



*DBRS Criteria: Preferred Share and
Hybrid Criteria for Corporate Issuers
(Excluding Financial Institutions)*

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Insight beyond the rating.

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DBRS Criteria: Preferred Share and Hybrid Criteria for Corporate Issuers (Excluding Financial Institutions)

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Overview

The following outlines the DBRS rating approach to preferred shares and hybrids for corporate issuers, other than financial institutions, including the manner in which DBRS assesses the ‘equity weighting’ to be given to a hybrid or preferred security in terms of adjusting certain key ratios. As part of this discussion, issues related to the rating on the hybrid or preferred share instrument itself will also be discussed.

The Background section below establishes the four key factors used in evaluating equity weighting.

Section (A) provides an overview of the base requirements before DBRS will consider any equity weighting for a hybrid.

Section (B) provides a prioritized list of ‘High’, ‘Medium’ and ‘Low’ considerations that DBRS views on a scale as having greater to lower value. It will be the combination of these considerations that will determine the final equity treatment.

Section (C) outlines the six categories of equity weighting used by DBRS and uses the list from Section (B) to provide combinations that are used as examples in coming to an overall assessment of specific equity weightings.

Section (D) discusses issues related to rating hybrid instruments.

Section (E) comments on a variety of related topics

Background

When assessing the equity weighting to apply to hybrids or preferred shares, the key question is ‘how closely does the instrument replicate the value of common equity?’ Common equity has the following attributes: (1) no maturity date; (2) no ongoing payments that could trigger default if missed; and (3) given its junior ranking, common equity provides a buffer or loss absorption mechanism for all other creditors. In most cases, hybrids and preferred shares will have some but not all of these attributes. Along with issuer intent (as defined below), these attributes constitute the four key factors considered by DBRS in evaluating the financial risks and benefits that a hybrid brings to an issuer.

‘Hybrid’ is a term used by DBRS to describe financial instruments that combine certain characteristics of both debt and equity. Hybrids typically combine the equity features of preferred securities with the tax deductibility of debt instruments. There is a wide variety of hybrid combinations in the marketplace and new versions emerge from time to time as financial intermediaries seek innovative ways to introduce instruments with equity-like components into an issuer’s capital structure. Investors are attracted to hybrids because the coupon rates are normally high relative to the general credit quality of the issuer. The latter compensates investors for some combination of risks that are not present with normal debt. Four of the more common such risks are: (1) hybrids are normally deeply subordinate in the capital structure, meaning that holders have a very junior claim in the event of default and bankruptcy; (2) many hybrids allow the issuer some ability to defer interest payments for up to five years without triggering a default; (3) many hybrids allow the issuer the ability to repay obligations in common stock, which may not be the holder’s preference; and (4) hybrids are often very long term in nature and are in some cases perpetual.

Preferred shares are normally less complicated than hybrids and hold the ranking as the most junior security next to common equity. As discussed herein, preferred shares are by definition equity and typically command a very high level of equity weighting. DBRS believes that there is a difference between debt



and equity regardless of the features that might attract equity weighting. As such, all things being equal, preferred share instruments will be preferable to debt hybrid instruments.

In assessing the equity weighting to apply to a hybrid or preferred share instrument, DBRS will consider the following four factors:

(1) Permanence

In order to receive the highest level of equity treatment, the hybrid should be close to perpetual status, with no maturity or cash repayment requirement, as with common equity. Since it is rare to find perpetual securities with no call provisions, this attribute is normally achieved by having coupon and principal payments paid with common shares. If this is at the issuer's option, it is known as a 'soft retraction' feature. Preferred shares with a 'hard' retraction feature can only be repaid with cash at the issuer's option, and are usually considered as debt. Those issues where market reset mechanisms could lead to redemption if the coupon cost became prohibitively expensive are often treated as debt-like, as the reset feature increases the chance that they would be redeemed for cash at some point in the future. Securities for which a trustee is required to sell stock into the open market to raise cash to pay off the hybrid are not considered valuable from an equity perspective.

(2) Subordination

Although not equivalent to the lowest-ranking status of common equity, most hybrid instruments are deeply subordinated. Hybrids would typically rank just above any traditional outstanding preferred shares, which would rank last in line before common equity. Hybrids provide a cushion for higher-ranking debt holders and creditors in cases of bankruptcy.

