S&P Global Ratings

RatingsDirect®

RFC Process Summary:

Corporate Methodology: Ratios And Adjustments

April 1, 2019

On Jan. 3, 2019, S&P Global Ratings published a request for comment on its proposed global methodology and assumptions for making analytical adjustments to companies' reported financial data, which included guidance for the application of the criteria. We'd like to thank investors, issuers, and other intermediaries who provided feedback. This RFC Process Summary provides an overview of the changes, if any, between the request for comment and the final criteria, and the rationale behind those changes.

In the RFC, we encouraged market participants to submit their written feedback to us by Feb. 4, 2019. We did not make any significant changes to the criteria as a results of comments received, but we did make some minor modifications to the guidance. We finalized and published our criteria, titled "Corporate Methodology: Ratios And Adjustments," on April 1, 2019.

ANALYTICAL CONTACTS

Leonard A Grimando
New York
(1) 212-438-3487
leonard.grimando@spglobal.com

Imre Guba
Madrid
(44) 20-7176-3849
imre.guba@spglobal.com

Sam C Holland, FCA
London
(44) 20-7176-3779
sam.holland@spglobal.com

Shripad J Joshi, CPA, CA
New York
(1) 212-438-4069
shripad.joshi@spglobal.com

Raam Ratnam, CFA, CPA
London
(44) 20-7176-7462
raam.ratnam@spglobal.com

Scott E Zari, CFA
Chicago
+ 1 (312) 233 7079
scott.zari@spglobal.com

See complete contact list at end of article.

Summary Of Changes

Cash interest received

Some respondents stated that they would like us to include cash interest received (and non-equity method dividends) in the calculation of funds from operations (FFO), because we depress FFO by cash interest paid. Cash interest received was not material to the calculation of FFO for the vast majority of issuers in our ratings universe. Our FFO measure primarily focuses on the cash flows that a company generates from its operating activities. We exclude cash interest received from our measure of FFO, and capture the cash flows derived principally from operations along with the cash tax and cash interest paid associated with those operations. By calculating FFO without cash interest received, we get an additional perspective on a company's cash flows besides that provided by our EBITDA and cash flow from operations (CFO) measures. Our EBITDA measure allows us to view a company's earnings before interest received or paid, and our CFO measure provides us with a measure of cash flows after both cash interest received and paid.

Another consideration for our exclusion of cash interest income from our FFO measure is the disclosure differences between International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP) accounting, as U.S. GAAP does not require disclosure of cash interest received.

It is important to note that we do not ignore a company's significant cash balances in our core ratio of FFO to debt. We may deduct the amount of a company's accessible cash balances that qualify for netting against debt when we calculate the debt amount in our FFO to debt ratio.

Testing results

A number of respondents stated that they would like the RFC to include more specific results from our testing. While we do not publish individual issuers' testing results, we thoroughly tested the impact of our proposed methodology on our universe of financial metrics and ratings. We determined that the changes would not substantially affect the existing metrics and that negligible rating changes would result from implementing the updated methodology. This relates to the definition of what a rating is and why it is different from a score: a rating incorporates both quantitative and qualitative assessments of a company's characteristics, and there is a degree of analytical judgement inherent in a rating.

Lease accounting

Some respondents asked us to clarify how we use analytical judgement when overriding reported on-balance-sheet lease accounting or making exceptions to our expectation that, in most cases, the reported lease liabilities should be at least three times the next 12 months' lease commitments.

As stated in our ratios and adjustments criteria and guidance, we will use analytical judgement when leases have artificially short terms or where other lease-like contracts are not accounted for in a way that captures our view of the transaction's underlying economics. The facts and circumstances of these instances need to be considered on a case-by-case basis, so it is not possible to publish very detailed or prescriptive guidance on how this will be done.

Discretionary cash flow

Some respondents stated that discretionary cash flow (DCF) should not be decreased by share buybacks because they are, by their nature, discretionary, and companies have flexibility around share buybacks compared to dividends. While companies may have flexibility around share buybacks, they have become increasingly popular and common. Share buybacks reduce the cash available to repay debt and should be considered in our calculation of DCF. Furthermore, if a company discontinues share buybacks at any time, our DCF metric will increase accordingly. Also, as with capital expenditures and special dividends, which allow companies a degree of flexibility as to when they are incurred, share buybacks also depress the cash flows available to the company.

Our corporate methodology, which supports the change in the definition of DCF in our ratios and adjustments criteria, states: "For corporate issuers primarily rated in the investment-grade universe, DCF to debt can be an important barometer of future cash flow adequacy as it more fully reflects a company's financial policy, including decisions regarding dividend payouts. In addition, share buybacks and potential M&A, both of which can represent very significant uses of cash, are important components in cash flow analysis."

Currency risk

Additionally, we clarified how we consider the risk arising from currency exchange and capital controls when calculating accessible cash. We deleted the references to country risk 5 and 6, which were mentioned in our RFC. The revised guidance specifies that our determination of accessibility of cash will assess whether there are risks of exchange or capital controls in a company's home country, or in the country or countries where its subsidiaries are located. This change addresses the transparency and clarity of the calculation while still allowing for analytical judgment.

We finalized and published our guidance article "Guidance: Corporate Methodology: Ratios And Adjustments," on April 1, 2019.

This report does not constitute a rating action.

Contact List

ANALYTICAL CONTACTS

Leonard A Grimando
New York
(1) 212-438-3487
leonard.grimando@spglobal.com

ANALYTICAL CONTACTS

Imre Guba
Madrid
(44) 20-7176-3849
imre.guba@spglobal.com

ANALYTICAL CONTACTS

Sam C Holland, FCA
London
(44) 20-7176-3779
sam.holland@spglobal.com

ANALYTICAL CONTACTS

Shripad J Joshi, CPA, CA
New York
(1) 212-438-4069
shripad.joshi@spglobal.com

ANALYTICAL CONTACTS

Raam Ratnam, CFA, CPA
London
(44) 20-7176-7462
raam.ratnam@spglobal.com

ANALYTICAL CONTACTS

Scott E Zari, CFA
Chicago
+ 1 (312) 233 7079
scott.zari@spglobal.com

ANALYTICAL CONTACTS

Mehul P Sukkawala, CFA
Singapore
(65) 6239-6337
mehul.sukkawala@spglobal.com

ANALYTICAL CONTACTS

Diego H Ocampo
Buenos Aires
(54) 114-891-2116
diego.ocampo@spglobal.com

METHODOLOGIES CONTACTS

Peter Kernan
London
(44) 20-7176-3618
peter.kernan@spglobal.com

METHODOLOGIES CONTACTS

Marta Castelli
Buenos Aires
(54) 114-891-2128
marta.castelli@spglobal.com

METHODOLOGIES CONTACTS

James A Parchment
New York
(1) 212-438-4445
james.parchment@spglobal.com

METHODOLOGIES CONTACTS

Veronique Chayrigues
Paris
(33) 1-4420-6781
veronique.chayrigues@spglobal.com