COVERAGE RATIOS : CRISIL'S VIEW

The present write up is a continuation of the series of articles aimed at describing the methodologies adopted in a rating process. This article deals with one of the aspects of financial risk analysis – the ability of companies to service their debt obligations.

Coverage ratios are designed to relate the financial charges of a firm to its ability to service or cover them. It signifies the degree of comfort the company has in meeting its fixed charge burden from earnings generated from its operations. Given below is a discussion on the important ratios that CRISIL looks at to evaluate coverage levels of a company.

Interest Cover

Interest cover is defined as the extent of cushion or comfort the company has in meeting its interest obligations from surplus generated from its operations. The ratio used to compute this parameter is :

$$\text{Interest Cover} = \frac{\text{Operating Profit before Depreciation, Interest and Tax (OPBDIT)}}{\text{Interest \& Finance charges}}$$

Operating Profit Before Depreciation, Interest and Tax (OPBDIT) indicates the profits made by the company from its various operations, prior to meeting its capital costs. It does not take into account any non operating or extraordinary income such as dividend, interest income, profit of sale of assets – physical or financial, etc. Similarly, on the expense side, OPBDIT does not take into account non operational or extraordinary expenses such as loss reported on sale of assets, expenses pertaining to VRS etc. This ratio is important as it is assumed that a company takes debt for its core business. Hence, all obligations related to the debt have to be met from returns generated from its main line of business.

Although operating profit is the most commonly used profit parameter for interest cover calculation, there are other parameters that are looked at to get an overall perspective.

(1) Profit before depreciation, interest and tax (PBDIT): This takes into account income and expense pertaining to operations as well as other activities such as investments, sale and purchase of assets, etc. Use of PBDIT for coverage calculations takes into account the total surplus available to the company to meet its financial obligations. This ratio is useful when companies have such non operational entries (income and expense) on a regular basis.

The ratio is also useful to ascertain the health of companies in the immediate future. For instance, interest cover would be low for companies who face temporary problems in manufacturing or operations and thus face a dip in their operating profits. In such cases, interest cover calculated on the basis of operating profits could be lower than 1 indicating difficulty of the company in fulfilling its obligations. However, the company might be able to honour its obligations through money received from non operational sources.

(2) PBDIT net of extraordinary expense / income : This ratio excludes one time items such as VRS expense, profits booked from sale of assets, etc. Such events are normally on account of a strategic decision taken by the company and their implications are felt primarily in the year of incidence. Such items have the potential to skew the picture of the

company's health and hence this ratio is looked at in order to normalise the effect of such one time occurrences.

Interest and Finance Charges: This captures the interest paid by the company for all its borrowings. Bank charges and commissions paid by the company are also included by CRISIL under this head.

In the calculation of interest coverage for a manufacturing company, gross interest is taken into account rather than net interest (net of interest income received). Interest income is obtained from investments made out of surpluses of the company. Since investment activity is not a part of the main business of the company and would depend on the amount of surpluses generated as well as management strategy on its deployment, the income source may not necessarily be stable. CRISIL believes that interest obligation of a company is fixed in nature and should be serviced out of stable income streams of a company. Hence interest income is excluded from coverage calculations.

As in the case of profits, there are different treatments of interest charges used for calculation of interest coverage. Some of the adjustments made again depending on the situation are given below:

(1) Capitalised Interest: Companies that have projects on hand capitalise all expenses incurred during the implementation of the project till the time of commissioning. This includes interest expense paid for borrowings taken for the project. This is because usually, the interest portion is incorporated in the original project cost and is funded by the lending agency. All expenses including interest incurred till the project commissioning date are charged to the balance sheet as fixed assets and depreciated over the future years. In such a case, the interest cover ratio need not include interest capitalised. However, in cases where the interest is not funded as part of the project cost and the company is required to make interest payments from its other operations, or in cases where there has been a cost overrun leading to higher borrowing, the interest cover would have to be viewed including the amount of interest capitalised.

(2) Lease rentals : The interest charges includes lease rental paid by a company for borrowings taken in the form of lease. However, the lease rental reported in a company's books includes both principal as well as the interest component. Hence, an adjustment is made by removing the principal amount from the lease and charging only the interest portion of the rental.

(3) Dividend on preference shares : If the company has preference shares outstanding in its books, the dividend which the company has to make towards these stocks are also incorporated as finance charges in the ratio calculation. This is because CRISIL treats preference shares as pure debt except under circumstances where the tenor is greater than 5 years or where the company has the flexibility of deferring dividend as in the case of cumulative preference shares.

