LIABILITY OR EQUITY

Every company has its own target capital structure (i.e. debt-to-equity ratio). This involves the considerations of

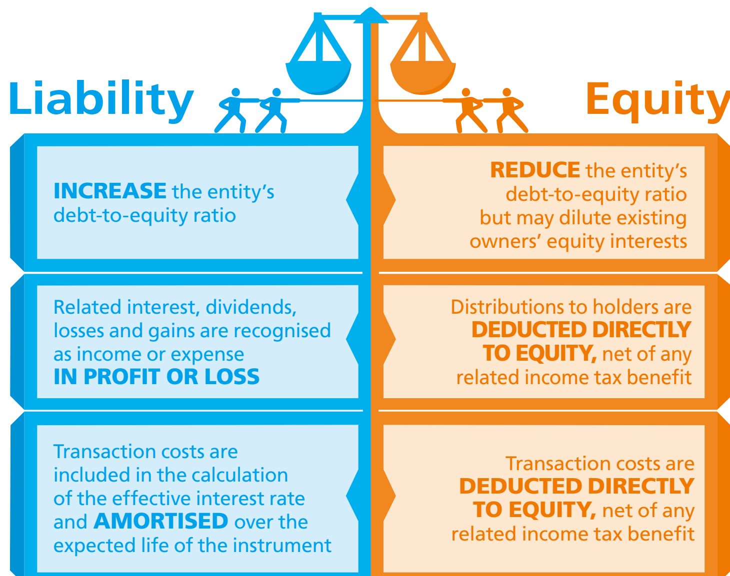
1. the amount of equity issued and dilution of shareholders' interests by issuing more equity;
2. using internally generated cash flows;
3. the tax advantages of borrowing; and
4. the financial distress in case of excessive leverage.

Appreciating that the power industry is a capital-intensive business, CLP has formulated its investment and financing strategies with an aim to grow its business as well as to achieve and maintain its good investment grade rating. Thus, when reviewing any investment proposals, CLP has to consider their impacts on the credit metrics. In the first half of 2014, CLP has issued perpetual capital securities to finance its funding requirement. This is a good opportunity to introduce how to account for these contemporary financial instruments and their impact on CLP's credit profile.

Liability or equity?

When a company issues a financial instrument, it must determine its classification either as a liability (i.e. debt) or as equity. That determination has an immediate and significant effect on the company's reported earnings and debt-to-equity ratio.

The Conceptual Framework for Financial Reporting defines a liability as 'a present obligation of the entity arising from the past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'. Specifically, HKAS 32 Financial Instruments addresses the classification of the financial instruments. HKAS 32 does not look to the legal form of instruments. Instead, it focuses on the instruments' contractual rights and obligations. A critical feature in differentiating a liability from equity is the existence of a contractual obligation of the issuer of a financial instrument to deliver cash or another financial asset to the holders. In practice, the classification is far from straightforward as some financial instruments contain both debt and equity features.



> "In constructing the terms of a financial instrument, each component clause would have an impact on the accounting classification."

To illustrate how the classification principles are applied, let's go through some common features found in most financial instruments:

1. Redeemable or non-redeemable

An equity instrument is usually non-redeemable. If a financial instrument has a fixed date of redemption, or which give the holders an option to redeem at some point in time, this instrument has to be classified as a liability. However, if the option to redeem the financial instrument is at the discretion of the issuer (i.e. the issuer has the right but not the obligation to pay cash to buy back the instrument), it may be classified as an equity instrument, subject to a further examination of other rights attaching to the financial instrument, especially in relation to the returns component.

2. Mandatory or discretionary returns

When distribution to the holders of a financial instrument is at the discretion of the issuer, the instrument is an equity instrument. If distribution is mandatory, the financial instrument has to be classified as a liability. When classifying an instrument, one should not only assess the obligations related to the principal payment, but also the coupon payment. A typical example of this is a perpetual debt instrument.

