Rating Transportation

Overview of the methodical rating assignment
to companies in the transportation industry

September 2020

Introduction

Public transport in Switzerland is very well developed. The rail network covers about 5,300km, the public road network over 22,000km. Public transport companies (TU) make a significant contribution to meeting the diverse mobility needs of the Swiss population. The total of 464 TU in regional passenger transport (RPV) can be divided into the following categories:

- **Railway (standard gauge & narrow gauge) 74**
- **Buses 133**
- **Ships 32**
- **Cableways & funiculars 225**

Basic services include around 1,400 lines with entitlement to compensation from the agglomeration to remote valleys in peripheral regions. Public transport lines record over 27 billion passenger kilometers annually. The modal split (market share) of public transport in terms of passenger kilometers has increased from about 18% in 2000 to 28% in 2015. However, despite a significant expansion of services, the modal split of public transport has hardly increased for about 10 years now, since motorized individual transport (about 65% share of passenger kilometers) has grown equally. Rising demand is particularly noticeable in the transport of people between cities, commuters, and inner-city traffic. This has been accompanied by a steady expansion of the range of services on offer. Even if the COVID-19 pandemic will lead to a significant slump in transport numbers at least in 2020, demand is likely to remain strong in view of the continuing population growth that is expected (around 20% in the last 20 years), and thus the need to renew infrastructure and operating resources will also remain high or even increase further.

General Conditions & Market Structures

RPV performs a development function and thus a basic supply mandate. At the legislative level, the so-called ordering principle was already introduced with the revision of the Railway Act in 1996 and was more broadly anchored with the adoption of the Passenger Transport Act in 2009. The public sector plays several roles simultaneously in state-controlled competition: as the ordering party, as the owner, and as the regulator.

The services of the RPV are jointly ordered and financed by the federal government and the cantons. They conclude a service agreement with the TU each for a two-year timetable period, which regulates the service (timetable) and the compensation. This covers the difference between the operating costs expected by the TU according to the submitted offers and the expected traffic revenues, whereby by definition no profits may be made over time. If such profits arise, they must be carried forward and will be considered in the next offer agreement. With the exception of just under two dozen agglomeration lines, the 1,400 lines of the RPV do not cover their costs, which is why the federal government and the cantons subsidize them with approximately CHF 2 billion annually. On average, the federal government pays half of this amount, with the distribution key being agreed with the cantons every four years. The cantons, for their part, determine in cooperation with the municipalities whether and how municipalities on cantonal territory participate.

With the FABI proposal (financing and expansion of the railroad infrastructure), which was clearly approved by the people and the cantons in 2014, a fund was created for an unlimited period of time, through which both maintenance and expansion of the railroad infrastructure will be financed directly by the federal government. In addition, a total amount of CHF 6.4 billion is to be spent on expansion measures up to 2025.

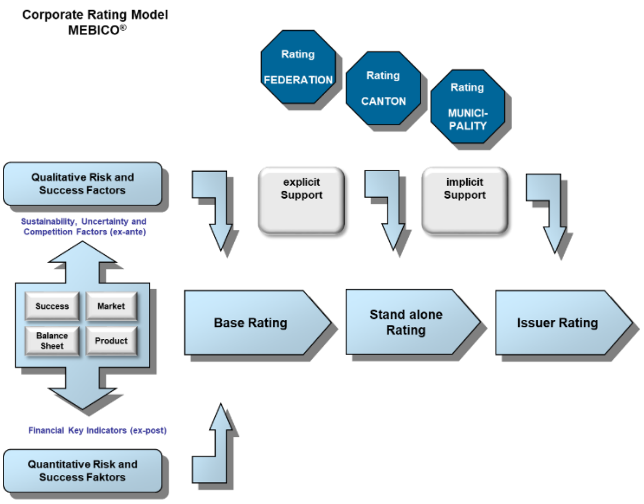
Since the end of 2010, the federal government has also been able to provide solidarity guarantees in the area of operating resources (rolling stock, buses, repair shops, etc.), which have made it possible for TU to obtain guaranteed financing on the capital market. So far, around CHF 2.6 billion of the CHF 11 billion credit line, which expires at the end of 2020, have been drawn down and a further CHF 900 million committed. The Federal Council's dispatch on the extension of the framework credit by a further ten years to 2030 is currently undergoing consultation. The Federal Council is also proposing to extend the maximum term of an individual surety from 25 to 40 years, which corresponds to the maximum depreciation period for rolling stock.

The Passenger Transportation Act defines a number of competences and duties for the regional TU. Among other things, they are obliged to participate in the national tariff alliance, i.e. passengers can - in contrast to many neighboring countries - travel with a single ticket or season ticket on all lines of the TU participating in the tariff communities. Approximately half of all adult inhabitants of Switzerland are holders of a season ticket and can be considered "regular customers".

Promotion and financing of public transport as a counterpart to private transport are always controversial in the political discussion because the tight network and the dense timetable have their price, of course. The Confederation, cantons, and municipalities subsidize public rail and road transport with a total of around CHF 8 billion per year, which is more than the amount spent on health care. The degree of self-financing of public transport from tariff revenues is only just over 50%.

