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Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers

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Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers

1. Standard & Poor's Ratings Services is refining its methodology for its liquidity analysis used when determining issuer credit ratings (ICRs) on global corporate issuers. We are publishing this article to help market participants better understand our approach to reviewing corporate liquidity. This article supersedes our criteria article "Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers," published July 2, 2010, on RatingsDirect. The article, "Principles Of Credit Ratings," published Feb. 16, 2011, forms the basis of these criteria.

SCOPE OF THE CRITERIA

2. These criteria apply to the analysis of corporate issuers globally. They do not apply to project finance ratings, because of the contractual cash management protections in place for those credits, nor to issuers with characteristics of finance companies, such as equipment leasing companies.

SUMMARY OF CRITERIA UPDATE

3. The methodology for scoring corporate liquidity addresses the liquidity factors used as a component of the analysis of corporate issuers. The quantitative analysis focuses on the monetary flows--the sources and uses of cash--that are the key indicators of a company's liquidity cushion. The analysis also assesses the potential for a company to breach covenant tests related to declines in earnings before interest, taxes, depreciation, and amortization (EBITDA). The methodology incorporates a qualitative analysis that addresses such factors as the ability to absorb high-impact, low-probability events, the nature of bank relationships, the level of standing in credit markets, and the degree of prudence of the company's financial risk management.
4. The methodology focuses on the standardization of liquidity descriptors into a five-point scale and a characterization of the features associated with each of the descriptors. The methodology also describes the impact of the criteria on ICRs.

UPDATES TO EXISTING CRITERIA

5. This article supersedes our criteria article "Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers." It clarifies previous criteria by stating that, to receive an ICR of 'BBB-' or higher, a company's liquidity must be scored as "adequate," as we define the term, or stronger. Companies with a score that is "less than adequate," as we define the term, will not receive an ICR higher than 'BB+'; those with a "weak" score, as we define the term, will not receive an ICR higher than 'B-'. In addition, the characteristics of adequate liquidity have been amended for companies with an ICR of 'BBB-' or higher to use a shorter time horizon when assessing the effects of undrawn committed bank lines and debt maturities (see "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded," published May 27, 2009).

IMPACT ON OUTSTANDING RATINGS

6. We expect only a small number of rating changes after publishing these criteria.

EFFECTIVE DATE AND TRANSITION

7. These criteria are effective Sept. 28, 2011, for all new and outstanding corporate ICRs. We expect to update our ratings over a period of up to six months.

METHODOLOGY

8. Liquidity is an important component of financial risk across the entire rating spectrum (see "2008 Corporate Ratings Criteria: Analytical Methodology," published April 15, 2008, under the Liquidity section). Unlike most other rating factors within an issuer's risk profile, a lack of liquidity could precipitate the default of an otherwise healthy entity. Accordingly, liquidity is an independent characteristic of a company, measured on an absolute basis, and the assessment is not relative to industry peers or other companies in the same rating category.
9. The descriptors for liquidity are:
 - Exceptional;
 - Strong;
 - Adequate;
 - Less than adequate; and
 - Weak.
10. Adequate liquidity is rating-neutral. To avoid the risk of default, a company's liquidity must be sufficiently robust to absorb a moderate level of stress. Accordingly, for a company to receive a rating of 'BBB-' or higher, its liquidity must be scored adequate or stronger.
11. The benchmarks to achieve "strong" and "exceptional" liquidity, as we define the terms, are intended to meet stress scenarios, but all investment-grade companies must have at least adequate liquidity. Strong and exceptional liquidity, by definition, exceed the norm. Excess liquidity can help bolster an ICR and differentiate between issuers in a given rating category; however, the basis for the projected continuation of such liquidity is rooted in other credit strengths. Therefore, these strengths must be considered in combination with strong or exceptional liquidity in order to have a higher ICR.
12. By contrast, less than adequate and weak liquidity are very likely to weigh on the ICR. As noted above, whatever a company's underlying performance, a lack of liquidity could precipitate a default, and ratings should reflect that risk.
13. Short-term ratings are highly correlated to long-term ICRs. However, to the extent that, for a given long-term rating, two short-term ratings are possible, liquidity is an important differentiating consideration. Accordingly, the assessment of a company's liquidity could translate directly into a higher or lower short-term rating.
14. For companies with ICRs based on their stand-alone credit profiles (SACPs), with ratings benefitting from potential extraordinary intervention from a parent, affiliate or governmental entity, the criteria assess liquidity at the SACP

