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Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers

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Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers

(Editor's Note: We originally published this criteria article on January 2, 2014. We're republishing this article following our periodic review completed on November 4, 2014. We republished this article to add a question to the frequently asked questions section. We've republished this article on Jan. 2, 2014, to add a question and answer that clarify our definition of funds from operations [FFO] within our liquidity criteria. This clarification has no impact on our ratings or the effective date of the criteria.)

1. Standard & Poor's Ratings Services is refining its methodology for its liquidity analysis used when determining stand-alone credit profiles (SACPs) on global corporate issuers. We are publishing this article to help market participants better understand our approach to reviewing corporate liquidity. This article supersedes our criteria article "Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers," published Sept. 28, 2011. The article is related to our global corporate criteria (see "Corporate Methodology," Nov. 19, 2013) and to our criteria article "Principles Of Credit Ratings," Feb. 16, 2011.

SCOPE OF THE CRITERIA

2. These criteria apply to the analysis of corporate issuers globally. They do not apply to project finance ratings because of the contractual cash management protections in place for those credits, nor do they apply to issuers with characteristics of finance companies, such as equipment leasing companies.

SUMMARY OF THE CRITERIA

3. The methodology for assessing corporate liquidity addresses the liquidity factors used as a component of the analysis of corporate issuers. The quantitative analysis focuses on the monetary flows--the sources and uses of cash--that are the key indicators of a company's liquidity cushion. The analysis also assesses the potential for a company to breach covenant tests related to declines in earnings before interest, taxes, depreciation, and amortization (EBITDA). The methodology incorporates a qualitative analysis that addresses such factors as the ability to absorb high-impact, low-probability events, the nature of bank relationships, the level of standing in credit markets, and the degree of prudence of the company's risk management.
4. The methodology focuses on the standardization of liquidity descriptors into a five-point scale and a characterization of the features associated with each of the descriptors. The methodology also describes the impact of the criteria on SACPs.

UPDATES TO EXISTING CRITERIA

5. This article supersedes our criteria article "Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers." It clarifies previous criteria by stating that, to receive an SACP (after applying all modifiers) of 'bbb-' or higher,

we must assess a company's liquidity as "adequate," as we define the term, or stronger. Companies with an assessment that is "less than adequate," as we define the term, will not receive an SACP (after applying all modifiers) higher than 'bb+'; those with a "weak" assessment, as we define the term, will not receive an SACP (after applying all modifiers) higher than 'b-'.

IMPACT ON OUTSTANDING RATINGS

6. We do not expect these criteria, in and of themselves, to result in any rating changes. See the global corporate criteria for more details about the potential impact.

EFFECTIVE DATE AND TRANSITION

7. These criteria are effective immediately on the date of publication.

METHODOLOGY

8. Liquidity is an important component of financial risk across the entire rating spectrum (see "Corporate Methodology," Nov. 19, 2013). Unlike most other rating factors within an issuer's risk profile, a lack of liquidity could precipitate the default of an otherwise healthy entity. Accordingly, liquidity is an independent characteristic of a company, measured on an absolute basis, and the assessment is not relative to industry peers or other companies in the same rating category.
9. The descriptors for liquidity are Exceptional, Strong, Adequate, Less than adequate, and Weak. Adequate liquidity is rating-neutral. To avoid the risk of default, a company's liquidity must be sufficiently robust to absorb a moderate level of stress. Accordingly, for a company to receive an SACP of 'bbb-' or higher, we must assess its liquidity as adequate or stronger.
10. The benchmarks to achieve "strong" and "exceptional" liquidity, as we define the terms, are intended to meet stress scenarios, but all investment-grade companies must have at least adequate liquidity. Strong and exceptional liquidity, by definition, exceed the norm. Excess liquidity can help bolster an SACP 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. Therefore, these strengths must be considered in combination with strong or exceptional liquidity in order to have a higher SACP.
11. By contrast, less than adequate and weak liquidity are very likely to weigh on the SACP. As noted above, whatever a company's underlying performance, a lack of liquidity could precipitate a default, and ratings should reflect that risk.
12. Short-term ratings are linked to long-term ICRs and liquidity assessments. Accordingly, the assessment of a company's liquidity could translate directly into a higher or lower short-term rating.
13. For companies with ICRs based on their SACPs and with ratings that benefit from potential extraordinary intervention from a parent, affiliate or governmental entity, the criteria assess liquidity at the SACP level. As stated in the criteria,

any relationship between the liquidity assessment and the ICR corresponds to a similar relationship between the liquidity assessment and the SACP.

