

# HIGHWAY INVESTMENT TRUST

## MARC RATING METHODOLOGY

The logo for MARC Ratings Berhad, featuring the word "MARC" in a bold, red, serif font, centered between two horizontal blue lines.

### SUMMARY

A highway investment trust is a special purpose trust company constituted to fully acquire toll road concessionaires from owners. The trust issues bonds/sukuk, proceeds of which is utilised to fund the acquisition to repay shareholders and the existing borrowings of the concession companies. In recent times, the key objective in setting up the trust domestically is to relieve the government of compensation obligations in lieu of toll hikes as stipulated in toll concessions while allowing existing toll rates to be maintained until the end of the extended concession periods. The extension to the concessions is necessary to realise the trust's objective. Post-acquisition, the concessionaires are likely to remain responsible for the day-to-day operations, toll collection and maintenance of the highways.

The trust ownership structure is made up of external directors who are equal shareholders in the trust and whose explicit role is to ensure adherence to objectives entrenched in the trust's constitution. The trust exhibits the characteristics of a not-for-profit entity given the prohibition of dividend distributions. Instead, any surplus generated from toll collections is used to pare down the outstanding bond/sukuk with the aim to reduce the concession period.

In arriving at the rating on the bond/sukuk issued by a highway investment trust, MARC incorporates the aforementioned characteristics of the trust to its existing methodologies on toll road project financing and sukuk/bond rating.

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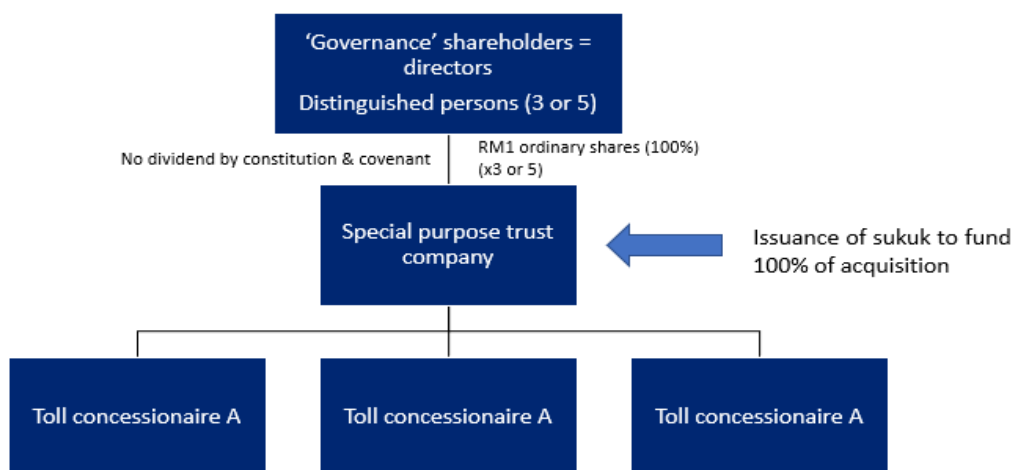
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## INTRODUCTION

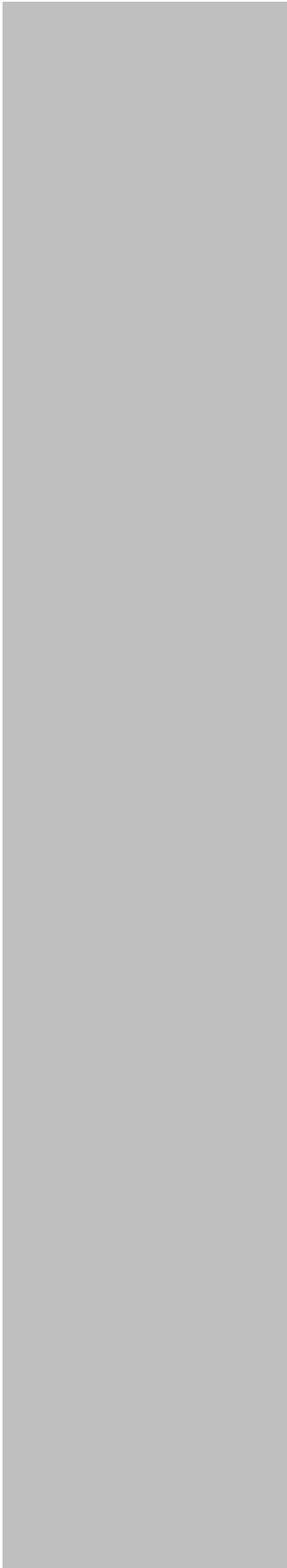
A highway investment trust contains a brownfield highway or a portfolio of brownfield highways and therefore is not exposed to construction risk. It, however, remains exposed to regulatory, traffic and operational risks. MARC monitors government policies governing the concessions and changes enacted by Lembaga Lebuhraya Malaysia (LLM), the regulatory body overseeing all toll roads in Malaysia. The rating agency examines the highways' traffic reports, forecasts and operational track record, financial performance, and cash flow analysis along with the features of the trust in its rating assessment. In arriving at the rating, the business risk, financial risk, and trust structure and governance are weighted accordingly.