level. Any relationship between the liquidity assessment and the ICR, as stated in the criteria, corresponds to a similar relationship between the liquidity assessment and the SACP.

15. When assessing a company's banking relationships, the criteria consider the history of the specific relationship (including periods when the company's credit quality was under stress); the variety of lending facilities in place; the degree of legal commitment involved in each facility; the tenor of existing facilities; the amounts involved, relative to bank lending limits; and the concentration/diversification of ties with various banks. (See "2008 Corporate Ratings Criteria: Analytical Methodology," and "2008 Corporate Ratings Criteria: Commercial Paper.")

Key Quantitative Measures

16. The key indicators of a company's liquidity cushion are:
 - A/B: Liquidity sources (A) divided by uses (B); and
 - A-B: Liquidity sources (A) minus uses (B).
17. Monetary flows within sources and uses of cash, for this purpose, refer to amounts generated or used over the next six to 24 months, with the timeframes identified by each of the liquidity descriptors. The amounts used in the calculations conform to an anticipated base case, assuming no refinancing for the company in question, and include both internal and external components. The analysis of monetary flows excludes the sources and uses of cash from captive finance operations (see "Assumptions: Analytical Adjustments For Captive Finance Operations," published June 27, 2008).

Sources

18. The criteria consider the following liquidity sources:
 - Cash and liquid investments;
 - Forecasted funds from operations (FFO), if positive;
 - Forecasted working capital inflows, if positive;
 - Proceeds of asset sales (when confidently predictable);
 - The undrawn, available portion of committed bank lines maturing beyond the next 12 months; and
 - Expected ongoing cash injections from a government or corporate group members, as appropriate.
19. Cash and liquid investments are netted against debt. This is the same approach used for surplus cash (see "Corporate Criteria: Ratios And Adjustments," under "Surplus cash"). If a company holds cash to satisfy upcoming, short-term obligations, the criteria net these to avoid the appearance of liquidity dilution. This may include hedged or presold commodity trading inventories.
20. Forecasted FFO will fluctuate with economic and business cycles. This effect is not smoothed, because the cyclical low point is where most cyclical companies experience liquidity problems. Management's expectation that a cyclical shortage of liquidity and the effectiveness of its measures to counter this risk may affect the calculation of FFO.
21. A contracted sale of a subsidiary or other asset to a creditworthy counterparty is included as a source of cash. Alternatively, the criteria do not include a potential sale of a subsidiary or property as a source of cash.
22. Undrawn portions of committed seasonal bank lines are also considered. If covenants are present, there must be a comfortable cushion or headroom.

23. Cash injections are considered based on a proven track record or an explicit guarantee provided by a government for the support of a government-related entity (GRE). This source of liquidity also includes similar ongoing support made to corporate subsidiaries by their parent companies or identified group members. The potential for extraordinary support (usually occurring in times of stress) is excluded from this source of liquidity.

Uses

24. The criteria consider the following uses of cash:
- Forecasted funds from operations, if negative;
 - Expected capital spending;
 - Forecasted working capital outflows, if negative;
 - All debt maturities (either recourse to the company or which it is expected to support);
 - Any required cash-based, postretirement employee benefit top-up needs;
 - Credit puts that cause debt acceleration or new collateral posting requirements in the event of a ratings downgrade of up to three notches; and
 - Contracted acquisitions and expected shareholder distributions under a stress scenario, including expected share repurchases.
25. Expected capital spending includes estimated maintenance spending, plus expansion project spending with a long lead time that will likely proceed even in a downturn, or that have been contractually committed.
26. To assess forecasted working capital outflows in companies with material intra-year working capital requirements (e.g., those companies in seasonal businesses), forecasted cumulative peak working capital outflows are used. In cases where working capital changes are positive over a given period because of large seasonal inflows that more than offset outflows, the criteria use the cumulative peak working capital outflows forecasted over the period.
27. Collateral posting requirements related to derivative contracts are not considered under liquidity uses. Potential uses in stress-case scenarios related to derivative contracts are analyzed separately (see "Analyzing The Liquidity Adequacy Of U.S. Energy Marketing And Trading Operations," published May 4, 2004).

