the greater the differentiation from traditional private sector corporate characteristics. Both the strengths and weaknesses, and how they impact GCR's assessment of credit strength are discussed in more detail through this research.

How does GCR define an SOE?

SOEs are companies established under the auspices of the national government to operate as independent (or semi-independent) legal entities. Typical characteristics of SOEs include;

- They are wholly or partly owned by the national government
- They have a distinct board of directors and management team, albeit the government often has voting control or the ability to appoint officers or directors
- They are generally granted some operating autonomy, but subject to strict regulation and service delivery targets
- They provide a service on a commercial basis, although the government may subsidise the cost of service provision. The entity may also derive income from government appropriations, tax revenue, licenses, fees, or royalties
- They would likely be funded by the government even if they do not break even.

There is a wide spectrum as to the extent of operational and financial autonomy that a particular SOE may have. On the one hand there may be very little distinction between the SOE and the national government. In essence, such SOEs act as an implementing agency of the national government and are likely to be almost completely financially dependent on the national government. At the other end of the spectrum are SOEs that operate in commercial sectors where there is meaningful private sector competition. Such companies may enjoy some benefits (or evidence some weaknesses) due to their position as an SOE, but the analysis would be in line with that for corporate entities in the same sector.

How does GCR factor in Government Support into its analysis?

Due to the ownership structure or their scope of operations, SOEs will often benefit from government support. Support factors may be built into the very business model or may extend to beyond operational considerations to additional support under difficult or exceptional circumstances. Support may be explicit or implicit. There may be a track record of support, or evidence of a lack of support in practice.

Support factors that are inherent to the business model are built in to the scoring for the 'Business Profile' and 'Financial Profile' components. For example, an SOE that has a monopoly on the provision of a particular service, could be assumed to have strong government support because of the special access to the relevant government department and minister it would likely enjoy. In fact, in many instances such SOEs are involved in the formulation of government policy in their area of operations. GCR would likely reflect such interlinked relationships in a stronger 'Business Profile' score, given the SOE's critical position in the specific industry.

An SOE's 'Financial Profile' score could also be much stronger than that implied by the credit protection and liquidity metrics because of demonstrated government support. For example, where an SOE has few committed bank facilities and little cash, it would likely have a very poor liquidity score. However, GCR could take into account the government's historical track record of funding the entity, which will often involve special transfers to the SOE just ahead of upcoming capital spending or debt redemption to meet its obligations. Even though these transfers are not committed and the exact timing may be uncertain, the track record of always ensuring sufficient liquidity to meet all requirements would be taken into account in adjusting the liquidity ratio.

Government support beyond that implied by the operating model is considered within the context of the 'Comparative Profile' component. Such additional support may be explicit or implicit. Where there is explicit support for an SOE's debt or for specific issues, the SOE or the issue credit rating can be equalised with the arm of government providing the guarantee (as detailed in the Criteria for the GCR Ratings Framework, section 6.4).

Implicit support within the 'Comparative Profile' is more subtle and will depend on the assessed importance of the SOE to the national government. In essence GCR will look to determine how likely the national government will be to provide exceptional financial support to the SOE. Support is considered more likely for entities that provide critical social services, or underpin economic activity. This is because the national government has a strong incentive to ensure that such entities continue to provide their services to the population or carry out necessary development work. Nevertheless, less important SOEs may also benefit from government support

GCR will not, however, provide issuer credit ratings uplift to the level of the national government in cases of implicit support. Rather, GCR's government support floor will be applied to all SOEs likely to benefit from extraordinary support. (Full details of the government support floor can be found in the Criteria for the GCR Ratings Framework, section 5.6.) Uplift will, however, only be given to SOEs in countries where the government has a track record of intervention and the capacity to support (as signified by a country risk score more than 3). Domiciles with fiscal constraints or legal/operational blockages to support typically have limited or no uplift.

What role does legislation play in the analysis of SOEs?

Because many SOEs often operate under sector specific legislation, an assessment of the applicable legislation that governs the industry and the establishment of the SOE is critical to provide a clear understanding of the obligations of the SOE and its pricing mechanisms, as well as delineate the relationship with the industry regulator. The various conditions and regulations will have on impact on GCR's assessment across 'Operating Environment', 'Business Profile' and 'Financial Profile' assessments.

In particular, an understanding of the authority granted to the industry regulator is necessary as this authority could, in different circumstances, support or weaken the competitive position of an SOE. Evidence of a productive working relationship between the authority and the SOE is important in assessing its market position and the sustainability of operations. Key to ensuring a productive relationship is transparency in the mechanisms for determining minimum service delivery targets (obligations of the SOE) and for calculating tariff rates (compensation for the SOE). Conversely, efficient operations will be impeded where there are multiple levels of bureaucracy and an uncertain legislative environment.