14. When assessing a company's banking relationships, the criteria consider 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 Methodology," Nov. 19, 2013, and "2008 Corporate Criteria: Commercial Paper," April 15, 2008)

A. Key Quantitative Measures

15. The key indicators of a company's liquidity cushion are:
 - A/B: Liquidity sources (A) divided by uses (B).
 - A-B: Liquidity sources (A) minus uses (B).
16. For this purpose, monetary flows within sources and uses of cash refer to amounts generated or used over the next six to 24 months, with the timeframes identified by each of the liquidity descriptors. The amounts used in the calculations conform to an anticipated base case, assuming no refinancing for the company in question, and include both internal and external components. The analysis of monetary flows excludes the sources and uses of cash from captive finance operations (see "Assumptions: Analytical Adjustments For Captive Finance Operations," published June 27, 2008).

1. Sources

17. The criteria consider the following liquidity sources:
 - Cash and liquid investments.
 - Forecasted funds from operations (FFO), if positive.
 - Forecasted working capital inflows, if positive.
 - Proceeds of asset sales (when confidently predictable).
 - The undrawn, available portion of committed bank lines maturing beyond the next 12 months.
 - Expected ongoing cash injections from a government or corporate group members, as appropriate.
18. Cash and liquid investments are included as a source of liquidity and could be discounted in certain circumstances (e.g., haircut for potential taxes payable). If a company holds cash to satisfy specific upcoming, short-term obligations, the criteria allow for the netting of cash against these obligations to avoid the appearance of liquidity dilution. This may include hedged or presold commodity trading inventories.
19. Forecasted FFO will fluctuate with economic and business cycles. This effect is not smoothed, because the cyclical low point is where most cyclical companies experience liquidity problems. Management's expectation that a cyclical shortage of liquidity and the effectiveness of its measures to counter this risk may affect the calculation of FFO.
20. A contracted sale of a subsidiary or other asset to a creditworthy counterparty is included as a source of cash. Alternatively, the criteria do not include a potential sale of a subsidiary or property as a source of cash.
21. Undrawn portions of committed bank lines are also considered. If covenants are present, we will only include the

portion of committed bank lines that we estimate is available without a covenant breach.

22. Undrawn portions of committed, short-term bank lines used explicitly to meet working capital uses are also considered. We would not include excess borrowing availability beyond our forecasted seasonal working capital needs included under uses of liquidity. If covenants are present, we will only include the portion of committed short-term bank lines that we estimate is available without a covenant breach.
23. Cash injections are considered based on a proven track record or an explicit guarantee provided by a government for the support of a government-related entity (GRE). This source of liquidity also includes similar ongoing support made to corporate subsidiaries by their parent companies or identified group members. The potential for extraordinary support (usually occurring in times of stress) is excluded from this source of liquidity.

2. Uses

24. The criteria consider the following uses of cash:
 - Forecasted funds from operations, if negative.
 - Expected capital spending.
 - Forecasted working capital outflows, if negative.
 - All debt maturities (either recourse to the company or which it is expected to support).
 - Any required cash-based, postretirement employee benefit top-up needs.
 - Credit puts that cause debt acceleration or new collateral posting requirements in the event of a downgrade of up to three notches.
 - Contracted acquisitions and expected shareholder distributions under a stress scenario, including expected share repurchases.
25. When assessing whether liquidity is at least "adequate", expected capital spending includes estimated maintenance spending plus expansion project spending with a long lead time that will likely proceed even in a downturn or that have been contractually committed. For the purposes of assessing "exceptional" or "strong" liquidity, all capital spending, including estimated discretionary spending, is generally included.
26. To assess forecasted working capital outflows in companies with material intra-year working capital requirements (e.g., companies in seasonal businesses), forecasted intra-year peak working capital outflows are used. In cases where working capital changes are positive over a given period because of large seasonal inflows that more than offset outflows, the criteria use the intra-year peak working capital outflows forecasted over the period.
27. Collateral posting requirements related to derivative contracts are not considered under liquidity uses. Potential uses in stress-case scenarios related to derivative contracts are analyzed separately (see "Analyzing The Liquidity Adequacy Of U.S. Energy Marketing And Trading Operations," published May 4, 2004).