Exhibit 1: Typical transaction structure



## BUSINESS RISK

Factor	Analytical focus
Regulatory risk	<p>Type of concession</p> <p>Highway concessions are generally based on the build, operate and transfer (BOT) model, and will be transferred back to the government at the end of concession, the duration of which is long, typically about 30 years. The analytical focus is on the rights, roles and responsibilities of all parties under the concessions. In the event of supplementary concessions, the focus is on the impact from the changes in the concession terms to the cash flow analysis.</p>



	<p>Termination provisions</p> <p>This includes events of defaults, force majeure (events that are beyond the concessionaires' control), terms and conditions relating to termination as well as compensation. The focus is on whether the concessions contain terms that protect sukukholder/bondholders in the event of termination.</p>
	<p>Extension of concession period</p> <p>Generally, extension to the concession is part of the compensation package provided by the government to address lower revised toll rates compared to the agreed toll rates as per the concession agreements. In the case of a trust's acquisition, the focus is on whether any extension of highway concessions is required and if so, whether regulatory approval is granted.</p>
	<p>Toll rate setting mechanism</p> <p>The focus is on the toll rate setting mechanism and approval from the regulators on toll rates movements, in the event there be a need to raise toll rates under adverse situations.</p>
<p>Traffic risk</p>	<p>Traffic profile and forecast</p> <p>The emphasis is on the area's traffic characteristics and existing traffic patterns from traffic consultant reports and traffic studies. The forecast is based on the average daily volume of vehicles estimated in the consultant report.</p> <p>Highway competitiveness</p> <p>The study area network is assessed with the average traffic volume (normally reported as passenger car unit, or PCU) estimated for each travel corridor. Alternative roads available in the vicinity of the toll road project are also considered. Comparative rates for similar toll roads within the region or area are taken into consideration and the consequent public acceptance of any increase in toll rates is assessed.</p> <p>Service area fundamentals:</p> <p>Demographics and historical traffic growth in the area are considered as well as key growth drivers such as matured and proposed commercial and residential development areas which serve as catchment areas.</p>

Operational risk	Operations and maintenance (O&M) contract terms  This includes the operator's scope of work, and the relevant parties' rights and responsibilities.
	Experience and track record of operators  Typically, under the trust structure, the same team of highway operators are retained under the same terms of the O&M contracts.

## Financial Risk

MARC focuses on cash flow coverage analysis and profitability of the toll road concessionaires, particularly their operating margins. Key drivers of profitability are traffic volume and operating expenditure. Capital expenditure of mature toll roads are not high and are related to maintenance works such as road resurfacing which are only required periodically. Typically for a trust structure, the toll rates are relatively stable under the approach to maintaining the toll rates at an acceptable level.

Factor	Analytical focus
Profitability/ Earnings	The main profitability measures include revenue, profitability, operating profit margin, interest paid, and operating profit interest (finance cost) coverage. The profitability measures are benchmarked against other toll road concessionaires in MARC's universe.
Cash flow coverage	Cash flow projections over the tenure of the financing facility are primarily based on assumptions made regarding traffic forecast and operating expenditure. Sensitivity analysis is carried out to ascertain the worst-case scenario. Debt repayment capacity is measured against the debt repayment schedule, i.e. to arrive at the minimum and average debt/finance service coverage ratio (DSCR/FSCR) under sensitised scenarios.
	The analyst uses past financial reports to carry out variance analysis against the forecast financial results. The analyst determines the historical FSCR, cash flow from operations (CFO) interest coverage and CFO debt coverage of the company. The analyst requests for confirmation on the FSCR calculation from the security trustee through the client to determine whether the FSCR meets the minimum FSCR requirement in the financial covenant.

Capitalisation	<p>The debt/finance-to-equity (DE/FE) ratio is an important indicator of the capitalisation structure to be monitored by the analysts against the maximum DE ratio allowed in the financial covenants.</p> <p>A favourable capital structure comprises a relatively lower level of senior debt which should significantly reduce the probability of default risk, particularly in the initial operating years.</p>
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## TRUST STRUCTURE AND GOVERNANCE

The analysis focuses on the trust's corporate governance structure and the background of the external directors who are equal shareholders in the trust. The trust ideally has a board of governors comprising professionals with sound background, significant corporate experience and no vested interests in businesses carried out by the trust. The appointments require approval of the government. These selected individuals who make up the board are instrumental in the governance of the trust in accordance with the established objectives and policies.

The Articles governing the board's roles is examined as to whether they are in accordance with the trust's objectives. Given that a trust exhibits the generic characteristics of not-for-profit organisations and is operated for collective public benefit, there is a prohibition of the distribution of dividends. The focus is on the mechanism where the available surplus is applied to shorten the concession period.

### Other considerations: Issue structure

The issue structure spells out the principal terms, conditions and covenants of the debt facility, such as repayment, security, and designated accounts. The focus is on the terms, conditions and covenants under the issue structure.

Factor	Analytical focus
Liquidity risk	This risk is somewhat mitigated through the requirement to maintain a minimum amount equivalent to six months to one year of the profit or interest in a debt reserve account throughout the tenure of the financing facility.
Investment risk	The risk of capital loss in respect of the investment of funds in the designated accounts is mitigated by the requirement to restrict investments to liquid assets, government-issued instruments or capital market instruments with a minimum rating of AAA or AA with maturity dates matching the debt obligation dates.

MARC has refined its methodology for rating Toll Roads and it should be read in relation to its "Project Finance" methodology which is available on the website at [www.marc.com.my](http://www.marc.com.my). This methodology partly amends and supersedes MARC's "Toll Roads Project Financing" published in 2015.

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Published and printed by:

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