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The link between interest rates and FCCR

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Rising interest rates warrant greater scrutiny of companies' debt burdens—especially their ability to service interest payments.

For many, the preferred metric is the Interest Coverage Ratio (ICR), which is calculated by dividing a company's EBITDA by its interest expenses. Essentially this ratio measures how many times a company's earnings can cover its interest obligations.

However, because the ICR only accounts for the EBITDA as a proxy for the cash at the firm's disposal, it may not tell the whole story.

In our view, the Fixed Charge Coverage Ratio (FCCR), which is calculated by dividing a firm's free cash flow by its principal *and* interest payments, offers a more comprehensive view that may be especially helpful during periods of economic uncertainty. Neither measure is perfect. But because FCCR allows for changes in capex among other factors, it provides additional insight into how companies can mitigate the impact of rising interest rates by better managing other areas of their balance sheets.

FCCR sensitivity to changes in the interest rate

Figure 1 is a simplified financial statement. We assume the base rate rises by 300 bps and isolate the effect this has by holding the EBITDA constant across both periods. For simplicity, we assume taxes are constant; we do not consider potential one-off effects like changes in net working capital. Additionally, we assume the company reduces capex in the second period to accommodate the increased interest burden.

The 300 bps increase lowers the ICR by 0.7x. By comparison, the FCCR falls by 0.4x owing to the base rate increase. The reduction in capex also helps to cushion the impact of higher interest rates by 0.1x, bringing the overall change in FCCR to -0.3x.

A strong FCCR (i.e., >2.0x) indicates a robust capacity to manage debt obligations. A ratio between 1.0x and 2.0x may warrant closer examination and possibly proactive measures to prevent financial deterioration. Lenders need to be more vigilant as the FCCR approaches 1.0x.

We consider FCCR to be a more robust measure of a company's ability to service its debt than the ICR.

FIGURE 1: COMPUTATION OF ICR AND FCCR

EBITDA & cash flow calculation	T	T+1
Revenue (1)	$350	$350
COGS (2)	$250	$250
Gross profit (3) = (1) - (2)	$100	$100
SG&A (4)	$50	$50
EBITDA (5) = (3) - (4)	**$50**	**$50**
Taxes (6)	$3	$3
Working capital (7)	$3	$3
Capex (8)	**$6**	**$3**
CF for debt service (9) = (5) - (6) - (7) - (8)	**$38**	**$41**

Debt	T	T+1
Total debt (10)	$250	$250
Rates (bps) (11)	S + 600	S + 600
Interest (12) = (10) * (11)	**$19**	**$26**
Principal (13)	$5	$5
Total fixed charges (14) = (12) + (13)	**24**	**31**

Metrics	T	T+1
ICR (15) = (5) / (12)	**2.6x**	**1.9x**
FCCR (16) = (9) / (14)	**1.6x**	**1.3x**

Source: StepStone, for illustrative purposes only. Assumed SOFR: T = 1.5; T+1 = 4.5.

Why an FCCR below 1.0x does not mean default is imminent

An FCCR below 1.0x, though unsustainable over the long run, does not mean default is imminent; FCCR does not provide insights into the liquidity situation of the firm.

For example, a lower FCCR may be the result of greater capex or a sudden and material change in net working capital. Therefore, reducing capex can be an option for a company to enhance its FCCR, as demonstrated in **Figure 2**.

Additionally, companies can utilize cash reserves or draw on Revolving Credit Facilities (RCFs) to meet upcoming interest payments.

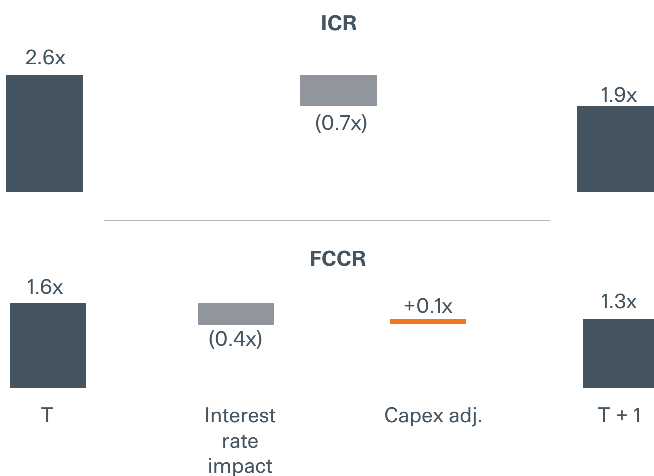
Companies can also negotiate with lenders to convert a portion of their debt into payment-in-kind (PIK) terms, which helps reduce immediate cash outflows. These tactics provide flexibility to manage financial commitments in the short term.

When interest rates rise, a growing number of firms having an FCCR below 1.0x can be expected. This indicates that although firms are not at immediate risk of default, they are potentially depleting their cash reserves and utilizing available credit facilities to manage cash outflows. However, it does not necessarily entail a wave of defaults since firms may still have enough cash on hand to meet their short-term obligations.

The FCCR and ICR are important metrics to estimate the capability of a firm to meet its debt obligations. However, on their own, neither can fully explain a firm's liquidity situation. As we saw in our example, higher interest rates can affect both measures substantially. And while it may appear that the FCCR is approaching the danger zone, taking a closer look at their balance sheets, companies can find ways to dampen the blow.

While current rate levels are important to monitor, lenders should also consider forward rates. If rates are expected to fall in the short term, firms may soon be able to refinance on more favorable terms thanks to improved valuations. Finally, high interest rates can be advantageous for investors, particularly in the direct lending market with floating rate loans. For direct lenders, elevated interest rates equal higher coupon rates, providing a significant buffer against potential increases in loss rates.

FIGURE 2: IMPACT OF INTEREST RATES ON FCCR



Source: StepStone, for illustrative purposes only.

> While unsustainable over the long run, an FCCR below 1.0x does not mean imminent default; companies have several cash management tools to make their debt payments on time.

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