Estimating the Credit Quality of Chemical Companies

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In a recently published paper, Wosnitza and Leker [1] suggested a logistic regression model for estimating the rank order of international companies according to their credit quality. The aim of the article at hand is to compare the classification performances between the outcomes of the proposed model and ratings from Standard & Poor’s (S&P’s) for chemical companies. The data sample contains S&P’s ratings and financial ratios of eleven international companies from 2010. Despite small deviations, both approaches come to very similar results. Therefore, this paper validates Wosnitza’s and Leker’s logistic regression model and suggests to apply the equation for assessing the credit quality of chemical companies.

According to the Basel Committee on Banking Supervision [2], the logistic regression has developed into a standard method for estimating large companies’ probabilities of default (PDs) from financial ratios. In order to understand how the logistic regression estimates corporate PDs, let us consider a company k whose relevant default information is summarized in the vector x_k. The logistic regression assigns a credit score between zero and one to company k according to the following relationship (Trustorff et al. [3]):

\[
\text{Credit score} = \frac{1}{1 + \exp[-(\beta_0 + \beta^T x_k)]}
\]

(1)

Where \( \beta_0 \) and \( \beta \) are predefined parameter values. Wosnitza and Leker [1] recently proposed a logistic regression model which allows the user to rank international corporates according to their credit qualities. They trained their logistic regression model on 618 financial reports of 312 international companies of which 156 had defaulted. Financial data from different industries except the financial industry was collected in order to obtain sufficient data. Their equation for calculating credit scores is based on the equity ratio (1) and S&P’s credit ratings are summarized in Table 1, for eleven chemical companies from their 2010 financial statements which were downloaded from Datastream [4]. The credit quality of this sample was also evaluated by S&P’s. From each available rating class, one chemical company was randomly selected and included in the data set. The random character of the sample helps to avoid a selection bias, i.e., a systematic error in choosing the individuals to take part in the study. Within this sample, A+ denotes the best and B the worst credit quality. S&P’s credit ratings were obtained from S&P’s Global Credit Portal [5]. The credit score and S&P’s rating are summarized in Table 1 for each company.

In order to evaluate the classification performance of equation (1), we compare the rank order produced by the credit scores with the ranking according to S&P’s ratings. The two rank orders differ only for four companies. Monsanto Co. and Sigma-Aldrich Corp. as well as NewMarket Corp. and Methanex Corp. changed places, respectively. However, the distances between these two pairs are small.

The close match between the two rankings confirms equation (1). This equation seems to be able to rank large chemical companies according to their credit quality.

References


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