Liquidity Categories

Exceptional

28. Companies with exceptional liquidity should be able to withstand severe adverse market conditions over the next two years while still having sufficient liquidity to meet their obligations. To have exceptional liquidity, an entity would have to meet the ratio test for A/B and at least four of the other supportive characteristics listed below. Few companies qualify for this category. The first three characteristics reference quantitative measures that apply in most industries. In exceptionally stable or volatile industries, however, the relevant "Key Credit Factors" article may specify different standards. Characteristics of a company with exceptional liquidity include:
- A/B of 2x or more projected each year over the next two years.
 - Positive A-B, even if forecasted EBITDA were to decline by 50%.
 - Few covenants. If covenants are present, headroom under these is such that forecasted EBITDA could fall by 50% without the company breaching covenant test measures; and debt at 30% below any covenant limits.
 - The likely ability to absorb, without refinancing, high-impact, low-probability events (such as market turbulence, sovereign risk, or the activation of material-adverse-change clauses).

- Well-established and solid relationships with banks.
- A generally high standing in credit markets. This can be assessed from equity, debt, and credit default swap (CDS) trading data relative to peers and market averages.
- Very prudent financial risk management. To meet this assessment, the company needs to show evidence that its management anticipated potential setbacks and took the necessary actions to ensure continued strong liquidity (see "2008 Corporate Criteria: Analytical Methodology," under "How Company Management Influences Business Risk And Financial Risk").

Strong

29. Companies with strong liquidity should be able to withstand substantially adverse market circumstances over the next 24 months while still having sufficient liquidity to meet their obligations. To have strong liquidity, an entity must meet the ratio test for A/B and demonstrate at least four of the other supportive characteristics listed below. The first three characteristics reference quantitative measures that apply in most industries. In exceptionally stable or volatile industries, however, the relevant "Key Credit Factors" article may specify different standards. Characteristics of a company with strong liquidity include:

- A/B for the upcoming 12 months of 1.5x or more. Even when measured over the next 24 months, the measure remains above 1.0x.
- Positive A-B, even if forecasted EBITDA declines by 30%.
- Sufficient covenant headroom for forecasted EBITDA to decline by 30% without the company breaching coverage tests, and debt is 25% below covenant limits.
- The likely ability to absorb, without refinancing, high-impact, low-probability events.
- Well-established, solid relationships with banks.
- A generally high standing in credit markets. This can be assessed from equity, debt, and CDS trading data relative to peers and market averages.
- Generally very prudent financial risk management. To meet this assessment, the company needs to show evidence that its management anticipated potential setbacks and took the necessary actions to ensure continued strong liquidity.

Adequate

30. Companies with adequate liquidity should be able to withstand adverse market circumstances over the next 12 months while maintaining sufficient liquidity to meet their obligations. Adequate liquidity is ratings-neutral, rather than an enhancing or detracting characteristic. To have adequate liquidity, an entity must meet the ratio test for A/B and demonstrate at least four of the other supportive characteristics listed below. The first three characteristics reference quantitative measures that apply in most industries. In exceptionally stable or volatile industries, however, the relevant "Key Credit Factors" article may specify different standards. Characteristics of a company with adequate liquidity include:

- A/B of 1.2x or more. In particular, any upcoming maturities should be manageable.
- Positive A-B, even if forecasted EBITDA declines by 15%.
- Sufficient covenant headroom for forecasted EBITDA to decline by 15% without the company breaching coverage tests, and debt is 15% below covenant limits (or, if not, the related facilities are not material).
- The likely ability to absorb high-impact, low-probability events, with limited need for refinancing. Liquidity is supplemented by the perceived flexibility to lower capital spending or sell assets, among other actions.
- Sound relationships with banks.

