DBRS Criteria

Preferred Share and Hybrid Criteria for Corporate Issuers

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Scope and Limitations

This criteria represents the current DBRS approach on preferred shares and hybrids for corporate issuers other than financial institutions, with the primary focus being the issue of how DBRS treats these instruments in terms of equity weighting. The methods described herein may not be applicable in all cases; the considerations outlined in DBRS methodologies are not exhaustive and the relative importance of any specific consideration can vary by issuer. Further, this criteria is meant to provide guidance regarding the DBRS methods used in the areas as covered and should not be interpreted with formulaic inflexibility, but understood in the context of the dynamic environment in which it is intended to be applied.

Overview

The following criteria outline the DBRS rating approach to preferred shares and hybrids for corporate issuers other than financial institutions, with the primary focus being the issue of how DBRS treats these instruments in terms of equity weighting. For clarity, these criteria are used predominantly by DBRS in its coverage of corporate finance issuers where the rating or equity weighting of preferred shares is required. For non-banking financial institutions (insurance companies, finance companies, etc.), the main Equity Weightings section is not applicable, but in some cases DBRS may nonetheless refer to these criteria because the Rating the Instruments section is applicable. For banking-related issuers, DBRS would typically use the criteria entitled Rating Bank Capital Securities – Subordinated, Hybrid, Preferred and Contingent Capital Securities, rather than this one. Finally, these criteria would not generally have any application to sovereign or public finance issuers, since they do not generally issue such instruments.

“Hybrid” is a term used by DBRS to describe financial instruments that combine certain characteristics of both debt and equity. There is a wide variety of hybrid combinations in the marketplace, with new versions emerging from time to time. This criteria is divided into the following two major sections:

EQUITY WEIGHTINGS

When dealing with hybrid securities or preferred shares, DBRS determines the appropriate equity weighting to be given to the security of five possible weighting categories (ranging from 100% to 0%, as discussed below under DBRS Specific Equity Weightings).

• Notwithstanding the equity weighting category assigned by DBRS for a specific hybrid or preferred share instrument, DBRS caps the combined equity weighting from all hybrid and preferred securities for a given issuer to 20% of common equity; the remainder is treated as debt. (Note that one exception where the 20% rule does not apply is when DBRS considers a security as equity within a parent subsidiary relationship, as discussed in more detail in the section DBRS Specific Equity Weightings.)

• Equity weightings are used to adjust debt and equity levels in several metrics that typically include debt-to-EBITDA, cash flow-to-debt and debt in the capital structure. However, interest expenses and preferred share dividends are not adjusted for equity weighting considerations and, therefore, related coverage ratios are not affected by equity weighting decisions. Until an entity exercises its discretion to defer or adjust its payments per the terms of the instrument, DBRS believes that payments will be made and coverage ratios should include such payments.

RATING THE INSTRUMENTS

This section discusses the key considerations related to assessing what the actual rating should be for a given hybrid or preferred security.

An appendix provides additional information on related topics.
Equity Weightings

When assessing the equity weighting to apply to hybrids or preferred shares, the key question is, “How closely does the instrument replicate the characteristics of common equity?” Common equity has the following attributes:

1. There is no maturity date, i.e., permanence;
2. It provides a buffer or loss absorption mechanism for all other creditors, i.e., subordination; and
3. There are no ongoing payments that could trigger default if missed, i.e., legal.

In many cases, hybrids and preferred shares will have some, but not all, of these attributes. Specifically, hybrids are normally deeply subordinate in the capital structure. Many hybrids allow (and, in some cases, require) the issuer some ability to defer interest payments (often for up to five years) without triggering a default or they may allow the issuer the ability to repay obligations in common stock. Hybrids are often very long-term in nature and are, in rare cases, perpetual, although in virtually all cases the issuer has redemption abilities in some measure.

For more background and detail on the three key areas of permanence, subordination and legal, please refer to the appendix.

