Risk Reward

riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

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10 KEY PREDICTIONS FOR 2011

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REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS

After a financial crisis, there is always room for improvement in corporate credit-risk analysis. Tracy E. Williams, former managing director at JPMorgan, makes recommendations for model updates and shows how analysis can be forward-looking and anticipate unforeseen risks. The second article of three parts examines financial ratios and profit margins and assesses how companies withstand business stress with strong balance sheets and sufficient liquidity.

Financial Ratios: Flexibility, Creativity

Financial ratios are usually the core of financial analysis—or at least the heart of analysis based on past information. Conventional ratios that help explain profitability, liquidity, leverage and other efficiencies work and can show why a company's balance sheet is susceptible to risk or why a company's earnings are sagging.

Sometimes, however, the favorite, conventional ratios overlook new risks and issues. They may not be granular enough to show balance-sheet problems or issues that plague profitability. Risk managers and analysts, hence, should try new metrics or ratios that might tell a better story.

They could be metrics that assess whether a company is deploying capital properly, matching assets and liabilities to avert liquidity problems, or managing costs efficiently to revenue growth. A new metric or ratio could show cash flow depleting more rapidly than what earnings suggest or the company not having sufficient reserves to meet upcoming principal payments. In the months before Lehman Brothers' collapse, some analysts zoomed in on a metric, "net cash capital" (a variation of working capital) and showed how its steady decline would doom the firm eventually. Lehman declared it had ample amounts capital, liquid assets and cash reserves. It survived the summer, although creditors grew wary. It didn't survive September, 2008. The declining amounts of "net cash capital" showed that it couldn't pledge more liquid collateral to keep creditors comfortable after they requested more.

If risk analysts suspect a company faces a specific risk, then they a new ratio or metric could demonstrate if the company is prepared. The metric might show a trend in cost management; it might highlight the growing importance of a far-away segment. Or it might show balance-sheet leverage doesn't reflect true leverage (especially if contingent liabilities are assumed). It might prove that a company is insolvent even if it reports large amounts of cash reserves.

Sustainable Profit Margins

When analysts assess profitability, they focus on revenues, cost trends, cost structures (variable and fixed) and profit margins. Analysts should focus, too, on "sustainability." Based on cost structures, trends, and efficiencies, what profit margins can the company sustain in the long term—through business cycles, downturns, and unexpected events? How can that sustainable, stable margin be measured? And is that margin sufficient to withstand declines, generate cash, meet debt payments and provide a return for investors?

Determining a sustainable margin is an art, not necessarily a derivation from past ratios. It requires examining the company's track record and assessing the company's ability to maintain efficiencies, while confronting new variables and risks. It means analyzing closely the major contributors to costs and the company's management of them in the past.

It also means understanding how management would encounter the unforeseen arising from any of the following: (a) the sudden closing of a business line or operation, (b) rampant fluctuation in currency rates, (c) surging costs related to a reputation issue or damage control after an isolated event, (d) unplanned compliance or legal costs, or (e) that new acquisition or investment that spiraled out of control. Such factors could undermine profit margins overnight. How would the company manage through them?

Balance Sheet: Can It Withstand Stress?

As many analysts or companies will attest, stable cash flow is critical; however, sturdy, sound balance sheets get companies through a crisis. The events of the past few years (especially for financial institutions) proved that when revenues decline and cash flow ebbs, strong balance sheets help companies ward off market risks, anxious creditors, tardy receivables, or mismatches in cash inflow and outflow.

After they identify an array of risks, financial analysts must determine whether the balance sheet can stand up to risks of all kinds. Never underestimate the importance of having a strong balance sheet. Sometimes in the past, risk managers might have tolerated fragile balance sheets (high leverage, dwindling cash reserves, minimal amounts of working capital, or low tangible net worth), if cash flow from operations continued at a steady pace.

REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS

The analyst should understand:
1. What factors and qualities contribute to strong balance sheets,
2. How to measure those qualities, and
3. How to assess whether they help a company survive a crisis or sudden downturn without much pain.

