# Ownership Structure Analysis in Corporate Credit Valuations: A Corporate Governance Insight

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## 1. Introduction

Credit Crisis in 2008, enhanced Sup prime Crisis in 2009-2010 and now Euro zone vulnerability. All these financial debacles point towards global economic integration and impact. Whenever these kinds of events take place, the elite class of Accountants, Analysts, Bankers and Policy specialists come together to interpret these critical financial situations. The strategic evaluations of these themes reveal the importance of Corporate Credit Analysis and Corporate Governance Principles.

The purpose of the research paper is to restate the magnitude of ownership structure in corporate credit valuation. This article weights non-financial characteristics to study areas of credit worthiness, liquidity and many other aspects of corporate credit. Although the major limitation in corporate credit analysis is that economic indicators always supersede the relationship between two variables of organizational structure and credit behavior of a company, yet this analysis provides an insight on credit valuation process and strategy. The paper illustrates this with 3 case situations of different scenarios:

? Importance of implied support mechanism (Petrocom Energy Group LLC)

? Emphasis of economic indicators and Credit rating agencies in ownership structural analysis (Pakistan Steel Mills Corporation); and

? Role of stock exchange in Corporate Credibility assessment (Petroplus Holdings AG).

The Geographic scope of this paper is from European, US and Asian economies with reference to steel and energy sectors. This shapes our analysis closer to realistic pattern of research ingrained with diverse economic behavior and sector studies.

## 2. Conceptual Statement of Corporate Credit and Corporate Governance

Corporate credit analysis is a study of obligor's ability and willingness to pay back the amount that is owed to seller of goods and services. Corporate credit involves five major parties that deal in a business situation. These are Buyer, Seller, and Lender of finance, Credit Rating Agency; and Ultimate Consumer.

Credit Analysis studies and quantifies credit risk and default point of any corporate dealing. It studies the financial muscle of any company to payback its financial obligations for short as well as long term debt. The Default point of any major deal is the financial figure that shows the breach in the financial payback capability. As the default point is approached, the expected default frequency increases. Expected Default Frequency (EDF) is a term which is denoted by a percentage and measures chances that a particular corporate will not entertain its assigned credit limit conditions. Both the Default Point and EDF are inversely proportionate to credit worthiness quotient of a company. Credit Risk is a valuable concept and is mainly made up of two dimensions of research:

1. Default of non-payment on stipulated time; and
2. The quantity of loss incurred due to counterparty failure to pay.

Corporate Credit Analysis is a very large segment and encompasses various financial and strategic techniques to evaluate every deal. A research analyst in this area works on historical financial statements carrying out fundamental research, advanced ratio analysis, linear and multiple structured trend analysis and preparation of financial metric for

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performance index. On advanced formats we also calculate the Z-score, which studies bankruptcy check. Whereas, on the strategic part, the analyst carry out Stakeholders analysis, SWOT Analysis, PESTLE Analysis, Peer Review and GAP analysis, Sector and Industry outlook and RISK Modeling of the deal. There are four basic areas of evaluation in Credit research for assigning of credit limits and ratings. These are Profitability, Liquidity, Financial Leverage; and Capital Structure Analysis.

The Second aspect of concern in turbulent financial times is the application of sound Corporate Governance principles. Corporate Governance practice has been emphasized since the emergence of credit crisis era. As per O'Brien , Australian National University ( 2009 ) states that as the fallout of the financial crisis continues to devastate the real economy, the design of effective and flexible regulatory and corporate governance rules, principles and norms has become a global policy imperative. Corporate Governance is a practice of ethical and moral standards at the helm of affairs of any corporate structure so as to drive an organization towards achievement of a common goal. A code of conduct and ethics is needed to be firmly stated at every level of the organization. There are various parties involved and affected by setting up of Corporate Governance norms which may include the Board of Directors, the elite class of CEO, CFO, COO and other top executives, the management class at every level of hierarchy line and staff managers, the lenders and suppliers of business amenities, the government representatives, individual experts and auditors, researchers and analysts, employees and the most important customers and society at large. When such huge collective interest is at stake, a fair play of business mechanism is of crucial value, which is the objective of sound corporate governance system. In such an environment the basic principles that need to be adhered to are:

1. Full disclosure of information and transparency towards stakeholders
2. Preservation of rights of minority shareholders
3. An effective and efficient Board of Directors
4. Independent chairmanship of the Audit and Remuneration Committee

