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Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers

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*(**Editor's Note:** We originally published this criteria article on Dec. 16, 2014. We've republished it following our periodic review completed on Dec. 15, 2016. As a result of our review, we revised paragraphs 2, 7, and 8, which related to the initial publication of the article. We have also amended paragraph 22 to reflect the guidance from "The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers," published Dec. 14, 2015 whereby we no longer necessarily exclude sources and uses of cash from captive finance operations.)*

1. These criteria present Standard & Poor's Ratings Services' methodology for liquidity analysis used when determining stand-alone credit profiles (SACPs) on global corporate issuers.

2. This paragraph has been moved to Section D.

SCOPE OF THE CRITERIA

3. These criteria apply to the analysis of corporate issuers globally. These criteria do not apply to project finance ratings because of the contractual cash management protections in place for those credits.

SUMMARY OF THE CRITERIA

4. The criteria describe the methodology we use to assess the liquidity position of global corporate issuers, including our approach for evaluating the adequacy of backup repayment sources for outstanding CP, as well as a company's treasury polices and controls regarding intra-year liquidity needs.

5. 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 the credit markets, and the degree of prudence of the company's risk management.

6. 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.

7. This paragraph has been deleted.

8. This paragraph has been moved to Section D.

METHODOLOGY

9. Liquidity is an important component of financial risk across the entire rating spectrum (see "Corporate Methodology," published 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.

10. The descriptors for liquidity are exceptional, strong, adequate, less than adequate, and weak. Adequate liquidity is ratings-neutral. To avoid the risk of default, a company's liquidity must be sufficiently robust to absorb a moderate level of stress. Accordingly, to receive an SACP (after applying all modifiers) of 'bbb-' or higher, we would have to assess a company's liquidity as adequate, as we define the term, or better. Companies with an assessment of less than adequate, as we define the term, would not receive an SACP (after applying all modifiers) higher than 'bb+'; those with a weak assessment, as we define the term, would not receive an SACP (after applying all modifiers) higher than 'b-'.

11. Our key quantitative liquidity measures (see section A) generally focus on liquidity sources and uses over a prospective 12-month horizon. In addition, under the methodology, we assess whether companies demonstrate prudent liquidity management to meet all forecasted intra-year debt maturities and working capital needs. For liquidity to be assessed as at least adequate, we expect appropriate forms of backup and sources of liquidity to cover at least 100% of intra-year working capital needs and debt maturities, including CP, over the following 12 months, subject to the provisions outlined in paragraphs 38-39 that include guidelines for assessing liquidity over a six-month time horizon if certain criteria are met. Companies will not receive an assessment of higher than less than adequate to the extent we observe liquidity management shortcomings that could lead to intra-year liquidity weakness. Due to the limitations of intra-year disclosure, our analysis generally focuses on general treasury liquidity polices and controls, including those that relate to CP backup coverage.

12. For short-term debt (excluding CP) and intra-year working capital funding needs (e.g. to fund gaps between the highest and lowest amounts of working capital investment) that typically result from seasonal patterns of sales and receivables collection, or from swings in or periodic concentration in taxes, dividend, capital expenditure, or interest payments, appropriate sources of coverage include those outlined in paragraph 23. If a company relies mainly on internal cash flow to meet these needs, as opposed to committed credit facilities and cash and liquid investments, we pay particular attention to the potential for cash flow timing mismatches.

13. For CP, appropriate backup includes committed credit facilities that we believe will be available and cash and liquid investments, as defined in paragraph 24. We expect backup in the form of credit facilities to be contractually committed (e.g. fully documented revolving credit facilities). We do not include uncommitted or verbally committed credit facilities as a form of CP backup or as a source of liquidity within our analysis. We do not expect committed backup facilities to be available exclusively to repay CP, as many credit facilities may be used for general corporate purposes. As outlined in paragraph 28, committed, short-term credit facilities used to backup CP would also be included.

14. If a company mainly relies on cash and liquid investments to backup CP, we pay particular attention to the seasonal level of cash balances in order to identify any potential timing mismatches between periods of peak CP maturities and potentially lower levels of cash and liquid investment availability. Additionally, we assess whether the company's treasury policies and controls provide for adequate coverage of maturing CP and other short-term obligations. This assessment considers whether cash pooling arrangements and committed credit facilities are sufficient to deliver cash on a timely basis in the same currency and same market as the maturing obligations. For CP, it also considers such factors as the size of the company's CP backup lines relative to expected peak CP maturities, and the entities' track record in renewing sufficient backup lines on a timely basis.

