CREDIT RATING FACTORS FOR CORPORATE BONDS

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INTRODUCTION

Recently there has been substantial interest in understanding the credit risk of corporate bonds. At present, an independent agency for rating credit risk of fixed income securities does not exist in Sri Lanka, and it is an essential institution for the development of the Sri Lankan debt securities market. It is understood that, on behalf of the Central Bank of Sri Lanka and the Asian Development Bank, the Canadian Bond Rating Agency has undertaken a feasibility study on establishing a rating agency in Sri Lanka.

The need for a credit rating agency was clearly evidenced in the case of the Vanik debenture issue. In March 1996, Vanik Incorporation made the first public issue of a debenture in Sri Lanka. It is a three-year unsecured debenture with a stated coupon rate of 20% payable quarterly, thus making it an effective rate of 21.55%. Potential investors had to determine whether the interest offered was adequate compensation for the risk of the debenture. This was difficult without an independent credit rating. As a result some argued that the higher rate reflected higher credit risk of the issue.

Others argued that the company had to offer a higher rate to entice investors since this was the first debenture issue in the country. The use of the term "unsecured" unduly emphasized the lack of security when by definition a debenture is an unsecured instrument. All these indicate the problems a debt issue encounters in the absence of an independent, credible evaluation of credit risk of the issue.

The purpose of this article is to provide an overview of the factors which are typically considered in determining credit quality of a corporate bond issue. It does not purport to be an exhaustive discussion of rating factors. To a certain degree, criteria will differ across industries and such differences are not covered in this article.

ROLE OF CREDIT RATINGS

A credit rating is simply an evaluation of credit quality of a specific debt issue. It is not a recommendation to buy, sell or hold a security, and it does not comment on market price or the risk preferences of investors. According to the Standard and Poor's Corporation, a premier rating agency in the United States, ratings are based on the following broader criteria [1].

1. Likelihood of default. This refers to the issuer's ability to meet interest and principal obligations on a timely basis in accordance with the terms of the issue.
2. The obligation's nature and provisions.
3. The protection afforded to, and relative position of, the obligation in the event of bankruptcy, reorganization, or other arrangement under bankruptcy laws and other laws affecting creditor's rights.

A specific rating is indicated by a letter code. For illustrative purposes, Standard and Poor's long-term rating definitions are shown in Exhibit 1. Bonds rated 'BBB' and above are generally regarded as investment grade bonds while those rated 'BB' and below are recognized as speculative grade bonds.

Exhibit 1

Standard and Poor's Long-term Rating Definitions

AAA Highest rating. Capacity to pay interest and repay principal is extremely strong.
AA  Capacity to pay interest and repay principal is very strong.
A   Capacity to pay interest and repay principal is strong. Somewhat susceptible to adverse effects of changing circumstances and economic conditions.
BBB Capacity to pay interest and repay principal is adequate. Adverse effects of changing circumstances and economic conditions are more likely to lead to weakened capacity to pay.
BB  Near-term vulnerability to default. It faces major ongoing uncertainties or exposure
affects the operating flexibility of companies. The factors to be considered include extent of unionization, occurrence of strikes and other industrial disputes, flexibility for retrenchment, employee turnover, nature of employment contracts, availability of qualified labour etc. In a highly unionized industry, flexibility for a company to deal with economic downturns will be limited, and this may lead to higher business risk.

There are other attributes of the industry environment which might be more relevant for some industry segments. Research and development expenditure is an important factor determining long-run competitiveness of companies, particularly that are technology-based. The degree and direction of regulation affect profitability. An analyst must also pay attention to special accounting practices in the industry in forming industry standards for comparison. Some examples of areas to review are consolidation basis, income recognition, depreciation methods, inventory pricing methods, employee benefits, and off-balance-sheet liabilities.

Management

A key factor in business analysis is management of the company. The objective is to assess the role of management in determining returns and risk of the company. The quality, depth and the track record of management and management credibility are important aspects. In addition, organizational problems such as over-reliance on one individual, lack of proper succession planning, and frequent management turnover also get reflected in ratings. A clear relationship between organizational structure and management strategy is a positive management attribute.

