FINANCIAL ANALYSIS:

THE RELEVANCE OF RATING AND COVENANTS

1. Rating

1.1. Concept

Rating represents an assessment regarding the capacity of the debtor to timely repay the interest and principal of the outstanding debt (typically bonds) that is being assessed. It is important to notice that this assessment, in the case of corporations, doesn't attempt to evaluate profitability or performance. Naturally, profits and returns are key variables in the analysis of the company conducted by the rating agencies. However, it is perfectly plausible that a given company has a better rating than another company although it may have a lower profitability but, instead, it has a more stable pattern of margins and profits or a more solid capital structure (less debt). Once again, rating only measures the capacity of the company to repay its debt (and associated interests).

In spite of using a complex and sophisticated framework to assess companies, rating became a popular tool mainly because of the simplicity of its final result (a grade/score), that everyone can easily read and understand. Rating, in practice, replaced, in an efficient and costless way, the research that each investor should undertake before buying a bond (in order to identify the risk of the bond issuer).

1.2. Rating agencies

In 1909 John Moody, owner of a small company dedicated to the analysis of railway companies, Moody's, decided to assign grades to the bonds issued by those railway companies, leading the way to the development of a new activity within the financial information sector. During several decades this rating activity was basically confined to the US, which had a large bond market. Following the globalization of the world economy in the 90's, rating became a tool used worldwide not only applied to companies but to countries as well, since these were becoming active players in the global bond market.

Currently, the global rating industry is dominated by three companies: Moody's and Standard and Poor's (S&P), fighting for the number one position, and Fitch. There are other rating agencies, but smaller and mainly working locally.

Generally, the assignment of a rating grade is a service paid by the issuers (companies or States) who want to have a grade. This grade is publicly announced and therefore everyone has freely access to the grade. However, the access to a more detailed report, supporting the grade, is a paid service.

The rating agencies have the obligation to closely monitor the situation of each issuer whose bonds were graded, and they can, in any moment, modify (upgrade or downgrade) the rating if they conclude that the financial risk profile of the issuer has changed. These sudden modifications have a huge impact in the price of the bonds. For instance, if the rating decreases, investors will demand a higher rate of return to buy those bonds, reducing their prices (the price of an outstanding bond is the present value of the interest and principal payments that will occur until the maturity of the bond).

1.3. Rating grades

There are different rating grade scales for long term debt and for short term debt (with a maturity up to one year). The next table provides a summary of the scale used by Fitch, S&P and Moody's for long term debt.

Table: Rating Agencies scales

S&P e FITCH	MOODY'S
Tier Investment Grade (Good probability of meeting debt obligations)	
AAA	Aaa
AA	Aa
A	A
BBB	Baa
Tier Non – Investment Grade (Junk)	

BB	Ba
B	B
CCC	Caa
CC	Ca
C [1]	C
D [1]	

(1) S&P has, below C a grade of CI (interest payment failure) and within D, has the grades of DDD, DD and D.

These grades can have two additional features:

Sub grades

Each grade (except the first, AAA/Aaa, and the scales below B) is divided in three sub grades:

S&P and Fitch: each grade can have a +, nothing, or - (for instance, AA^{+}, AA and AA^{-})

Moodys: each grade can have 1, 2 or 3 (for instance Aa1, Aa2 and Aa3)

The variation from one sub grade to the next sub grade (for instance from A to A^{-}), that is, the minimum variation, is usually called one notch.

Perspectives

Associated with the grade there is also an indication of how the rating agency views the future evolution of the grade, usually using the mention "*positive outlook*", "*negative outlook*" or "*stable outlook*", indicating that on a 6 to 12 months period there is a strong possibility of reviewing the grade upwards, downwards or maintaining it unchanged. It is important to notice that any rating upgrade or downgrade can be done at any time. It can also be changed in several notches (from A^{+} to BBB^{-}, for instance), and not just by one notch.

There is also another feature, a negative one, called "credit watch", indicating the sudden appearance of a fact or an eventual upcoming event, that may cause the downgrade of the rating in the short term (up to three months).

Regarding the grades for short term debt, agencies use a smaller scale. S&P has the grades of A-1, A-2 and A-3 and Moody's P-1, P-2 and P-3 in the investment grade tier. S&P has B, C and D in the junk tier while Moody's has only the grade NP for all the remaining cases.

1.4. Assessment criteria

Rating agencies make available, at no cost, the methodologies, criteria and metrics employed to produce the rating grades. Essentially, companies are analyzed regarding two main areas: business risk and financial risk. Regarding business risk, the key areas of analysis are the economic status of the home country, the industry risk profile, the competitive position in the market, operational efficiency, profitability (trend and comparison with main competitors). Subjects like the corporate control and the quality of corporate governance are also relevant. In terms of financial risk, topics such as cash flow adequacy versus the company's financial needs, the capital structure equilibrium, the liquidity of assets or the availability of unused credit lines are taken into serious consideration. Specific criteria taking into account the nature and characteristics of the company´s industry will also be used.

One interesting feature is the definition of benchmarks for several (financial) ratios, associated with each grade. By other words, the company will know what values in those ratios should be met in order to maintain (or to improve) a given grade.

