

# Rating Methodology Real Estate Companies

Fedafin's methodology for rating assignments to public and private sector real estate companies

February 2024

## 1. General Remarks

This rating methodology describes the general principles and criteria for the credit risk assessment of private and public sector real estate companies. Real estate company ratings can be assigned to legal entities only.<sup>1</sup> The methodology does not generally apply to real estate investment companies and real estate investment foundations. For these issuers the Expected Loss Credit Rating Methodology developed specifically for the Swiss real estate sector is applied.

The real estate company issuer rating is a long-term credit rating reflecting our opinion of the relative creditworthiness of the issuer. Specifically, the issuer rating reflects an issuer's ability to fully and timely meet senior unsecured debt obligations. According to our monitoring policy for standard annual rating updates, our rating opinion covers a period of one year. However, when analysing the creditworthiness of an issuer, more than one year is taken into consideration by the analysts. The issue of stability in rating assignments is addressed by including forward-looking criteria and stability factors and by using appropriate analytical methods and valuation approaches. We therefore believe that the rating methodology for real estate companies meets the requirements for a through-the-cycle rating as far as possible.

This rating methodology describes a number of risk factors and criteria that may have an impact on the rating assignment. Nevertheless, the risk profiles of individual companies may be very different, and the rating team may classify certain criteria as not relevant or include other criteria not described in this methodology. One example is the distinction between private and public sector companies. For private

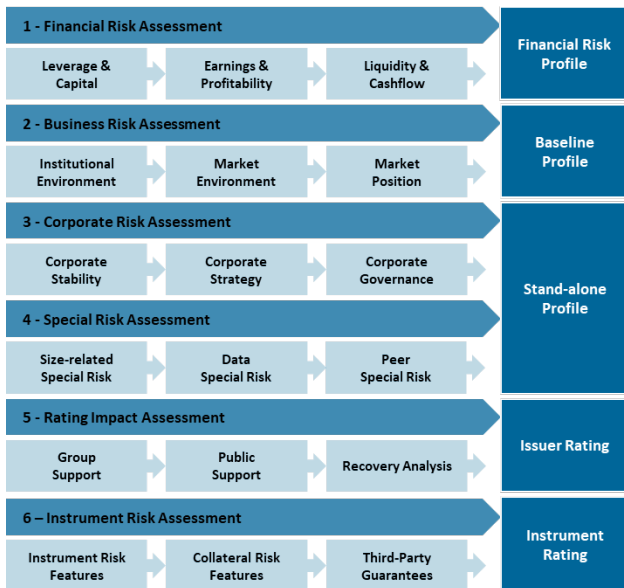
sector companies, the rating assessment is largely driven by financial ratios and business and corporate risk factors. In contrast, for public sector companies, guarantees and extraordinary public support may be much more important to the credit rating assessment than the issuer's current financial situation or business risk factors. The rating team may also deviate from the standard weighting of individual risk drivers if considered appropriate.

## 2. Real Estate Company Rating Architecture

Figure 1 shows the general framework for private and public sector real estate company credit ratings. The starting point usually is the financial risk assessment (Section 2.1). This is augmented by an analysis of business risks (Section 2.2), corporate risks (Section 2.3) and other entity-specific risks (Section 2.4), resulting in the stand-alone profile (SAP). The SAP reflects the creditworthiness of a company independent of extraordinary support or guarantees (Section 2.5). As a next step, any relevant extraordinary group or public support needs to be assessed in order to arrive at the issuer credit profile (separate Guarantee and Extraordinary Support Methodology). The issuer credit profile reflects a company's overall creditworthiness. If no extraordinary support or guarantees apply, the issuer credit profile coincides with the stand-alone profile. A systematic recovery analysis (Section 2.6) finally leads to the issuer rating and thus to the issuer's ability to meet its senior unsecured debt obligations in full and on time. The credit ratings for other financing instruments are also based on the recovery analysis but can include additional notching to reflect the specific characteristics of these instruments (Section 2.7).

<sup>1</sup> Legal entities include, for example, public sector entities, corporations, cooperatives, foundations and associations.