Where an SOE's revenue may be limited by legislated tariffs or the need to provide some free services, GCR will investigate the mechanism for determining tariffs or other pricing mechanisms. Tariffs should be set at a rate that adequately compensates the utility for all expenses incurred in service provision, including the depreciation of assets and the funding costs of new equipment. However, GCR recognises that in many jurisdictions, and particularly in developing economies, tariffs may not fully reflect the total cost of service provision. Accordingly, GCR may consider the extent to which tariffs meet cash operating costs on a sustainable basis.

Given the inherent tensions between the political and management arms within SOEs, how does GCR assess management and governance?

GCR's assessment will follow the universal management & governance criteria. However, this is overlaid with analysis that focusses on the potential conflicts of interest and opportunities for malfeasance that arise from the intersection between commercial and political interests.

The composition of the Board, and the Board committees is important as it attests to the operating independence of an SOE. Where the Board is weighted towards political appointments, rather than independent professionals, this would imply greater political interference in the utility's operations. Similarly, Board actions that overstep into the general operations of the utility or seek to influence appointments, is indicative of political meddling and would be considered ratings negative. Conversely, the demonstrated ability of executive management to take actions for the benefit of the utility, even if they are politically unpopular, point to an entity with operational independence.

Internally, GCR expects an SOE to have all the necessary policies in place to limit opportunities malfeasance or political influence. This includes a clear policy for how to conduct business with politically exposed people and how to manage general conflicts of interest, both internally and with clients. Strong supply chain oversight is also critical to ensuring that funds are spent correctly. GCR may refuse to provide a rating or will severely penalize an entity's rating if these conflicts are not adequately dealt with. The incidence of malfeasance as well as the extent to which corrupt or wasteful activities are investigated and guilty parties held to account, are amongst the best indicators of the importance accorded to good governance within a public entity.

Typically, GCR will rely on the findings of official oversight bodies, which opine on the quality of the financial statements, management processes and compliance, amongst other issues. However, adjustments to the earnings will be made where the quality of information is considered to be questionable.

How does GCR determine the sector risk score for SOEs, especially those that operate in restricted industries?

As mentioned, SOEs operate across the economy and in most instances determining the sector risk score is straight forward and in line with GCR's general corporate criteria. Where an SOE competes in an industry with other players, GCR will typically include the SOE under the relevant published sector risk score. Thus, if a rating is being accorded to a state-owned airline, then the SOE will be included under an airline or logistics sector risk score. If it operates a communications network it would fall into the telecommunications industry. Similarly, state-owned banks or financing companies will be included under the relevant country bank or non-bank financial institution sector.

When an SOE is effectively a government arm or provides a public service that is not (or cannot) be operated by the private sector we tend to use the straight SOE score. This is because the operating dynamics of these market segments are more likely to be driven by government and social considerations than by market forces. Such considerations would include how robust the legal framework for managing the SOE is, what level of control government tends to exert over the Board or operations of the SOE, whether competition is typically allowed in sectors where there are large SOEs, the strength of public sector unions and environmental concerns, as well as the financial and technical ability of the governing entity to provide necessary support. Such industries are characterized by substantial regulation and typically require significant government grant funding, or the right to charge tariffs for usage.

By way of example, GCR considers South African Roads Agency Limited ("SANRAL") to be an arm of Government operating in a restricted market segment. Accordingly, it has been accorded the SOE sector risk score. On the other hand, the Industrial Development Corporation's ("IDC") sector score is a blend of the non-bank financial institution score and the SOE score to reflect its dual characteristics.

Does diversification benefit an SOE?

Diversification is less important for SOEs as they are generally established to provide a particular service in a defined jurisdiction. In fact, having a focus and dominance in a particular industry may be the most critical factor in strengthening its market position. Where an SOE operates in more than one industry, this would only be positively considered if the different lines of business contribute materially to the SOEs performance, and do not distract from the provision of its core services. For example, the competitive position assessment for a utility that is the sole provider of electricity in a particular region, will likely be stronger than for a company that provides electricity as part of a range of services, albeit where none enjoy a monopoly position.

Most SOEs operate in a single country, making the country risk assessment straight forward. In the minority of cases where SOEs may operate across several countries, a blended score will be used if there are meaningful operations in the secondary countries which demonstrably strengthens the operations in the SOE's domestic market. However, there is a counteracting concern that such operations may weaken the SOE's position in its core home market and potentially diminish its support assessment.

