Credit Standing

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

Credit ratings, a most common tool in assessing a credit standing, address the solidity of financial instruments of firms, but also – for instance - of sovereigns or complex structures of debt. Usually, credit ratings are associated with a handful of globally operating Credit Rating Agencies (CRAs), the most prominent of them Standard & Poor´s and Moody´s, together combining some 80 per cent of the market. However, also banks have their own internal credit rating systems to assess loans they extend to corporate or retail customers.

CRAs apply a whole set of financial ratios to assess corporates, addressing aspects like 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, such as 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 among others on financial data delivered by the firm as well as impressions gathered in the course of meetings with executive management.

Despite some creditors and most suppliers won´t have the time, capacity or ability to run similar processes like a CRA, there are a few straightforward, but powerful ratios which can easily be applied to evaluate a firm´s financial liabilities and standing:

Assessing a firm´s leverage (indebtedness) is a good start. Thereby, a firm´s financial liabilities are weighted in relation to its overall assets and / or its equity. These leverage ratios can then be put into perspective relative to the firm´s industry peers as well as historical trends. Whereby, the higher a firm´s leverage, the higher also the risk that financial obligations may sooner or later 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 in regards to cyclical industries. At the same time, though, equity is the most expensive source of funding on a firm´s balance sheet: By using leverage, the average cost of capital can be reduced. – But also the quality of a firm´s equity has to be assessed: If, for instance, a major component of equity were accumulated in its sub-component retained earnings, then this could potentially vanish, if the firm decided paying (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: Interest payments made by its corporate customers are a bank´s most important revenue item. - In calculating interest coverage, one divides a firm´s EBIT (earnings before interest and taxes) 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 EBITDA (earnings before interest, taxes, depreciation and amortization) covers its financial liabilities (including both, principal and interest). Depreciation and amortization are included in the 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 also rely and draw on these sources). - 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, a firm´s "complete" credit standing will also have to take into account working capital-related analytical tools.

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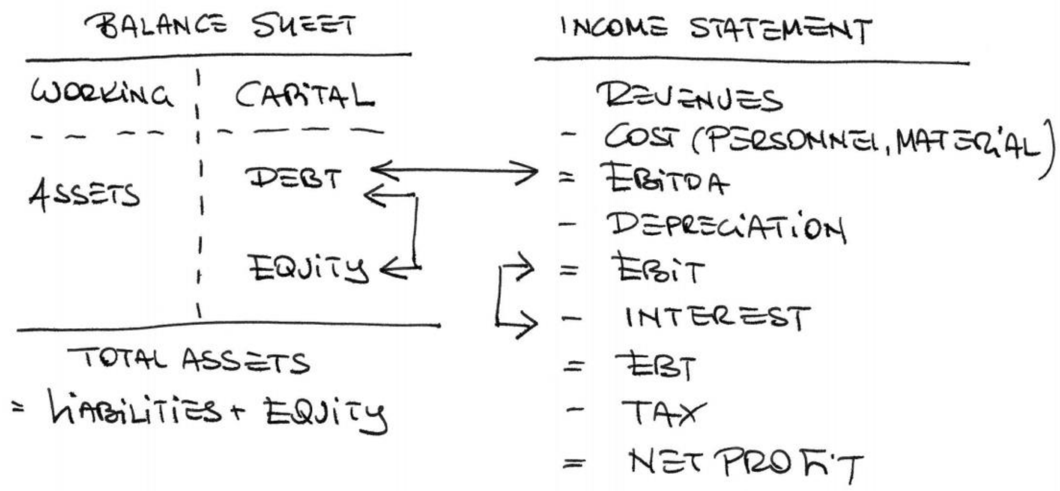

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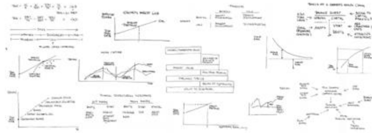

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