Figure 1: Real Estate Company Rating Methodology



## 2.1. Financial Risk Assessment

In the financial risk assessment of real estate companies, we mainly focus on three areas of analysis: (1) leverage and capital, (2) earnings and profitability, and (3) liquidity and cash flows. We apply a logit transformation to a number of key financial ratios<sup>2</sup> and aggregate the resulting scores to the financial risk profile. In addition, further key figures are systematically included if they fall below or exceed certain predefined values. The financial risk profile is usually averaged over four years to smooth minor annual fluctuations.

The financial analysis is generally based on the company's audited financial statements. Interim statements and forecasts may be considered for plausibility checks, but are not included in the financial analysis as standard. However, significant deviations from past performance due to a material change in corporate policy or the business environment may lead to a review of the current rating or the rating outlook.

When calculating key figures on the basis of the company's financial statements, systematic adjustments are made where necessary to increase comparability between

different accounting standards and practices (e.g. in the case of operating leases in the balance sheet or interest paid and received in the cash flow statement).

Fedafin acknowledges that hybrid debt instruments may exhibit more or less pronounced equity-like elements. Our analysts assess the equity character of hybrid capital based on a pre-defined set of criteria. The key question is to what extent hybrid capital can reduce the likelihood of a default for example through the possibility of suspending coupon payments or mandatory conversion to equity. An equity ratio of 0%, 50% or 100% can be attributed to specific instruments. A similar criteria-based analysis is performed for shareholder loans.

## 2.2. Business Risk Assessment

The financial risk profile must be interpreted in the context of the specific economic environment in which a company operates. Therefore, in this section, we analyze the extent to which the institutional environment, the market environment in the real estate industry and the market position of a company influence credit risk. The analysis of these qualitative factors leads to a better comparability of companies' financial profiles across market environments and institutional environments.

The business risk assessment includes the three modules (a) institutional environment, (b) market environment, and (c) market position. In the first two modules a "floor" and a "ceiling" are defined, which serve as lower and upper limits applied to the financial risk profile of the company under consideration. For example, if a company operates in an industry environment with particularly high risks, the resulting lower ceiling means that a "Aaa" rating cannot be achieved even with the best financial ratios. At the same time, this compression of the curve of achievable score values affects the entire rating range. Therefore, with moderate or weak financial ratios, a difficult market environment can lead to additional downgrades too, albeit these will be less severe.

<sup>2</sup> More information on definitions and details of key financial ratios is provided on [e-rating](#).

On the other hand, institutional conditions (e.g. concession obligations, regulatory customer ties, ordinary financing support), particularly in the case of government-related entities (GRE), can mean that the evaluation does not fall below a certain threshold (floor) even if the financial risk profile is very poor. Moreover, this upward shift in the curve of achievable score values can also lead to rating upgrades for issuers with a moderate financial profile, although these upgrades will be smaller. Finally, the assessment of the issuer's market position may lead to a direct up- or down-notching.

#### 2.2.1. Institutional Environment Profile (Floor)

This module looks at a largely unregulated market as the default case. From this starting point, the analysts assess whether certain regulatory provisions systematically reduce an issuer's credit risk, essentially on the basis of two criteria: (1) intensity of competition; (2) financing system.

Possible criteria to evaluate the intensity of competition are the legal framework determining the scope of business activities (e.g. provision of public goods and infrastructure) or regulatory market entry barriers in terms of administrative authorization requirements. The focus here is really on institutional protection against competition. Economic barriers to market entry leading to lower intensity of competition are assessed within the market position profile in Section 2.2.3.

The central question in the analysis of the financing system is to what extent the company's uncovered costs are financed by regular public subsidies, statutory cost recovery contributions or cost-covering user fees, thereby reducing credit risk.

The institutional environment profile can be categorized as "excellent", "very strong", "strong", "favorable", or "standard". Given that real estate companies in Switzerland do not usually benefit from regulatory market entry barriers or direct public subsidies that finance uncovered costs, the resulting assessment will be "standard" for both private and public sector real estate companies in Switzerland in most cases.

#### 2.2.2. Market Environment Profile (Ceiling)

This module focuses on the market environment of a corporate issuer, with the two main criteria being (1) country risks and (2) industry sector risks. When analyzing country risks we ask how supportive economic or political conditions are in the countries the issuer operates in. To evaluate economic risks, we look at average per capita income in the relevant countries. For the assessment of political conditions, we use country data on the Worldwide Governance Indicators (WGI) from the World Bank.