Credit Rating Concept

The credit rating model is designed as an expert system and considers the fact that the creditworthiness of public companies such as TU is determined both externally (exogenous) and internally (endogenous). In the first stage, the exogenous credit rating factors are systematically analyzed, identified, and assessed. In a second step, the endogenous creditworthiness factors are assessed using quantitative and qualitative factors (see Figure 1).



1 Assessment of creditworthiness of public sector companies

Credit Rating Architecture

In contrast to the assignment of credit ratings to companies in the private sector, the conceptual distinction between stand-alone rating and issuer rating is significant in the segment of public-sector companies, even if these are organized as public limited companies, as are many TU. While the stand-alone rating considers, among other things, explicit guarantees by third parties in their various forms, the issuer rating can at best additionally benefit from implicit support by the public sector as owner or operator of a company. It is worth noting that public-sector companies often have significantly worse financial ratios than comparable private companies when they are aware of existing guarantees. In the case of Swiss public transport companies, this is due in particular to the fact that, due to the compensation system, no profits may be made in RPV and thus no significant reserves can be built up. This is reflected in lower balance sheet ratings. Due to the basic service character of the RPV, this circumstance must be considered appropriately when assessing the creditworthiness of a TU entitled to compensation.

Financial support from the public sector is of central importance in the transport sector. The ordering principle is intended to enable TU to cover its costs with the agreed payments. However, the financing guarantees are not suitable to cover the entrepreneurial risk comprehensively from the creditor perspective. In particular, in a competitive environment controlled by the state, the instrument of public tendering of transport offers poses the risk that the loss of several important lines in the transport network could jeopardize the operating basis of the company concerned. However, according to the Passenger Transport Act, a new provider must take over the operating resources acquired for these lines at residual book value as well as the staff necessary for their operation, which should cover the existing obligations of the previous provider.

It is therefore particularly important - just as with all public-sector companies with performance contracts from the public sector - to systematically assess any explicit guarantees and/or implicit support from the public sector as owner or operator of a TU in a first step.

Credit Rating Methodology

The methodical foundation of the rating assignment is an asymmetrically extended logit function, which realistically maps the dynamics of credit risks. In particular, it allows for a consistent consideration of the financial-legal interrelationship between the public sector as the owner or operator of a TU through various parameters and indices. The methodical system allows a risk-adequate and objectively directly comparable credit assessment of different TU.

Rating Criteria

Within the framework of the credit assessment, both quantitative and qualitative elements are considered when assigning a corporate credit rating to a TU. In the quantitative part, the credit risk is identified, analyzed, and assessed (ex-post situation) on the basis of key figures specific to TU from the balance sheets and income statements of past years. This provides an objective picture of the autonomous financial management in comparison with other TU. In the qualitative part, the credit rating is supplemented by various risk and success factors that exert a systematic influence on the future development of the credit risk (ex-ante trend). These primarily include the institutional framework and structures of the TU as well as any incentives for sustainable financial management.

Qualitative Rating Criteria

Qualitative risk and success factors are systematically identified and evaluated by the rating team. As part of the rating process, creditworthiness relevant issues are generally relevant to TU (without completeness) in four areas of the qualitative rating criteria:

Institutional framework

- Market structures and barriers to competition
- Legal compensation and financing regime
- Strategic risk profile of the TU

Corporate structure and strategy

- Complexity of the corporate and business structure
- Sustainability of corporate strategy
- Effectiveness of corporate governance

Accounting and informational content

- Accounting and disclosure standards
- Balance sheet structure and valuation practice
- Expected development of leverage

Competitive position and market environment

- Transport network and geographical catchment area
- Passenger development and tariff policy
- Additional offers and diversification

Quantitative Rating Criteria

The systematic identification and evaluation of the actual financial situation is carried out in the form of a balance sheet rating. As part of the rating process, three circumstances relevant to creditworthiness within the financial autonomy and sphere of influence of a TU (without completeness) are fundamentally relevant:

Assessment of capital structure and indebtedness

- Debt burden and coverage
- Net interest charges
- Debt financing structure and potential
- Asset coverage ratios

Assessment of earning power and profitability

- EBITDA margin
- Cash flow profitability
- Total capital return
- Depreciation rates
- FFO margin

Assessment of cash flow potential

- Operating cash flow
- Free cash flow
- Cash flow margins

Outlook

In view of the pressure on the public sector to save money and the already heavily exploited productivity increases in the TU's service offerings in many places, long-term sustainable financing of public transport is not assured. The challenges in the transport sector remain great in view of the need to expand capacity while at the same time customer demands are rising and financial resources are limited. In addition, the COVID-19 pandemic has recently been added to this situation, whose longer-term effects on the public transport sector are not yet really foreseeable.

In any case, the future prospects for public transport are closely linked to other important social issues such as zoning, the environment, sustainability, and general economic and population development. At the political level, the most diverse measures for managing public transport are subject to controversial discussion. Proposed solutions range from incentive charges to mobility pricing and limiting immigration to Switzerland.

With the adoption of the FABI proposal in 2014, the financing of rail transport by the creation of the Rail Infrastructure Fund has been put on a solid basis, at least for the time being, and the prerequisites have been created for the long-term implementation of the guidelines for future services with better connections and the elimination of bottlenecks.

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