



ICPAK FINANCIAL SERVICES SECTOR SEMINAR  
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VIRTUAL



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# SESSION



- ✓ Value addition to the **credit rating process** and the various inputs required to improve the rating process
- ✓ Discussion of the **rating methodology**



# Introduction

## What is a Credit Rating?

- A credit rating is an opinion of a particular **credit agency** regarding the ability and willingness of an entity (government, business, or individual) to fulfill its financial obligations in completeness and within the established due dates.
- A credit rating also signifies the likelihood a debtor will default.



# Introduction

- There are only two ways in which any company would fund its business – **equity or debt**.
- The equity portion of the capital structure could be derived broadly from three sources: Promoters investing in the business, Company's internal **cash flows** accruing over the years to equity, or IPO (Initial Public Offering).
- Any form of **debt** issuance demands validation from a credit rating process.

# Credit Rating Information



- The information may be sourced from internal information provided by the entity, such as **Audited financial statements, Annual reports,** as well as external information such as **Analyst reports, published news articles, overall industry analysis, and projections.**

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# Benefits of Credit Ratings

- A credit rating can be the deciding factor on whether a borrower does or does not receive a loan.
- Good credit ratings allow people, companies, and governments to easily borrow from financial institutions or public debt markets.
- At the consumer level, banks will usually base the terms of a loan as a function of a credit rating or credit score; this typically means that the better your credit rating, the better the terms of the loan.

# Benefits of Credit Ratings



- On the other hand, if your credit rating is poor, the bank may even reject your request for a loan.
- Businesses and governments can benefit from high credit ratings as well.

# CREDIT RATING PROCESS



1. Business Profile
2. Operating segment and industry standing
3. Business Risk
4. Historical performance analysis
5. Scale and margins compared with competitors
6. Revenue and margin drivers in the past and their sustainability

# CREDIT RATING PROCESS



7. Cashflow generation capability
8. Balance sheet analysis and liquidity profile
9. Financial ratios

# CREDIT RATING PROCESS



- **#1 – Business profile**
- The very first thing that the analyst would do is to understand company's business profile, its competition, core products, number of employees, facilities, clients, etc.