B. Liquidity Categories

1. Exceptional

28. Companies with exceptional liquidity should be able to withstand severe adverse market conditions over the next two years while still having sufficient liquidity to meet their obligations. To have exceptional liquidity, an entity would have

to meet the ratio test for A/B and at least four of the other supportive characteristics listed below. Few companies qualify for this category. The first three characteristics reference quantitative measures that apply in most industries. In exceptionally stable or volatile industries, however, the relevant "Key Credit Factors" article may specify different standards. Characteristics of a company with exceptional liquidity include:

- A/B of 2x or more projected each year over the next two years.
- Positive A-B, even if forecasted EBITDA were to decline by 50%.
- Few covenants. If covenants are present, headroom under these is such that forecasted EBITDA could fall by 50% without the company breaching covenant test measures, and debt is at least 30% below any covenant limits.
- The likely ability to absorb, high-impact, low-probability events (such as market turbulence, sovereign risk, or the activation of material-adverse-change clauses) without refinancing.
- Well-established and solid relationships with banks.
- 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.
- Generally prudent risk management. To meet this assessment, the company needs to show evidence that its management anticipated potential setbacks and took the necessary actions to ensure continued exceptional liquidity (see the "Comprehensiveness of enterprise-wide risk management standards and tolerances" section of "Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers," Nov. 13, 2012).

2. Strong

29. Companies with strong liquidity should be able to withstand substantially adverse market circumstances over the next 24 months while still having sufficient liquidity to meet their obligations. To have strong liquidity, an entity must meet the ratio test for A/B and demonstrate at least four of the other supportive characteristics listed below. The first three characteristics reference quantitative measures that apply in most industries. In exceptionally stable or volatile industries, however, the relevant "Key Credit Factors" article may specify different standards. Characteristics of a company with strong liquidity include:

- A/B for the upcoming 12 months of 1.5x or more and remaining above 1.0x over the subsequent 12-month period.
- Positive A-B, even if forecasted EBITDA declines by 30%.
- Sufficient covenant headroom for forecasted EBITDA to decline by 30% without the company breaching coverage tests, and debt is at least 25% below covenant limits.
- The likely ability to absorb high-impact, low-probability events without refinancing.
- Well-established, solid relationships with banks.
- 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 prudent risk management. To meet this assessment, the company needs to show evidence that its management anticipated potential setbacks and took the necessary actions to ensure continued strong liquidity.

3. Adequate

30. Companies with adequate liquidity should be able to withstand adverse market circumstances over the next 12 months while maintaining sufficient liquidity to meet their obligations. Adequate liquidity is ratings-neutral, rather than an enhancing or detracting characteristic. To have adequate liquidity, an entity must meet the ratio test for A/B and demonstrate at least four of the other supportive characteristics listed below. The first three characteristics reference quantitative measures that apply in most industries. In exceptionally stable or volatile industries, however, the relevant "Key Credit Factors" article may specify different standards. Characteristics of a company with adequate liquidity

include:

