CORPORATE ANALYSIS

Credit Rating

A Credit Rating evaluates the ability of a debtor to pay interest and at the end of respective maturities pay back financial liabilities and obligations. In essence, a credit rating aims to predict the risk of a debtor to default.

Therefore, a Credit Rating addresses the solidity of financial instruments of firms, such as bonds outstanding, but also, for example, of sovereigns or merely – on a stand-alone basis - complex structured debt products. Usually, Credit Ratings are associated with a handful of globally operating credit rating agencies, the most prominent of them being Standard & Poor´s and Moody´s, together combining more than 80% of the market. But also banks have their own internal credit rating systems for loans they extend to corporate or retail customers.

Credit rating agencies apply a whole arsenal of financial ratios and multipliers to assess corporates, among them ratios addressing financial liquidity and leverage, profitability or operational efficiency. But equally relevant in the course of a credit rating process are soft parameters, such as the quality of a firm´s management, a firm´s competitive strength or compliance with corporate governance and principles of transparency. This is usually assessed in the course of meetings with senior firm executive management.

In the following, we will just focus on such ratios which directly deal with and assess a firm´s financial liabilities and standing: To start with, creditors, but also suppliers will assess a counterparty´s leverage, or gearing. (Please note that suppliers can - as having previously argued - also be regarded as short-term creditors, because they may not be paid immediately when delivering a product or service). In assessing leverage, a firm´s financial liabilities are weighted in relation to its overall assets, but also its equity. These resulting leverage ratios will then be put in perspective relative to the firm´s industry peers as well as historical trends. Obviously, the higher a firm´s leverage, the higher the risk that financial obligations may sooner or later not be fulfilled. - The rationale is that the equity – as the most relevant basis in assessing a firm´s leverage – is the principle buffer available to smooth potential, unexpected shocks as well as short- and medium-term economic or firm weaknesses, such as in cyclical industries. Leverage focuses therefore on the funding structure as such.

Another key indicator - especially relevant for commercial banks - addresses a firm´s ability to meet its interest payments (Just remember that firms´ interest payments are the most important revenue item for any commercial bank). For this purpose one may consider a parameter called Interest Coverage: In calculating it, usually a firm´s EBIT (earnings before interest and taxes) is divided by a firm´s due interest payment, but variations of this approach exist: The higher such ratio, the better for a lender. – The rationale is that regularly incurring interest payments have to be met from sources generated by a firm´s economic activity and EBIT is a reasonable proxy for a firm´s operating cash flow.

Debt Coverage is another among many relevant parameter: Usually, it is calculated by assessing how many times a firm´s EBITDA (earnings before interest, taxes, depreciation and amortization) covers a firm´s financial liabilities (thereby looking at both, principle and interest). Depreciation and amortization are included in the numerator, as these factors are non-cash cost items. They are - at least theoretically - available liquidity or cash sources for redeeming outstanding debt. (Having said this, one must not – in following this approach – ignore possible corporate investment and capex commitments to sufficiently maintain a firm´s asset basis). Also in this case, the rationale is that a firm´s liabilities should be covered by its ongoing economic activity.

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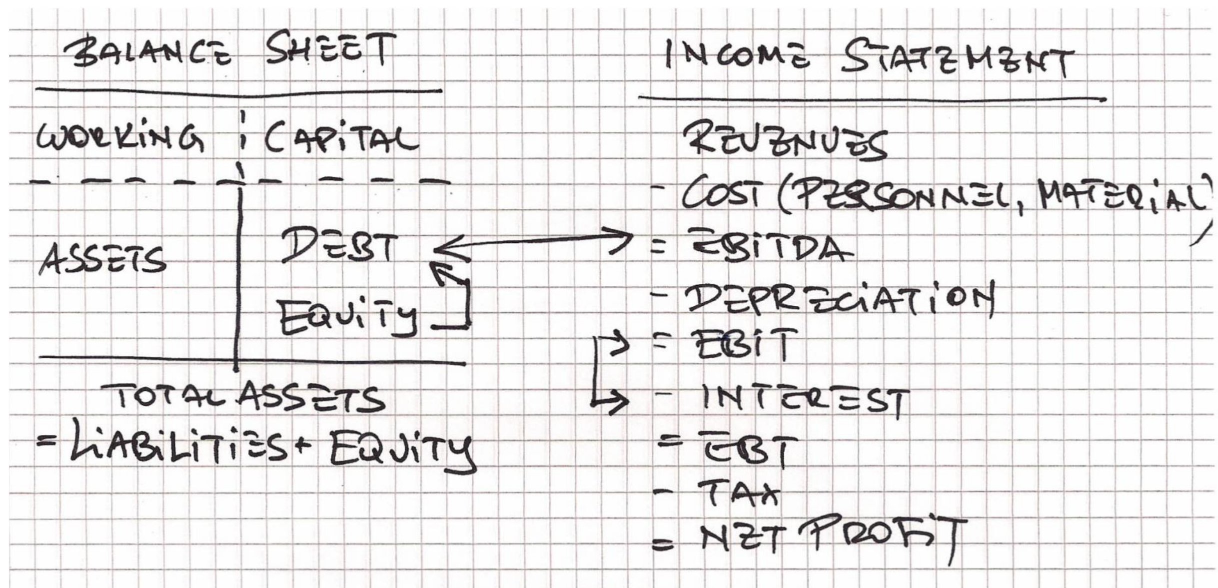

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