15. The benchmarks to achieve strong and exceptional liquidity, as we define the terms, are intended to meet stress scenarios that incorporate steep EBITDA declines from our base-case projections, but all investment-grade companies must have at least adequate liquidity. Strong and exceptional liquidity, by definition, exceed the norm. Exceptional or strong liquidity can raise the anchor by one notch for issuers whose anchor is 'b+' or lower if the issuers' financial policy assessment is positive, neutral, FS-4, or FS-5. While exceptional or strong liquidity does not provide an uplift for companies with an anchor of 'bb-' or higher, it can help differentiate between issuers in a given rating category. In all cases, the basis for the projected continuation of such liquidity for these issuers is rooted in other credit strengths, such as their competitive position and ability to generate strong cash flows. Therefore, the durability of these strengths must be considered in combination with exceptional or strong liquidity in order for issuers to have a higher SACP or be differentiated in a given rating category.

16. By contrast, less than adequate and weak liquidity will cap the issuers' SACP. As noted above, whatever a company's underlying performance, a lack of liquidity could precipitate a default, and ratings will reflect that risk.

17. Short-term ratings are linked to long-term ICRs and liquidity assessments. The assessment of a company's liquidity could translate directly into a higher or lower short-term rating. Accordingly, we incorporate our analysis of an issuer's CP usage and the backup sources for these programs within the context of our liquidity assessment.

18. For companies that benefit from potential extraordinary intervention in periods of stress from a parent, affiliate, or governmental entity for government related entities (GRE), the criteria assess liquidity at the SACP level, which includes ongoing support, but not extraordinary support. As outlined in "Stand-Alone Credit Profiles: One Component Of A Rating," published Oct. 1, 2010, the determination of an SACP incorporates direct support already committed and the influence of ongoing interactions or influence from the government, parent, or affiliate. In the case of GREs, the support can be channeled through government owned or controlled banks or agencies and would typically include ongoing certain and timely cash contributions or access to funding provided to a GRE from a government or another GRE, or government directed funding from government owned or controlled banks or agencies. To be included under our liquidity assessment at the SACP level, such ongoing liquidity or funding support needs to be certain and timely and be demonstrated by a track record and government policy, or an agreed and established process and ongoing interactions by the government and government owned or controlled funding bank (s) or agencies to provide such liquidity or access to funding as required. The short-term rating for a GRE, however, is 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).

19. When assessing a company's banking relationships, the criteria consider the history of the specific relationship (including any 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," published Nov. 19, 2013).

20. Our analysis seeks to identify and measure risks from concentrated exposure to individual financial counterparties. To the extent we believe that a material bank counterparty would be unable to provide committed financing in a stress scenario, and the counterparty could not be easily replaced on a timely basis, we do not include this portion of committed financing for CP backup or as a source of liquidity within our analysis. For CP, this assessment will play a greater role in cases when CP is a permanent element of the company's funding mix, and where the company primarily relies on committed facilities as opposed to cash and liquid investments for backup, as opposed to CP only being issued when pricing is particularly favorable or where cash and liquid investments are the major source of backup. In addition, when analyzing committed lines for the purposes of liquidity or CP backup, we do not give credit for lines where the credit spread over market indices is not fixed but linked to certain market or issuer variables, such as credit default swap (CDS)-indexed lines, rendering liquidity access extremely costly at the time of a company's greatest need. More specifically, we exclude any market or issuer variable-linked lines where we believe the cost of borrowing would become excessive in a stress scenario.

A. Key Quantitative Measures

21. 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).

22. 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, and include both internal and external components. The analysis of monetary flows now may include funds from the captive (typically in the form of dividends or intercompany loans) as a source of liquidity for the parent when we consider that transfers from the captive are available to the parent at all times, including during times of stress, and we expect this to continue (see "The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers," published on Dec. 14, 2015).

1. Sources

23. 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 credit facilities maturing beyond the next 12 months.
- Expected ongoing support as outlined in paragraph 18.

24. Cash and liquid investments are included as a source of liquidity and could be discounted in certain circumstances (e.g., haircut for potential repatriation taxes). 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. Within our liquidity measures, we exclude this cash as a source of liquidity, and within uses of liquidity, only include the net obligation amount. Investments should be able to be quickly liquidated without requiring deep discounts to their carrying value. This does not preclude long-term investments from being included. It does, however, exclude large stakes in non-liquid equity investments.

25. We include our base-case forecasted FFO as a source of liquidity. 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 of a cyclical shortage of liquidity and the effectiveness of its measures to counter this risk may affect the calculation of FFO.

26. 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.

27. Undrawn portions of committed credit facilities maturing beyond the next 12 months are also included. If covenants are present, we will only include the portion of committed credit facilities that we estimate is available without a covenant breach. If a committed credit facility is contractually exclusive for specific purposes, such as CP backup, we do not include excess availability (e.g. borrowing capacity in excess of peak CP usage) to cover other uses of liquidity.