The assessment of industry sector risks includes the analysis of cyclicity of the sector due to economic fluctuations, interest rates, or exchange rates and the assessment of growth prospects in relevant business areas and geographical markets (e.g. based on consumer preferences). We also consider potential risks due to changing regulatory framework conditions or the vulnerability of a sector to technological disruption (e.g. digitalization, carbon-free technology).

The evaluation of the relevant criteria in this module results in an assessment of "favorable", "moderate", "limited", "weak", or "very weak". If the assessment is "favorable", the rating is unchanged compared to the financial risk profile. However, if the assessment is less than "favorable", the rating ceiling may be lowered, reflecting that certain risks in the market environment cannot be fully offset by strong a financial profile.

#### 2.2.3. Market Position Profile

In this module we analyze the relative competitive position of an issuer and its resilience to negative shocks compared to competitors in the same industry. A particularly strong competitive position can lead to more stability of the company in the business cycle, whereas a weak competitive position can make a company especially vulnerable in a downturn. We evaluate a company's competitive position based on, for example, the exclusivity of corporate marketing or brands, its technology and innovation leadership, or its product and service quality. We also examine factors that increase (or decrease) an issuer's resilience towards certain shocks, e.g. due to financial crises, energy crises or

pandemics. Positive or negative resilience factors include the issuer’s market share or its efficiency and cost structure. The particular resilience or vulnerability to specific risks such as climate change risks, resource scarcity or reputational risks are also considered in this module.

The evaluation of the relevant criteria in this module results in an assessment of “excellent”, “strong”, “fair”, “limited”, or “weak”, which in turn is reflected in an up- or downgrade of the rating of up to two notches. At this stage in the rating process, the financial risk profile including floor and ceiling serves as an anchor. Figure 2 describes how an asymmetric notching approach is applied, based on the level of the anchor. The possible range for down-notching is somewhat higher for investment-grade issuers since we expect strong financial metrics to be reflected to some extent in a corporate’s qualitative risk profile. Analogously, the possible range for up-notching is higher for speculative-grade issuers, since we expect weak financial metrics to be reflected in a corporate’s qualitative risk profile.

Figure 2: Example of a module notching approach depending on the respective anchor rating

		MARKET POSITION PROFILE				
		excellent	strong	fair	limited	weak
ANCHOR RATING	Aaa – Aa-	1	0	0	-1	-2
	A+ - Baa-	1	1	0	-1	-1
	Sub-investment	2	1	0	0	-1

The resulting stage in the rating process after the financial risk assessment and the business risk assessment is called the baseline profile 1. This serves in turn as the input for the corporate risk assessment.

### 2.3. Corporate Risk Assessment

The previous qualitative analysis emphasizes the issuer’s business environment. In the corporate risk assessment, on

the other hand, we focus more directly on the issuer and assess company-specific factors that affect credit risk. The three main risk profiles considered are (1) the corporate stability profile, (2) the corporate strategy profile, and (3) the corporate governance profile.

#### 2.3.1. Corporate Stability Profile

In this module, we assess the entrepreneurial and financial stability of an issuer. We focus on diversification of business activities and the quality of the issuer’s assets and liabilities. The criteria to evaluate corporate stability for real estate companies include diversification of investment properties regarding geographical location and type of use, diversification within the customer portfolio, as well as the quality of the real estate portfolio in terms of the age and condition of buildings and vacancy rates. Stability of additional income e.g. from development activities is also considered. We then look at concentration in off balance-sheet positions (e.g. granted guarantees) or in specific tangible or intangible balance-sheet assets. Finally, we account for diversification of the financing structure, or a lack thereof.

Figure 3 shows how the resulting assessment as “excellent”, “strong”, “fair”, “limited”, or “weak” translates into a maximum of two upward or downward notches, based on the baseline profile 1 as the anchor rating. As corporate stability factors are highly relevant for credit risk, the possible notching impact can reach +/-2 even for issuers with an intermediate level of the baseline profile 1.

