



# EQUIPMENT LEASE AND LOAN RATING METHODOLOGY

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## EQUIPMENT LEASE AND LOAN RATING METHODOLOGY

### Overview

Egan-Jones Ratings Company, Inc. (“Egan-Jones” or “EJR”) is a credit rating agency established in 1995. Privately owned and operated without affiliation to any financial institution, Egan-Jones is respected for its timely, accurate evaluations of credit quality.

Egan-Jones ratings and research are available via e-mail, its website, and other distribution platforms. EJR is committed to continuously refining its expertise in the analysis of credit quality and is dedicated to maintaining objective and credible opinions within the global financial marketplace.

### SEC Requirements

A general description of the procedures and methodologies used to determine credit ratings. The description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed in determining credit ratings, including, as applicable, descriptions of: policies for determining whether to initiate a credit rating; a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings; the quantitative and qualitative models and metrics used to determine credit ratings, including whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction factor into the determination of credit ratings; the methodologies by which credit ratings of other credit rating agencies are treated to determine credit ratings for securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction; the procedures for interacting with the management of a rated obligor or issuer of rated securities or money market instruments; the structure and voting process of committees that review or approve credit ratings; procedures for informing rated obligors or issuers of rated securities or money market instruments about credit rating decisions and for appeals of final or pending credit rating decisions; procedures for monitoring, reviewing, and updating credit ratings, including how frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to

existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings; and procedures to withdraw, or suspend the maintenance of, a credit rating. Market participants are provided the opportunity to comment on the methodologies through the EJR's website (publicly available) for EJR's consideration.

## Executive Summary

This document describes EJR's approach to rating equipment assets (i.e., loans and leases) which do not contain a waterfall liability structure. This document shall be used in conjunction with EJR's main Methodologies (<https://egan-jones.com/>), in which other rating approaches and methodologies may be considered as appropriate.

In contrast to transactions with security or collateral whereby the analysis is based primarily on the credit quality of the obligor, in the case of pooled assets, the emphasis of the analysis is on the underlying assets and the performance of the pooled assets.

Funding equipment via leases or loans provides an efficient means for meeting the needs of obligors and investors. Using such a structure facilitates the distribution of risk and yet avails the obligors of low-cost funding. Below is a description of the methodology used by Egan-Jones for rating such transactions. The key steps in the rating process are listed below and described in greater detail:

- Asset analysis
- Financial structure, cash flows, expected losses, resulting liability coverage, and a comparison to the implied rating matrix
- Originator and servicer review
- Credit support analysis
- Transaction documentation and legal analysis
- Final ratings
- Surveillance.

## The Rating Approach

Asset and Obligor Analysis includes a review of the type of equipment, usage, industry trends, value deterioration, remarketing process and costs, and residual value assumptions. Key considerations are the performance of the asset pool, delinquencies, bankruptcies, foreclosures, assets owned, and prepayments. Additional considerations are the spread between assets values and liabilities, condition of the assets, concentrations, prior credit characteristics, risk factors, obligor data, and trends. An acceleration in the delinquencies and losses for the pool would generally be considered a negative event. EJR makes best efforts to review the time, cost, and potential losses associated with remarketing assets and, where appropriate, the reasonableness of residual value assumptions.

Financial Structure, Cash-flows, Expected Losses, Resulting Liability Coverage, and a Comparison to the Implied Rating Matrix analyzing the financial structure of the transaction involve analyzing the payment priority and credit enhancements. EJR uses cash flow models to determine the adequacy of the credit enhancement structure using the default, recovery and/or loss expectations. EJR aims to determine the true level of credit support by subtracting from the calculated credit support the various delinquencies (30, 60 and 90+ day delinquencies when available), bankruptcies, foreclosures, and assets owned in order to obtain EJR "adjusted asset coverage" or "adjusted credit support." In addition, an evaluation is made of the debt service coverage. EJR then compares the two coverage measures to an EJR credit matrix which calibrates minimum support levels by rating levels (the higher the level, the higher the implied rating) in order to obtain an implied credit rating. Ratings analysts review the implied rating in conjunction with its assessment of any difference between historical performance and expected future performance, and evaluates the likely future coverage.

Below is an analysis framework for a simple transaction:

Year	Contracted Equip Income	Shortfall	Realized Equip Income	Expected Residual Values	Realized Residual	Total Revenue	Principal at \$80
	<u>1</u>	<u>2</u>	<u>3=2-1</u>	<u>4</u>	<u>5</u>	<u>6=3+5</u>	<u>7</u>
1	23.0	0.5	22.5			22.5	16
2	23.0	1.0	22.0			22.0	16
3	23.0	0.5	22.5			22.5	16
4	23.0	0.5	22.5			22.5	16
5	23.0	0.0	23.0	30.0	41.0	64.0	16
<u>Debt Service Coverage</u>				<u>Liability Coverage</u>			
Year	Interest at 5%	Total DebtPmt	Debt Serv Coverage	Asset Value	Principal	Liability Coverage	
	<u>8</u>	<u>9=(7+8)</u>	<u>10=6/9</u>	<u>11</u>	<u>12</u>	<u>13=11/12</u>	
1	4.0	20.0	1.13	100.0	80	125%	
2	3.2	19.2	1.15	82.5	64	129%	
3	2.4	18.4	1.22	65.0	48	135%	
4	1.6	17.6	1.28	47.5	32	148%	
5	0.8	16.8	3.81	30.0	16	188%	

In the above simplistic example, \$100 of equipment is financed using \$80 of debt at 5.0%, and the contracted annual equipment income is \$23 per annum. The equipment is assumed to experience real depreciation of \$17.5 per annum. The resulting debt service coverage is listed above in column 10 and the resulting liability coverage is listed column 13. As illustrated above, assuming the projections are accurate, credit quality improves steadily over the term of the transaction. The rating(s) assigned is ultimately based on judgment of analysts, but the debt service coverage and liability coverage are significant components. Below section is the information sought on transactions to be rated.