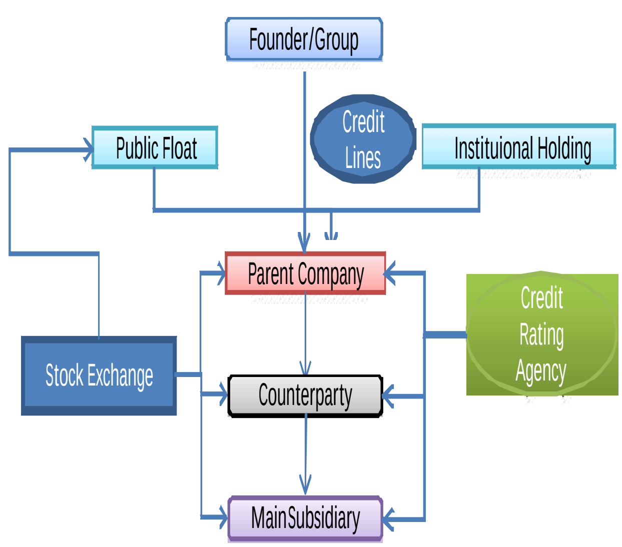
3. Understanding an Ownership Structure from Credit perspective

Corporate governance is hugely affected by ownership structures and the dominance of individuals within. A family owned business structure is going to be well knitted and be dominated by the founder member, usually, at the helm of decision-making as against the public company being run by bureaucrats. This helps the family owned structure with dynamic vision and decisions to strike the right opportunity at the right time. The founder member and his business philosophy also gains goodwill overtime which in turn acts as a boon for functioning of the entire system.

As per a study by Credit Suisse, the companies in which "founding members retain a major stake enjoy a superior performance over their respective peers in the same sector." 1

A simplified ownership chart involving major parties in analysis of corporate credit is given below as Chart 1. Although every organization has a different setup, but for research purposes, this model can be adequately analyzed.

Chart 1: An Organizational Ownership chart from Credit Analysis viewpoint



4. Analysis of Ownership Structure in Corporate Credit Valuation

An ownership structure or an organizational chart is a depiction of levels of hierarchy for a corporate or any other association. It shows the various modes of relationships clearly crafted throughout the organization. The two most important inferences from the above description are "Hierarchy" and "Relationship". An organizational chart answers lot of pertinent questions for corporate credit analysts, which are imperative for the assignment of trade limits to any buyer of goods or services. There are a great many pertinent questions which need to be addressed.

? Who is our counterparty?
? What should be the amount of trade limit and trade tenor?
? Is there any implied support provided to it by Government/Institutions/Group holdings?
? Is this entity a rated one and does it have a favorable rating from a third party?
? Is the entity Public or Private counterparty?
? What are its third party credit lines apart from its parent or holding company?
? Does it have an elongated corporate presence in form of subsidiaries and affiliates?
? Has the entity worked in the area of backward or forward integration?
? Does the entity enjoy diversified business operations and is able to raise finances overseas?

The answers to these questions are germane for the understanding of qualitative research in formulation of Credit limit/summary table. This metric so formed is further combined with financial and strategic research to arrive at a final solution.

A Counterparty is an entity which is involved in a trade deal with a seller of business amenities. It may be association, body of individuals, corporate, government body or any other form of organization, for which a comprehensive credit evaluation is being done. The first step towards carrying out a credit research proposal is to understand our counterparty. The answer to our first question is study of economy, business domain and leadership structure of the entity. If the economic and political scenario of the counterparty is unstable, it leads to a cautious approach for the latter part of credit review. The business operations detail out the possibilities of any risky outlook i.e. volatility of raw material prices, unstable or negative growth rate of industry, too much dependence on single asset class etc. The leadership pattern is the third factor of influence which is of vital significance. It shows whether our trade partner has a holding company or a bigger group or government department as the major shareholder. If such a situation persists then, the credit limit assignment can be easier. A renowned founder having major stake say more than 50% has strong structural relationships within industry, sector and on a national scale, which is further escalated by his existing goodwill and thus lead to lower default expectation. Similarly, large financial institutions of international repute can add feather to the cap while considering enhanced credit agreements with the counterparty.

The Trade limit is an amount of credit to be given when dealing with any counterparty. A trade deal involves sanction of trade limit and fixation of trade cycle or trade tenor. Trade tenor is a time period which acts as a credit period for our counterparty. The flow of major cash payments takes place after the end of this time period. A trade limit is assigned after careful evaluation of financial performance, benchmarking with peers and strategic analysis of the counterparty. It is a mix of above three factors that are assigned weights and then a weighted average is calculated so as to come to a credit rating. This credit rating is used to assign limit based on previous experience with the trade partner. Trade tenor is decided upon by analyst after taking into consideration points like ageing schedule analysis of payments in the past and economic scenario of the country of counterparty.