# Credit Score

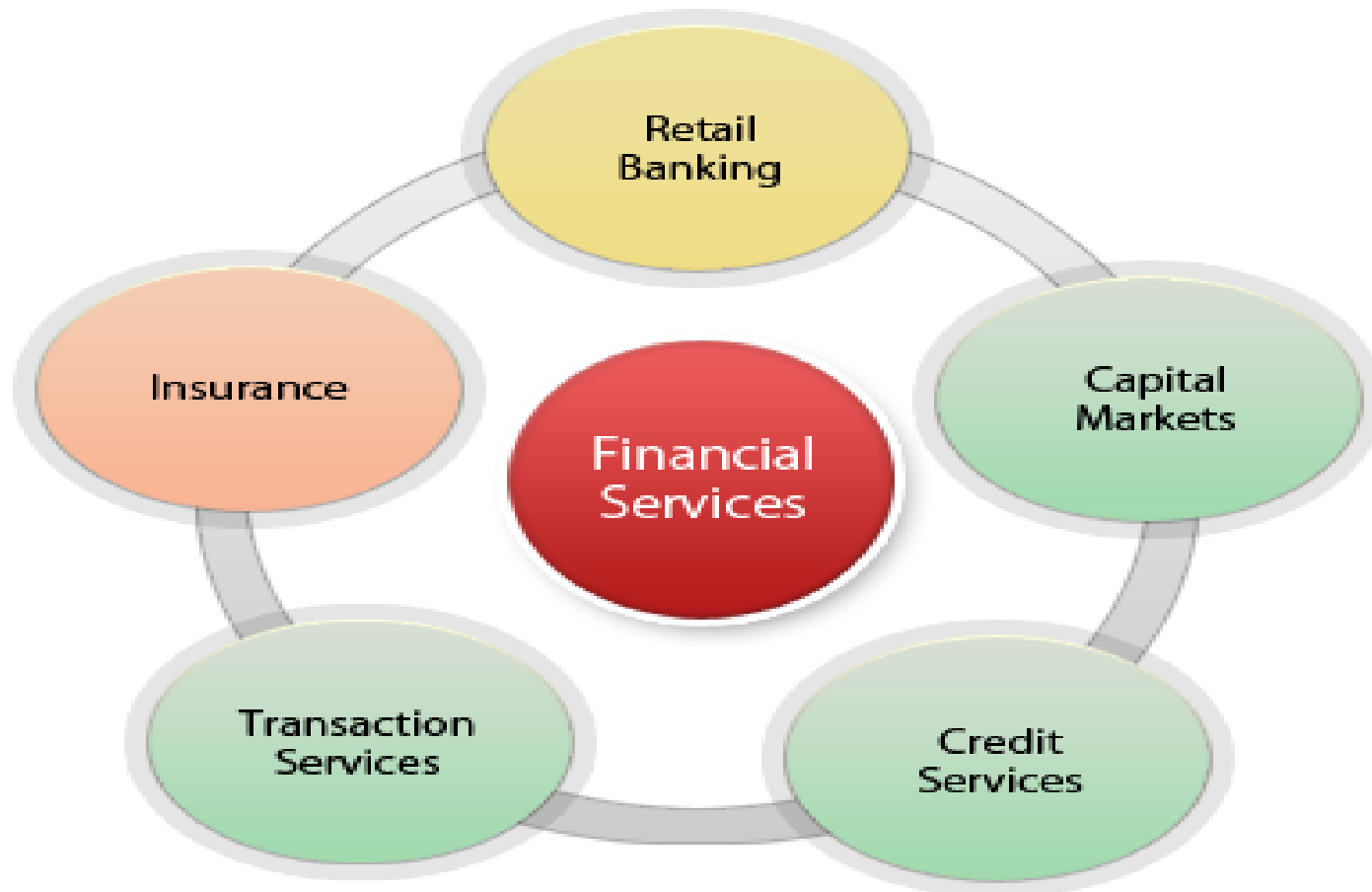




Credit rating can be applied in the following areas/instruments:

- Equity shares
- Rating for banking sector
- Individual credit rating
- Rating for insurance sector
- Rating of intermediaries in financial services
- Securitization
- Rating of companies raising funds overseas.

Credit rating can be applied in the following areas/instruments:



# Methodology of Credit Rating



- The process of credit rating begins with the prospective issuer approaching the rating agency for evaluation.

# The key factors generally considered



## **Business Analysis or Company Analysis**

- This includes an analysis of industry risk, market position of the company, operating efficiency of the company and legal position of the company.

# Business Analysis or Company Analysis



- **Industry risk:** Nature and basis of competition, key success factors; demand supply position; structure of industry; government policies, etc.
- **Market position of the company within the Industry:** Market share; competitive advantages, selling and distribution arrangements; product and customer diversity etc.
- **Operating efficiency of the company:** Locational advantages; labor relationships; cost structure and manufacturing as compared to those of competition.
- **Legal Position:** Terms of prospectus; trustees and then responsibilities; system for timely payment and for protection against forgery/fraud, etc.

# Economic Analysis



- Individual companies are always exposed to changing environment and the economic activities affect corporate profits, attitudes and expectation of investors and the price of the instrument.
- The relevance of the economic variables such as growth rate, national income and expenditure cannot be ignored.

# Financial Analysis



- **Accounting Quality:** Overstatement/under statement of profits auditors qualification; methods of income recognition's inventory valuation and depreciation policies, off balance sheet liabilities etc.
- **Earnings Protection:** Sources of future earnings growth; profitability ratios; earnings in relation to fixed income changes.
- **Adequacy of cash flows:** In relation to working capital needs variability of future cash flows; capital spending flexibility working capital management etc.
- **Financial Flexibility:** Alternative financing plans in times of stress; ability to raise funds asset redeployment.