### Originator and Servicer Reviews

While EJR’s analysis of the credit quality of the underlying collateral is the key part of the rating process, the risk caused by operational weaknesses is often not apparent in the collateral characteristics but manifests itself in pool performance. EJR believes conducting originator and servicer reviews provides a limited indication of the risk attributable to an originator level of risk management and disclosure. The factors which might be included in a servicer analysis include corporate stability, financial condition, management and staff experience, technological

capabilities, policies and procedures, controls, and historical servicing performance. Below section is information for ratings.

### Credit Support Analysis

In some cases there is credit support; a prime example being that of a monoline insurance firm's support. If such support is provided, EJR will include it in assigning a rating.

Transaction Document and Legal Analysis Review: EJR does not review the transaction documents addressing the characteristics of the underlying assets pool to confirm structure, duties of the transaction parties, servicing and reporting provisions or the representations and warranties, as would be provided by the transaction parties. The publicly available representations and warranties provide assurances that certain facts about the collateral and transaction parties can be relied upon.

### Assigning the Ratings

After an analysis is completed, the rating is assigned and listed in the rating analysis report (RAR). Such ratings are subsequently reviewed. Rating file documents notes are retained by EJR.

### Surveillance

EJR's surveillance of existing transactions follows the same approach and adheres to the same regulatory requirements as those for assigning new ratings, as described above. Transactions are monitored on an ongoing basis with an updated rating action (affirmed, upgraded, or downgraded). Transactions are monitored for variations in performance that are outside the norm for stipulated collateral, or deviations from EJR's initial performance expectations. Rating actions for transactions may occur frequently particularly if performance of the underlying pool of assets exhibits rapid deterioration.

## Information for Ratings

### Sponsor/organizer/servicer

- Description of the firm and its principals
- Organizational charts
- Strategy, market position, focus
- Three years audited financial statements and pro formas
- Regulatory and compliance issues, litigation (current and pending)
- Recent developments
- Description warehouse lines and debt terms
- Origination process
- Training
- Underwriting process
- Documentation administration
- Performance on prior programs
- Servicing, billing, and collection expertise/ process
- Cash controls
- Equipment support expertise
- Remarketing expertise

### Sponsor/organizer/servicer information specific to transaction

- Underwriting criteria
- Underwriting approval and exception reporting
- Servicing and collections policies and procedures
- Contract amendment and modification procedures
- Charge-off and repossession policies and procedures
- Collateral Data/Portfolio Stratification

### Description of the equipment

- Type of equipment and manufacturers
- Age
- Usage
- Maintenance
- Remarketing
- Valuation support
- Residual value support

## Portfolio data

- Obligors – profile, selection
- Underlying lease or note terms, original and remaining, yields, periodicity
- Delinquencies, contract modifications, defaults, and charge-offs/ losses
- Remarketing experience/ recoveries
- Obligor concentrations
- Obligor industry distribution
- Geographic distribution and concentrations;
- Original and remaining terms
- Vendor concentrations

EJR's method for assigning ratings is consistent with the EJ Ratings Code of Conduct and documented in detail in a combination of the EJ's published methodologies and its internal policies and procedures. The Rating Process above addresses EJ's general approach to initiating and monitoring ratings, review by the RRC, and updating of ratings.

## Limitations and Disclaimers

All EJR credit ratings and published methods are subject to certain limitations and disclaimers.

**Information:** Adequate information must be available to reach a view on the creditworthiness of the issuer, entity, or transaction in question. This includes publicly available information on the issuer, such as company financial and operational statistics, reports filed with regulatory agencies, and industry and economic reports. In addition, the rating process may incorporate data and insight gathered by EJR. If the available information appears insufficient to form a rating opinion, EJR may decide not to assign or maintain a credit rating.

**Audit:** Egan-Jones does not perform an audit in connection with any credit rating and may rely on unaudited financial information.

**Usage:** EJR's ratings remain its property at all times, and EJR has full discretion to determine if and when to withdraw a rating. Thus, EJR can choose to withdraw a rating at any time and for any reason, for example, due to a lack of information or a lack of market interest.

**Methods:** EJR does not intend to assume, and is not assuming, any responsibility or liability to any party arising out of, or with respect to, its published ratings methodology. Its ratings methodology documents are not intended to and do not form a part of any contract with anyone and no one shall have any right (contractual or otherwise) to enforce any of their provisions, either directly or indirectly. At its sole discretion, EJR may amend its ratings methodology documents and the processes described therein in any way and at any time as EJR may elect.

**Disclosure of Ratings:** Egan-Jones follows the applicable regulatory rules and requirements for the disclosure of ratings. Rating definitions and the terms of use of such ratings are available on the firm's website at [www.EGAN-JONES.com](http://www.EGAN-JONES.com). Published ratings, criteria, and methodologies are available from this site. Policies and procedures concerning conflicts of interest and other relevant topics are also available from this site.

Market participants are provided the opportunity to comment on the methodologies through the EJR's website (publicly available) for EJR's consideration.