

Ganguin, Blaise & Bilardello, John – Fundamentals of Corporate Credit Analysis*McGraw-Hill, 2005, [Finance] Grade* ★★ ★

If you ever wondered how credit ratings are set, here's the answer. The authors are managing directors at Standard & Poor's and John Bilardello manages the corporate ratings division, few know more about how credit ratings are set. In all effects this is a book on how S&P performs credit analyses, outlining both the methodology and thought process. It was published just a few years prior to the financial crisis when the credit rating agencies were at the zenith of their influence.

The book is organized into three parts where the first covers an analysis of the company. The process looks to country risks, sector risks and company specific risks. The financial position and future cash flows are analysed, all to enable forming an opinion on the probability of whether the company will pay interest and principal in time. For me the fact that the process starts with the country risk, and the potential cap this imposes on the credit, rating feels a bit backward but perhaps it's just a matter of ticking all the boxes and the order is less important. There is a useful and comprehensive check list used to evaluate the level of governance-, management- and accounting risk. It's interesting to see that just 8 years ago the rock solid, self-evident opinion was that developed markets are stable and credit worthy while emerging markets are volatile, dependent on capital flows and doubtful credits. For someone with equity background it's also a bit amusing, although fully logical, that instead of using a bear case, normal case and a bull case in the scenario analysis the credit analyst uses a normal case, a bear case and a default case...

The second part of the book covers the more technical and esoteric area of various debt instruments, different types of terms and conditions, debt structures etc. and the subsequent effects on the recovery prospect should a firm become insolvent. This area is clearly a heavy duty task to take on for the analyst. I get the same feeling reading about indenture contracts,

covenants etc. as when I wrote IPO prospectuses once upon a time. It's a world for the initiated.

In the last part of the book – not counting the many and extensive examples of credit analyses in the appendix – the components of a simplified credit rating system are presented. In the end the credit rating should mirror the risk for losses for creditors. To make an informed judgement about this risk you need to form an opinion on the probability of default by analysing business risks, financial risks and liquidity risks plus also an opinion on the probable recovery rate should the worst come true. In some aspects this analysis is down to experience and feeling but in others it's more about process and statistics. How the various factors were summarized and weighted was in my opinion the most giving part of the text.

A few complementary statistical and market price driven methods for estimating credit quality such as Altman's Z-score, the Merton model etc. are briefly presented. The authors however clearly take a stand for a fundamentally driven analysis as opposed to using market prices of for example CDS contracts, for credit control. In this they were probably slightly behind the curve with regards to current trends in 2005, but they are also the more credible today post the 2008 financial crisis and after the backlash for the use of market prices for risk control.

This is a very useful and comprehensive text that I definitely would want to have on my desk as a credit analyst. Is it fun to read? No, not really. It's too much a collection of check lists that the authors then elaborate on and you never really feel any market nerve in the text. As the credit analyst seems to put 99,9 percent of the effort into answering "Will it be repaid?", I can't - after reading this book - help but wonder if there could be excess returns in devoting at least 10 percent of the analysis to the question "Will this bond be upgraded in 1,5 years' time?"

Mats Larsson, July 7 2013