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Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers

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*(**Editor's Note:** This article partly amends "Corporate Ratings Criteria," published April 15, 2008.)*

SCOPE OF THE CRITERIA

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.

2. We are publishing this article to help market participants better understand our approach to reviewing corporate liquidity. This article is related to, and partly amends, our criteria article "Corporate Ratings Criteria," published April 15, 2008, on RatingsDirect.

SUMMARY OF CRITERIA UPDATE

3. Standard & Poor's is updating its criteria for corporate liquidity analysis to clarify several areas. The clarification focuses on:

- The standardization of our descriptors into a five-point scale;
- A characterization of the features associated with each of the descriptors; and
- A description of the impact of the criteria on ICRs.

UPDATES TO EXISTING CRITERIA

4. This article partly amends "Corporate Ratings Criteria," published April 15, 2008, on RatingsDirect, notably by introducing standard descriptors for our assessment of a company's liquidity and two quantitative indicators of a company's liquidity cushion based on liquidity sources and liquidity uses.

IMPACT ON OUTSTANDING RATINGS

5. We do not expect any rating changes as a result of the publication of these criteria.

EFFECTIVE DATE AND TRANSITION

6. These criteria are effective immediately for all new and outstanding corporate ICRs.

METHODOLOGY

7. Liquidity is an important component of our financial risk assessment across the entire rating spectrum (see "Corporate Ratings Criteria", Liquidity, page 45). In our view, unlike most other rating factors that we blend together in assessing an issuer's risk profile, a lack of liquidity could precipitate the default of an otherwise healthy entity. Accordingly, we assess liquidity as an independent characteristic of the specific company; the assessment is not relative to peers or other companies in the same rating category.

8. We standardize our descriptors for corporate liquidity as:

- "Exceptional"
- "Strong"
- "Adequate"
- "Less than adequate"
- "Weak"

9. In our analysis, "adequate" liquidity is rating-neutral at most rating levels. To avoid the risk of default, a company's liquidity must be sufficiently robust, so we typically expect companies with ICRs of 'B+' and above to possess "adequate" (or stronger) liquidity, or to have credible, very near-term plans to achieve this status; otherwise, liquidity could weigh on the ICR.

10. The benchmarks that must be met to achieve "strong" and "exceptional" liquidity are demanding, but we expect most investment-grade companies typically to post at least "adequate" liquidity.

11. "Strong" and "exceptional" liquidity, by definition, exceed the norm. Such 'excess' liquidity can help to bolster a long-term 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; accordingly, we do not view the liquidity assessment, by itself, as a reason 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 the ratings should reflect that risk. Nonetheless, reflecting the independent aspect of the liquidity assessment, "less than adequate" liquidity could, in some circumstances, pertain to a company with an investment-grade rating for a short period. If for example, other credit attributes are solid and recognized as such by the credit market, the company would likely be in a position, in our opinion, to be able to address its immediate liquidity issues. However, we would typically not expect to maintain existing ratings in such an anomalous liquidity situation for long.

13. (Our short-term ratings are highly correlated to our long-term ICRs--see "Corporate Ratings Criteria," Commercial Paper, page 105. However, to the extent that, for a given long-term rating, two short-term ratings are possible, liquidity is an important consideration. Accordingly, our assessment of a company's liquidity could translate directly into a higher or lower short-term rating.)

14. When assessing banking relationships, we take into account 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 "Corporate Ratings Criteria," pages

48-51 and 107-108 for additional discussion.)

15. In the case of companies whose credit standing is supported by other entities (such as government-related entities) liquidity is part of the stand-alone analysis. We separately assess the potential for support in dealing with potential liquidity shortfalls.

KEY QUANTITATIVE MEASURES

16. In our analysis, 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, for this purpose, refer to amounts that we expect to be generated or used over the upcoming 12 months. The amounts used in the calculations conform to our anticipated base case, assuming no refinancing for the company in question, and include both internal and external components.