Those qualities include (a) asset content, quality and proportions, (b) liquidity (including cash reserves), (c) reasonable and sensible capital structure and (d) capital as a cushion when the going gets rough.

Asset quality depends on the company's industry. A financial institution's balance sheet will differ significantly from that of an Internet start-up or that of large-scale manufacturer or retailer. But certain characteristics that apply to most companies. To measure it, the analyst will need to examine some of the following:
1. Asset concentration and diversity,
2. Efficiencies in deploying and using cash,
3. Effectiveness in managing financial assets,
4. Optimal inventory levels
5. Default histories of accounts receivable
6. "Asset conversion" cycles—the cycle from raw material to sold product
7. Depreciation, and replacement costs of fixed assets
8. Foreign-exchange translations, and
9. Intangibles (including whether they are amortized or not)

Liquidity: Beyond Just Cash Reserves

Liquidity, or lack thereof, in a sudden downturn can make or break companies—even those that have streaks of strong performance. A company might survive a decline or confront a barrage of unfortunate events, as long as reported earnings are positive. But if it mismanages liquidity, then credit and insolvency concerns will drown out most any earnings statement.

Risk managers sometimes assess liquidity in superficial ways, by looking cursorily at "current ratios" (current assets/current liabilities) on an outdated statement or by accepting the company's disclosure that it has sufficient cash reserves. Crisis events remind analysts they must scrutinize the company's liquidity profiles in every way possible. A company may claim that 10 percent of its asset total is cash. It may not tell you or may not realize itself that the cash may not be readily accessible. In problem situations, cash may exist, but may be trapped in unconsolidated subsidiaries, may not easily be repatriated to parent companies, may be restricted because of new requirements imposed by regulators or because of crushing demands from short-term creditors.

There is no one ratio that tells a comprehensive liquidity story. Analysts, therefore, should assess liquidity as a whole—sizing up cash reserves, funding sources, liquidity profiles, and management's strategies, its contingencies for emergencies or lenders disappearing. The conventional "current ratio" is a start, but the analyst should seek a broader assessment by attempting to:
1. Understand all short-term cash sources: the balance sheet, committed or reliable lenders, asset sales, etc.
2. Evaluate trends in cash reserves maintained
3. Assess cash, if available, for immediate obligations, business needs, and emergencies
4. Measure cash available for unexpected obligations
5. Allow for cash set aside for necessary investments or technology upgrades
6. Understand the importance, purpose and use of working capital, and
7. Determine management's preparation to endure a liquidity crisis.

To evaluate whether a company is ready for unforeseen risks is to measure how liquidity is impaired in some of the following scenarios:
1. Business declines
2. Falling asset values (including or marketable securities)
3. Short-term lenders declining to lend or refinance
4. Short-term lenders demanding full payout, even if they have no right
5. Short-term lenders requesting more collateral
6. Unexpected payouts from legal action
7. Inability to sell assets the company thought it could

Working Capital: Coming to Grips with It

Working capital (current assets minus current liabilities) can be tricky. It's part of the liquidity story. But its purpose may differ according to the industry. Depending on the company, sometimes it shouldn't be too high (signaling aging inventory and receivables); it shouldn't be too low (suggesting there may be insufficient resources to meet short-term obligations).

Analysts, who might have relied on one or two ratios to evaluate working capital, should pay more attention to whether it is:
1. Managed at optimal or efficiency levels: not too high, not too low
2. Managed adequately relative to growth and expansion
3. Managed properly relative to asset-conversion cycles
4. Managed sufficiently relative to cash needs, regulatory requirements, or financial covenants and
5. Funded in a way that permits it to increase to higher levels when necessary.

Optimal levels of working capital depend on numerous factors: business growth, contraction, and stability. If it's too high, the company may have unnecessary funding requirements; if it's too low, the company has insufficient cash reserves or may not be in compliance of regulators or creditors that have cash requirements.

Financial institutions can never have enough working capital, since they rely on much higher amounts of short-term debt and require excess amounts of liquid assets to ensure they meet the demands of creditors and requirements of regulators.

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