The holders of a perpetual debt instrument generally have no right to receive principal repayments. However, they usually have the contractual right to receive interest payments indefinitely. Purely looking at the non-redeemable nature of the principal may indicate that this instrument is an equity instrument. However, the obligation to pay interest indefinitely alters its classification. Though the principal will never be repaid, the value of the instrument is wholly derived from the mandatory interest payments. Therefore, the perpetual debt instrument should be classified as a liability in its entirety.

3. Dividend pusher and dividend stopper

Sometimes a financial instrument contains certain special provisions such as "dividend pusher" and "dividend stopper". One example of "dividend pusher" is that the holders of a financial instrument will receive a distribution automatically when a distribution is made to the ordinary shares. "Dividend stopper" is a converse situation. A distribution cannot be made to the ordinary shares unless a distribution is made on the financial instrument.

As the distribution to the ordinary shares is at the discretion of the issuer, both the dividend pusher and the dividend stopper clauses of the financial instrument do not introduce a contractual obligation to the issuer (i.e. the issuer has discretion to determine the delivery of cash or another financial asset). Thus the instrument should be classified as equity in its entirety.

"Classifying an instrument as equity can strengthen the balance sheet by reducing the gearing ratio of an entity. This enhances the capital structure and improves credit metrics."

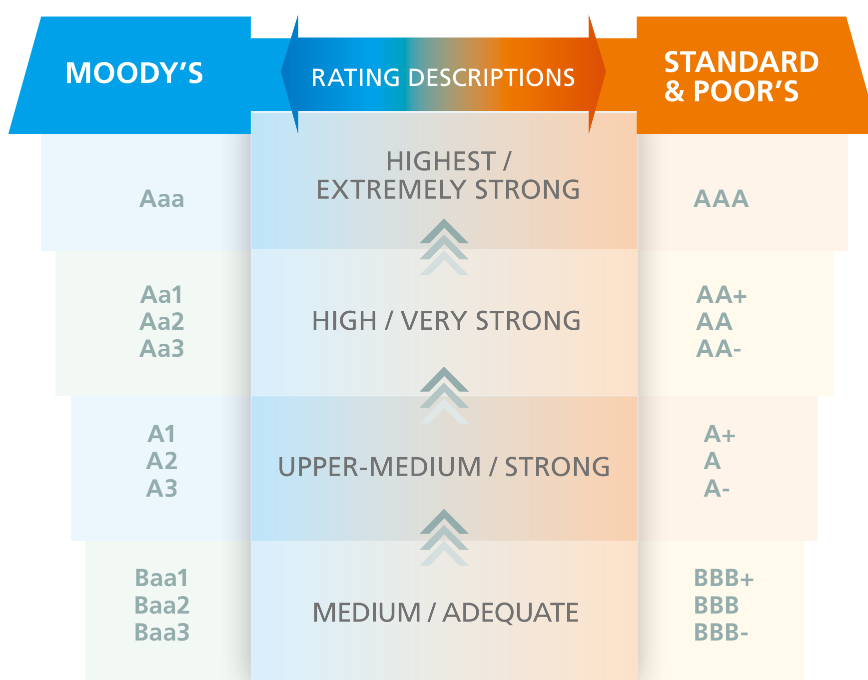
What is credit rating?

A corporate credit rating is an evaluation of the credit worthiness of a company, including the company's ability to pay the principal as well as interest at the scheduled dates and the likelihood of default.

Credit ratings are not based on mathematical formulas. Instead, credit rating agencies assign ratings to companies based on their evaluation of qualitative and quantitative information of these companies. They use letter designations such as A, B, C. Higher grades are intended to represent a lower probability of default. A corporate debt is considered "investment grade" if its credit rating is BBB- or higher by Standard & Poor's or Baa3 or higher by Moody's. CLP Holdings has a corporate rating of A- from Standard & Poor's and A2 from Moody's.

The credit rating has a material impact on the yield of a debt instrument. If an issuer has a better rating than its peers, it should be able to issue debt at a lower cost than those entities having similar business parameters.