**DBRS BASE REQUIREMENTS**

There are certain fundamental factors that must normally be in place before DBRS will consider a hybrid instrument for equity treatment, including the following:

- Excluding 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.
- There can be no debtholder ability to request redemption in cash.
- It is important that the covenants do not cause an issuer to change its view on the value of a hybrid by changing the attributes of redeeming the instrument (including consideration for any covenant that allows redemption when another credit rating agency has altered its methodology and reduced its equity weighting).
- DBRS must be satisfied with any dividend reset terms that could alter the financial costs of the hybrid (in relation to then-current market rates), thus changing the issuer’s attitude toward its affordability.
- To achieve permitted equity treatment for the ability to defer interest, DBRS would expect 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 payments are made.
- The hybrid is clearly subordinated to all unsecured debt and there are no cross-default covenants that would cause issues with higher-ranking debt.
- Most instruments provide the issuer with the right to call or redeem at some future point in time. If not covered by capital replacement language, DBRS must have comfort that the issuer views the instrument as equity-like in nature, notwithstanding these redemption abilities. This would typically occur through an understanding of the issuer’s targets regarding its overall capital structure.

Even when all of these factors are satisfied, DBRS believes that even the strongest hybrid should not receive full or, in some cases, any credit in certain DBRS ratios if an issuer uses such securities excessively. Therefore, DBRS will treat preferred shares and hybrids as debt when the ratio of preferred equity and hybrid to common equity exceeds 20% (for the portion of hybrids that exceed this limit and after, considering the equity value of the instrument). The definition of common equity will typically be the unadjusted number reported by the company on its audited balance sheet, noting that DBRS retains flexibility to make adjustments for meaningful areas, such as treatment of certain items, e.g., inclusion of non-cash marked-to-market derivative gains (losses) in retained earnings and in accumulated other comprehensive income, as deemed appropriate.
DBRS PRIORITIZED CONSIDERATION LEVELS
The following is a prioritized list of considerations to indicate if DBRS sees higher or lower value with some of the more common terms and covenants in hybrid structures. 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, as such, permanence and legal considerations are typically the key drivers that differentiate hybrids from one another.

High Value Considerations
• The security consists of equity (preferred shares), as opposed to debt.
• Mandatory conversion to common equity (or preferred equity, in the case of a debt hybrid) occurs in three years or less.¹
• The existence of a legal capital replacement covenant.
• Interest is deferrable for a minimum of five years.
• Issuer has ability to use common equity to pay interest.²

Other Positive Considerations
• The instrument is convertible to equity that falls away in a one-year or, at most, a two-year time frame and the conversion price is strongly in the money.
• 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.
• The term of the instrument is lengthened from ten years to a more valued 50 years, or to perpetual status.
• Mandatory conversion to equity occurs, but the time frame is beyond three years.
• A capital replacement covenant is present on a best-efforts basis.
• The ability to defer payments is ten years (versus the more typical five-year period), noting that DBRS views most of the benefit as derived in the first five years.
• The ability to use common equity to repay principal at maturity.
• The existence of a best-efforts objective to sell lower-ranking securities to repay deferred interest.
• Where payments have been deferred, there are restrictions on the amount that can be repaid.
• Securities are more deeply subordinated than simply ranking below senior debt.
• Any missed payments are non-cumulative.

DBRS SPECIFIC EQUITY WEIGHTINGS
After assessing all aspects of the hybrid as discussed above, DBRS determines which of the following five categories of equity weighting should apply:

<table>
<thead>
<tr>
<th>Equity Weighting</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exceptional</td>
<td>100%</td>
</tr>
<tr>
<td>Superior</td>
<td>75%</td>
</tr>
<tr>
<td>Moderate</td>
<td>50%</td>
</tr>
<tr>
<td>Low</td>
<td>25%</td>
</tr>
<tr>
<td>None</td>
<td>0%</td>
</tr>
</tbody>
</table>

¹ DBRS prefers fixed conversion terms, rather than market conversion.
² On a fixed basis, not where trustee must make a market.
Example
The following example shows how DBRS would calculate adjustments for debt and equity for a hypothetical capital structure that has two different types of hybrid securities, each with a different equity assessment.

