

# Corporate Credit Ratings: A Quick Guide

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## What is a credit rating?

In its simplest form, a credit rating is a formal, independent opinion of a borrower's ability to service its debt obligations. Most credit ratings are publicly disclosed and are used by debt investors in their investment appraisal process, although they are also used by creditors and other parties for understanding an entity's credit profile. From a borrower's perspective, a credit rating is generally a requirement of public bond issuance (corporate or high yield) and certain loan structures (with institutional lenders) and thus provides access to a wider range of lenders and debt products.

## The rating agencies

Credit ratings are predominantly provided by three main independent rating agencies, namely; Standard & Poor's (S&P), Moody's Investor Services (Moody's) and Fitch IBCA (Fitch). Although the agencies adopt different rating scales, there is equivalence across the scales which facilitates comparison such that a Baa1 rating (for example) from Moody's is equivalent to a BBB+ rating from S&P and BBB+ from Fitch. The full rating scales are shown in Figure 1 below.

Figure 1: The ratings structure

	MOODY'S		S&P		FITCH		
	Long term	Short term	Long term	Short term	Long term	Short term	
INVESTMENT GRADE	Aaa	Prime 1	AAA	A-1+	AAA	F1+	HIGHEST
	Aa1		AA+		AA+		
	Aa2		AA		AA		
	Aa3		AA-		AA-		
	A1	Prime 2	A+	A-1	A+	F1	
	A2		A		A		
	A3		A-		A-		
	Baa1	Prime 3	BBB+	A-2	BBB+	F2	
	Baa2		BBB		BBB		
	Baa3		BBB-		BBB-		
NON-INVESTMENT GRADE	Ba1	Not prime	BB+	B	BB+	B	LOWEST
	Ba2		BB		BB		
	Ba3		BB-		BB-		
	B1		B+	B+			
	B2		B	B			
	B3		B-	B-			
	Caa	C	CCC	C	CCC	C	
	Ca		CC		CC		
	C		C		C		
			D		D		

Source: The Association of Corporate Treasurers

Investors broadly categorize “**investment grade**” debt as **Baa3/BBB-/BBB- and above** and “**non-investment grade**” (aka as speculative, junk or high yield) as **Ba1/BB+/BB+ and below**. An investment grade rating is important for certain borrowers to ensure full market access (as some investors are prohibited from investing in non-investment grade debt), achieving flexible / attractive covenants and terms on debt issues, and in some cases for the prestige value in front of competitors, customers and suppliers. Non-investment grade debt issues tend to require greater operating and financial restrictions and inevitably attract higher pricing.

When the bond markets shut for several weeks post Lehman, even the strongest investment grade companies could not issue bonds, far less BBBs and below. When the markets did reopen, they did so gradually, opening first to issuers at the top end of the rating spectrum and then eventually moving down towards the bottom. So even a ‘AA’ or ‘A’ rating should not be seen as a guarantee of capital markets access.

An important extension to the concept of a borrower or an issue’s credit rating is the rating outlook (positive, stable, negative or developing), which is a directional evaluation of where the rating is likely to move over time. In addition, certain entities subject to announced or expected major corporate events (typically around M&A) can be placed on credit-watch pending outcome of the event, and in some circumstances the agency will give a view about what would happen to the rating under different outcomes.

A rating looks not just at “probability of default”, but also “loss given default”. This is particularly important for non-investment grade issues, where the presence of credit enhancements (asset backing, security, covenants, priority ranking) or weaknesses (contractual or structural subordination, absence of security or covenants) can lead to individual issues being “notched up” or “notched down” relative to other issues by the same borrowing group to reflect a lower expectation of recovery in the event of a default.

### **Rating agency methodology**

The rating agencies use broadly similar methodologies in arriving at their credit rating determination, although they operate independently of each other and so differences in approach and rating outcome may exist in certain instances and for certain sectors or products, notwithstanding identical information. The agencies provide an overview of their detailed rating methodologies on their websites, but in general the analysis will focus on two broad areas:

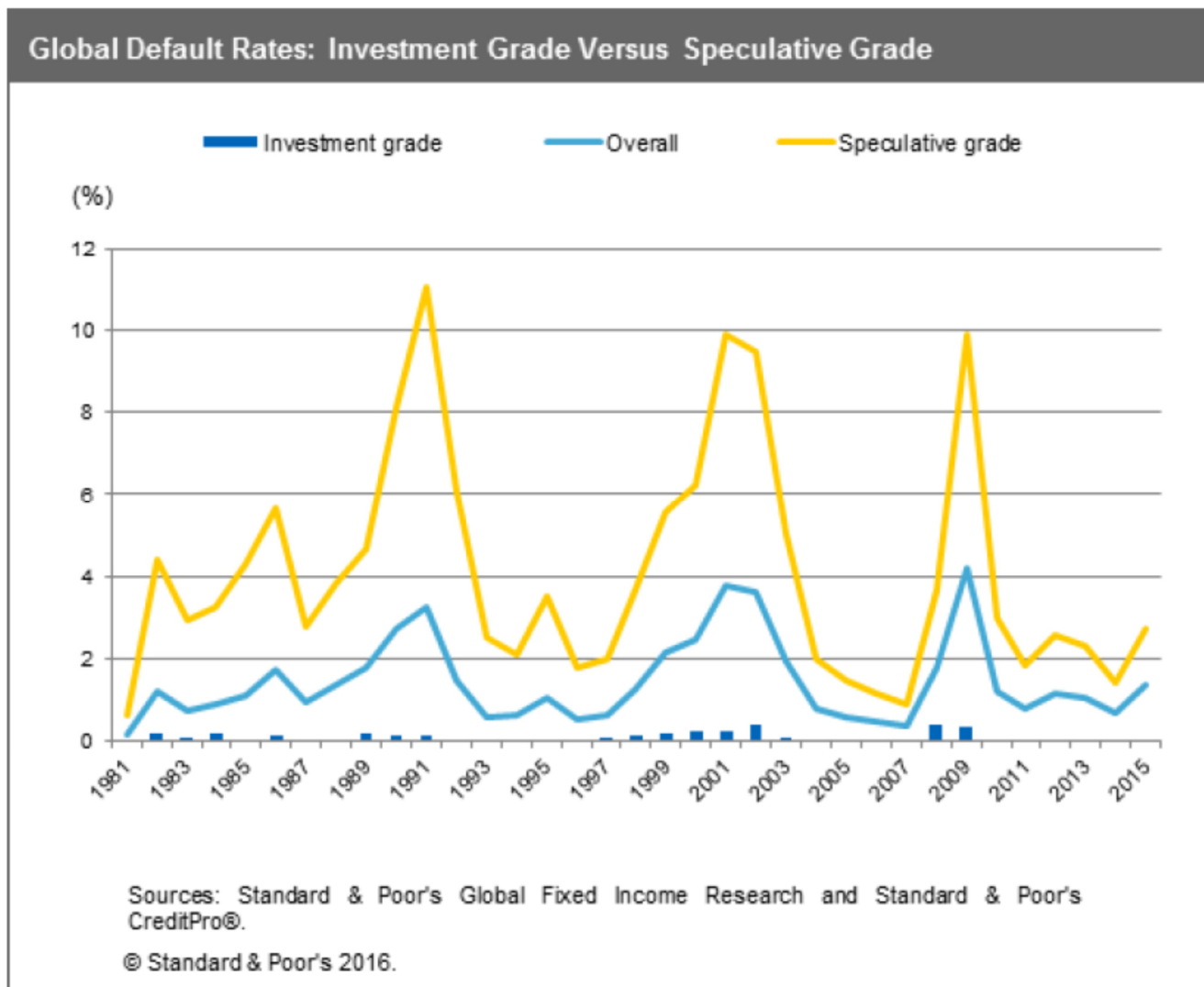
- *Business Risk*: Evaluation of strengths/weaknesses of the operations of the entity, including: market position, geographic diversification, sector strengths or weaknesses, market cyclicality, and competitive dynamics. This approach allows businesses to be compared against each other and relative strength/weakness to be identified.
- *Financial Risk*: Evaluation of the financial flexibility of the entity, including: total sales and profitability measures, margins, growth expectations, liquidity, funding diversity and financial forecasts. At the heart of this analysis is credit ratio analysis, which is used to quantitatively position companies of similar business risk against each other.

One additional consideration for the agencies is the “sovereign ceiling”, which can serve to cap at country rating level the Foreign Currency Credit Rating of a high credit corporate with jurisdiction and primary operations in a lower credit country. The agencies updated their methodology in 2005/6 to reflect perceived lower likelihood that a government default would be accompanied by a more general moratorium on foreign-currency payments (following expansion of international capital markets), but such instances tend to be restricted to the larger players within the infrastructure, natural resources, and to a certain extent financial services sectors.