(3) Legal

Debt has a contractual obligation to pay principal and interest, and omission results in default or bankruptcy, with cross default triggers being commonplace. While an issuer will go to great lengths to maintain common share dividends, this is not a fixed requirement that could lead to default if omitted. In a crisis, reducing or omitting the common share dividend is an option that the issuer will likely consider. Preferred shares often fall in between these extremes, with the ability to defer coupon payments without triggering default for a set period of time being a relatively common feature. While both preferred and common dividends can be missed without triggering default, an issuer is normally more reluctant to omit a preferred dividend payment. In general, the easier and longer an issuer can pass on payments, the more equity-like is the security in question. In the event that the deferral option is used, the ability to pay an accumulated obligation with equity is a valuable one, as is the non-cumulative feature.

(4) Issuer Intent

Consideration is given to the subjective issue of issuer intent as it can override other strengths regarding any hybrid issue. For example, some hybrids have call options allowing for redemption within five years of issue. Regardless of payment in kind (PIK) or deferral options, it is difficult to give equity consideration to securities if the issuer is likely to redeem them for cash after only five years, unless there is some assurance that that it will be replaced with a similar or better security in terms of equity consideration. There are also cases where the pricing penalty at the end of five years becomes so severe that it increases the probability that the issuer would use a call feature to redeem the securities. As such, while a hybrid may be perpetual on a legal basis (since there is no legal mandatory redemption or ability for the holder to retract for cash), it would not be given equity consideration if, in all likelihood, redemption after five years is expected. Therefore, knowing the issuer's intent becomes a very important consideration. Even if a conversion feature to common equity within a hybrid is mandatory, an issuer still has the option of offsetting this benefit by repurchasing an equal amount of common stock. As such, hybrids should in many cases be evaluated in the context of an issuer's future capital structure plans, including its view on share buybacks.



Note that Permanence and Legal considerations are typically the key drivers that differentiate hybrids from one another and lead to diverse equity weightings. The DBRS treatment of individual instruments uses a blend of qualitative and quantitative considerations that will all relate to the four overriding factors mentioned above. Assessing equity weighting for hybrids is not simply a quantitative exercise. In order to be transparent as to how DBRS approaches this topic, the following sections will describe the different aspects of its approach.

(A) DBRS Base Requirements

There are certain fundamental factors that must normally be in place before DBRS will consider a hybrid instrument for equity treatment. While preferred shares will feature some of these because they are ‘equity’ to begin with, some of the requirements will also be relevant to preferred shares. To reflect the related major area(s) that pertain, each comment notes this by use of the first letter – Permanence (P), Legal (L), Subordination (S) and Intent (I).

- In the absence of those hybrids where conversion to longer term and/or more junior capital is a key factor, a term of ten years is viewed as the minimum. (P)
- There can be no security holder ability to request redemption in cash, a feature sometimes referred to as hard retraction. (P)
- It is important that the issuer does not have the ability to change its view on the value of a hybrid such that redemption becomes a consideration, due to a covenant that allows redemption when another credit rating agency has altered its methodology and reduced its equity weighting. (P, I)
- DBRS is satisfied that there are no potentially problematic interest/dividend reset terms that could alter the financial costs of the hybrid and change the issuer’s attitude toward its affordability. (P, L, I)
- DBRS believes that even the strongest hybrid loses its value if an issuer uses such securities excessively. As an approximate standard, DBRS will consider reducing or eliminating equity value when the ratio of preferred equity and hybrid to common equity exceeds 20% (for the portion of hybrids that exceed this limit). In view of future expectations and significance tests, DBRS may allow credit when the latter ratio exceeds 20%, but this should not be assumed. (L)
- For credit to be given for the ability to defer interest, there should be restrictions in place preventing dividend and/or interest payments to more junior instruments and the repurchase of common shares until the deferral period ends and all deferred contributions are paid. (L)
- The hybrid is clearly subordinate to unsecured debt and there are no cross default covenants that would cause issues with higher-ranking debt. (S)
- Most instruments provide the issuer with the right to call/redeem at some future point in time. If not covered by capital replacement language, DBRS typically confirms that the issuer views the instrument as equity-like in nature, notwithstanding these redemption abilities. If not, the absence of capital replacement language would be of particular concern if a high step-up in rates were to occur at the point of redemption. (P, I)

(B) DBRS Prioritized Consideration Levels

The following provides a prioritized list of High, Medium and Low considerations to indicate how DBRS values some of the more common terms and covenants in hybrids. In the interest of adding clarity, this list is provided for a general overview. It is critical to remember that equity consideration will ultimately reflect the combination of attributes present, including consideration for the issuer’s own situation. In most cases, Subordination is a given and Intent is subjective. As such, as noted previously, Permanence and Legal considerations are typically the key drivers that differentiate hybrids from one another and lead to diverse equity weightings.



