Approach to Financial Ratios

Credit Rating

Financial ratio analysis is a process of selecting, evaluating, and interpreting financial data, along with other pertinent information, in order to formulate an assessment of a company's present and future financial condition and performance.

Financial Ratios are one of the key parameters BWR uses to assess the financial risk profile of a company. Financial risk along with an assessment of Business Risk, Management Risk, Industry Risk, Project Risk, Operating Efficiency and Financial Flexibility are used to assess the creditworthiness of a company. The ratio analysis broadly helps to understand; i) Effectiveness in putting its asset investment to use (Activity ratios), ii) Ability to meet short-term immediate obligations (Liquidity ratios), Ability to satisfy debt obligations (Solvency Ratios) and iv) Ability to manage expenses to produce profits from sales (Profitability ratios).

This document gives an overview of the some of the critical ratios that BWR generally employs to understand the overall financial risk profile and evaluation of the credit quality of a company. Some of the ratios may play a critical role under some circumstances. As such the importance of ratio analysis may vary form case to case basis.

Net worth Size / Tangible Net worth

Net worth is the amount by which assets exceed liabilities. Net worth is a key measure of how much an entity is worth. A consistent increase in net worth indicates good financial health; conversely, net worth may be depleted by annual operating losses or a substantial decrease in asset values relative to liabilities. Net worth is also known as book value or shareholders' equity.

Tangible net worth is most commonly a calculation of the net worth of a company that excludes any value derived from intangible assets such as copyrights, patents and intellectual property. Tangible net worth is a simple calculation of a company's total tangible assets minus the company's total liabilities.

BWR believes Net worth is a true reflection of its size and hence considered as an important parameter in the analysis. Higher the net worth, the higher is the ability of the company to withstand changes in the economic and competitive environment. Hence an entity with a large size (large net worth) is less likely to default as compared to a small entity.

Capital Structure – Debt-Equity or Gearing Ratio

A company's capital structure denotes the mix of debt and equity in its funding. Gearing Ratio or Debt-Equity ratio or leverage is used to capture the capital structure of a company. An optimum mix of debt and equity in the funding mix is important to add maximum value to the company by keeping the cost of capital low. Since credit rating assesses the probability of servicing of a company's debt obligation, a high debt-equity ratio would translate into higher financial risk. Brickwork Ratings computes Debt-equity ratio as follows:

Debt-Equity = Total Debt/Tangible Net worth

In Total Debt, BWR includes secured loans, unsecured loans - both long term and short term, subordinated debt, redeemable preference shares, optionally convertible debentures. Appropriate adjustments are made to Contingent liabilities, off balance sheet items, factored receivables, guarantees, derivatives and pension liabilities while calculating gearing.

Tangible Net worth of a company is assessed by analyzing the reported net worth figure which includes the paid up equity capital and reserves and surplus. Revaluation reserves and miscellaneous expenditure not written off are deducted from the reported net worth to calculate tangible net worth. Hybrid instruments are assessed to form an opinion as to whether they exhibit equity like or debt like characteristics. They are then appropriately classified as equity or debt. Hybrid instruments (carrying equity features) would include convertible preference shares, optionally-convertible debt, compulsorily-convertible debt and Foreign currency convertible debt (FCCBs) besides any other instrument with both debt and equity like features.

Deferred Tax Liabilities are excluded from the calculations of Tangible Net worth.

Interest Service Coverage Ratio

Interest Coverage is used to assess the number of times a company can meet its finance charges from the surpluses generated from its operations. Brickwork Ratings computes Interest Service Coverage Ratio as follows:

ISCR = Earnings before interest, tax, depreciation and amortization (EBITDA)/Interest and Finance charges.

The finance charges include total interest payable by the company, bank guarantee commission, any other finance charges, etc.

Debt Service Coverage Ratio (DSCR)

While the interest coverage focuses on capability of a company to pay interest and other finance charges, the Debt Service Coverage ratio also takes into account the scheduled repayments of debt by the company. It is the ability of the company to service its debt obligations, both principal and interest, through operating earnings. While calculating DSCR, BWR takes into account the fact that part of the operating earnings will be ploughed back into the company's operations prior to payment of finance charges. This part funding of company's operations is assumed to be at 25% of the incremental net working capital. Brickwork Ratings computes Debt Service Coverage Ratio as follows:

DSCR = (Profit After Tax (PAT) + Interest & Finance charges+ Amortization+ Depreciation – 25% of incremental Net working Capital)/(Debt payable within one year + Interest and finance charges)

The debt payable within one year includes the current portion of long term debt i.e. repayment of debt maturing in the current year and short term debt obligations excluding debt that is automatically rolled over such as commercial papers and working capital bank borrowings.

Profitability- Net Profit Margin (NPM) and Return on Capital Employed (RoCE)

Profit margins are a good indicator of a company's fundamental health, competitive position and ability to sustain its cash accruals. A company that has been consistently making losses or witnessing decline in its margins and returns coupled with bleak industry prospects cannot be expected to remain creditworthy for long. Thus, in the overall analysis, the profitability analysis is coupled with industry and business analysis to form an opinion on the sustainability of the business. BWR uses Net Profit Margin and Return on Capital Employed for this assessment.

Net Profit Margin

This ratio is a measure of the ability of the company to generate earnings which can be ploughed back into the business. It is a function of the company's competitive positioning within the industry, its brand positioning, value addition and the industry's overall profitability. Profit after Tax (PAT) margins can also be used to compare various industries and their profit potential.

PAT Margin = Profit after Tax / Net Operating Income

Return on Capital Employed

Return on Capital Employed indicates the ability of a company's management to generate returns for both the debt holders and equity holders. Higher the ratio, more efficiently is the capital being employed by the company to generate returns. RoCE , like PAT margin, is also a function of the industry that the company operates in and its competitive positioning. BWR calculates RoCE as follows:

RoCE = Earnings Before Interest and Taxes (EBIT) / Capital Employed.

where Capital employed = Tangible Networth + Total Debt +Deferred Tax Liability

Net Cash Accruals (NCA) to Total Debt

The company's current year debt obligation is to be paid out of the cash that the company generates. This ratio indicates the amount of cash being generated as a proportion of the total debt that the company currently has on its books.

NCA/Total Debt = (PAT + Depreciation - Dividend) / (Total debt (short term and long term + off balance-sheet debt))

Current Ratio

Current Ratio indicates a company's liquidity position. A Current Ratio greater than 1 (one) indicates that the company's liquid assets are enough to cover its short term liabilities.

Current Ratio = Current Assets/ Current Liabilities (including Current Portion of Long term Debt i.e. CPLTD)