Figure 3: Notching approach for the corporate stability profile module

		CORPORATE STABILITY PROFILE				
		excellent	strong	fair	limited	weak
ANCHOR RATING	Aaa – Aa-	1	0	0	-1	-2
	A+ - Baa-	2	1	0	-1	-2
	Sub-investment	2	1	0	0	-1

### 2.3.2. Corporate Strategy Profile

In the corporate strategy profile, we evaluate the impact of a company’s strategic focus in various dimensions on credit risk. Possible criteria include the corporate growth strategy including M&A activities, the corporate remuneration policy in terms of bonus incentive structures, or the dividend distribution policy including share buyback programs and funding thereof. We also assess corporate risk management including the use of derivate instruments and the corporate funding policy in terms of complexity and lending covenants.

Based on the resulting assessment of “excellent”, “strong”, “fair”, “limited”, or “weak”, an asymmetric notching approach as specified in Figure 2 is applied, based on the baseline profile 1 as the anchor rating.

### 2.3.3. Corporate Governance Profile

The core question of the corporate governance profile is whether the issuer’s corporate governance is adequate or whether certain negative aspects may increase the credit risk of an issuer. Possible criteria are board diversity and independence, transparency and reporting standards (financial disclosure and ESG disclosure), or the company’s reputation in terms of compliance flaws.

Figure 4: Example of a notching approach independent of the respective anchor rating

		CORPORATE GOVERNANCE PROFILE		
		fair	limited	weak
ANCHOR RATING	Aaa – Aa-	0	- 1	- 2
	A+ - Baa-	0	- 1	- 2
	Sub-investment	0	-1	- 2

The evaluation of the relevant criteria in this module results in an assessment of “fair”, “limited”, or “weak”. In contrast to the previous modules, we believe that the risks of weak

corporate governance affect issuers in different rating classes in a uniform manner. Therefore, the down-notching is independent of the anchor rating (Figure 4).

## 2.4. Corporate Special Risk Assessment

The combined assessment of the issuer’s financial risk profile, its business environment and company-specific characteristics is referred to as the baseline profile 2. In rare cases, it may be necessary to add some special modules to the risk assessment. Specific examples are (a) size-related special risks, (b) data and peer special risks, and (c) benchmarking and adjustment.

### 2.4.1. Size-related Special Risk Profile

While the corporate rating methodology has been developed predominantly for medium-sized and large companies, it generally also applies to small and medium-sized enterprises (SME) since business activities and risk profiles frequently exhibit a high degree of similarity.

Some specific risk factors for smaller companies can already be captured by the financial risk, business risk and corporate risk modules mentioned above. Examples include a smaller market share or less diversification. In this module, it is possible to consider additional risk factors due to limited size and/or track record. One possible risk factor is the risk that the company’s success depends on a few key persons. Further limitations may arise if a company is particularly small compared to relevant competitors or does not have sufficient know-how in relevant areas. Another aspect to consider may be the company’s position in supply chains, including contractual arrangements with key clients.

The evaluation of the relevant criteria in this module leads to an assessment of “fair”, “limited”, or “weak”. Using the baseline profile 2 as a starting point, the resulting down-notching normally is minus one notch if the resulting assessment is “limited” and minus two notches if the resulting assessment is “weak” (Figure 4).

#### 2.4.2. Data and Peer Special Risk Profile

This special risk module summarizes potential risks from poor data quality and other special risks. Possible indicators include a limited track record due to newly established or restructured companies, distorted or incorrectly disclosed corporate data and information, or exceptional data fluctuations due to trend breaks or imbalances. In addition, this module may capture increased credit risk due to violations of national laws and regulations or the occurrence of a risk event (e.g. accidents, reputational damage, called guarantees, lost lawsuits) that was not sufficiently captured by the other modules above.

The assessment of the relevant criteria in this module may be “fair”, “limited”, or “weak”. Starting from the baseline profile 2, the resulting down-notching normally is minus one notch if the resulting assessment is “limited” and minus two notches if the resulting assessment is “weak” (Figure 3).

#### 2.4.3. Benchmarking and Adjustment

In a final step, analysts compare the resulting stand-alone profile with market benchmarks or the credit risk assessment for relevant peers. Although this only applies in exceptional cases, analysts have the option in this module to raise or lower the stand-alone profile by one notch if necessary.