<table>
<thead>
<tr>
<th>Instrument</th>
<th>$ Amount (A)</th>
<th>Equity Weighting (B)</th>
<th>A x B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal Debt</td>
<td>500</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>Subordinated Debt Hybrid #1</td>
<td>200</td>
<td>50%</td>
<td>100</td>
</tr>
<tr>
<td>Subordinated Debt Hybrid #2</td>
<td>200</td>
<td>25%</td>
<td>50</td>
</tr>
<tr>
<td>Preferred Equity</td>
<td>150</td>
<td>100%</td>
<td>150</td>
</tr>
<tr>
<td>Hybrid and Preferred Total</td>
<td>550</td>
<td></td>
<td>300</td>
</tr>
</tbody>
</table>

Common Equity: $1 billion
Maximum credit possible: 20% x $1 billion = $200 million
Outcome: The total of $300 million of notional equity value as determined above is subject to the cap of $200 million.

Of the $550 million in hybrid/preferred securities, $200 million will be treated as equity for applicable DBRS ratios.
The remaining $350 million of securities will be treated as debt for applicable DBRS ratios.

Debt/Capital Structure Ratio
Debt = 500 + 350 = 850
Equity = 1,000 + 200 = 1,200
Ratio = 850/(850+1200) = 41.5%

The additional discussion noted below provides illustrations, but they are not meant to be exhaustive.

Exceptional – Potential to Receive Equity Treatment of 100%
It is difficult for a hybrid security to entirely replicate the strengths of common equity and receive completely equal equity equivalent status. Practically, however, DBRS would consider certain preferred share securities to be very close to common equity, based on consideration of the three key factors. While common equity is still preferable, the gap is narrow enough that it is not necessary, under limited circumstances, to differentiate preferred shares from 100% equity treatment. All things being equal, DBRS generally views preferred shares as preferable to a debt hybrid. If rate resets are constructed such that DBRS is of the opinion that the feature does not create an undo incentive to redeem early and replace the instrument with a more debt-like security, a rate reset will not preclude a high equity weighting.

Examples
• Perpetual preferred shares.
• Preferred shares with mandatory conversion to common equity in less than three years.
• Preferred shares where call/redemption risks are viewed as acceptable.
• There are cases where a parent may invest in a subsidiary through deeply subordinated debt for tax or other reasons with the intension that the security mirrors the attributes of equity. DBRS would typically assess a range of factors to establish if the latter has been achieved, such as cross default trigger, covenants, term and ability to defer interest or pay with cash. Regardless of these factors, the parent subsidiary relationship is key and represents the only reason that DBRS would consider these debt instrument for high equity treatment. In these cases, the 20% cap rule does not apply.
**Superior – Potential for Equity Treatment of 75%**

DBRS considers equity treatment of 75% to be a very high weighting and not easily attainable. The main distinction between 75% (Superior) and 100% (Exceptional) is that debt hybrids can attain 75% equity treatment provided those designated as permanence, subordination and/or legal are addressed to a very high degree. To successfully accomplish this, the examples below show how many of the individual terms and covenants most highly valued by DBRS might be included in some illustrative combinations.

**Examples**

- Ninety-nine-year subordinate debt with ten-year deferral (including a covenant with triggers to initiate such an action) and 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.
- Sixty-year junior subordinate debt with the ability to defer interest for ten years (including a covenant that has triggers to initiate such an action) or repay interest and principal with common equity, a legal capital replacement covenant and a best-efforts objective to sell junior ranking securities for use in repaying any interest due following a deferral action.

**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 permanence, subordination and legal considerations, so the hybrid is viewed as equally debt-like and equity-like.

