

DEBT SECURITIES, SEMESTER 1, 2012 - ADDITIONAL QUESTION FOR TUTORAL 6

As an analyst for a leading Australian corporate ratings company, you have been assigned the task of determining an appropriate short-term credit rating for Paperlinx Limited for the purposes of pricing an upcoming debt issue. You have obtained the following financial ratios for Paperlinx Limited for the 2009, 2010 and 2011 financial years and comparable firm ratio and credit rating information for 2011:

Ratio	2009	2010	2011
EBIT / Interest expense	-0.019	0.086	-0.108
Current assets / Current liabilities	1.538	1.781	1.822
Cash flow from operations / Total liabilities	-0.004	0.017	0.046
Working capital / Total assets	0.274	0.338	0.360
Retained earnings / Total assets	-0.301	-0.498	-0.661
Total liabilities / Total shareholders' equity	1.319	1.495	1.621
Sales / Total assets	2.137	2.202	2.414
EBIT / Total assets	-0.001	0.002	-0.001
Market value of equity / Total liabilities	0.155	0.271	0.082
Net profit after tax / Sales	-0.127	-0.044	-0.023

Ratio	TFS Corporation Limited Credit rating – B1	Gunns Limited Credit Rating – C2
EBIT / Interest expense	1.932	-0.322
Current assets / Current liabilities	3.656	1.512
Cash flow from operations / Total liabilities	0.280	0.053
Working capital / Total assets	0.278	0.215
Retained earnings / Total assets	0.253	-0.082
Total liabilities / Total shareholders' equity	0.926	0.814
Sales / Total assets	0.216	0.336
EBIT / Total assets	0.093	-0.007
Market value of equity / Total liabilities	1.097	0.267
Net profit after tax / Sales	0.201	-0.554

You plan to apply the original Altman (1968) Z-Score model in formally assessing the financial health of Paperlinx Limited. The Altman Z-score model is:

$$Z = 1.2(X1) + 1.4(X2) + 3.3(X3) + 0.6(X4) + 1.0(X5)$$

where:

X1 = Working capital / Total assets

X2 = Retained earnings / Total assets

X3 = EBIT / Total assets

X4 = Market value of equity / Total liabilities

X5 = Sales / Total assets

A Z-Score of less than 1.80 indicates potential financial distress and a Z-Score greater than 3.00 indicates a financially-healthy firm.

Your initial expectation for the credit rating of Paperlinx Limited is within the speculative grade band of short-term ratings encompassing the B1, B2, B3, C1, C2, and C3 rating levels.

Required:

1) Using the ratio information above, calculate the Altman model Z-scores for Paperlinx Limited for the 2009, 2010 and 2011 years. What are your conclusions regarding the financial health of Paperlinx Limited based on these Z-scores?

2) Using the ratio information and peer company information provided and your credit scoring outcomes, provide a recommendation for the appropriate short-term credit rating for Paperlinx Limited.