The Implied support is a mechanism where the long term sustainability and short term working capital cycle of the counterparty is adequately funded with liquidity, credit lines and operational backup from the government or financial institutions or the parent company/holding company/any bigger group. It reveals the strength of the counterparty to honor its commitments in time. This commitment is generally in the form of funds flow, hedging commitments on foreign currency, diversified asset base, strong operating metrics of the parent company etc. The caselet to illustrate the theme of implied support mechanism is highlighted below.

*Caselet 1: Petrocom Energy Group LLC (US Economy and Energy Sector)*

Petrocom Energy Group LLC is a US enterprise organized on December 17, 1998 and commenced operations primarily in April 1999. It is headquartered in Houston, Texas and is engaged in wholesale energy marketing and trading transactions. The financial metrics for the company in year end 2010 showed deficit trend in cash flows, weak liquidity and low current cash balance, aggressive leverage profile with Debt-to-Capitalization of 59%. In the event of such a scenario which was coupled with volatility in oil prices, we will generally see two areas before trading with this company. These are expected strong implied support and investment grade credit ratings. Petrocom Energy has a dubious organizational structure as it is neither rated as a company nor it has a defined parent-node relationship with a bigger entity. It has four individual members with controlling stake of 32%, 32%, 32% and 4%. Its operations are managed by Bush Petroleum Inc. and Timberwilde Investment Corp. Thus, it has no implied support in terms of Holding company or Government stake.

A credit rating agency plays a big role in credit review of the counterparty. It helps in providing a fair view and genuine assessment of the operations of the counterparty and its affiliates. The role of a credit rating agency in corporate credit evaluation can be understood on the same lines as an independent audit is carried out for an organization. If an entity is rated from a third party/credit rating agency, it increases the chances of better trade exchange between two companies. There are basically three types of credit ratings i.e. investment grade, speculative grade and default ratings with the investment grade being the best and others follow suit. Therefore, if the entity enjoys an investment grade rating, it is deemed to be having a healthy financial and operational index, which enables enhanced credit limits and tenors. Credit rating agencies on the international front like S&P, Moody's, and Fitch are the best in the business, whereas some renowned Indian ratings agencies are CRISIL, ICRA, CARE,


The above screened maps show the relative rating grade of nations around the globe by Moody's and S&P MAPS.

Caselet 2 mentioned below highlights the theme on the *Emphasis of economic indicators and Credit rating agencies in ownership structural analysis.*

Caselet 2: Pakistan Steel Mills Corporation (Asian Economy and Steel Sector) 3

Pakistan Steel Mills Corporation (PSMC) is a good example of Asian economy which is considered better off relative to its peers in recent times of crisis. This organization is a 100% government owned company and the largest steel enterprise in the country. Although being a part of strong Asian economy and enjoying implied support from the national government, PSMC did not live up to the expectations of being a healthy trade counterparty in year 2009-10. The counterparty has been exposed to political instability, with extremely weak financial position reporting around Rs 20 billion losses in 2008-09, first time in 9 years. The accumulation of losses was due to less than target production and sales, import of raw material at exorbitant rates and global economic crisis. The country risk has been assessed by rating agencies as high (with S&P rating of B- and B3 by Moody's, one notch above implied default). Moreover, the major economic risk to Pakistan's framework policy was massive flood in August 2010. This all concludes the heavy impact that economic and political stability has on trade policies. Although, the company is largest public sector undertaking in the industry in Pakistan, yet it had negative trade connotations for corporate deals. At this point, it was for credit agencies to come out with a substantial analysis for rating purposes and help trading companies to avoid impending default.

A counterparty which has publicly floated shares and is listed on a national stock exchange has greater credit worthiness and credibility in terms of business operations. This is due to the fact that it has increased responsibility towards fund providers via free float. Moreover, it is under the regulatory microscope of government and other national agencies to follow stringent rules and regulations. The default point in the case of such an entity is significantly reduced due to increased liquidity available at its disposal. This increased access to capital and debt market is a strong fundamental factor to be considered while credit evaluations.

Although, there are certain instances where negative event information can hurt the credibility of an entity faster and to a greater extent when it has presence on the bourse. There is a related Caselet to this situation, which explains the importance of market forces mechanism of the stock exchanges.

