

## CREDIT RATING

# Celebrating failure

The model for predicting bankruptcies is finding applications in emerging markets too

People have strange ways of celebrating events. Edward Altman, professor of finance, Stern School of Business, New York University, confessed that he and his wife opened a bottle of wine whenever a company was declared bankrupt. "It provides more data points to test the bankruptcy model," points out Altman, explaining that bankruptcies do not mean the end of the world. They need not be looked at negatively, as they also provide companies a chance to restructure their leveraged financial position. Lenders are more comfortable lending to a bankrupt firm, as they also enjoy a priority over earlier lenders in most cases.

An acclaimed expert on corporate bankruptcy, Altman had developed a model for predicting bankruptcy way back in 1964. Known as the Z-model, the formula, based on a set of financial ratios, helps in gauging the health of a company and predicts the probability of it going bankrupt in case the score falls below a certain standard.

The overall application of the model in identifying a potentially bankrupt firm within a period of two years with a high degree of probability (70-80 per cent) has led to its wide popularity. It is widely used by bankers, credit analysts and creditors, as an assessment tool. Over the past five-and-a-half decades, the formula has been refined and some new models have also been added.

Altman, who was the main speaker at a corporate credit conference organised by Cedar Management Consulting International, gave new insights into the evolution of credit scoring models too. He dwelt on the various applications of the same for estimating the quantum of stress to which a company is subjected.

Altman, who has authored/co-authored 25 books on this subject, said that he did not advise companies.

However, his opinion was mostly sought by lawyers, turnaround management companies and vulture funds. The latter, as the name suggests, buy into a firm, which is virtually on the death-bed, infuse funds or raise new debt through the issue of junk bonds and salvage value through various means, after a period of time.

While the predictive nature of a model is similar to the function of a credit rating agency, Altman explained that, in more cases than not, they fail to act quickly in their regular assessment. "They do an excellent job while assessing plain vanilla bonds or when they do the original rating. However, they do not do a good job on rerating." The stock markets are by far quicker to sense future problems, which a firm may be subjected to, and this gets reflected in their share prices. In one of the newer models, Z-matrix, the weightage to the market values remains high at 30-40 per cent. Z-double prime does not, however, rely so much on markets. As such, it is not as volatile and does not change as often.

### Model for evolving markets

Altman models cannot be uniformly applied across sectors. In case of non-banking finance companies, it is difficult to make assessments, as many of the problems arise from their off-balance sheet exposure. In the case of banks, a downgrade, however, puts many others at risk.

Altman has developed a model for evolving markets, and also one for assessing sovereign debts. Sanjiv Anand, MD, Cedar Management Consulting International, explained that



Anand and Altman: real estate could well be an asset bubble

his company has also tested Altman's model on Indian companies and is currently looking at developing a similar model for assessing SMEs. Explaining the rationale, he points out that "despite the contribution of SMEs, bankers are still reluctant to take on direct exposure. Altman's model could provide them with a better degree of comfort." Besides, allowing them to access institutional and bank credit, SME assessment could also help promoters to list their companies on the SME stock exchanges or SME platform, like the one which BSE is planning to open shortly.

Altman, who is looking more closely at India, feels that the lack of bankruptcy data points makes it difficult for him to give a view on how stressed the Indian companies are. "India tends to grow without too much debt." However, one area which he feels could see more stress is real estate.

In India, bankruptcies are not common. Neither companies nor banks are allowed to die. Weak banks are often merged with some stronger banks, with some persuasion by the RBI. While Altman may find good business in India, he may not have too many occasions to celebrate failures. And a new event for drinking wine will have to be sought!

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