

Treatment of Non-Common Equity Financing for Nonfinancial Corporate Entities

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Executive Summary

This publication presents FiinRatings' methodology for analyzing non-common equity that financial sponsors and strategic owners provide to nonfinancial corporate entities.

- This paper describes FiinRatings methodology for analyzing non-common equity financing--such as shareholder loans or preference shares--that financial sponsor provide to nonfinancial corporate entities.
- FiinRatings excludes the non-common equity financing that financial sponsors provide to a nonfinancial corporate company from our financial analysis, including leverage and overage calculations, if (1) the financial sponsor control the company and have economic incentive to not enforce any creditor rights associated with the non-common equity financing, the non-common equity financing includes terms and conditions that we believe in aggregate are favorable to third-party creditors; and (2) the company's behavior and the financial sponsor's financial policy does not lead us to believe that the company's leverage and coverage ratios (excluding the financial sponsor non-common equity) are likely to weaken.
- FiinRatings excludes the non-common equity financing strategic owners provide to a nonfinancial corporate company from our financial analysis, including leverage and overage calculations, when (1) we consider the owners to be strategic owners and (2) when the non-common equity financing includes terms and conditions that we believe in aggregate are favorable to third-party creditors.
- If you have any question or concern, please contact our Analytical Team at <https://fiingroup.vn/ContactUs>, or email fiinratings@fiingroup.vn.

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I. Non-Common Equity Financing
Provided by Financial Sponsors



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1. We exclude the non-common equity financing provided by financial sponsors from our financial analysis, including our leverage and coverage calculations, if all of the following conditions are met:

- **Ownership and control:** The financial sponsor controls the company through either
 - its ownership of at least 35% of the company's common equity; or
 - its retention of the majority of the voting rights through preference shares if management holds all or substantially all of the common equity;
- **Economic incentives** (Part 2 of this Section): The forementioned ownership structure creates an economic incentives for the financial sponsor not to enforce any creditor rights associated with the non-common equity financing;
- **Credit protective terms and conditions** (Part 3 of this Section): The non-common equity financing includes terms and conditions that we believe in aggregate are favorable to third-party creditors.

In this case, we exclude the non-common equity financing provided by financial sponsors from our financial analysis, including leverage and coverage calculations, provided that the company's behavior and the financial sponsor's financial policy (Part 4 of this Section) do not lead us to believe that the company's leverage and coverage ratios (excluding the financial sponsor non-common equity) are likely to weaken.

2. Alignment of economic incentives

An alignment of economic incentives is created between the common equity and the non-common equity financing if,

- First, we believe that **the financial sponsors control the company** through their ownership of common equity and the financial sponsors also provide substantial non-common equity financing. In this case, we believe that the financial sponsor would not exercise any creditor rights associated with the non-common equity financing because doing so could jeopardize its control of the company; and
- Second, the **financial sponsors do not have other interests that could affect its economic incentives**, such as being creditors and holding a position in the company's existing debt instruments, unless we consider that such position supports the consolidated company's credit quality. For example, if the financial sponsor had purchased the company's debt at a distressed value, we include the entire non-common equity financing in our leverage measures. To exclude the non-common equity financing from our leverage measures, we must believe that the financial sponsor's incentives and financial policy will lead the sponsor to act as an equity holder, rather than a creditor; and
- Third, **credit-protection terms** (Part 3 of this Section) are present, and the non-common equity financing does not pay interest, dividends, or provide any other form of economic return for as long as outstanding debt obligations to third parties remain, unless FiinRatings believes the distributions to financial sponsor is minimal and not significantly impact the financial risk profile and the cash flow position of the company.
 - In this case, to strengthen the alignment of economic incentives and avoid the possibility of the non-common equity financing being sold to a third party with no interest in the common equity, the sale of the non-common equity financing to a third party must be prohibited by the documentation of the non-common equity financing and any intercreditor agreement of which the non-common equity financing is part, unless the non-common equity financing and common equity are owned and sold together. Absent such explicit protection, we do not exclude the non-common equity financing from our financial analysis, including our leverage and coverage calculations.

3. Credit-protective terms and conditions of the non-common equity financing

In addition, for us to exclude the non-common equity financing from our financial analysis, including our leverage and coverage calculations, all of the following conditions must be met:

- **Default-proof financing terms:** The non-common equity financing does not contain any events of default, provisions for cross default or cross acceleration, or financial covenants that could lead to an event of default or the acceleration of repayments.
- **Maturity beyond senior debt:** The non-common equity financing must at all times mature at least 90 days later than all of the company's other debt, and no contractual repayment of the non-common equity financing, including accrued interest, can be made while the other debt is outstanding. This means that repayments of principal of the non-common equity financing do not burden the issuers' debt maturity profile, liquidity, and cash flow while the other debt is outstanding. The financial sponsor must record its intention to meet this condition at all times, including if it undertakes any debt refinancing, in the non-common equity financing documentation.
- **No fixed or regular payments:** The non-common equity financing cannot require fixed, periodic cash interest or dividend payments to the financial sponsor, such as payments that are not based on earnings or other financial performance measures.
- **Subordinated to all debt:** The non-common equity financing is structurally and/or contractually subordinated to all the debt in the capital structure. This ensures that the non-common equity financing would be available to act as loss-bearing capital in a stress scenario while the other debt is outstanding.

