Credit Rating Agency

Rating Methodology for Infrastructure and Project Finance

Infrastructure
January 23 2023

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HR Ratings publishes its update to the rating methodology for infrastructure and project financing. It also reports on the impact on its current ratings.

HR Ratings informs that starting today, January 23 2023, the rating actions determined by HR Ratings for debt instruments backed by cash flows and assets from large-scale and infrastructure projects will be produced in accordance with the updated version of its Rating Methodology for Infrastructure and Project Finance. Additionally, HR Ratings informs that there are no effects on the outstanding ratings derived from this update. The methodology can be consulted at the following link: https://www.hrratings.com/methodology/.

The New Methodology

The purpose of this new methodology is to describe the rating process for long-term debt backed by revenues and assets associated with large-scale projects. Revenues generated by such projects must be fully isolated from the rest of the assets of the developing entity or entities and/or shareholders through legal protections and/or the creation of a special purpose vehicle (SPV). The transaction's legal structure must establish the basis for the development and operation of the project, as well as the role of each of the parties involved, limiting the influence that shareholders and/or the developer may have over income management and project operation.

The analysis process focuses on reviewing concepts relevant to any type of project. These concepts are: 1. Construction Risk, 2. Counterparty Exposure Risk, 3. Operational Risk, 4. Risk Associated with Transaction Structure and 5. Financial Metrics Analysis. These items may be weighted in different ways depending on the project's development stage and the nature of its revenues.

For the review of the first concept, HR Ratings will analyze the current adherence to the project's construction calendar, complying with all the characteristics and standards established in the construction's executive summary.

The review of the second concept is divided into two sections, the first of which focuses on measuring the risk from a breach of the financial, legal, performance or operational obligations of the counterparties. The second section of the analysis will consider the characteristics of the project's demand based on the market in which it is involved, as well as its' payment system, flexibility in updating tariffs and prices, and the barriers of entry into the market in which the project is involved.

The third concept analyzes the risks that could arise for infrastructure projects during the operation phase. These risks could manifest from a failure in the monitoring systems, reporting, established agreements, budget management or goals that are difficult to achieve within the established timeframe. For the fourth concept, the protections established to ensure project continuity are analyzed. The factors to be considered are the shareholder, contractual, organizational and administrative structure established for the project.

These first four concepts will be evaluated by assigning labels. The process for incorporating this evaluation into the credit rating consists of three steps: (i) each factor analyzed is given a label of either *{Superior, Average and Limited},* based on the quality of processes or mitigants associated with the risk factor in question; (ii) each label is assigned a value of {3,2,1}, respectively, with which the weighted average of these values is calculated; and (iii) an integer value is estimated between 1 (lowest) and 19 (highest) according to a correspondence to the weighted average of the label values.

The metrics analysis consists of two steps to determine the set of metrics relevant to the project subject of the credit quality assessment. In the first instance, the evaluation will differentiate between two possible categories based on the nature of the income: (i) projects subject to demand volume or market price risk and (ii) projects with payments under long-term agreements. The second step considers: (i) the timing of the payments associated with the debt, and whether they are mandatory, and (ii) conditions or clauses related to the possibility of partial or complete release of remnants, or their application to advance payment of the debt. Once the categories associated with the project

are identified, HR Ratings will use a combination of the following metrics: (i) Annualized Stress Rate, (ii) Average Primary Debt Service Coverage Ratio, (iii) Average Primary Debt Service Coverage Ratio in Stress, (iv) Short-Term Secondary Debt Service Coverage Ratio and (v) Loan Life Coverage Ratio. For the analysis of these metrics, HR Ratings builds a financial model with projections under a base and stress scenario. The first one incorporates the most probable evolution of the project, considering its strategies and current macroeconomic context. The stress scenario incorporates an assumption of the manifestation of macroeconomic, financial and operational risk factors to which the project is exposed.

Finally, HR Ratings may assign a qualitative adjustment of up to three notches. These adjustments are applicable whenever HR Ratings identifies and exogenous factor that could have a direct impact on the project's credit quality, subordination levels on the payment waterfall, or whenever there's uncertainty or volatility associated with one of the project's main variables for example usage level, production level, tariffs, and their effect on demand, amongst others.

Impact of the Implementation of the New Methodology on the Current Ratings

HR Ratings currently maintains 31 public ratings on debt backed by flows and assets associated with large-scale and infrastructure projects. Due to the incorporation of this methodology into the analysis process, HR Ratings carried out a review of each of these concluding that none of them have been altered from because of the new methodology.

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