# Management Evaluation



- Track record of the management planning and control system, depth of managerial talent, succession plans.
- Evaluation of capacity to overcome adverse situations
- Goals, philosophy and strategies.

# Geographical Analysis



- Location advantages and disadvantages

# Fundamental Analysis



Fundamental analysis is essential for the assessment of finance companies.

- **Liquidity Management:** Capital structure; term matching of assets and liabilities policy and liquid assets in relation to financing commitments and maturing deposits.
- **Asset Quality:** Quality of the company's credit-risk management; system for monitoring credit; sector risk; exposure to individual borrower; management of problem credits etc.
- **Profitability and financial position:** Historic profits, spread on fund deployment revenue on non-fund based services accretion to reserves etc.
- **Interest and Tax sensitivity:** Exposure to interest rate changes, hedge against interest rate and tax law changes, etc.





# Country's Credit Rating

- **Country's credit rating** denotes its ability to source debt from the international market at a reasonable cost.
- **Country's credit rating** involves evaluation of external financial accounts and macro economic factors and is directed towards future trends.

# Areas of Evaluation



- **Economic growth and development** : Gross national product and gross domestic product, population growth, Infrastructure development, good financial management, saving growth rate, industrial production, agricultural production, growth of services sector etc.
- **Balance of trade and balance of payments** : Export products, export prices, diversification of products and export market, global competition, import substitution, etc.

# Areas of Evaluation



- **Debt service ratio** : This indicates the country's external vulnerability. This is a ratio of external debt to total external earnings including export earning and earning from tourism, etc.
- **Debt composition** : Soft loans, commercial borrowings, interest rate structure, proportion of external debt
- **Liquidity** : Level of reserves, foreign exchange reserves, import coverage ratio, currency backed by assets such as gold.
- **Political and internal stability** : Socio-religious conflicts, majority government strong opposition, unequal economic distribution, relations with neighboring countries, political factors are not predictable and is prone to unexpected events.

# Example

**GCR affirms Equity Group Holdings Plc's rating of AA-(KE); Outlook Stable.**

# Example 1 - Equity Group Holdings Plc

- Johannesburg, 31 October 2018 – **Global Credit Ratings** affirmed the national scale ratings assigned to Equity Group Holdings Plc (formerly Equity Group Holdings Limited) of **AA<sub>(KE)</sub>** and **A1<sub>(KE)</sub>** in the long term and short term respectively; with the **outlook accorded as Stable**.
- The ratings are valid until September 2019.

# RATING RATIONALE

1. The ratings reflect its core business in Kenya, supported by better than average geographic diversification.
2. Good revenue stability.
3. Adequate levels of capitalization that benefits from above average levels of internal capital generation.
4. Low credit losses and risk concentrations.
5. Stable funding
6. Good liquidity.



# Example 1 – Kenya Police DT SACCO

## Rating Action

- Johannesburg, 30 September 2020 – GCR Ratings (“GCR”) affirmed the Kenyan long and short-term issuer ratings of Kenya Police Sacco Society Limited of BBB<sub>(KE)</sub> and A3<sub>(KE)</sub> respectively, with the outlook accorded as Positive.

# RATING RATIONALE

The ratings on Kenya Police Sacco Society Limited (“Kenya Police Sacco”, “the Sacco”) reflect ;

1. Limited competitive position
2. Strong capitalization
3. Solid risk position
4. Stable funding structure
5. Appropriate liquidity.

# Key take aways



- A credit rating helps lender determine a borrower's creditworthiness.
- Personal credit ratings are determined by factors such as history of taking loans, loan balances, and payment history.
- Investors often base their decisions about whether to buy a bond, and sometimes stock, based on the company's credit rating.
- Countries with higher credit ratings are more likely to attract bond buyers in the form of foreign capital.

**Q & A**



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# CONTACTS



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