The various coverage ratios incorporating the above factors are as follows:

$$\text{Interest Cover} = \frac{\text{PBDIT}}{\text{Interest \& Finance Charges}}$$

$$= \frac{\text{PBDIT – net of extraordinary expense and income}}{\text{Interest \& Finance Charges}}$$

$$= \frac{\text{PBDIT – net of extraordinary expense and income}}{\text{Interest \& Finance Charges + Capitalised Interest}}$$

$$= \frac{\text{PBDIT – net of extraordinary expense and income}}{\text{Interest \& Finance Charges + Capitalised Interest – Lease Rental}}$$

Other Ratios for Measuring Coverage

Debt Service Coverage Ratio (DSCR)

DSCR indicates the ability of the company to service its debt obligations, both principal as well as interest, from earnings generated from its operations. DSCR is calculated as :

$$\text{DSCR} = \frac{\text{Profit After Tax + Depreciation - Extraordinary income and expense}}{\text{Debt payable within one year + Interest + Preference share dividend}}$$

According to the methodology adopted by CRISIL, the constituents of debt are primarily short term obligations which are due for maturity in the next one year and the current portion of long term debt. Specifically, the entries included in debt are current portion of long and short-term debt, amount of fixed deposit maturing in the next one year, short-term inter corporate deposits, etc.

According to the simple definition of DSCR, a ratio of greater than 1 implies that a company would be able to service its debt obligations, including principal as well as interest from accruals generated in a year. On the other hand, a ratio of less than 1 might appear unfavourable as it would imply that surpluses of one year are insufficient to meet all the immediate debt obligations of the company. CRISIL however views a low DSCR in conjunction with the company's financial flexibility on account of the following reasons:

- The debt taken for a project is typically is of a lower tenor than its payback period. This implies that the company would have to replace its debt when the need arises.
- A growing company would constantly require debt for its business requirements. The company may not use all its proceeds to repay its debt obligations but rather plough it back to enhance its business. This is more true for Indian companies who are still in their growing stage than their counterparts in the developed world.

CRISIL recognises the need for constant debt by companies and hence a low DSCR may not necessarily have an unfavourable impact on the rating. Rather, the ability of the company to replace its existing debt with fresh funds, either in the form of equity or debt is what assumes significance from the rating point of view.

Therefore what is important from the rating point of view is the financial flexibility available to the company to access funds, either from the equity or debt market. The factors that influence such an access are low gearing, strong parentage, strong operating cashflows, etc.

Net Cash Accruals to Total Debt

The ratio indicates the amount of cash generated in comparison to the total debt of the company. The ratio also gives an approximate time over which the company would be able

to fulfil its debt obligations through proceeds from its operations. The method of computation is as follows:

$$\frac{\text{Net Profit} + \text{Depreciation} - \text{Dividend paid}}{\text{Total Debt}}$$

Cash Coverage : CRISIL also assigns adequate importance to cash interest coverage of a company. The difference here is that the ratio is based on the actual cash outflow on account of interest obligations and the company's ability to service it. Such an indicator is useful in cases where the debt carries interest moratorium thus resulting in lower interest burden on a cash basis. The formula used for calculating the cash flow interest coverage is as follows:

$$\text{Cashflow interest coverage} = \frac{\text{PBDIT}}{\text{Adjusted Cashflow interest}}$$

where adjusted cash flow = opening interest accrued but not due + interest charges for the year (as reported in the Profit and Loss account) + Preference Dividend declared + interest portion of lease rentals + non-funded interest capitalised – closing interest accrued and due – interest portion on deep discount bonds*.

Interest portion on deep discount bond is computed as (closing deep discount bond – opening deep discount bond – deep discount bonds issued during the year)

Importance of Interest Coverage in Rating Analysis

Interest coverage relates the financial charges of a company to its ability to service them from generations made from its operations. It reflects the extent of cushion available to the company to service its interest costs, which is a fixed obligation. This ratio serves as one measure of the firm's ability to meet its interest payments and avoid bankruptcy.

The importance of interest coverage in a rating process arises from the fact that the rating is a reflection of the firm's ability to fulfil its repayment obligations on a timely basis. This implies that the company should be generating adequate income in order to meet its interest obligations. The higher the ratio of interest coverage, the more likely it is for the company to meet its obligations. Interest coverage is a consequence of both the company's profitability as well as its level of gearing and cost of borrowings. For businesses which have intrinsically low level of profit margins, a high interest burden either on account of high gearing level or high cost of funds, or both may have an adverse impact on the rating.

Although a final rating given to a company is a summary of its business and financial risk, CRISIL expects OPBDIT interest cover levels to be in specified bands for various rating categories. For instance, the expected interest cover for various rating categories would typically be 6.0 for AAA, 3.0 for AA, 2.0 for A and greater than 1.5 for the BBB category. These benchmarks are not meant to be precise but are intended to convey ranges that characterise levels of credit quality as represented by rating categories. In other words, the above correlation does not mean that a company with an interest cover higher than 6 will always get a AAA rating just as it does not imply that a company having a cover lower than 6 will never be qualified to get a AAA. Moreover, strengths evidenced in one financial measure can offset, or balance, relative weakness in another.