### 2.5. Stand-Alone Profile and Issuer Credit Profile

Figure 1 shows that the modules described so far lead to the issuer's stand-alone profile (SAP). The SAP reflects the creditworthiness of a company independent of extraordinary support or guarantees. For issuers that might benefit from extraordinary group or public support or guarantees, a separate analysis of the respective features is required. The general principles and guidelines for this analysis can be found in our separate “Guarantee and Extraordinary Support Methodology”. After this step, or if this step is not required, the resulting issuer credit profile reflects the overall creditworthiness of a company. To arrive at the issuer rating, and thereby the issuer's ability to meet its senior unsecured debt

obligations in full and on time, analysts perform a systematic recovery analysis as described in the next section.

### 2.6. Recovery Analysis

The objective of the recovery analysis is to systematically analyze the expected loss for each seniority class in the liability structure in the event of a default. Important components for this analysis are the expected general recovery rate of a real estate company with the corresponding probability distribution and the expected seniority structure of the liabilities in the event of a default (waterfall). The result of this analysis serves as an important input for analysts to determine the issuer rating and the rating of the corresponding financial instruments.

#### 2.6.1. Necessity of a Detailed Recovery Analysis

Real estate companies often have a substantial proportion of mortgage-backed debt. We assess these cases with a detailed recovery analysis. However, for an issuer with a strong issuer credit profile (“far from default”) and a standard liability structure (e.g. no subordinated or secured debt), the rating for senior unsecured debt instruments usually corresponds to the issuer credit profile. In these cases, we typically refrain from performing a detailed analysis.

#### 2.6.2. Expected Average Company Recovery Rate

Since the recovery rate of a company at the time of its default is uncertain from today's perspective, it is not modeled as a fixed value but as a probability distribution. For real estate companies we usually assume a beta distribution with an expected mean recovery rate of 60%. Analysts may choose a different parameterization (expected firm-wide recovery rates of 50% or 35%) if there are clear reasons for doing so (for example extraordinarily high loan-to-value ratios or due to the specific real estate portfolio). The selected beta distribution forms the basis for calculating the expected loss rate in the default event for each seniority class.



### 2.6.3. Seniority Structure of Liabilities

As a second element, the seniority structure of the liabilities at the time of the default must be determined (waterfall). The starting point is the current seniority structure of the liabilities according to the annual financial statements. In addition, legal provisions in national resolution law for companies need to be considered.

The analysts are not strictly bound to the current liability structure, however. Deviations are reasonable for example if the issuer is in the process of a major merger or is planning a major increase in debt due to investments. Furthermore, in very cyclical industries it may be reasonable to use average values. If a company has a somewhat more complex structure, structural subordination must also be considered: If a company conducts its business through one or more legally separate subsidiaries, but issues debt at the level of the parent company (i.e. the holding company), the creditors of the subsidiaries have first claim on the assets of the subsidiaries in the event of bankruptcy of the entire group. The creditors of the parent company have only a subordinated claim based on the residual value of the assets of the subsidiaries after liquidation. A very broad overview on how the seniority structure might look like is depicted in Figure 5.

Figure 5: Seniority structure (Waterfall)

Senior secured	Secured loans and bonds: assets and real estate
Secured	Secured claims: e.g. salaries in arrears
Senior unsecured	Loans and bonds
Senior subordinated	Subordinated debt (no interest deferability)
Subordinated	Subordinated debt (with cumulative interest deferability)
Junior subordinated	Perpetual debt (with non-cumulative interest deferability)

### 2.6.4. Recovery Analysis Calculations

Based on the selected beta distribution (parameterization according to the company-wide expected recovery rate) and the defined waterfall, the expected loss rate in the default event (loss given default, LGD) is calculated for each individual seniority class. The expected loss rate (EL) is then obtained by multiplying the loss given default by the probability of a default event (LGD x PD). The probability of a default event (PD) is based on the issuer credit profile, which implies a certain probability of default.