How does operating performance considerations differ from common corporates?

GCR's starting point is to recognize that SOEs are seldom driven primarily by a profit motive. Most SOEs are tasked with delivering a service in the most efficient way possible and any profitability is of secondary benefit. In addition, SOE pricing flexibility is often limited by the industry regulator. This will typically relate to SOEs that provide critical social services or facilitate economic activity, such as utilities or companies that are established to operate critical infrastructure. In contrast, profitability will be of much greater importance for those SOEs that operate in commercial sectors, albeit that even in such sectors the national government may be willing to accept a lower return on capital because of the broader economic/societal benefits that are generated through the SOE's operations (for example a national airline stimulating a country's tourism).

Accordingly, GCR will assess operating performance on two factors:

- Is the SOE able to deliver on its core service provision mandate on a sustainable basis. This would include the reliability of service delivery, the ability the extend services to other parts of the population or jurisdictions, and the ability to maintain its infrastructure (as well as any other functions that its is mandated to perform). Strong service delivery is not only important in supporting a sustainable financial position, but also in cementing its position within an economy (impacting the 'Business Profile' assessment).
- Is the SOE operating on a financially sustainable basis. Even in instances where GCR considers the SOEs service provision to be of greater importance than profitability, highly rated entities are still expected to cover their operating expenditure on a sustained basis.

How does GCR determine if the SOE is fulfilling its service delivery mandate?

Key performances metrics ("KPIs") for an entity are determined by the industry in which it operates and the legislative environment. Often the deliverables for an SOE are mandated by legislation or by a regulator. Such KPI's generally include a requirement to ensure service provision at a high level of reliability, to provide a high-quality service, to expand the availability of the service within a country, to manage levels of usage, and to ensure this is achieved while adhering to set operating efficiency standards.

GCR will identify the KPIs applicable to the SOE under review. KPIs are not assessed on an absolute basis, but relative to the performance of previous years and relative to targets as outlined in its medium-term development plan or other internal or external strategy documents. A positive trend in KPIs will generally indicate a highly performing utility, while negative trends would be indicative of operational challenges.

While external to the SOE, GCR will also analyse the environment in which the SOE operates. This is because SOEs that operate in well developed economies, with broad and modern infrastructure will tend to report a stronger, more stable performance than SOEs in developing markets. Moreover, SOEs in developing markets may also be faced with a greater burden of infrastructure development and the provision of some free services to poorer portions of the population.

If profitability is not of primary concern, how does GCR determine an SOE's financial performance?

As an SOE may have limited ability to grow revenue (as demand is often inelastic and tariffs determined externally), a key factor in GCR's earnings considerations is its ability to manage its costs. Highly rated SOEs will generally evidence good earnings flexibility. Flexibility, may however, be hampered by a mix of political and business constraints, the presence of which would be considered negatively. For example, an SOE's ability to control staff costs may be constrained by a high level of unionized staff, which may make it harder for the entity to control staff levels and costs. Similarly, SOEs may be required to include social criteria when evaluating potential service providers, which although producing a societal benefit, may increase the costs of service provision.

Given the above, cost ratios form an important part of the earnings assessment. Relevant cost metrics will differ amongst various SOEs but they will largely be variations of the delivery cost ratio, which measures the cost of providing the service against revenue earned (akin to the gross margin). The efficiency of an SOE can be measured by the ratio of s*taff costs relative to total expenditure and/or revenue*. A higher staff cost ratio than that typical of a similar private sector company may signal excessive social and political consideration which could constrain performance. Another important window through which to review the quality of operations is the ratio of fixed capital expenditure, and/or maintenance expenditure to total expenditure or income. This ratio can provide a good indication if the SOE is meeting its developmental goals and whether it is maintaining the assets it already operates. A low development to total expenditure ratio would likely be a sign of a bloated cost base and poor implementation capacity, while low maintenance spend could signal that current operational performance is being prioritized over long-term sustainability.

What else could impact operating performance and cashflows?

Collections remain one of the most challenging aspects of SOE performance, particularly in developing countries, as the willingness to pay for public services is low. However, without an efficient collection system revenue is meaningless. While ensuring that bad debt recognition and provisioning policies are adequate is important, GCR places greater emphasis on current collections versus current billings. Gross debtors that increase ahead of internally generated revenue is usually indicative of deficiencies in the debtor's collection process. GCR may thus make negative adjustments to future income expectations to account for weak debtors' performance.

Are any additional adjustments made for an SOE's capital structure?