- A/B of 1.2x or more over the upcoming 12 months. In particular, any upcoming maturities should be manageable.
 - Positive A-B, even if forecasted EBITDA declines by 15%.
 - Sufficient covenant headroom for forecasted EBITDA to decline by 15% without the company breaching coverage tests, and debt is at least 15% below covenant limits (or, if not, the related facilities are not material).
 - The likely ability to absorb high-impact, low-probability events, with limited need for refinancing. Liquidity is supplemented by the perceived flexibility to lower capital spending or sell assets, among other actions.
 - Sound relationships with banks.
 - 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. To meet this assessment, the company needs to show evidence that its management anticipated potential setbacks and took the necessary actions to ensure continued adequate liquidity.
31. For the purposes of calculating adequate liquidity, the debt maturities and the undrawn, available portion of committed bank lines are based on a six-month time horizon for companies with certain strong credit characteristics. The A/B and A-B tests for the adequate category use debt maturities within the next six months as a use of liquidity and include the undrawn, available portion of committed bank lines that matures beyond the next six months as a source of liquidity when:
- The company's anchor is at least 'bbb-'.
 - All three of the following qualitative characteristics--normally associated with strong liquidity--apply: (1) Well-established and solid relationships with banks, (2) A generally high standing in credit markets. This can be assessed from equity, debt, and CDS trading data relative to peers and market averages. and (3) Generally prudent risk management. To meet this assessment, the company needs to show evidence that its management anticipated potential setbacks and took the necessary actions to ensure continued adequate liquidity.
32. If the A/B and A-B tests do not meet the requisite levels outlined in Paragraph 30 using a six-month time horizon, it may still receive a liquidity assessment of adequate if it meets all other characteristics outline in Paragraph 31 and it has a credible plan that will result in the A/B and A-B tests meeting the minimum levels specified in Paragraph 30 at least three months before the refinancing date. However, in this event, the SACP on the company will be no higher than in the 'a' category. Characteristics of credible plans generally include advanced discussions with lending groups or bond underwriters with clear timetables for proposed refinancings or new issues, which would not extend beyond the next three months.
- 4. Less than adequate**
33. A company with less than adequate liquidity has an SACP no higher than 'bb+'. To have a level of liquidity that is less than adequate, an entity would have one or more of the negative characteristics described below or would not qualify for an adequate or weak liquidity assessment. Characteristics of a company with less than adequate liquidity include:
- A/B of less than 1.2x over the next 12 months. This level offers scant protection against unexpected adverse developments.
 - A-B of about zero or below.
 - Covenant headroom so tight that coverage tests could be breached if forecasted EBITDA were to decline by just 10%. (A covenant breach on any related facilities would likely have a significant impact because the debt containing

the covenants in question could not easily be repaid.)

- The likelihood of the company not being able to absorb low-probability adversities, even factoring in capital-spending cuts, asset sales, and cuts in shareholder distributions.
- No particular core bank relationship and indications of a poor standing in credit markets, such as wide CDS trades for several consecutive weeks or share price declines.

5. Weak

34. Weak liquidity represents an overarching credit risk. In all cases, such an assessment will translate into an SACP of 'b-' or lower. To have weak liquidity, an entity would display the first characteristic listed below and typically one or both of the two subsequent characteristics. Characteristics of a company with weak liquidity include:

- A/B or A-B reflecting a material deficit over the next 12 months.
- The likelihood that covenants will be breached unless there is a very credible plan to avert such a breach in a timely fashion or lenders appear likely to provide a covenant waiver or amendment (assuming that the related facilities are material). Only low-probability, unforeseen positive events would allow the company to regain a level of liquidity better than weak.
- Indications of a poor standing in credit markets, such as very wide CDS trades or a serious share price decline.

Frequently Asked Questions

For purposes of the liquidity criteria, how does Standard & Poor's define FFO?

35. Our definition of FFO for purposes of the liquidity criteria differs modestly from the FFO definition in our ratios and adjustments criteria (see "Corporate Methodology: Ratios And Adjustments," published Nov. 19, 2013). This is because, as we describe in paragraph three above, our quantitative liquidity analysis "focuses on the monetary flows--the sources and uses of cash--that are the key indicators of a company's liquidity cushion."
36. For liquidity purposes, we define forecasted FFO on an unadjusted basis, excluding Standard & Poor's analytical adjustments for items such as leases, postretirement employee benefits, asset retirement obligations, etc. However, we may add back certain noncash items to our unadjusted FFO forecast (e.g. noncash interest, share-based compensation expenses, etc.) in order to estimate a more cash-like measure.

How do you assess liquidity for a government-related entity (GRE)?

37. For a corporate GRE, we assess liquidity strictly based on the SACP analysis, which includes ongoing support, but not extraordinary support, while the short-term rating for such GRE will be based on a liquidity descriptor that has been adjusted for extraordinary support (see paragraph 13 of "Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers," published May 7, 2013).

RELATED CRITERIA AND RESEARCH

- "Principles Of Credit Ratings," Feb. 16, 2011
- "Corporate Methodology," Nov. 19, 2013
- "Assumptions: Analytical Adjustments For Captive Finance Operations," June 27, 2008
- "Analyzing The Liquidity Adequacy Of U.S. Energy Marketing And Trading Operations," May 4, 2004

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