1.5. Company´s rating vs. Home country´s rating

In the majority of the cases the rating of a company is conditioned by the rating of the home country. This relationship is based on fact that the public debt of a given country is, typically, the safest investment in that country and the debt of the local companies will tend to offer a higher risk. However, there are cases in which this rule is not followed.

The most common case of companies having a better rating than the home country is when the local activities represent a small fraction of the global activity, that is, companies with an extensive international exposure. If these international activities are well diversified (or in spite of being in just a couple of countries, those countries have a better rating than the home country), it is plausible that the company will have a better rating than the home country. Usually, though, rating agencies establish a cap allowing a maximum of 3 notches above the country´s rating.

2. Covenants

Covenants represent the inclusion of restrictive clauses in financial debt operations. Their main objective is the protection of the creditors from certain actions that, if taken by the firm, may affect the risk profile of the debt. To illustrate, let´s suppose that a given firm decides to "give" some assets as collateral to a specific creditor. This operation will leave in a less favorable position the other creditors of the firm. In case of default, the proceeds from the sale of those collateralized assets will be used to pay, firstly, the holder of the collateral and the remaining creditors will only be paid afterwards (with a an eventual surplus from the sale of the collateralized assets and from the proceeds from other asset disposals). A covenant designed to avoid this more favorable position to a future lender would be, for instance, to prohibit in any future loan the collateralization of assets without the authorization of the lender who has this covenant.

When a firm doesn´t comply with contracted covenants, the loan agreement establishes the consequences, typically:

- The debt will mature immediately, independently of the contractual maturity or,
- The interest rate is increased according to what is established in the loan agreement (in order to compensate the creditor for the additional risk of the loan).

There are many types of covenants. The most common ones can be divided in four main categories.

1- Restrictions to undertake new debt

The objective is to avoid the deterioration of the firm's capital structure or, by other words, to prevent the relative increase of debt over equity. For instance, let´s assume that a firm is going to finance a new and large investment using only debt. The relative weight of debt in the capital structure would increase, and therefore also increment, the risk to the current creditors of the firm. An example of a covenant could be the establishment of a maximum value for the debt-to-equity ratio.

2- Restrictions to dividend payments

Once again, the main objective is to avoid the deterioration of the firm's capital structure, this time driven by a very aggressive distribution of dividends (a high payout ratio), reducing though the internal generation of funds remaining in the company and, thus, funds available for growth opportunities. An example of a covenant would be the definition of a maximum value for the payout ratio.

3- Restrictions to mergers and acquisitions

If a firm decides to merge with another firm or to buy it, the final result of the merger or acquisition may represent an important change from the initial capital structure. Let´s consider firm M with assets of 1,000 and financed in 50% by equity and the other 50% by debt. Let´s assume now that M is going to merge with Z, a firm with assets of 500 financed by equity in 20% and by debt in 80%. Keeping the example simple, the new firm resulting from the merger will have assets of 1,500, financed by equity in 600 (1,000 x 0.5 + 500 x 0.2) and the remaining 900 by debt. Let´s now look to the example from the perspective of a creditor of firm M. Before the merger the debt only represented 50% of assets, but after the merger it will represent 60% of the assets, meaning an increase of the financial risk of the firm. An example of covenant could be the prohibition of M&A without the approval of M creditors or, alternatively, the imposition of some limit to some financial ratios (debt-to-equity ratio, for instance) that cannot be surpassed in a M&A operation. In this case, let´s assume that creditors of firm M would impose the limit of 1 in the debt–to– equity ratio. If the firm wants to go forward with the merger it would have to increase its equity (issuing more shares) in order to comply with the covenant.

In this line of reasoning, but somewhat different from a typical covenant, we may have change of control clauses. These try to prevent from significant modifications in the shareholder control of the firm. Let´s assume that bank F lent money to a firm owned (or controlled by J). Let´s now assume that J decides to sell his control position to R. The bank, when it decided to lend money to the firm knew who his/her main shareholder was and what type of strategy and financial policy the dominant shareholder would follow. Now, the firm is controlled by a new shareholder, R, who may have very different perspectives regarding the financial policy of the firm. In order to prevent this situation, the change of control clause is exercised and the associated debt will mature immediately (in those cases, the more common situation would be R, before buying the share from J, to engage in a negotiation with the creditors who have this type of clause, in order to assure (eventually at a higher interest rate) the maintenance of the outstanding loans (another option may be the negotiation with other banks of the refinancing of the amount needed to meet the exercise of the clauses).

4- Restrictions to the use of assets

The more common clause in this category is called *negative pledge*. The clause doesn´t allow the firm to offer assets as collateral in future financing operations in order to avoid the subordination of current debt to future debt in case of default.

Other covenants - Affirmative restrictions

In order to assure that a firm’s financial policy is consistent with maintaining a certain risk profile, there is often the definition of floor limits for some key financial ratios for a certain period until the maturity of the associated debt. Examples are the net debt/EBITDA and EBITDA/net interest costs. If the firm fails to comply with the established limits, it can lead to an obligation to repay, immediately, the debt or to an automatic adjustment of the interest rate.