A primary motivation for establishing an SOE is for them to access a wider range of funding sources, and thereby reduce the financial burden on the governing entity. Accordingly, GCR would expect that highly rated SOEs evidence robust capital structures, comparable to those of highly rated corporate entities. Conversely, factors that would have a negative impact on the corporate capital structure would likely negatively impact an SOE's capital structure assessment.

SOEs do have a number of potential advantages over general corporate companies, which could strengthen GCR's assessment. These include access to government grants and other public funding, access to funding from development finance institutions ("DFIs"), and various other socially responsible pools of finance. As these funding sources tend to be provided on concessionary terms, either through favorable interest rates or with long term maturities, GCR considers a track record of strong working relationships with such organisations to bolster the financial profile.

On the other hand, SOEs are often tasked with undertaking large capital projects with very long payback periods. Debt typically comprises a large portion of the funding for such projects, as a result of which an SOE can report weak debt service metrics. Concerns are somewhat mitigated by lower cyclicality in industries that many SOEs are exposed to, as well as access often being supported by mandated sources of income (such as license fees). Nevertheless, weak debt service metrics will negatively impact the credit rating. Low scores will be accorded when a SOE depends on non-committed funding from the government or another entity to meet its debt service obligations, including redemptions.

Are there any changes to the liquidity assessment that need to be considered?

The basic calculation remains the same, being the ratio of *sources of income to uses*. But there are some different items within both the numerator and the denominator. In particular, SOEs may have access to sources of income that are not available to private sector companies. For example, GCR would include budgeted grant income or financial transfers in sources of income where there is a strong track record of financial support being provided. Similarly, committed financial support from DFIs or similar organisations may be included.

Assessing uses with regard to capital expansion projections is somewhat more complicated and needs to take the broader operating and legislative environment into account. SOEs may have service delivery responsibilities that have not been adequately accounted for in budget projections and need to be added to potential uses of resources. This could arise if there are large infrastructure backlogs, or there is a shift in the operating environment that could burden the SOE with providing additional services without commensurate income. On the other hand, many SOEs and government entities are prohibited from carrying out work if they do not have the funding resources immediately available. Accordingly, GCR may assume a *balanced sources versus uses* ratio on the expectation that capex will need to be withheld. Clearly, the delay in necessary capex due to funding constraints will have a negative impact on the operating performance and future prospects of an SOE over the medium to long term (and a negative adjustment may be made in the 'Business Profile' or 'Earnings Profile' sections), but such restrictions do contribute to short term financial sustainability.

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Related Criteria and Research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Corporate Entities, May 2019
Criteria for Rating Local and Regional Governments, May 2019
Criteria for Rating Financial Services Companies, May 2019
GCR Ratings Scales, Symbols & Definitions, May 2019

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S GLOSSARY

Bond	A long term debt instrument issued by either a company, institution or the government to raise funds.
Borrower	The party indebted or the person making repayments for its borrowings.
Corporate Governance	Refers to the mechanisms, processes and relations by which corporations are controlled and directed, and is used to ensure the effectiveness, accountability and transparency of an entity to its stakeholders.
Country Risk	The range of risks emerging from the political, legal, economic and social conditions of a country that have adverse consequences affecting investors and creditors with exposure to the country, and may also include negative effects on financial institutions and borrowers in the country.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Creditworthiness	An assessment of a debtor's ability to meet debt obligations.
Currency Risk	The potential for losses arising from adverse movements in exchange rates.
Debt Service Coverage	Measures the ratio of cash available for debt servicing to interest, principal and lease payments.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Debtor	The party indebted or the person making repayments for its borrowings.
Default Risk	The probability or likelihood that a borrower or issuer will not meet its debt obligations. Credit Risk can further be separated between current credit risk (immediate) and potential credit risk (deferred).
International Scale Rating.	An opinion of creditworthiness relative to a global pool of issuers and issues.
Issuer	The party indebted or the person making repayments for its borrowings.
Leverage	With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liabilities	All financial claims, debts or potential losses incurred by an individual or an organisation.
Liquid Assets	Assets, generally of a short term, that can be converted into cash.
Liquidity Risk	The risk that a company may not be able to meet its financial obligations or other operational cash requirements due to an inability to timeously realise cash from its assets. Regarding securities, the risk that a financial instrument cannot be traded at its market price due to the size, structure or efficiency of the market.
Long-Term Rating	A long term rating reflects an issuer's ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
National Scale Rating	National scale ratings measure creditworthiness relative to issuers and issues within one country.
Working Capital	Working capital usually refers to the resources that a company uses to finance day-to-day operations. Changes in working capital are assessed to explain movements in debt and cash balances.