

# Ratings and Ratios

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## Ratio Medians

Presented on the next pages are key ratio medians for U.S. corporates by rating category. Definitions of the ratios appear on page 55. The ratio medians are purely statistical, and are not intended as a guide to achieving a given rating level. Ratio Guidelines are presented on page 56. They more faithfully represent the role of ratios in the ratings process.

Ratios are helpful in broadly defining a company's position relative to rating categories. They are not intended to be hurdles or prerequisites that should be achieved to attain a specific debt rating.

Caution should be exercised when using the ratio medians for comparisons with specific company or industry data because of major differences in method of ratio computation, importance of industry or business risk, and impact of mergers and acquisitions. Since ratings are designed to be valid over the entire business cycle, ratios of a particular firm at any point in the cycle may not appear to be in line with its assigned debt ratings. Particular caution should be used when making cross-border comparisons, due to differences in accounting principles, financial practices, and business environments.

Financial ratio medians are adjusted for unusual items and to capitalize operating leases.

Company data are adjusted for the following:

- Nonrecurring gains or losses are eliminated from earnings. This includes gains on asset sales, significant transitory income items, unusual losses, losses on asset sales, and charges due to asset writedowns, plant shutdowns, and retirement programs. These adjustments chiefly affect interest coverage, return, and operating margin ratios.
- Unusual cash flow items similar in origin to the nonrecurring gains or losses are also reversed.

- The operating lease adjustment is performed for all companies. Companies that buy all plant and equipment are put on a more comparable basis with firms that lease part or all of their operating assets. The lease adjustment impacts all ratios.

Still, several adjustments commonly made by Standard & Poor's analysts are not incorporated in the adjusted medians. Omitted are alterations reflecting net debt and the captive finance company methodology. The net debt adjustment would affect median ratios largely for the 'AAA' rating category, which is almost entirely composed of cash-rich pharmaceutical companies. (If the net debt adjustment were made, interest coverage, cash flow to debt, and debt ratios for the 'AAA' category would not be meaningful, since many of these firms have no net debt.) The captive finance adjustment has a greater effect, mainly on automobile, department store, and some capital goods companies.

The adjusted ratio median universe includes about 500 companies. The data exclude companies, such as the auto manufacturers and cable television firms, that, even with adjustments, have financial ratios that are not representative of those used in the rating process.

The medians themselves are affected by economic and environmental factors, as well as mergers and acquisitions. The universe of rated companies is constantly changing, and in certain rating categories, adding or deleting a few companies can materially change the financial ratio medians.

Strengths and weaknesses in different areas have to be balanced and qualitative factors evaluated. There are many nonnumeric distinguishing characteristics that determine a company's creditworthiness.

## ADJUSTED KEY INDUSTRIAL FINANCIAL RATIOS

### U.S. Industrial long term debt

Three-year (1998 to 2000) medians	AAA	AA	A	BBB	BB	B	CCC
EBIT int. cov. (x)	21.4	10.1	6.1	3.7	2.1	0.8	0.1
EBITDA int. cov. (x)	26.5	12.9	9.1	5.8	3.4	1.8	1.3
Free oper. cash flow/total debt (%)	84.2	25.2	15.0	8.5	2.6	(3.2)	(12.9)
FFO/total debt (%)	128.8	55.4	43.2	30.8	18.8	7.8	1.6
Return on capital (%)	34.9	21.7	19.4	13.6	11.6	6.6	1.0
Operating income/sales (%)	27.0	22.1	18.6	15.4	15.9	11.9	11.9
Long-term debt/capital (%)	13.3	28.2	33.9	42.5	57.2	69.7	68.8
Total debt/capital (incl. STD) (%)	22.9	37.7	42.5	48.2	62.6	74.8	87.7
Companies	8	29	136	218	273	281	22

Data for earlier years and in greater detail are available by subscribing to Standard & Poor's CreditStats.

## KEY UTILITY FINANCIAL RATIOS

### U.S. Electric Utility long-term debt

#### For 12 months ended Sept. 2001

	AA	A	BBB	BB
EBIT interest coverage (x)	4.2	3.4	2.8	1.9
Preferred dividend coverage (x)	4.1	3.3	2.7	1.8
Return on equity (%)	12.3	12.5	10.9	11.4
Common dividend payout (%)	92.3	81.7	81.6	33.9
Short term debt/capital (%)	8.2	10.4	11.2	6.2
Total debt/capital (%)	51.7	55.92	58.78	73.3
Preferred stock/capital (%)	2.3	3.0	2.7	4.5
Common stock/capital (%)	50.9	43.2	39.6	26.1
Funds from operations interest coverage	5.1	4.0	3.5	2.4
Funds from operations/total debt (%)	35.5	23.76	20.42	12.47
Net cash flow/capital expenditures (%)	97.5	74.8	80.6	65.2

EBIT—Earnings before interest and taxes.

EBITDA—Earnings before interest, taxes, depreciation, and amortization.