Sources

- Cash and liquid investments. (See "Corporate Ratings Criteria," Surplus cash, page 81, for additional discussion regarding surplus cash and netting cash against debt. This netting approach also pertains to liquidity ratio calculations. If a company holds cash to satisfy upcoming, short-term obligations, we net these to avoid the appearance of liquidity dilution. This may include hedged or presold commodity trading inventories.)
- Funds from operations, if positive. This measure will fluctuate with economic and business cycles. We do not 'smooth' this effect, since the cyclical low point is where most cyclical companies experience liquidity problems. We review the degree of management's anticipation of a cyclical shortage of liquidity and assess the effectiveness of its measures to counter this risk.
- Net working capital inflows. (If seasonal, we use the lowest level seen in the course of the year. However, we also include seasonal bank facilities that cover the temporary outflows, to the extent that they are committed in the long term.)
- Proceeds of asset sales (to the extent that we can confidently predict these).
- The undrawn, available portion of committed bank lines that matures beyond the next 12 months. If covenants are present, there must be what we view as a comfortable cushion or headroom.

Uses

- Funds from operations, if negative.
- Expected capital spending. This amount should include estimated maintenance spending, plus expansion project spending with a long lead time that will likely proceed even in a downturn.
- Working capital needs. If seasonal, we use the lowest level seen in the course of the year.
- All debt maturities (in the next 12 months).
- Any pension top-up needs.
- Any potential need to post derivative collateral or unwind hedges early. Our objective is to assess the size of this potential by considering various scenarios for the performance of the asset underlying the derivative and for the performance of the rated entity, if ratings triggers are present.
- Contracted acquisitions and expected shareholder distributions.

18. We also consider the reliability of the information at our disposal. To the extent that information is unavailable,

tardy, or, in our view, of dubious veracity, we would discount the data.

LIQUIDITY CATEGORIES

"Exceptional"

19. We consider "exceptional" liquidity to be that which we believe would protect a company's credit quality even in severely adverse market conditions.

20. Characteristics of a company whose liquidity we assess as "exceptional" include:

- A/B of 2x or more and our belief that it will remain so for the next two to three years.
- Positive A-B, even if EBITDA were to decline by 50%. However, we may apply a different test for industries that we view as exceptionally volatile or exceptionally stable (for example, copper mining companies may need to withstand a decline in EBITDA of more than 50% to meet this measure, while regulated utilities may only need to demonstrate that they can still meet this measure with a decline in EBITDA of less than 50%.) In such cases, the test that we apply will be specified in the related "Key Credit Factors" for that industry.
- Typically, a lack of covenants. If covenants are present, headroom under these is such that EBITDA could fall by 50% without the company breaching covenant test measures; debt at 30% below any limits on borrowing.
- The likely ability, in our view, 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, in our assessment.
- 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, in our view. To meet this assessment, we would have to conclude that the company's management attempts to anticipate setbacks and proactively take necessary actions to ensure continued strong liquidity. (See "Corporate Ratings Criteria," pages 33-37, for additional information about how we assess the role of management.)

21. To have a level of liquidity that we consider "exceptional", an entity would have to meet the ratio test for A/B and at least four of the other supportive characteristics. We expect few companies to qualify for this category.

"Strong"

22. We consider "strong" liquidity to be that which we believe would protect a company's credit quality from significantly adverse market circumstances.

23. Characteristics of a company whose liquidity we assess as "strong" include:

- A/B for the upcoming 12 months of 1.5x or more. Even when measured over the next 18-24 months, the measure remains above 1.0x.
- Positive A-B even if EBITDA were to decline by 30%. However, we may apply a different test for industries that we view as exceptionally volatile or exceptionally stable (for example, copper mining companies may need to withstand a decline in EBITDA of more higher than 30% to meet this measure, while regulated utilities may only need to demonstrate that they can still meet this measure with a decline in EBITDA of less than 30%.) In such cases, the test that we will apply will be specified in the related "Key Credit Factors" for that industry.
- Sufficient covenant headroom for EBITDA to decline by 30% without the company breaching coverage tests; debt is 25% below covenant limits.

- The likely ability, in our view, to absorb, without refinancing, high-impact, low-probability events.
- Well-established and solid relationships with banks, in our assessment.
- 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, in our view. To meet this assessment, we would have to conclude that the company's management would be likely to anticipate setbacks and proactively ensure continued strong liquidity.

24. To have a level of liquidity that we consider "strong", an entity would have to meet the ratio test for A/B and demonstrate at least four of the other supportive characteristics.

"Adequate"

25. We consider "adequate" liquidity to be that which we believe would protect a company's credit quality from reasonably adverse market circumstances. We view "adequate" liquidity as ratings-neutral, rather than an enhancing characteristic.