28. Undrawn portions of committed, short-term bank credit facilities that we believe will be used to meet working capital uses or short-term debt maturities such as CP are also included. We do not include excess borrowing availability beyond our forecasted seasonal working capital needs and any short-term debt maturities such as CP, which are included as uses of liquidity. If covenants are present, we will only include the portion of committed short-term credit facilities that we estimate is available without a covenant breach.

29. Expected ongoing support from a parent, affiliate, or governmental entity for GREs, as outlined in paragraph 18, is included as a source of liquidity.

2. Uses

30. 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 (including outstanding CP maturities).
- 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.

31. 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.

32. 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 inflows exceed outflows, the criteria use the intra-year peak working capital outflows forecasted over the period. If a company issues CP to fund all or a portion of its working capital needs, we exclude this amount from forecasted intra-year peak working capital outflows if it is already captured in outstanding CP maturities as described in paragraph 33.

33. Our calculation of liquidity uses includes outstanding CP maturities. We do not include potential future CP issuance as a liquidity source since our liquidity analysis does not assume companies are able to borrow in debt capital markets, including CP markets.

34. 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 Commodities Trading Industry Methodology," published Jan. 29, 2015).

B. Liquidity Categories

1. Exceptional

35. 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 (see first bullet point below) and at least four of the other supportive characteristics listed below. Few companies qualify for this category. The first three characteristics refer to quantitative measures that apply in most industries. In exceptionally stable or volatile industries, however, the relevant "Key Credit Factors" criteria 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 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, as well as demonstrate sufficient intra-year liquidity management as outlined in paragraphs 11-14 (see the "Comprehensiveness of enterprise-wide risk management standards and tolerances" section of "Methodology:

Management And Governance Credit Factors For Corporate Entities And Insurers," published Nov. 13, 2012).

2. Strong

36. 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 concern quantitative measures that apply in most industries. In exceptionally stable or volatile industries, however, the relevant "Key Credit Factors" criteria 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, as well as demonstrate sufficient intra-year liquidity management as outlined in paragraphs 11-14.

3. Adequate

37. 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 concern quantitative measures that apply in most industries. In exceptionally stable or volatile industries, however, the relevant "Key Credit Factors" criteria 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 debt 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, as well as demonstrate sufficient intra-year liquidity management as outlined in paragraphs 11-14.

38. For the purposes of calculating adequate liquidity, the debt maturities and the undrawn, available portion of committed credit facilities 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 credit facilities 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.

39. If the A/B and A-B tests do not meet the requisite levels outlined in paragraph 37 using a six-month time horizon, the company may still receive a liquidity assessment of adequate if it meets all other characteristics outlined in paragraph 38 and it has a credible plan that will result in the A/B and A-B tests meeting the minimum levels specified in paragraph 37 at least three months before the refinancing date. However, in this event, the SACP on the company will be no higher than 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 debt issues, which would not extend beyond the next three months.

4. Less than adequate

40. 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

41. 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 material 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 the credit markets, such as very wide CDS trades or a serious share price decline.

C. Frequently Asked Question

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

42. 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 five 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."

43. 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.

D. Summary Of Historical Changes To This Article

These criteria became effective on the date of publication and supersede "Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers," published Jan. 2, 2014; "2008 Corporate Criteria: Commercial Paper," published April 15, 2008; and "Methodology And Assumptions: Analysis Of Corporates' Swap-Indexed Bank Lines," published Dec. 16, 2008.

The article is related to our global corporate criteria (see "Corporate Methodology," published Nov. 19, 2013) and to our criteria article "Principles Of Credit Ratings," published Feb. 16, 2011.

Following the release of "Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers," published Dec. 14, 2015, we updated paragraph 22 of these criteria to reflect guidance in the Funding And Liquidity Assessment section. As a result, the analysis of monetary flows no longer categorically excludes the sources and uses of cash from captive finance operations.

We republished the article following our periodic review completed on Dec. 17, 2015. As a result of our review, we updated the author contact information, and references to superseded criteria.

This article was republished on Dec. 14, 2016 to reflect the publication of "Key Credit Factors For The Operating Leasing Industry," reflecting the entities covered by this criteria are now in scope of the Liquidity criteria.

RELATED CRITERIA AND RESEARCH

Related Criteria

- Methodology For Rating General Trading And Investment Companies, June 10, 2015
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015

- Commodities Trading Industry Methodology, Jan. 29, 2015
- Methodology: The Impact Of Captive Finance Operations On Nonfinancial Corporate Issuers, Dec. 14, 2015
- Corporate Methodology, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Principles Of Credit Ratings, Feb. 16, 2011
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.