## FORMULAS FOR KEY RATIOS

1. EBIT interest coverage = 
$$\frac{\text{Earnings from continuing operations* before interest and taxes}}{\text{Gross interest incurred before subtracting (1) capitalized interest and (2) interest income}}$$
2. EBITDA interest coverage = 
$$\frac{\text{Earnings from continuing operations* before interest, taxes, depreciation, and amortization}}{\text{Gross interest incurred before subtracting (1) capitalized interest and (2) interest income}}$$
3. Funds from operations/total debt = 
$$\frac{\text{Net income from continuing operations plus depreciation, amortization, deferred income taxes, and other noncash items}}{\text{Long-term debt** plus current maturities, commercial paper, and other short-term borrowings}}$$
4. Free operating cash flow/total debt = 
$$\frac{\text{Funds from operations minus capital expenditures, minus (plus) the increase (decrease) in working capital (excluding changes in cash, marketable securities, and short-term debt)}}{\text{Long-term debt** plus current maturities, commercial paper, and other short-term borrowings}}$$
5. Return on capital = 
$$\frac{\text{EBIT}}{\text{Average of beginning of year and end of year capital, including short-term debt, current maturities, long-term debt**, non-current deferred taxes, and equity}}$$
6. Operating income/sales = 
$$\frac{\text{Sales minus cost of goods manufactured (before depreciation and amortization), selling, general and administrative, and research and development costs}}{\text{Sales}}$$
7. Long-term debt/capital = 
$$\frac{\text{Long-term debt**}}{\text{Long-term debt + shareholders' equity (including preferred stock) plus minority interest}}$$
8. Total debt/capital = 
$$\frac{\text{Long-term debt** plus current maturities, commercial paper, and other short-term borrowings}}{\text{Long-term debt plus current maturities, commercial paper, and other short-term borrowings + shareholders' equity (including preferred stock) plus minority interest}}$$

\*Including interest income and equity earnings; excluding nonrecurring items.

\*\*Including amount for operating lease debt equivalent.

## Ratio Guidelines

Risk-adjusted ratio guidelines depict the role that financial ratios play in Standard & Poor's rating process, since financial ratios are viewed in the context of a firm's business risk. A company with a stronger competitive position, more favorable business prospects, and more predictable cash flows can afford to undertake added financial risk while maintaining the same credit rating.

The guidelines displayed in the matrices make explicit the linkage between financial ratios and levels of business risk. For example, consider a U.S. industrial—which includes manufacturing, service, and transportation sectors—with an *average* business risk profile. Cash flow coverage of 60% would indicate an 'A' rating. If a company were *below average*, it would need about 85% cash flow coverage to qualify for the same rating. Similarly, for the 'A' category, a firm that has an *above-average* business risk profile could tolerate about 40%

leverage and an average firm only 30%. The matrices also show that a company with only an *average* business position could not aspire to an 'AAA' rating, even if its financial ratios were extremely conservative.

Ratio medians that Standard & Poor's has been publishing for more than a decade are merely statistical composites. They are not rating benchmarks, precisely because they gloss over the critical link between a company's financial risk and its business risk. Medians are based on historical performance, while Standard & Poor's risk-adjusted guidelines refer to expected future performance.

Guidelines are not meant to be precise. Rather, they are intended to convey ranges that characterize levels of credit quality as represented by the rating categories. Obviously, strengths evidenced in one financial measure can offset, or balance, relative weakness in another.

## U.S. INDUSTRIALS

### Manufacturing, Service and Transportation Companies

#### Funds from Operations/Total Debt Guidelines (%)

Company business risk profile	—Rating category—				
	AAA	AA	A	BBB	BB
Well above average business position	80	60	40	25	10
Above average	150	80	50	30	15
Average	—	105	60	35	20
Below average	—	—	85	40	25
Well below average	—	—	—	65	45

#### Total Debt/Capitalization Guidelines (%)

Company business risk profile	—Rating category—				
	AAA	AA	A	BBB	BB
Well above average business position	30	40	50	60	70
Above average	20	25	40	50	60
Average	—	15	30	40	55
Below average	—	—	25	35	45
Well below average	—	—	—	25	35

## U.S. UTILITIES

### Funds from Operations/Total Debt Guidelines (%)

Company business risk profile		—Rating category—					
		AAA	AA	A	BBB	BB	B
Well-above-average business position	1	23	18	15	10	5	—
	2	29	23	19	14	9	—
Above average	3	35	29	23	17	12	7
	4	40	34	28	21	15	9
Average	5	46	37	30	24	18	11
	6	53	43	35	27	19	13
Below average	7	63	52	42	31	21	14
	8	75	61	49	35	23	15
Well below average	9	—	—	57	41	27	17
	10	—	—	69	50	34	22

### Total Debt/Capitalization (%)

Company business risk profile		—Rating category—					
		AAA	AA	A	BBB	BB	B
Well-above-average business position	1	47	53	58	64	70	—
	2	43	49	54	60	66	—
Above average	3	39	45	50	57	64	70
	4	35	41	46	53	61	68
Average	5	33	39	44	51	59	67
	6	30	36	43	50	57	65
Below average	7	27	34	41	49	56	64
	8	23	31	39	47	55	62
Well below average	9	—	—	35	43	51	58
	10	—	—	29	37	43	50