High Value Considerations

- The security consists of equity (preferred shares), as opposed to debt. (L, S)
- Mandatory conversion to common equity (or preferred equity in the case of a debt hybrid) occurs in three years or less. (P)*
- The existence of a legal capital replacement covenant. (P)
- Interest is deferrable for a minimum of five years. (L)
- Issuer has ability to use common equity to pay interest. (L)**

Moderate Value Considerations

- The term of the instrument is lengthened from the minimal acceptable ten years to a more valued fifty years or perpetual status. (P)
- The instrument is convertible to equity that falls away in one year and the conversion price is strongly in the money. (P)
- Any missed payments are non-cumulative. (L)
- The interest deferral feature is strengthened through the existence of covenants that would trigger its use. In some cases, this same benefit may be achieved through the expected mandate of a regulatory body. (L)

Lower Value Considerations

- The term of the instrument is lengthened from ten years to a 20- to 50-year maturity. (P)
- Mandatory conversion to equity occurs beyond three years. (P)
- A capital replacement covenant is present on a best-efforts basis. (P)
- The instrument is convertible and highly in the money, but option lasts beyond three years. (P)
- The ability to defer payments is ten years versus the more typical five-year period. (L)
- The ability to use common equity to repay principal at maturity. (L)
- The existence of a best-efforts objective to sell lower-ranking securities to repay deferred interest. (L)
- Where payments have been deferred, there are restrictions on the amount that can be repaid. (L)
- Securities are more deeply subordinated than just ranking below senior debt. (S)

* DBRS prefers fixed conversion terms rather than market conversion.

** On a fixed basis, not where trustee must make a market.

(C) DBRS Specific Equity Weightings

After assessing all aspects of the hybrid as per Section (B), DBRS determines which of the following six categories of equity weighting should apply.

Exceptional	100%
Superior	80%
High	65%
Moderate	50%
Low	25%
None	0%

The examples noted provide actual illustrations, but are not meant to be exhaustive.



(1) Exceptional – Potential to receive equity treatment of 100%

It is exceptionally difficult for a security to totally replicate the strengths of common equity and receive completely equal status. Practically, however, DBRS would consider certain preferred share securities to be very close to common equity based on consideration of the four key factors. While common equity is still preferable, the gap is narrow enough that it is not necessary to differentiate these preferred shares from 100% equity treatment under limited circumstances. All things being equal, DBRS views preferred shares as preferable to a debt hybrid.

EXAMPLES

- Perpetual Non-Cumulative Preferred Shares
- Preferred Shares with mandatory conversion to Common Equity < three years
- Traditional Preferred Shares where no call/redemption concerns exist

(2) Superior – Potential for equity treatment of 80%

DBRS considers equity treatment of 80% to be a very high weighting and not easily attainable. The main distinction between 80% (Superior) and 100% (Exceptional) is that debt hybrids can attain 80%, provided that P, S, L and I are addressed to a very high degree. To successfully accomplish this, the examples below show that many of the individual terms and covenants most highly valued by DBRS are included.

EXAMPLES

- 99-year Subordinate Debt with ten-year deferral (including a covenant that has triggers to initiate such an action), the ability to satisfy interest through common equity and a legal capital replacement covenant.
- Three-year Junior Subordinate Debt with a mandatory conversion to common equity at maturity, the ability to either defer or pay interest in common equity through the life of the instrument and a legal capital replacement covenant in place

(3) High – Potential for equity treatment of 65%

Given the high requirements for 80%, most debt hybrids have limited ability to achieve such and are more likely to be assigned equity treatment at either the 50% or 65% level. While 65% is more easily attainable than 80%, 65% implies that the security in question is still more equity- than debt-like and, as such, the High and Moderate value considerations are prevalent.