**Examples**

- Thirty-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 toward selling 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.
- Fifty-year subordinate debt with the ability to repay interest and principal with common equity and a best-efforts capital replacement covenant.

**Low – Potential for Equity Treatment of 25%**

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

**Examples**

- Ninety-nine-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.
- Thirty-year convertible subordinate debt that is at least 50% in the money, with a debtholder conversion option ending within two years and risks that are deemed low with respect to falling out of the money.

**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 (i.e., permanence) is a problematic issue. An example of this is a rate reset that could provide a meaningful incentive for redemption – noting, however, that many rate resets are established in a way that does not cause this issue.

The appendix provides additional comments on several related topics:
• Rate reset preferred shares, preferred default definition, cumulative versus non-cumulative and ratio analysis.
• Issuer specifics and payment-in-kind (PIK) features.

Rating the Instruments

Relationship Between Rating and Equity Weighting
Excluding normal notching considerations related to the ranking of securities, 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 covenants and/or 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. Investors should be aware that these covenants could lead to a variety of scenarios that have an impact on performance, but DBRS does not see these considerations as part of its credit analysis.

Nomenclature
As with the choice of rating scale, the name of the instrument should not be viewed as a determining factor in DBRS's decision regarding 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.

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 should be used may be a consideration. Note that the choice of rating scale to be used 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, how the investment community perceives the security, whether payments are dividends or interest, the tax treatment of payments, the relative ranking of the issue in relation to outstanding preferred share issues and their ranking in liquidation.

There is a standard ranking relationship whereby an entity with an “A” issuer rating will typically have its preferred shares rated as Pfd-2, a BBB issuer rating at Pfd-3, and so on. While this generally holds, there are situations where ratings may deviate from the standard rating mapping. While not exhaustive, we have noted one example for having preferred shares rated above and below the standard rating mapping.
Lower Than Standard Rating
When preferred shares become a proportionately large segment of the capital structure, the preferred share dividends will absorb a higher proportion of cash and earnings. DBRS may, in some situations, consider it appropriate that the preferred share rating should be rated one notch lower than the standard mapping, although it should be noted that a very high level of preferred equity (and related dividend payments) would be just as likely to be an issue with the overall issuer rating, which would have an impact with all ratings of the issuer in question. Because any preferred equity in excess of 20% of common equity is already treated as debt, an additional notch would only be considered necessary in unique circumstances where the ratio of preferred shares to common equity is at a high enough level that an issuer who is under pressure may have an additional incentive to pass on preferred dividends simply due to the relative size of the cash savings. DBRS approaches these situations on a case-by-case basis and would typically not consider such action unless the ratio of preferred to common equity was at least in the 40% to 50% range (note that this ratio is based on preferred shares outstanding, not the amount that is given equity weighting) and this situation was causing the fixed charges coverage ratio to be considered weak. Credits with issuer ratings in non-investment-grade territory are also more likely to have examples of wider-than-typical notching.

Higher Than Standard Rating
In a case where an issuer has no or very minimal debt outstanding and no plans to issue any in the future (including subordinated debt and intermediate hybrid instruments), the preferred shares may warrant a rating one notch higher than is typical, as there are no debt obligations senior to it. However, most issuers will have non-debt unsecured obligations that would rank higher than the preferred equity (such as accounts payable and off-balance sheet liabilities), and this will be taken into consideration by DBRS. With respect to the possibility of future debt issuance, the ideal situation is where the issuer notes such intention in public covenants. Absent such covenants, DBRS may consider management comments, past actions and whether the situation at hand supports making an exception. This situation could occur with either an operating or a holding company. This situation is rare and should not be considered the norm.

Appendix

CHARACTERISTICS OF EQUITY
Permanence
In order to receive the highest level of equity treatment, the security 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 sometimes 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. Those securities where market reset mechanisms could lead to redemption if the coupon cost became prohibitively expensive in relation to then-current market rates are typically treated as debt-like, if the reset feature materially 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 treatment perspective.