### **S&P Global Ratings Direct – Annual Global Corporate Default Study and Ratings Transitions**

### Investment Grade Default Rates are Far Lower than Non-Investment Grade Default Rates

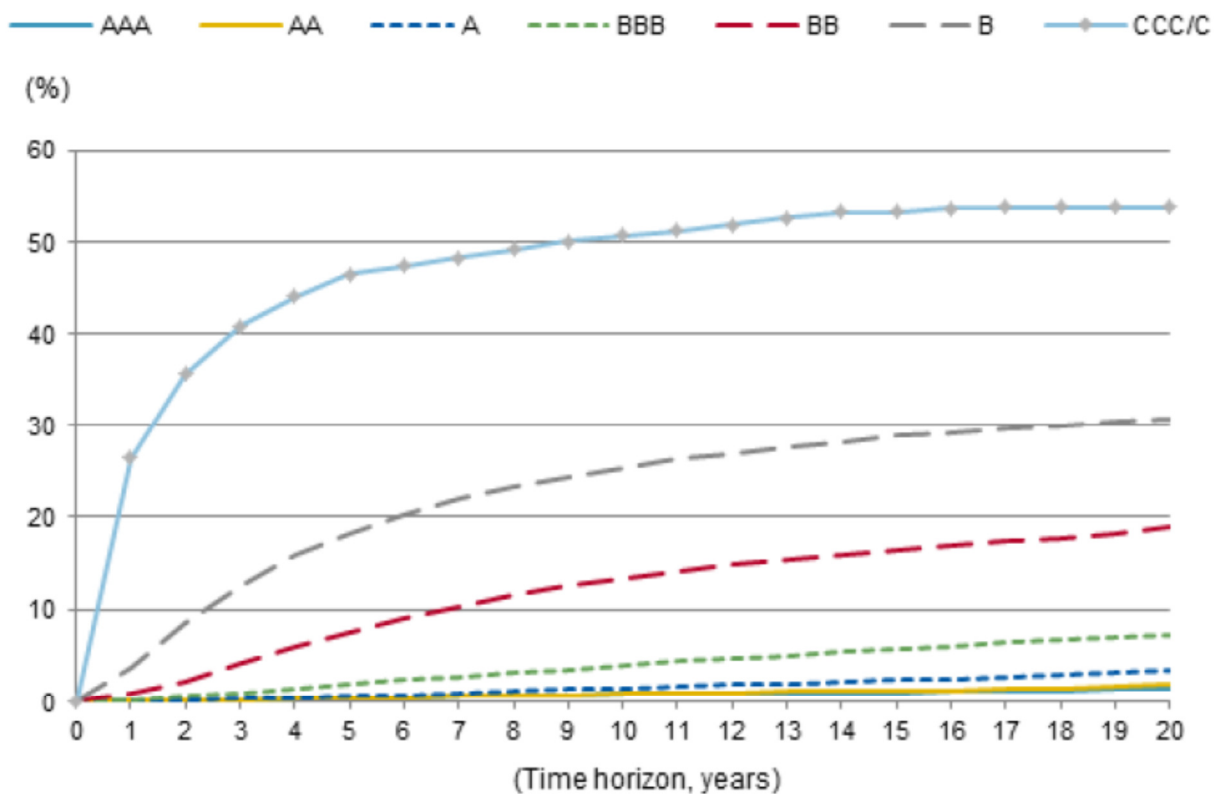
The chart below shows **Investment Grade** default rates as a **blue bar** noting there are many years in which the default rate is zero and has not exceeded 0.43% in any calendar year since 1981. In contrast, **Non-Investment (or Speculative Grade)** default rates are represented by the **yellow line** and have never been less than 0.62% (in 1981) while peaking at over 11% on 1991. (The lighter blue line represents the combined overall default rates for both Investment Grade and Speculative Grade.)



### Cumulative Default Rates Rise as Debt Terms Extend from 1-Year to 20-Years

The prior chart only depicted annual default rates. The following chart highlights the cumulative impact of default rates as debt terms extend from 1 year to 20-years. Cumulative default rates for **BB** credits peak at nearly 20% in year 20, while **CCC/C** default rates peak at over 50% (in year 20). In contrast, the **BBB** cumulative default rate remains below 10% in year 20. This chart reinforces the desire to obtain additional forms of credit protection when taking long-term credit risk from non-investment grade entities.

## Global Corporate Average Cumulative Default Rates By Rating (1981-2015)



Sources: Standard & Poor's Global Fixed Income Research and Standard & Poor's CreditPro®.

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### Sources:

*Corporate Credit Ratings: A Quick Guide* by Krista Santos, Debt Advisory, Rothschild London  
*2015 Annual Global Corporate Default Study and Ratings Transition* by S&P Ratings Direct®

### Structuring Implications – Personal Opinion offered by David Hunter

Given the vast difference in default experience between Investment Grade (with a peak annual default rate of less than 0.5%) and Non-Investment Grade credit (with a peak annual default rate of over 11.0%), most investors demand sharply higher interest rates for Non-Investment Grade Debt. Given the long-term nature of many investments/projects, many investors also demand additional security in the form of cash collateral (or possibly irrevocable letters of credit from a highly rated financial institution), when providing long-term financing to non-investment grade borrowers. In the structured debt markets, this could take the form of a Cash Collateral Account inserted at the top of the revenue waterfall contract provisions that must be fully funded from the first cash flow generated by a project and which is not released until the decommissioning requirements and expenses have been satisfactorily completed and paid for in full. On a side note, the Bank of North Dakota, with a AA depositor rating, could serve as custodian of the Cash Collateral Account to enhance overall payment priority and control of project cash flow. Sizing the Cash Collateral Account is important and should incorporate carrying costs during the decommissioning at estimated long-term rates in the future.