FINANCIAL ANALYSIS

Next step is to conduct a financial analysis of the company. Ratios used as well as weight given to each of them vary from one industry to another. Some of the most important aspects are discussed below.

Financial Policy

The management’s financial policies define and shape the nature of business and financial risks of a company. An analyst must examine whether the company has clear financial policies, and goals which are consistent with corporate strategies. It is also important that there are specific programs to achieve the stated financial goals or that the company has already taken steps to implement them. The main financial policies relate to capital structure, dividend policy, and capital budgeting.

The capital structure policy may specify optimal debt-equity mix, proportion of short-term vs long-term financing, and use of internally generated funds vs external funds. Financial risk is directly related to debt-equity decision. Dividend policy is primarily concerned with dividend payout, which in turn sets the amount of funds retained. The retention rate is a primary determinant of future growth of the company. Capital budgeting policies define the types of investments to be undertaken along with the expected return and risk. Earnings and business risk of a company are directly influenced by capital expenditure decisions. All these policies affect long-term credit quality of the company in various ways, and credit evaluation must pay particular attention to the soundness of the financial objectives spelled out by the company, the management commitment to achieve them, and their implications for credit quality.

Profitability

The two main methods of assessing the profitability of a company are:

A. Operating profit margin

Operating profit margin is earnings before interest and taxes expressed as a percentage of sales. This indicates the profitability from the core business, and a company with highly volatile operating margins is exposed to higher business risk.

B. Pretax pre-interest return on average capital

This is calculated as the pretax income from continuing operations plus interest expenses divided by average capital employed. The capital employed is the average of the beginning of the year and end of the year long-term debt and equity including preferred stock and minority interest.

Coverage

A. Interest coverage

Interest coverage measures the ability of the firm to cover interest charges, and is one of the key ratios used in credit evaluation. This is calculated as pretax income from continuing operations plus interest expenses divided by total gross interest. A higher ratio compared to industry average indicates more safety to bondholders.

B. Fixed charge coverage

Interest coverage does not reflect safety properly when there are other significant fixed obligations such as rents and lease payments. In such cases, more appropriate coverage ratio is to use interest plus other fixed charges in the denominator.

Capital Structure

Debt-equity mix plays a critical role in determining credit quality of a firm. The most commonly used leverage ratio is long-term debt as a percent of total capitalization. Higher leverage means that the company has to have
This shows that a higher ROE can be obtained by achieving a higher pretax margin, higher asset turnover, higher equity multiplier (leverage), or lower effective tax rate. The analysis needs to be carried out for a minimum of last five years preferably covering a complete business cycle in order to uncover major sources of growth. Each ratio must be compared with industry standards as well. Different industries or companies within a given industry may employ different variables to achieve a particular level of ROE. Business and financial risk of each company will vary, depending on which component of ROE a company emphasizes in its financial strategy.

**SUMMARY**

The credit rating performs the function of credit evaluation of specific debt issues. The general methodology is to carry out both a business and a financial analysis covering qualitative and quantitative aspects of the factors influencing credit risk. The final result is to assign a symbol such as the ones assigned by S&P. Ratings are reviewed as business and financial conditions change.

Debt rating is necessary for development of a debt market. It provides potential investors an independent assessment of the credit risk of the instrument after a thorough business and financial analysis of the business. An issuer with high credit quality will be given a high credit rating while an issuer with low credit quality will be assigned a low rating. Then, investors have to weigh the risk rating with the promised yield of the instrument. As the market develops we would expect debt instruments to pay a coupon rate that is closely correlated with its risk. However, development of a corporate debt market is severely constrained by the lack of benchmarks by way of yield-maturity structure for government bonds. The yield on a corporate bond incorporates a default premium and a term premium. But without a yield curve, it is difficult to distinguish between the two premia. And as a consequence, an investor will not be able to properly assess the adequacy of yield differences in corporate debt with different maturities. Therefore, the development of a yield curve and a rating agency must be both considered vital infrastructure for development of a corporate debt securities market in Sri Lanka.

**REFERENCES**


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**PERFORMANCE RANKING OF COMMERCIAL BANKS OPERATING IN SRI LANKA BASED ON THE FOLLOWING**

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*Source: ASIA Week Sept 1996*