The subjective issue of issuer intent can play a key role in determining permanence. For example, virtually all new issues of hybrids today 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 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 (see discussion of rate reset under Rate
Reset Preferred Shares section). Therefore, 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. Gauging the issuer’s intent, therefore, becomes a very important consideration, and hybrids must always be evaluated in the context of an issuer’s future capital structure plans.

Preferred shares are normally less complicated than hybrids and, next to common equity, hold the ranking as the most junior security. 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. Therefore, all things being equal, preferred share instruments will typically garner higher equity weighting than debt hybrid instruments.

This may still raise the related question as to why DBRS is comfortable in treating preferred shares as 100% equity, even though the issuer typically has the ability to redeem the preferred shares with debt financing. Our rationale involves the following considerations:

(1) As already noted, DBRS only treats preferred shares as equity when we believe that the issuer does not have the intent to replace the preferred shares with debt in the future.

(2) While this may appear to be a subjective standard, it is important to note that a company has the flexibility to alter its capital structure in various ways at any time. Even common equity can change quickly, if a company decides to buy back stock or pay a meaningful special dividend. We view these events as similar to an unexpected reversal in a company’s desire to maintain its outstanding preferred equity.

(3) When DBRS assesses an issuer’s financial risk, a critical component of our assessment is our opinion as to the appropriate capital structure. If this changes for any reason, rating changes are possible. The treatment of preferred shares is not an isolated item, but is viewed by DBRS as part of our overall expectation for an entity’s future capital structure.

(4) As outlined in this criteria, DBRS limits the amount of preferred shares that can receive 100% treatment. Above a relatively conservative limit (defined as 20% of common equity), preferred shares are treated as 100% debt. This reflects our view that preferred shares should be viewed as equity only when used in moderation. High levels of preferred equity increase fixed charges, increasing the risk that the company may consider debt-financed redemptions in the future.

(5) Notwithstanding the ability of companies to issue moderate amounts of preferred equity to be treated as equity, all preferred share dividend payments (not just those in excess of the 20% threshold) are considered in such metrics as the fixed-charge coverage ratio and the analysis of free cash flow.

(6) It is not an event of default for preferred dividends to be undeclared. While it is true that this does not typically occur until a company is under severe stress, the same holds true for common dividends. As noted above, DBRS assesses both in the context of free cash flow. Preferred share dividends are seldom the leading factor for cash flow issues, which are more commonly the result of items such as reduced business prospects, high debt levels, common dividends and capital expenditure requirements.

(7) DBRS does not assign higher debt ratings based simply on the argument that additional preferred shares have created a higher base of junior security, although such criteria do address the fact that lower-ranking securities that receive equity credit can play a role in equity and related metrics.

(8) Historically, DBRS has experienced few instances of companies that have altered their views on preferred shares such that they are replaced with debt.
Subordination
Although not equivalent to the lowest-ranking status of common equity, most hybrid instruments are deeply subordinated. Hybrids 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.

Legal
Debt has a contractual obligation to pay principal and interest, with omission resulting in default or bankruptcy, cross-default triggers being common. 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. While preferred shares may have the ability to indefinitely avoid declaring a dividend, hybrids typically only have the ability to defer coupon payments without triggering default for a set period of time. While both preferred and common dividends can be missed without triggering default, an issuer is typically more reluctant to omit a preferred dividend payment (noting that common dividends are typically precluded from being paid if preferred shares are in arrears).

Nevertheless, consideration must be given to the fact that taking these options could have an impact on future issuance for the company, and that headline risk is possible and some payment options may have a dilutive aspect that the company may wish to avoid. These considerations represent challenges that are all part of the complexity in assessing the correct equity weighting for hybrids.

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.

Permanence (including issuer intent) and legal considerations are typically the key drivers differentiating hybrids from one another, and can 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 three 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.

OTHER COMMENTS ON RELATED TOPICS
The following sections provide a mixture of additional information and further detail on prior comments.