4. Financial policy assessment

The financial sponsor's historical behavior or our perception of its financial policy must not lead us to believe that the company's leverage and coverage ratios (excluding the financial sponsor non-common equity) are likely to weaken under the financial sponsor's ownership.

- **Redemption risk:** We assess redemption risk, or the risk that the non-common equity is replaced with external financial debt, and the company's and financial sponsor's risk tolerance by analyzing the company's and financial sponsor's financial policy. Financial policy refines the view of a company's risks beyond the conclusions arising from the standard assumptions in the cash flow/leverage assessment in our Corporate Methodology. Those assumptions do not always reflect or entirely capture the short- to medium-term event risks or the longer-term risks stemming from a company's financial policy. To the extent movements in one of these factors cannot be confidently predicted within our forward-looking evaluation, we capture that risk within our evaluation of financial policy.
- **Cash flow and leverage assessment:** We observed during the previous two years and the trends we expect to see for the coming two years based on operating assumptions and predictable financial policy elements, such as ordinary dividend payments or recurring acquisition spending. This holds unless the company has undergone a transformational event (such as a leveraged buyout) during the two-year period, in which case our focus will be more forward looking. Over that period and, generally, over a longer time horizon, the company's financial policies can change its financial risk profile based on management's or, if applicable, the company's financial sponsor owner's or controlling shareholder's appetite for incremental risk or, conversely, plans to reduce leverage.

We apply a forward-looking, risk-based approach in assessing redemption risk and cash flow and leverage profile of the company and the financial sponsor. A more conservative view may be taken when historical patterns or qualitative signals suggest a persistent risk of rising leverage, weakening interest coverage, or the replacement of non-common equity with debt-like instruments.

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II. Non-Common Equity Financing
Provided by Strategic Owners



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1. When we consider the owners of a nonfinancial corporate institution to be strategic owners, we exclude any non-common equity financing they have provided from our financial analysis of the institution, including our leverage and coverage calculations, if:

- **Strategic ownership:** The strategic owner holds a controlling interest; the investment is a long-term holding; and the owner has the resources and incentives to support the investment, and
- **Operational alignment:** The institution or subsidiary is reasonably successful at what it does or has realistic medium-term prospects of success relative to group management's specific expectations or group earnings norms.

2. In such case, our exclusion of any non-common equity financing provided by strategic owners from our financial analysis, including our leverage and coverage calculations, is also contingent on our belief that all of the following conditions are met:

- **Default-proof financing terms:** The strategic owner would not trigger an event of default, and the financing includes no financial covenants that will lead to either an event of default or acceleration of repayment.
- **Group Rating Methodology criteria, if applicable:** We classify the subsidiary as a moderately strategic, strategically important, highly strategic, or core subsidiary.
- **Restructuring flexibility:** The strategic owner would restructure the financing, if necessary, without creating an event of default.
- **Maturity beyond all debt:** The effective maturity date of the non-common equity financing is beyond the maturity dates of all debt by virtue of strong contractual or intercreditor provisions. Such provisions include those that would prevent the non-common equity financing from becoming due and payable until any senior debt has been fully repaid. This condition would not be met if the non-common equity financing includes a call option or any economically similar mechanism that would enable the non-common equity financing to be bought back. This holds unless the non-common equity financing is funded by an instrument that would not become due and payable before all senior debt has been repaid. Alternatively, the non-common equity financing matures at least 90 days after all other debt if the financing is not a perpetual instrument, or we believe that the issuer intends to extend the maturity date of the non-common equity financing to at least 90 days after all the other debt matures.
- **Subordinated to all debt:** The non-common equity financing is structurally and/or contractually subordinated to all other debt in the capital structure.

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Glossary of Key Terms



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- **Financial sponsors:** Institutions that follow what we deem to be an aggressive financial strategy in using debt and debt-like instruments to maximize shareholder returns. These sponsors may dispose of assets within a short to intermediate time frame. Financial sponsors include private equity firms, but not infrastructure and asset-management funds, which in our experience maintain longer investment horizons.
- **Financial sponsor non-common equity financing:** Investments in the form of shareholder loans or preference shares that sponsors make in the top company (topco) within FiinRatings' scope of consolidation for the group. Non-common equity financing can also take the form of intercompany loans that sponsors use to downstream shareholder loans or preference shares to other group companies. If the financial sponsor non-common equity financing meets our criteria, we exclude the financing from our consolidated financial analysis, including our leverage and coverage calculations. If any part of the financial sponsor non-common equity financing does not meet our criteria, we include it in our consolidated financial analysis, including our leverage and coverage calculations. If the topco non-common equity financing is of a different size to any intercompany loans, and the investments and intercompany loans meet our criteria, we exclude the topco financing from our consolidated financial analysis, including our leverage and coverage calculations.
- **Strategic owners:** We define strategic owners as investors that are not financial sponsors and that have a long-term investment horizon and the resources and incentives to support their investment financially in case of need. We consider that such an owner invests predominantly for strategic reasons, such as geographical diversification or the realization of synergies through vertical or horizontal integration. Strategic owners may include governments and do not include financial sponsors.

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