26. Characteristics of a company whose liquidity we assess as "adequate" include:

- A/B of about 1.2x or more. No significant expected shortfall in liquidity, even in the second year out. In particular, any upcoming maturities should be manageable, in our assessment.
- Positive A-B, even if EBITDA were to decline by 15%-20%. However, we may apply a different test for industries that we view as exceptionally volatile or exceptionally stable (for example, copper mining companies may need to withstand a decline in EBITDA of more higher than 15%-20% to meet this measure, while regulated utilities may only need to demonstrate that they can still meet this measure with a decline in EBITDA of less than 15%-20%.) In such cases, the test that we will apply will be specified in the related "Key Credit Factors" for that industry.
- Sufficient covenant headroom for EBITDA to decline by 15%-20% without the company breaching coverage tests; debt is 15% below covenant limits. (or, if not, the related facilities are not sizeable)
- The likely ability, in our view, to absorb, with limited need for refinancing, high-impact, low-probability events. Liquidity is supplemented by the perceived flexibility to lower capital spending or sell assets, among other actions.
- Sound relationships with banks, in our assessment.
- 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 risk management, in our view.

27. To have a level of liquidity that we consider "adequate", an entity would have to have nearly all of the supportive characteristics described above. Some minor deviation from one or two of these characteristics may still enable us to assess a company's liquidity as "adequate".

"Less than adequate"

28. We consider "less than adequate" liquidity to be that which we believe represents a risk that contributes to a low ICR or would likely lead to a downgrade if not remedied. The actual implications depend on whether there is a credible, near-term plan to improve liquidity. We could rate a company with liquidity that we assess as "less than adequate" in the 'BB' category, or even the 'BBB' category, provided that the company has in place a credible plan to address the lack of liquidity and that, in our view, the plan would be likely to result in adequate liquidity in the near term. If we were to assess a company's liquidity as "less than adequate" on a sustained basis, and if this level of liquidity is the norm for that company, this would generally be consistent with a lower rating.

29. Characteristics of a company whose liquidity we assess as "less than adequate" include:

- A/B of barely 1x. This level offers scant protection against unexpected adverse developments, in our view.
- A-B of about zero.
- The potential, in our assessment, for significant liquidity deficits beyond the following four quarters even when A/B currently exceeds 1x.
- Covenant headroom so tight that coverage tests could be breached if EBITDA were to decline by just 10%; borrowing within 5%-10% of limits. (A covenant breach on any related facilities would likely have a significant impact, such that the debt containing the covenants in question could not easily be repaid.)
- The likelihood of the company, in our view, not being able to absorb low-probability adversities, even factoring in capital-spending cuts, asset sales, and shareholder distributions.
- No particular core bank relationship, in our assessment.
- Indications of a poor standing in credit markets, such as wide CDS trades for several consecutive weeks and/or share price declines.

30. To have a level of liquidity that we consider "less than adequate", an entity would have two or more of the negative characteristics described above. In some cases, even one characteristic (for example, exposure to a serious covenant violation) might lead us to view the entity's liquidity as "less than adequate".

"Weak"

31. We consider "weak" liquidity to be that which we believe represents an overarching credit risk. In many, if not most, cases, such an assessment will translate into a very low ICR (at the 'B' rating level or lower), especially in periods when financial markets are less than robust.

32. If we were to view a company's liquidity management as imprudent, this would prompt us to review that company's overall business risk scores, in order to factor in the actions, or inaction, of management in this regard. On the other hand, if we remain satisfied that the company's business risk profile and financial risk profile remain sound in all other respects, a deficit that is not imminent would not automatically translate into a cap on the rating.

33. Characteristics of a company whose liquidity we assess as "weak" include:

- A/B or A-B that reflects a material deficit in the next three quarters.
- The likelihood that covenants will be breached unless there is a very credible plan to avert such a breach in a timely fashion (assuming that the related facilities are sizeable). Only low-probability, unforeseen positive events would allow the company to regain what we view as liquidity of better than "weak".
- Considerable debt maturities in the next four to six quarters, in our assessment.
- Indications of a poor standing in credit markets, such as very wide CDS trades and/or a serious share price decline.

34. To have a level of liquidity that we consider "weak", an entity could have any two of the four negative characteristics described above, or just one out of the first two.

RELATED CRITERIA AND RESEARCH

Corporate Ratings Criteria 2008, April 15, 2008

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.