Table 1: Recovery Analysis Example

Expected company-wide recovery rate	60%			
Issuer credit profile	Ba			
Implied PD (see Idealized Benchmark Table)	6.05%			
Seniority Structure	% of total Liabilities	Expected LGD Rate	EL Rate (LGD*PD)	Proposed Issue Rating
Senior Secured	60.3%	18.6%	1.1%	Baa-
Secured	0.0%			
Senior Unsecured	39.7%	73.7%	4.5%	<b>Ba-</b>
Subordinated	0.0%			

As an example, in Table 1 we assume a real estate company with an average firm-wide recovery rate of 60% and an issuer credit profile of Ba. The fedafin Idealized Benchmark Tables imply that a Ba rating corresponds to an average probability of default of 6.05% over a term of five years. Assuming a seniority structure with about 40% senior unsecured liabilities and about 60% senior secured debt from mortgage loans, the expected loss rate in the default event per seniority class is calculated using the beta distribution. Multiplied by the implied probability of default of 6.05%, the expected loss rate for each seniority class is obtained. Based on the Idealized Benchmark Tables this can be represented as a rating letter (proposed issue rating). The result of the analysis: The assessment of senior unsecured debt and thus the issuer rating are one notch below the issuer credit profile with the Ba- rating, as the analysis considers that senior unsecured debt is in fact subordinated to a substantial portion of senior secured debt.

In cases with a very high share of subordinated liabilities, for example due to a large hybrid bond, the recovery analysis could have the reverse effect, whereby the issuer rating would raise above the issuer credit profile.

## 2.7. Instrument Risk Assessment

The specific assessment of individual financial instruments is generally based on the results of the recovery analysis. The analysts may however deviate from the proposed issue ratings based on specific characteristics of the respective financial instruments. The following sections provide more detail on the factors to be considered when assessing specific financial instruments.

### 2.7.1. Instrument Risk Features

One element to be considered for the assessment of financial instruments are special covenants. In general, we already consider potentially positive effects of creditor-friendly debt covenants when assigning the issuer credit profile. This applies in particular to standard covenants that relate either to the entire outstanding corporate debt or to all debt instruments of the same seniority class. In this context, we do not normally consider the prevailing standard clauses, such as cross default, pari-passu, change-of-control, or negative pledge, to be directly relevant to the rating of a financial instrument. Nevertheless, general contract clauses may be particularly relevant in specific segments and would be considered accordingly.

In a credit risk assessment of a hybrid debt instrument, the specific characteristics of the instrument are evaluated and may lead to further down-notching from the issue rating proposed in the recovery analysis for this seniority level. Important aspects to be considered in this context are the maturity of the instrument (short-term maturity vs. perpetual bond) or whether and under which circumstances interest payments may be suspended and whether or not outstanding coupon payments have to be made cumulatively upon

resumption of payments. Furthermore, the conversion provisions (optional vs. mandatory, conversion into shares vs. partial or full write-down) and the corresponding thresholds are assessed. Based on this evaluation, the proposed issue rating from the recovery analysis may be reduced by up to four notches.

### 2.7.2. Collateral Risk Features

To assess a collateralized financial instrument, the assets underlying the collateralization must be evaluated for each individual case. For the credit rating of debt instruments secured by real estate, mortgage-backed bonds (covered bonds), and structured financing with tranches (notes), the Expected Loss Credit Rating Methodology is applied.

### 2.7.3. Third-Party Guarantees

If a debt instrument benefits from an explicit and direct third-party guarantee, it is not always necessary to determine an issuer rating and perform a recovery analysis. Instead, the first step in this case would be to determine the anchor rating, where we use the credit ratings of the guarantors as a starting point.<sup>3</sup> If several guarantors are present or per quota guarantees are issued, we typically calculate the weighted average of the individual credit ratings. However, it is also possible that we consider the credit rating of only one guarantor as the relevant measure. It is further possible to adjust the anchor rating calculated by several notches. For instance, if an expected guarantee payment is so high as to become detrimental to the guarantor's own creditworthiness, we can make a deduction of one or more notches. Similarly, if we view changes in the pool of guarantors or of their credit ratings as probable, we might incorporate a corresponding adjustment in the anchor as well.

The evaluation of guarantees is based on two criteria: (1) the extent of the risk transfer between the issuer and the guarantor and (2) their timeliness and enforceability.

The extent of the risk transfer can be judged "integral", "strong", or "limited". If guarantees cover the entire

<sup>3</sup> If fedafin does not assign its own credit rating for a guarantor or support provider, the credit ratings of other recognized credit rating agencies can also be used. Such use will be disclosed on the respective credit rating documentation.



obligations arising from the financial instrument, the corresponding risk transfer is normally considered “integral”. In the case of limited guarantees with a binding cap, analysts would likely judge the resulting risk transfer as weaker.

