IMPORTANCE OF CREDIT ANALYSIS

Credit is an integral part of the modern economy and the global financial system. The expansion of credit has been a major contributing factor to global economic development and is often described as the lifeblood of the economy. Access to credit has facilitated GDP expansion through an increase in consumption and the allocation of resources to productive purposes. It has also helped to improve the efficiency and profitability of business by enabling access to funding for things like expansion, capital expenditures, research and development, and staffing. In this environment, investors are inevitably faced with tremendous amounts of potential bond offerings from companies seeking funds to perform various activities. Before purchasing corporate bonds, savvy investors typically undertake credit analysis to determine whether the company has the financial ability to meet its obligations. Failure to perform adequate credit analysis can potentially expose investors to significant losses. Of the estimated USD $30 trillion invested across the global corporate bond market, $240 billion was in default in 2016, more than double the previous year’s figure of $110 billion. Furthermore, there were 162 corporate defaults in 2016, the most since 2009 and the second consecutive year since 2009 with over 100 defaults. Effective credit analysis, while by no means a guarantee against default, can help to manage default risk and significantly lower the probability of investors experiencing this high magnitude loss event. This article aims to provide an effective framework that can be used to analyze issuers of corporate credit.

FIVE Cs OF CREDIT ANALYSIS

A common way to categorize the key components of credit analysis is by the five Cs of credit analysis – capacity, collateral, covenants, character and credit rating. Together, these five factors offer a structured and measurable approach for assessing the creditworthiness of a bond issuer.

Capacity

Capacity refers to a corporate borrower's ability to repay its debt obligations on time. This is perhaps the most important ‘C’ and it typically includes three levels of assessment: (1) industry structure, (2) industry fundamentals, and (3) company fundamentals.

Industry Structure

The first level of capacity analysis involves examining the industry structure within which the issuing firm operates. Industry structure can be analyzed using Porter's five forces framework of rivalry among existing competitors, threat of new entrants, threat of substitute products, bargaining power of buyers, and bargaining power of suppliers.

Industry Fundamentals

The next level of credit analysis focuses on industry fundamentals, including the influence of macroeconomic factors on an industry's growth prospects and profitability. Evaluating industry fundamentals involves analyzing industry cyclicality, industry growth prospects, and industry published statistics.

Company Fundamentals

The final level of credit analysis assesses company fundamentals. A corporate borrower should be assessed based on a quantitative analysis of its financial statement, its competitive position, operating history, management’s strategy and execution. Of the three levels of analysis used to determine an issuer’s capacity, company fundamentals is the most critical.
Collateral

Collateral refers to assets that can be pledged to secure repayment of a loan. Collateral analysis tends to be more important for less creditworthy companies. However, the market value of a company's assets can be difficult to observe directly. When assessing collateral values, it is important to consider issues such as the value of intangible assets (if any), the impact of depreciation, company market cap vs. book value, and human and intellectual capital as well as the marketability/liquidity of those assets.

Covenants

Covenants are legally binding terms and conditions that the bond issuer agrees to as part of a bond issue. Covenants can be affirmative or negative, and serve to protect lenders while still allowing some operating flexibility for the borrowers to run the company. Affirmative covenants require the borrower to take certain actions, such as paying interest, principal, and taxes, and maintaining certain financial ratios within prescribed limits. On the other hand, negative covenants restrict the borrower from taking certain actions, such as incurring additional debt or directing cash flows to shareholders in the form of dividends and stock repurchases.

Character

Character refers to management's integrity and its commitment to repay the loan. Factors such as management's business qualifications and operating record are important for evaluating character. When assessing character, the investor must consider management’s strategy, track record, accounting policies and tax strategies, fraud and malfeasance record, and the prior treatment of bondholders.

Credit Rating

A credit rating is an evaluation of the credit risk of a prospective debtor. It estimates the ability of the borrower to repay their debt, and includes an implicit forecast of the likelihood of default. Credit ratings are issued by ratings agencies that analyze the prospective debtor and then assign them a grade based on their estimated creditworthiness. Issuers with a high rating are perceived to have a low probability of default and are termed investment grade. An investor’s risk tolerance and return requirements will ultimately determine how far down the credit rating spectrum they are willing to allocate to.

CONCLUSION

It is critical to carefully analyze each company and the particulars of its debt offering before deciding whether to purchase. Effective credit analysis is essential for investors seeking to determine whether a company has the financial ability to meet its financial obligations. Understanding and applying the five Cs of credit analysis provides investors with a practical and effective framework for assessing the creditworthiness of a corporate issuer. This framework includes an analysis of capacity, collateral, covenants, character, and credit rating. While by no means a guarantee against default, credit analysis involving the five Cs can help to manage default risk.

ABOUT QUANTUM

Our team combines over 50 years of investment expertise, analysing fixed income securities with particular emphasis on investment grade corporate and government credits. We have extensive research capabilities allowing us to not only identify the most financially sound issuers, but to also monitor our portfolios for any deterioration in credit quality on an ongoing basis. As responsible stewards of our clients’ capital, managing risks is at the heart of what we do.

Contact us for more information on our fixed income portfolios and to learn more about our approach to credit analysis.
Works Cited