Rating Private Sector Corporations

Overview of methodology and process for
credit assessments of private sector corporations

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Introduction

The CHF capital market has recently become much more important for private sector companies due to the low interest rate environment, relatively low transaction costs, and the ongoing lack of investment opportunities for institutional investors. Certainly, the domestic segment is still dominated by the public sector (Confederation, cantons, and municipalities), the two central issuing institutions, and (public-sector) financial institutions. However, with a volume of over CHF 30 billion, corporate bonds (excluding real estate companies) form a segment that should not be neglected. Only around one in seven Swiss companies listed on the CHF capital market is rated by one or more internationally recognized credit rating agencies.

The corporate bond segment is very heterogeneous. Factors such as sector affiliation, sales volume, capital utilization intentions, accounting standards, etc. require an individual credit rating for each borrower. Assigning a corporate rating to a private sector company therefore involves a well-founded assessment of the creditworthiness of the respective debtor. Credit rating concept and methodology for companies were developed by fedafin itself and incorporate both findings from economic literature and best market practice in model validation. Fedafin's rating process accounts for the different market needs and regulatory requirements with regard to principals, disclosure, and data sources.

Fedafin issues corporate ratings on behalf of companies (Issuer Solicited) or on behalf of investors (Investor Solicited). Credit ratings on behalf of investors are generally issued for internal purposes of the principal (non-public rating reports). In contrast, when credit ratings are assigned on behalf of companies, credit ratings can also be published at the request of the client, for example with regard to a bond issue on the CHF capital market.

Rating assignments are usually based on the use of the entity's public and non-public information. If the inclusion of non-public information of the company is not possible or not required, the designation NPCI (Non Participating Corporate Issuer) is used. If the issuer is involved in the rating process, the designation PCI (Participating Corporate Issuer) is used. In any case, credit ratings will only be assigned if fedafin considers that the information and documents available are sufficient for a sound assessment of the qualitative and quantitative elements.

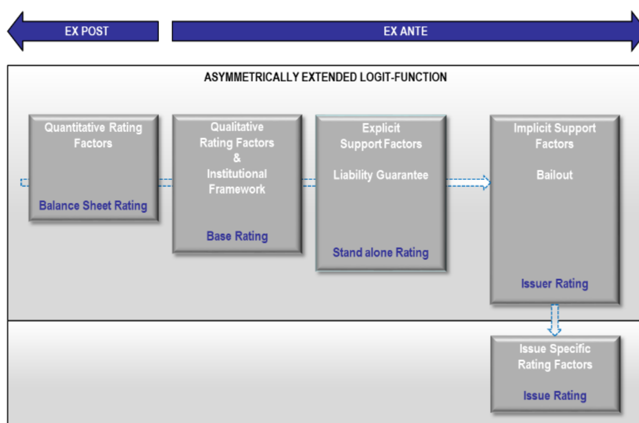
This paper provides a brief overview of the main features of rating methodology and process in the credit assessment of private sector corporations[1].

[1] By analogy, the explanations apply to public-sector and private-sector companies with different structures and legal forms (holdings, foundations, etc.).

Credit Rating Concept

The credit rating architecture basically consists of four modules and allows a consistent and flexible consideration of systematic credit-relevant factors for companies of different market segments and sectors (see Figure 1).

The methodological foundation for valuation is a Logit function, which has been asymmetrically extended by several company-specific parameters. With regard to the traditional definition of the default risk, fedafin explicitly distinguishes between the stand-alone rating (without implicit support) and the corporate rating (with implicit support) and displays them transparently on the corresponding credit rating documentation. Normally, stand-alone rating and corporate rating are identical for private sector corporations, as there is no support or guarantees.



1 *Rating concept for credit assessments of corporations*

Quantitative Rating Criteria

Credit assessments are generally based on selected financial ratios from previous years (ex-post situation). Strict criteria are applied to the selection and construction of the respective key figures. These include direct relevance to creditworthiness, clear ranking, objective comparability (e.g. adjustment for obligations from operating leases), extensive resistance to manipulation (e.g. changes in accounting standards), and statistical robustness.

Parameterization of financial ratios is based on numerous test procedures of model validation. Within the scope of the credit rating process, three issues relevant to creditworthiness in the financial autonomy and sphere of influence of a company are fundamentally relevant (without completeness):

Assessment of capital structure and indebtedness

- Equity ratio
- Net indebtedness
- Debt financing structure
- Goodwill ratio

Assessment of earning power and profitability

- EBITDA margin and EBIT margin
- Return on sales
- Total capital return

Assessment of cash flow potential

- Cash ratio and quick ratio
- FFO and operating cash flow
- Free cash flow
- Depreciation rate

Qualitative Rating Criteria

In addition to selected key financial figures, credit assessments include an analysis of the institutional framework conditions that have an influence on the sustainability and stability of a company's performance. These risk factors allow conclusions to be drawn about the future creditworthiness development of a company (ex-ante trend). The assessment is supplemented by the analysis of other factors which, among other things, allow systematic conclusions to be drawn about the relative competitive position of a company vis-à-vis its competitors or the future capital structure.

Qualitative risk and success factors are systematically identified and evaluated by the rating team and subjected to critical review by the Rating Committee. As part of the credit rating process, matters relevant to creditworthiness are generally relevant in three divisions (not exhaustive):

Institutional framework

- Market structures and barriers to competition
- Political and regulatory risks
- Cyclicality and growth prospects of the industry

Corporate structure and strategy

- Diversification and innovations
- Investment cycle and acquisition policy
- Complexity of the corporate and business structure

Capital structure

- Subordinated and/or secured debt
- Shareholder loans

Explicit or implicit support by third parties

Any existing liability guarantees are systematically identified and assessed as part of the credit rating process. State guarantees exist in principle in the form of legally binding legislation or, in the case of systemically important companies, as implicit liability guarantees without a legal basis. As already mentioned, such guarantees are rarely in place in the case of private sector companies.

Risk factors for assessing the probability of financial assistance (support) from the public sector in the event of an impending default event include:

- Opportunity costs arising from the reorganization of a constitutional or statutory service mandate of the public sector

- Opportunity costs arising from local, regional, or systemic contagion risks at the expense of the public sector's finances

The assumption of a positive probability of support not only leads to a possible upgrading of the company rating, but may also cause a possible downgrade of the guarantor.

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