

DEBT SECURITIES (FIN5DBS) – SEMESTER 1, 2012

TUTORAL ASSESSMENT TASK 3 – CREDIT ANALYSIS OF TEN NETWORK HOLDINGS LIMITED

As a research analyst for the media sector for Petersons Securities Limited, you plan to employ credit analysis techniques as part of your evaluation of Ten Network Holdings Limited. The following tables provide, firstly, financial ratio information for Ten Network Holdings Limited for the 2009, 2010 and 2011 financial years and, secondly, comparable firm ratio and credit rating information for 2011:

Ratio	2009	2010	2011
EBIT / Interest expense	2.294	4.604	4.020
Tangible assets / Total assets	0.264	0.291	0.302
Working capital / Total assets	0.047	0.097	0.086
Total debt / Total Shareholders' Equity	0.491	0.335	0.431
EBIT / Total assets	0.074	0.107	0.087
Cash flow from operations / Total liabilities	0.087	0.139	0.110
Pre-tax profits / Current liabilities	0.308	0.623	0.441
Retained earnings / Total assets	-0.213	-0.149	-0.208
Sales / Total assets	0.565	0.595	0.595

Ratio	Prime Media Group Limited Credit rating – BB-	Southern Cross Media Group Limited Credit Rating – C
EBIT / Interest expense	4.248	2.823
Tangible assets / Total assets	0.395	0.167
Working capital / Total assets	0.030	0.010
Total debt / Total shareholders' equity	1.002	0.473
EBIT / Total assets	0.132	0.062
Cash flow from operations / Total liabilities	0.158	0.083
Pre-tax profits / Current liabilities	0.581	0.374
Retained earnings / Total assets	-0.423	-0.047
Sales / Total assets	0.687	0.204

You plan to apply the Springate (1978) credit scoring model as part of your assessment of Ten Network Holdings Limited. The Springate model is:

$$Z = 1.03(X1) + 3.07(X2) + 0.66(X3) + 0.40(X4)$$

where:

X1 = Working capital / Total assets

X2 = EBIT / Total assets

X3 = Pre-tax profits / Current liabilities

X4 = Sales / Total assets

A Springate model Z score of less than 0.862 indicates potential financial distress.

Your perception of the likely credit rating for Ten Network Holdings Limited is within the speculative grade band based on the Standard & Poor's ratings criteria incorporating the BB+, BB, BB-, B, CCC+, CCC, CC, and C rating levels.

1) Using the financial ratio information for Ten Network Holdings Limited, explain whether the interest expense obligations of the company have increased or decreasing over the period from 2009 to 2011. (3 marks)

The EBIT / Interest expense ratio has increased over the period which suggests that either EBIT has increased, interest expense levels have decreased or a combination of these two outcomes has occurred. The other useful ratio information to help clarify this is the Total debt / Total shareholders' equity ratio, which has decreased over the period suggesting that the reliance on debt financing relative to equity financing has diminished over the period, or the company has reduced their overall magnitude of debt. Furthermore, the fact that the Retained earnings / Total assets ratio has remained relatively constant, and the company has exhibited profitability over the period, implies that shareholders' equity is also unlikely to have declined. Putting these ratio indicators together would suggest that the interest expense obligations of Ten Network Holdings Limited have declined over the period from 2009 to 2011, which can be confirmed by looking at the Statements of Financial Performance for the company over this period.

2) Using the ratio information above, calculate the Springate model Z-scores for Ten Network Holdings Limited for the 2009-2011 years, and comment on what these results suggest about the underlying credit risk of the company. (3 marks)

The Springate credit score model results are as follows:

$$2009 \text{ Z score} = 1.03(0.047) + 3.07(0.074) + 0.66(0.308) + 0.40(0.565) = 0.705$$

$$2010 \text{ Z score} = 1.03(0.097) + 3.07(0.107) + 0.66(0.623) + 0.40(0.595) = 1.078$$

$$2011 \text{ Z score} = 1.03(0.086) + 3.07(0.087) + 0.66(0.441) + 0.40(0.595) = 0.885$$

The Springate Z scores have fluctuated over this period, first increasing from below the distress likelihood cut-off of 0.862, and then in 2011 decreasing to be just above this cut-off level. Given the consistent proximity of the Springate Z scores to the distress indicator level, this would suggest that the company's financial health is not particularly strong in general. The decline in the Z score from 2010 to 2011 is a concern, and would suggest a recent increase in the credit risk of the company, with the likelihood that a continuing declining trend could indicate future financial distress.

3) Based on your credit scoring analysis and the comparative firm rating information, provide a recommend for what you think an appropriate credit rating would be for Ten Network Holdings Limited. Provide suitable justification for your recommendation. (4 marks)

The financial ratio information and credit scoring analysis would suggest a recent decline in the financial health, and a potential increase in the credit risk, of Ten Network Holdings Limited. This is supported by the decrease in the Springate Z score in 2011, and evidence of declining interest coverage, liquidity, and profitability and increasing use of debt financing from 2010 to 2011. Peer analysis is also particularly useful in assessing the status of the company. In this case, Ten Network Holdings Limited is inferior to Prime Media Group Limited based on every ratio indicator except for liquidity, leverage and long-term earnings generation (retained earnings / total assets) and is superior to Southern Cross Media Group Limited based on every indicator except for long-term earnings generation. It is also useful to calculate the Springate Z scores for 2011 for the two peer companies for direct comparison purposes:

- Prime Media Group Limited Z score = 1.094

- Southern Cross Media Group Limited Z score = 0.529

These relative Z scores are consistent in terms of company ranking with the evaluation of the companies based on the financial ratio information. Overall, this analysis would suggest that a suitable credit rating for Sigma Pharmaceuticals Limited would be in between BB- and C. The financial ratio and Z score information would suggest that Ten Network Holdings Limited is closer in terms of financial health and credit risk to Prime Media Group Limited rather than Southern Cross Media Group Limited, which would suggest a suitable credit rating for Ten Network Holdings Limited of CCC+.