EXAMPLES

- Three-year Junior Subordinate Debt with a mandatory conversion to common equity at maturity, the ability to either defer or pay interest in common equity through the life of the instrument and a best-efforts capital replacement in place.
- 60-year Junior Subordinate Debt with the ability to defer interest for ten years (including a covenant that has triggers to initiate such an action), a legal capital replacement covenant and a best-efforts objective to sell junior ranking securities to use in repaying any interest due following a deferral action.
- 60-year Subordinate Debt with the ability to repay interest and principle with common equity, a legal capital replacement covenant and a best-efforts objective to sell junior ranking securities to use in repaying any interest due following a deferral action.

(4) Medium – Potential for equity treatment of 50%.

Equity treatment at this level is very common for debt hybrids as there is more flexibility in the P, L, S and I considerations, so the Hybrid is viewed as equally debt- and equity-like. Some hybrid instruments that only just miss meeting the standards necessary for 65% will by definition be relegated to this 50% level for equity treatment.



EXAMPLES

- 30-year Subordinate Debt with the ability to defer payments for at least five years, a best-efforts capital replacement covenant, the ability to repay principal with a fixed amount of common shares and written goals to use best efforts to sell common equity to deal with any deferred interest.
- Five-year Subordinate Debt with a mandatory conversion to common equity at maturity and the ability to either defer or pay interest in common equity through the life of the instrument.
- 50-year Subordinate Debt with the ability to repay interest and principal with common equity and a best-efforts capital replacement covenant.

(5) Low – Potential for equity treatment of 25%

Equity treatment at this level reflects debt that has a narrow range of equity features and, as such, is seen as significantly more debt-like than equity-like.

EXAMPLES

- 99-year Subordinate Debt that has the sole ability to defer interest payments for five years.
- Five-year Subordinate Debt with the ability to repay interest in common shares.
- 30-year Convertible Subordinate Debt that is at least 50% ‘in the money’ and the debt holder conversion option ends within two years.

(6) No Consideration – Equity treatment of 0%

Equity treatment at this level reflects debt where there are no equity features considered to be of any meaningful value. DBRS considers these instruments as debt.

EXAMPLES

- Long-dated Subordinate or Junior Subordinate Debt.
- Convertible Subordinate Debt that is not highly ‘in the money.’
- Convertible Subordinate Debt where the conversion option period extends beyond five years.
- Any hybrid where holders hold a retraction call to be paid in cash.
- A hybrid with moderate or lower value considerations where DBRS believes that intent is a problematic issue.

(D) Rating the Instruments

Relationship between rating and equity weighting

There is no direct correlation between the rating of a hybrid instrument and the level of equity weighting that it is assigned. This is because DBRS views the embedded terms within a hybrid as non-credit risks and does not penalize the rating of the hybrid for such. By definition, hybrids are instruments that combine certain characteristics of debt and equity, yet these characteristics do not normally cause any change in the likelihood of default. Investors should be aware that these covenants could lead to a variety of scenarios that have an impact on performance and add risk outside of credit, but DBRS does not see these considerations as part of credit risk and, as such, DBRS ratings are not affected by hybrid covenants and provide no opinion on them. As such, hybrids and preferred share instruments will be rated based on notching from the Issuer Rating (or if none, the senior debt rating) of the Company. Notching reflects ranking, subordination and default considerations.

Choice of rating scale – Canadian only issue

In Canada, DBRS uses a ‘Pfd’ rating scale for preferred share instruments and, since hybrid instruments often share the attributes of equity and debt, the matter of which rating scale to use may be considered. Note that the choice of the rating scale to use with a hybrid and the degree to which the hybrid is viewed as more debt- or equity-like are not related issues. Those preferred instruments that are assigned a debt rating could still have a meaningful degree of equity allocated to them in the analysis. Unlike the key



factors used to determine equity weighting, the choice of a rating scale is generally based on the nature of the hybrid. Specifically, considerations here would include the legal status of the instrument (whether it is referred to as preferred); how the investment community perceives the security; whether distributions are dividends or interest, quarterly or semi-annual; the tax treatment of distributions; the relative ranking of the issue in relation to outstanding preferred share issues and their ranking in liquidation.

Nomenclature

As with the choice of rating scale, the name of the instrument should not be viewed as a determinant in DBRS's decision on its equity value. Hybrids may be referred to as debt equivalents for tax, accounting or regulatory reasons, but this label does not preclude the fact that they may have significant equity value and vice versa.