The caselet 3 mentioned below is on the theme of *Role of stock exchange in Corporate Credibility assessment 4*

Caselet 3: Petroplus Holdings AG (European Economy and Oil & Petroleum Sector)

Petroplus Holdings AG is the largest independent refiner and wholesaler of petroleum products in Europe. It has a throughput capacity of 667,000 barrels per day and Nelson complexity of 8.3. Although being the largest organization, on evaluation, the company witnessed a rating downgrade in February 2010 and is again under review for further downgrade. The company has a disturbed operating metric since last one year and has been reporting net losses after third quarter of 2009, barring only one quarter results. After such events at the bottom-line affairs, the stock Market .i.e. the SIX Stock exchange, where it is listed under the symbol of "PPHN", has shown a dip in its Market Capitalization owing to the fact that the company reported a wider than expected net loss from second quarter earning in June 2011. Meanwhile, the company has transformed its Reichstett refinery site into a marketing and storage capacity. This might be the company strategy to spin off or sale it to some other interested competitor as marketing facility will churn out more finances than a refinery site on being sold.

## 5. The concept of Credit Lines

Credit Lines are facilities that any counterparty may resort to related to funds usage. It can be a short term or long term facility. Credit Lines are arrangements with financial institutions that companies may avail funding for capital expenditure, expansion purposes, repayment of debt, short term working capital adjustments etc. Credit lines may be committed for a particular use or uncommitted and available for general purpose. These facilities can be revolving i.e. with an enhancement clause every year. Moreover, the financial institutions require the counterparties to comply with some “financial covenants” so as to follow a cautious lending approach. Any breach of covenants lead to cancellation of the agreement or penalty in the form of exorbitant interest expenses. Many a times, the interest paid for these credit lines is linked to “LIBOR” rates. Sufi (2007) found that credit lines account for over 80% of the bank financing provided to U.S. public firms, while Kashyap et al. (2002) found that 70% of bank lending by U.S. small firms is through credit lines. For Spanish firms, credit lines account for 42% of firm's bank financing.5

A strong support in the form of adequate credit lines is an example of sound banking relations and ample liquidity with any company. This increases the credit worthiness and trade positions of the company. Credit lines may be available as an agreement of the parent company with these lenders or a direct relation of the counterparty and supporting banks. If the company has strong credit lines and with increased revolving clause, it provides a surety of liquidity of the entity with better current ratio and cash ratio. The available amount in the credit lines along with cash and cash equivalents as on the date of closure of financial statements enhances trade limits for the organization.

6. The existence of subsidiaries and affiliates define strong hierarchy in ownership structure.

It helps to refine the relationship of a group as a whole. The holding company and its shareholding is specifically mentioned in form of percentage of ownership in the structure. With a strong affiliate network, the scale as well as the efficiency of operations increases tremendously. A major strategy followed by big players in their respective sectors is to develop an international affiliation structure so as to derive the benefits of global market penetration. It also helps in diversification of markets and customer base. Another key strategy followed is to distribute the operations of the major production process or to decentralize the support functions keeping in mind the regional topography of the country.

One major aspect in the study of corporate credit valuations is established strategic presence in the form of Backward or Forward Integration. Backward and Forward integration occurs by the control of supply of raw materials and similar control over the distribution mechanism. Any organization having a strong supply and distribution network will have a timely trade delivery schedule. It reduces overall trade cycle time and makes a counterparty creditworthy qualitatively. By being integrated, the companies become cost efficient and thus the benefit percolate to their trade partners in form of lower priced goods.

Another point of noteworthy representation in any company's credit health is its access to “Global Wealth”. With an increased presence in international financial markets via, international IPO, ADR and GDR's, foreign currency debt and Capital contributions, the risk of sovereign disturbances is reduced. Overall, the organization also increases its presence in global debt, capital and credit markets, thus having more funds at its disposal.

7. Conclusion

The process of credit research entails analytical approach of study, wherein various financial and non-financial parameters are judged to evaluate creditworthiness and credit risk. This article lays stress upon the relevance of qualitative factors of credit standing of any organization. The incorporation of three sectors and three economies enhances the quality of research taking into consideration the globalization factor. The next step of study in this domain would be calculation and interpretation of Agency cost factors through credit scoping. Each level of discussion in this article explains the different perspectives of corporate governance, whether it is relations with its parent company, external credit line agencies or financial institutions etc. Throughout this article we have analyzed the linking of corporate governance with corporate credit valuations.

This research will create a background for understanding various corporate credit concepts on the lines of corporate ownership structure for Chartered Accountants, Company Secretaries, Cost Accountants, Chartered Financial Analysts and other professionals in the field of finance who desire to make a career in the domain of Corporate Credit Valuation and research.

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