

Corporate Credit Analysis Framework

A Structured Approach to Evaluating Creditworthiness

I. Purpose of Credit Analysis

A forward-looking assessment of whether a company generates sufficient cash flow to meet its financial obligations.

- Rating agencies (Fitch, Moody's, S&P) assess issuers seeking to raise debt capital; ratings influence the interest rate the issuer must offer investors
- Lenders and investors evaluate the probability of default and structure covenants calibrated to the issuer's projected cash flows
- An independent credit opinion increases the marketability of debt securities to a broader investor base

II. Analytical Framework

Three layers, moving from broad to specific:

- Macro: Country and currency risk, economic conditions, interest rate environment
- Industry: Lifecycle stage, competitive dynamics, cyclicality, regulatory environment
- Company — Qualitative: Management track record, business model, competitive positioning, governance
- Company — Quantitative: Financial ratio analysis benchmarked against peers and industry averages

III. Step 1 — Position in the Capital Stack

First identify where the instrument sits in the capital structure. Recovery in default varies by seniority. Ratings methodology distinguishes between the issuer rating (probability of default) and the instrument rating (default probability × loss given default):

- Senior Secured: First claim on pledged assets; highest recovery; typically notched above the issuer rating
- Senior Unsecured: General asset claim; rated at or near the issuer rating
- Subordinated / Junior: Absorbs losses first; notched down from the issuer rating
- Equity: Residual claim; not rated but provides the first-loss buffer protecting debtholders

IV. Step 2 — Key Credit Ratios

All EBITDA-based ratios use Adjusted EBITDA, normalized for non-recurring items (restructuring charges, stock-based compensation, asset sale gains/losses). Using unadjusted EBITDA can materially distort leverage and coverage metrics.

Ratio	Formula	Benchmark / Interpretation
Interest Coverage	$Adj. EBITDA / Interest Expense$	Min. 2.0×; higher is better; deterioration is a warning signal
Leverage (Gross)	$Total Debt / Adj. EBITDA$	≤4.0× typical for investment grade; varies significantly by sector
Leverage (Net)	$(Total Debt - Cash) / Adj. EBITDA$	Adjusts for deployable cash; more conservative view of net debt burden
Current Ratio	$Current Assets / Current Liabilities$	<1.0× signals near-term liquidity stress
Quick Ratio	$(Cash + Securities + A/R) / Current Liab.$	Excludes inventory; more conservative liquidity test
CFO / Total Liabilities	$Cash Flow from Ops / Avg. Total Liabilities$	Degree to which operations generate cash sufficient to cover all liabilities

Ratio	Formula	Benchmark / Interpretation
Liabilities / Assets	<i>Total Liabilities / Total Assets</i>	Higher = greater financial leverage and long-term solvency risk
Return on Assets	<i>Net Income / Avg. Total Assets</i>	Overall asset efficiency; benchmarks vary significantly by sector

V. Step 3 — Free Cash Flow & Debt Service Coverage

FCFF (Free Cash Flow to the Firm) is the primary metric — cash available to all capital providers before debt service.

EBITDA → DSCR Walkthrough

- Adjusted EBITDA → Less: Capex → Less: Δ Net Working Capital → Less: Cash Taxes = FCFF
- FCFF → Less: Cash Interest → Less: Scheduled Principal Repayments = Cash After Debt Service

$$\text{DSCR} = \text{FCFF} \div (\text{Interest Expense} + \text{Scheduled Principal Repayments})$$

DSCR >1.0× = obligations are covered; most lenders require 1.2×–1.5× as a safety margin. Project forward to confirm coverage is sustainable over the debt's life.

VI. Step 4 — Debt Maturity Profile & Refinancing Risk

Coverage ratios alone are insufficient. A company can appear healthy today but face a near-term “maturity wall” — a large tranche of debt due in 1–3 years with limited refinancing options.

- Map the full maturity schedule by year; identify near-term concentrations
- Assess availability of committed revolving credit or other backup liquidity
- Evaluate refinancing risk: can the issuer access capital markets at manageable rates at the relevant future date?
- Review covenant step-downs or provisions that could accelerate maturities

VII. Step 5 — Covenant Analysis

Covenants are contractual protections that limit borrower flexibility and provide lenders with early warning or remedies if credit quality deteriorates.

- Maintenance covenants (bank loans): Periodic compliance with ratio thresholds; breach triggers a technical default
- Incurrence covenants (high-yield bonds): Restrict actions unless a financial test is met at the time; less protective in deteriorating scenarios
- Cross-default provisions: Default under one instrument triggers default under others
- Covenant-lite structures reduce lender protections; their presence is a qualitative negative in the credit assessment

VIII. Step 6 — Legal, Regulatory & Other Risk Factors

Quantitative analysis must be supplemented by a review of material non-financial risks:

- Litigation and regulatory exposure: Pending lawsuits, fines, or investigations and their potential cash flow impact
- Concentration risk: Customer, supplier, or geographic concentrations creating revenue vulnerability
- ESG and governance: Environmental liabilities, regulatory trends, and governance quality affecting long-term franchise value and capital markets access