(E) Related Topics

The following sections provide a mixture of additional information and further detail on prior comments.

Ratio Analysis

Where the level of the hybrids is material, DBRS will calculate adjusted ratios such as:

- **Adjusted debt in the capital structure.** For example, a hybrid receiving a 65% equity weighting means that 65% of the dollar value of the hybrid would be treated as equity and 35% would be treated as debt.
- **Cash flow from operations/adjusted debt.** Adjusted debt includes the debt portion of hybrids and preferred shares. The CF numerator would be adjusted for a portion of the hybrid dividend.

DBRS does not typically adjust income or cash flow coverage ratios. In addition to being more complex than the aforementioned ratios, this reflects the fact that until hybrid covenants are used, payments must continue to be made. Yet by providing the adjusted debt and cash flow ratios noted above, DBRS acknowledges the future flexibility that hybrids may provide and that would also be beneficial for other coverage ratios.

It is important to note that all ratings are based on future expectations. There may be cases where adjusted ratios and the quality of equity are very conservative, but, where a less conservative position is anticipated in the future, full credit for the present situation will not be given.

Because DBRS adjusts key ratios to reflect its views on the equity value of hybrid instruments, any changes in accounting or differing accounting treatments would not impact DBRS adjustments.

Issuer Specifics

There is no simple formula that will hold for every issuer. Even when two companies issue exactly the same security, DBRS may view the issuer's impact on financial strength differently if there are significant differences in areas such as credit ratings, issuer intent, industry type, regulation, or the level of hybrid dependence. For example, the ability to defer dividend payments for a B-rated industrial company is far more likely to be a realized future benefit than is the case for an AA-rated entity. DBRS may also give more equity credit to an issuer where hybrids make up a small part of capital versus a company with a relatively higher dependence. In summary, notwithstanding the quantitative framework provided by herein, the assessment of hybrids can vary depending upon the issuer's business, its financial strength and DBRS views regarding an issuer's appetite to take on more risk.



PIK Features

There are various securities with PIK features. From an equity treatment perspective, the best structure involves mandatory conversion to common equity at a future date. The sooner conversion to common equity occurs – and the more predictable it is – the more equity credit it can be given. Other common structures include: (1) Securities where conversion to equity depends on the ability of a trustee to sell common shares in the open market, which can be problematic in weak markets, or when there are major company issues. DBRS gives no equity consideration for this feature since the potential for the trustee to make a market cannot be depended on. DBRS does give some credit where the entity can issue paper to extinguish its liability. (2) Securities where the issuer has the ability to make or force the conversion decision. Here, the time frame should be considered (the sooner the better) and the likelihood that the issuer would use this ability. (3) Lastly, there are convertible securities where conversion is at the option of the debt holder. In this case, DBRS may give partial equity credit when the conversion price is deep in the money (and will likely stay that way), and conversion is both possible and likely in the medium term. Conversion can be achieved by having the issue callable, in which case intent is also an issue. The treatment of securities that are callable at the holder's option can vary significantly and a high level of equity treatment is normally precluded by the volatile nature of the stock market, which can quickly change an 'in the money' position to 'out of the money'. DBRS believes that in many cases hybrids are issued with PIK-like terms only to receive a mixture of tax and rating benefits and, in reality, the issuer has little intention of using these options. In this case, minimal equity consideration would be provided.

Use of Proceeds

In some cases, the use of proceeds from the issuance of hybrids is a meaningful consideration in their treatment by DBRS. For example, from a credit perspective, using proceeds from a hybrid issue to reduce debt is preferable to using proceeds to buy back common stock.

Voting Rights

Voting rights may be a consideration in certain hybrid structures. The greater the ability for holders of hybrid instruments to obtain a vote at some future point, the more power this class would have in negating covenants that could affect the financial flexibility of the issuer. All things being equal, this would make it more difficult to provide the same equity treatment as structures where the hybrid holders had less ability to obtain a vote in future decisions.

History of this methodology

The last revision to this methodology was made in June 2005 when DBRS expanded the ability for all preferred shares to receive 100% equity weighting and reduced equity weightings for certain convertibles.

In addition to providing opinions on new aspects of hybrids that are now in the market and additional detailed data and opinions, the main change in the present methodology is the narrowing of equity weighting options to just six classifications. Prior to this, DBRS allowed changes to equity weightings in stages as small as 5%.

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