Rate Reset Preferred Shares
Cumulative redeemable preferred shares featuring rate reset provisions are prevalent in many terms and conditions. While having no stated maturity, these securities often feature a rate reset mechanism, combined with the option to redeem (both typically occurring every fifth year). The redemption option and rate reset do not preclude high levels of equity treatment if (1) the reset spread, set at the time of initial issuance, is not viewed as onerous on a basis relative to market, and would therefore not be expected to be a major incentive to redeem (while this is subjective, as an issuer’s credit spread will change over time due to both market- and company-specific factors, DBRS will compare an issuer’s reset spread to its peer group to assess its potential to have an impact on future actions) and (2) DBRS is confident that the securities will remain a permanent part of the issuer’s capital structure.

Preferred Share Default
A preferred share is only assigned a D rating (for default) when the security is in default according to the legal documents. Therefore, the non-payment of a dividend does not necessarily give rise to the assignment of a default rating. When preferred dividends are not declared, the preferred share rating will likely be downgraded by a minimum of one notch to reflect the non-payment situation. Further downgrades may occur, should the overall ratings for the organization be downgraded as a result of a negative situ-
ation that relates to the decision not to pay preferred share dividends. In addition, DBRS may consider additional downward notching of the preferred share rating to reflect concerns related to either (1) the expectation that non-payment of dividends may continue for several more quarters or (2) the probability of a future default, as defined in the legal documents, which could occur without any defaults of higher-rated securities, including “distressed exchanges” as defined in the DBRS default definition.

**Cumulative Versus Non-Cumulative**

Whether a security is cumulative or non-cumulative does not generally have a large impact on treatment and has no impact on ratings. While a non-cumulative security is more beneficial for an issuer, in that missed payments do not have to be made up in the future, DBRS views this as a modest factor for equity treatment, as an issuer may be more hesitant to miss a payment on a noncumulative security given potential consequences, as already noted.

Additionally, the rating itself is generally indifferent to cumulative versus non-cumulative, given the minimal difference in expected recovery.

**Ratio Analysis**

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

- **Adjusted debt in the capital structure.** For example, a hybrid receiving a 75% equity weighting means that 75% of the dollar value of the hybrid would be treated as equity and 25% would be treated as debt.
- **Cash flow from operations/adjusted debt.** Adjusted debt includes the debt portion of hybrids and preferred shares.

DBRS does not typically make adjustments for hybrid equity allocations with income statement-related coverage ratios. In addition to providing more complexity than the aforementioned ratios, this reflects the fact that until hybrid covenants are used, hybrid interest or preferred share dividend payments will continue to be made. However, 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, should changes occur. Even if not part of the primary financial risk ratings (FRR) metrics in a DBRS methodology, a fixed-charge coverage ratio could be an additional rating consideration for entities with meaningful preferred share dividends.

It is important to note that ratings are focused 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.

DBRS also makes changes for accounting treatments as deemed necessary.

**Issuer Specifics**

There is no simple formula that will hold for every issuer. Even when two companies issue the exact same security, DBRS may view the impact on the issuer’s financial strength differently if there are significant differences in areas such as credit ratings, expected permanence, 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. Notwithstanding the quantitative framework provided herein, the assessment of hybrids can vary depending upon the issuer’s business, its financial strength and DBRS’s 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. As already noted, the sooner conversion to common equity occurs – and the more predictable it is – the more equity credit 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 major company issues exist. DBRS gives no equity consideration for this feature, since the potential for the trustee to make a market cannot be depended on, yet it 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 timeframe should be considered (the sooner the better), along with the likelihood that the issuer would use this ability.

(3) Lastly, there are convertible securities where conversion is at the option of the debtholder. In this case, DBRS may give partial equity credit when the conversion price is deep in the money and conversion is both possible and likely in the near 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 one that is out of the money. DBRS believes that, in some 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 these cases, minimal equity consideration would be provided.