When an instrument is not a pure debt or equity, credit rating agencies assign the "equity credit" to the instrument by assessing whether the instrument is more equity-like or debt-like in terms of its effect on the issuer's corporate credibility. An equity credit of 50% means that when computing standard credit metrics, the credit rating agencies would split the principal amount of that instrument 50% equity, 50% debt. Distributions would also be split; 50% dividends, 50% interest expense. Different credit rating agencies use different methodologies to assess the weighting between equity-like or debt-like instruments; as a result different equity credits may be assigned.



How are our perpetual capital securities being accounted for and the impact on our credit metrics?

CLP Power Hong Kong has issued an aggregate of US$750 million perpetual capital securities in 2014 with the following key contractual terms:

- Perpetual and non-callable in the first 5.5 years.
- Subject to conditions as mentioned below, securities holders can receive distribution at a fixed rate of 4.25% per annum in the first 5.5 years, floating thereafter and with fixed step up margins at year 10.5 and at year 25.5, payable semi-annually in arrears, cumulative and compounding.
- Coupon deferrable at the discretion of CLP unless CLP Power Hong Kong declares or pays dividend to CLP Holdings within the 6-month period prior to the scheduled distribution date (Dividend Pusher) or other circumstances including distribution, payment or repurchase of junior or parity obligations.
- If CLP elects to defer distribution to the holders, CLP Power Hong Kong will also defer dividend distribution to CLP Holdings (Dividend Stopper).

Accounting classification:

Based on the above criteria, the perpetual capital securities are classified as equity because:

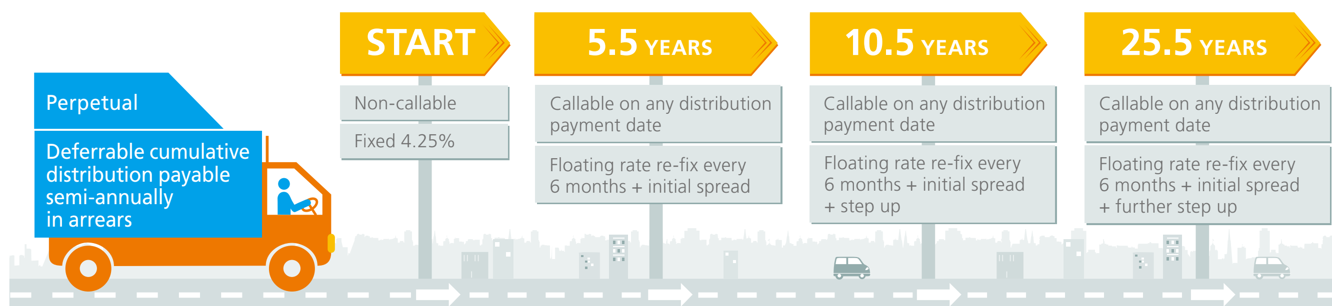
1. the securities are non-redeemable with the option to redeem at the discretion of CLP; and
2. distributions are also at the discretion of CLP.

The perpetual capital securities are presented as non-controlling interests in the consolidated financial statements and any coupon payments on the securities are deducted directly to equity.

Impacts on credit metrics:

The issuance of perpetual capital securities allows CLP Power Hong Kong to achieve:

- 50% equity credit for life from Moody's; and
- 50% equity credit for the first 5.5 years from issuance from Standard & Poor's.



Is there an optimal gearing for a company?

An optimal gearing means an optimal mix of debt and equity in a company's capital structure where its cost of capital is minimised so that the company's value can be maximised.

The cost of capital is the cost of a company's sources of funds. One must calculate both the cost of debt and the cost of equity to determine a company's cost of capital. The cost of capital is the minimum return that investors expect for providing capital to the company. A rate of return larger than the cost of capital is usually required.

Because of tax advantages on debt issuance and its priority repayment, it is usually cheaper to issue debt rather than equity. However, beyond certain leverage, the cost of issuing new debt will be greater than the cost of issuing new equity because adding more debt will increase the default risk of the company. This will increase the interest rate that the company must pay in order to borrow money. Increasing default risk due to increasing debt financing will drive up the cost of equity of the company as well.

CLP's financing strategy aims to achieve the optimal gearing by monitoring the risk profile of the Company to reduce its cost of equity and preserving strong credit metrics in order to maintain good investment grade credit ratings for its debt.