Credit Standing

A credit standing evaluates a debtor´s creditworthiness in general terms as well as in context of a specific financial obligation. It assesses a debtor´s ability to make (regular) interest payments as well as redeem a debt´s principal at the end of maturity. Hence, a credit standing aims to predict the risk of default.

Credit ratings, a common tool in assessing a firm´s credit standing, address the solidity of financial instruments issued by corporates or sovereigns, but also – for instance – of complex debt structures. Most of generally acknowledged and relevant credit ratings are issued by just a handful of globally operating Credit Rating Agencies (CRAs), most prominent of them Standard & Poor´s and Moody´s, together combining some 80 per cent of the market. Banks, for instance, use their own internal credit rating systems to assess loans they extend to corporate or retail customers.

In assessing corporates, CRAs apply an extensive set of financial parameters, addressing items such as financial liquidity, leverage, profitability or operational efficiency. Next to quantitative parameters, also qualitative aspects are taken into account in the course of a credit rating process, for instance the standing of a firm´s management, a business´s competitive strength or its compliance with corporate governance standards and principles of transparency. Thereby, CRAs rely on financial data delivered by a firm as well as impressions gathered in the course of meetings with executive management.

Despite some creditors and most suppliers frequently not having sufficient time, capacity or ability to run processes like a CRA would do, there are a few straightforward, powerful ratios which can be applied to evaluate a firm´s credit standing:

Assessing a firm´s leverage (indebtedness) is a good starting point. Thereby, a firm´s financial liabilities are weighted in relation to its overall assets or its equity position. These leverage ratios can then be compared with that firm´s industry peers as well as along historical trends. Whereby, the higher a firm´s leverage, the higher the apparent risk that sooner or later financial obligations may not be met.

A firm´s equity is the principle buffer to smooth unexpected shocks as well as temporary economic or firm-related weaknesses. Latter is especially relevant when dealing with cyclical industries or such showing volatile performance patterns. At the same time, though, equity is any firm´s most expensive source of funding: Hence, using leverage helps reducing the average cost of capital. – However, also the quality and components of a firm´s equity need to be assessed: If, for instance, equity were foremost composed of retained earnings (only), then that could (unexpectedly) vanish, if – all of a sudden – a firm decided to pay (extraordinary) dividends to shareholders.

Interest coverage indicates a firm´s ability to pay debt-related interest payments. This parameter is especially relevant for a corporate´s house banks, as interest payments made by its corporate customers are a bank´s most important revenue item. - In calculating interest coverage, one divides a firm´s Earnings before Interest and Taxes (EBIT) by interest payments due, whereby variations of this approach exist: The higher such ratio, the better a firm´s standing. – The rationale behind the interest coverage concept is that regular interest payments should be met by a firm´s ongoing business activity, with EBIT being an (inaccurate, though) proxy for a firm´s free cash flow (with required investments already accounted for).

Debt coverage indicates how many times a firm´s Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA) covers its financial liabilities (including both, principal and interest). Depreciation and amortization are included in this calculation´s numerator, as these factors are non-cash cost items: They are interpreted as (theoretical) liquidity or a cash source available for redeeming outstanding debt. (One has to keep in mind, though, that corporate investment and related commitments will rely and draw on these sources, too). - Also in this case, the rationale behind the approach is that a firm´s liabilities should be covered by its ongoing business activity.

NOTE: Mentioned credit concepts focus on debt (i.e. interest-bearing liabilities). Therefore, payables, for instance (i.e. non-interest bearing liabilities) are not included, despite a firm´s suppliers technically extending credit. Hence, in assessing a firm´s "ultimate" credit standing also working capital-related analytical tools would have to be applied.

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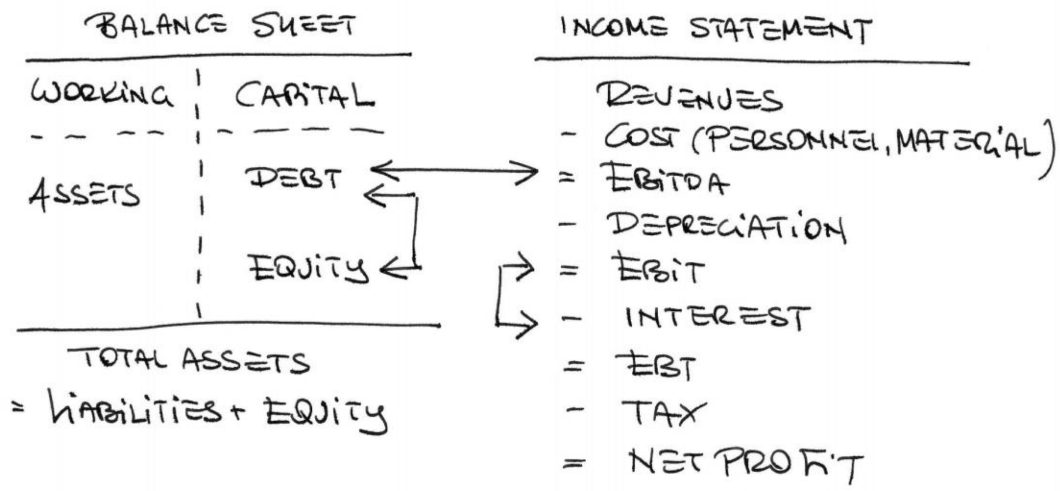

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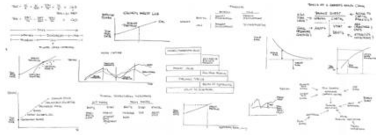

Corporate Finance Concepts

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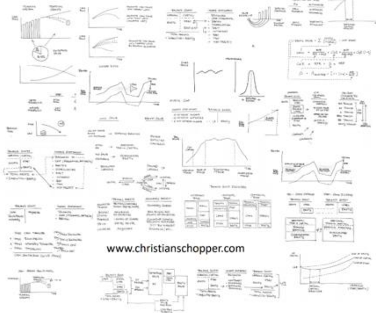

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