The timeliness and enforceability of a guarantee is categorized as “integral”, “strong”, or “limited”, depending on how well the following criteria are met: whether the guarantee is direct or subsidiary; if legal enforceability is unproblematic or limited; if payments are timely or delayed; and how easily the guarantee can be terminated or substantially altered.

Figure 6: Guarantee assessment

GUARANTEE RISK MITIGATION ASSESSMENT			
	integral risk transfer	strong risk transfer	limited risk transfer
integral enforceability	excellent	strong	fair
strong enforceability	strong	fair	limited
limited enforceability	fair	limited	weak

Figure 6 shows how the two criteria are combined to determine the guarantee risk profile. This can take one of five assessments: “excellent”, “strong”, “fair”, “limited”, or “weak”.

Figure 7: Notching framework for explicit guarantees

GUARANTEE RISK PROFILE					
	excellent	strong	fair	limited	weak
Notches subtracted from anchor	0	-1	-2	-3	-4

The qualification of the guarantee risk profile then translates into a specified number of negative notches that are applied to the anchor rating (see Figure 7). If the guarantee risk profile is considered “excellent”, the issuer credit profile is aligned with the anchor rating. For qualifications ranging from “strong” to “weak”, between one and four notches can be deducted from the anchor rating.

### 3. Corporate Rating Outlook

For capital market issuers in particular, an outlook can be assigned to the rating. The outlook (“positive”, “stable”, “negative”) reflects fedafin’s assessment of the medium-term rating development.

The rating outlook does not represent a specific probability of rating change, but provides an indication on the likely direction of a potential rating change. The outlook covers a period of 12 to 18 months following the rating outlook assignment.

### 4. ESG Factors Material to Credit Rating

Fedafin acknowledges the fundamental importance of ESG criteria for corporate business performance. ESG related variations in consumer behavior, technologies and regulatory environments as well as considerations regarding good corporate governance already materialize in corporate rating assignments and have done so in the past. The credit rating model outlined above contains several criteria related to ESG. While the characteristics of corporate governance are evaluated in a separate module, environmental and social factors can affect the credit rating in a number of different modules. For instance, for a real estate company with a real estate portfolio of predominantly very old and energy-inefficient buildings, public pressure to reduce greenhouse gas emissions could lead to a change in the relevant political or regulatory environment. If policymakers then pass laws that prescribe extensive investment in energy-efficient refurbishment, the company might face very high investment requirements in the future. This influence would be reflected in a deterioration of the company’s market environment profile or in the corporate stability profile if they were considered sufficiently likely to materially affect the company’s credit metrics in the medium term.

Similarly, changes in customer preferences like an increased awareness for energy-efficiency could already now reduce demand for a company with predominantly energy-inefficient buildings in the portfolio, while stimulating demand for a company with a focus on an energy-efficient

portfolio. In both instances, current revenues and profits would be affected, which influences the financial risk profile. As future demand will diverge even more strongly as the shift intensifies, we would evaluate the market environment quite differently for the two types of companies. These examples emphasize that ESG factors can impact a credit rating in various ways.

As an independent credit rating agency operating at the nexus of investors and capital seekers, we feel an obligation to be transparent about our approach to credit relevant ESG factors, which is why we signed [PRI's "Statement on ESG in credit risk and ratings"](#) in August 2018. PRI is an investor initiative in partnership with the United Nations Environment Programme Finance Initiative and the United Nations Global Compact, dedicated to highlight the investment implications of ESG factors and to help investors integrate these factors into their investment decisions. By signing the statement, we share a common vision to improve the systematic and transparent consideration of ESG factors in credit ratings.

Any material influence of ESG factors on the credit risk of an issuer is therefore disclosed in our credit rating reports. In longer reports we include a separate block that lists the relevant ESG factors and states whether their respective impact on the credit rating is positive or negative. However, it is important to understand that in making this influence transparent, we do not issue a moral statement or an ideological endorsement of a specific activity. We merely show how the probability of default of an issuer or the associated expected loss of a financial instrument are affected by ESG factors.

## Kontakt

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fedafin AG  
Galerieweg 8  
CH-9443 Widnau

Telefon: +41 71 552 32 00  
E-Mail: [info@fedafin.ch](mailto:info@fedafin.ch)  
Internet: [www.fedafin.ch](http://www.fedafin.ch)

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