- A generally satisfactory standing in credit markets. This can be assessed from equity, debt, and CDS trading data relative to peers and market averages.
 - Generally prudent financial risk management. To meet this assessment, the company needs to show evidence that its management anticipated potential setbacks and took the necessary actions to ensure continued adequate liquidity.
31. For the purposes of calculating adequate liquidity, the debt maturities and the undrawn, available portion of committed bank lines are based on a six-month time horizon for companies with certain strong credit characteristics. The A/B and A-B tests for the adequate category use debt maturities within the next six months as a use of liquidity and include the undrawn, available portion of committed bank lines that matures beyond the next six months as a source of liquidity when:
- The company's issuer credit rating is at least 'BBB-', and
 - All three of the following qualitative characteristics--normally associated with strong liquidity--apply: (1) Well-established and solid relationships with banks; (2) A generally high standing in credit markets. This can be assessed from equity, debt, and CDS trading data relative to peers and market averages; and (3) Generally very prudent financial risk management. To meet this assessment, the company needs to show evidence that its management anticipated potential setbacks and took the necessary actions to ensure continued adequate liquidity.
32. If the A/B and A-B tests do not meet the requisite levels outlined in paragraph 30, using a six-month time horizon, but a company meets all other characteristics outlined in paragraph 31, it may still receive a liquidity score of adequate. A company's liquidity may still receive a score of adequate, if it has a credible plan to within three months address the lack of liquidity that would cause the A/B and A-B tests to increase to the levels outlined in paragraph 30. However, in this event, the ICR on the company will be no higher than in the 'A' category. Characteristics of credible plans generally include advanced discussions with lending groups or bond underwriters with clear timetables for proposed refinancings or new issues, which would not extend beyond the next three months.

Less than adequate

33. A company with less than adequate liquidity has an ICR no higher than 'BB+'. To have a level of liquidity that is less than adequate, an entity would have one or more of the negative characteristics described below or would not qualify for an adequate or weak liquidity assessment. Characteristics of a company with less than adequate liquidity include:
- A/B of less than 1.2x. This level offers scant protection against unexpected adverse developments.
 - A-B of about zero or below.
 - Covenant headroom so tight that coverage tests could be breached if forecasted EBITDA were to decline by just 10%. (A covenant breach on any related facilities would likely have a significant impact, because the debt containing the covenants in question could not easily be repaid.)
 - The likelihood of the company not being able to absorb low-probability adversities, even factoring in capital-spending cuts, asset sales, and cuts in shareholder distributions.
 - No particular core bank relationship and indications of a poor standing in credit markets, such as wide CDS trades for several consecutive weeks or share price declines.

Weak

34. Weak liquidity represents an overarching credit risk. In all cases, such an assessment will translate into an ICR of 'B-' or lower. To have weak liquidity, an entity would display the first characteristic listed below and typically one

or both of the two subsequent characteristics. Characteristics of a company with weak liquidity include:

- A/B or A-B reflecting a material deficit over the next 12 months.
- The likelihood that covenants will be breached unless there is a very credible plan to avert such a breach in a timely fashion or lenders appear likely to provide a covenant waiver or amendment (assuming that the related facilities are material). Only low-probability, unforeseen positive events would allow the company to regain a level of liquidity better than weak.
- Indications of a poor standing in credit markets, such as very wide CDS trades or a serious share price decline.

RELATED CRITERIA AND RESEARCH

- Principles Of Credit Ratings, Feb. 16, 2011
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Assumptions: Analytical Adjustments For Captive Finance Operations, June 27, 2008
- Corporate Ratings Criteria 2008, April 15, 2008
- Analyzing The Liquidity Adequacy Of U.S. Energy Marketing And Trading Operations, May 4, 2004

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

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