DEBT SECURITIES, SEMESTER 1, 2012 – TUTORIAL 6

CHAPTER 15: GENERAL PRINCIPLES OF CREDIT ANALYSIS

Problem 2)
a. In additional to credit ratings, what other information is provided by rating agencies that investors can use to gauge the credit risk of an issuer?
b. How do long-term credit ratings differ from short-term credit ratings?

Problem 3)
What are some of the major factors considered by rating agencies in assessing the quality of management?

Problem 5)
In 1998 there were several developments in Europe leading to the liberalization of the European telecommunications industry. In October 1998, Moody's Investors Service published a report ("Rating Methodology: European Telecoms") addressing the issues in the rating of European telecommunication companies. Below are quotes from the report followed by questions that should be answered.
a. "We look carefully at a company's general funding strategy – the debt and equity markets the company accesses, and the sources of bank financing it arranges….This becomes more important the lower down the rating scale, particularly in the case of high yield issuers…" (p. 10) Why is the funding strategy of high-yield issuers of particular concern to Moody's analysts?
b. "As a very general rule of thumb, the larger the company's cushion of cash and assets above fixed payments due, the more able it will be to meet maturing debt obligations in potential adverse conditions, and the higher the rating. In many cases, the size of this cushion may be less important than its predictability or sustainability. Moody's views the telecom industry as having generally predictable revenue streams, which accounts for the relatively high level of ratings of the telecom industry compared to other industries." (p. 10) Explain why "predictability and sustainability" may be more important than size of a coverage ratio.
c. In discussing the financial measures it uses, the report explains the importance of "cash flow to debt figures." The report stated (p. 11), "We also look at adjusted retained cash flow which includes any items which we view as non-discretionary to gauge the financial flexibility of a company, …" What is meant by "financial flexibility of a company"?
d. The quote in the previous part ends with "as well as adjusted debt figures which include unfunded pension liabilities and guarantees." Why would Moody's adjust debt figures for these items?
e. In the report, Moody's looks at various measures considered in ratings such as coverage ratios and capitalization ratios, and shows these ratios for a sample of European telecom companies. In each case when discussing ratios, Moody's notes the "loose correlation" between ratings and ratios; that is, it is not necessarily the case that companies with the best ratios will always receive a better rating. Moody's noted that "inconsistencies underscore the limitations of ratio analysis." (p. 11). Explain why one might expect a loose correlation between ratios and ratings.

Problem 20)
a. Why do ratings agencies assign both a local currency debt rating and a foreign currency debt rating to the bonds of a sovereign government?
b. How do the factors considered in deriving a local currency debt rating differ from those for a foreign currency debt rating?

Problem 22)
Krane Products Inc. is a manufacturer of ski equipment. The company has been in operation since 1997. Ms. Andrews is a credit analyst for an investment management company. She has been asked to analyse Krane Products as a possible purchase for the bond portfolio of one of her firm's accounts. At the time of the analysis, Krane Products Inc. was rated BB by S&P. The bonds of the company trade in the market with the same spread as other comparable BB bonds.
Ms. Andrews collected financial data for Krane Products Inc. for the years 2000 and 1999 and computed several financial ratios. Information for selected ratios is given below:

Ratios	**2000**	**1999**
EBIT interest coverage	3.8	2.7
EBITDA interest coverage	5.9	4.1
Fund from operations / total debt	28.3%	24.5%
Free operating cash flow / total debt	19.2%	1.2%
Pre-tax return on capital	24.4%	17.1%
Operating income / sales	25.5%	19.5%
Long-term debt / capitalization	55.0%	57.4%
Total debt / capitalization	57.1%	59.5%

Based on the first three quarters of fiscal year 2001, Ms. Andrews projected to following ratios for 2001:

Ratios	2001
EBIT interest coverage	4.5
EBITDA interest coverage	6.9
Funds from operations / total debt	41.5%
Free operating cash flow / total debt	22.5%
Pre-tax return on capital	24.2%
Operating income / sales	25.12%
Long-term debt / capitalization	40.5%
Total debt / capitalization	45.2%

Ms. Andrews obtained from S&P information about median ratios by credit rating. These ratios are reproduced as follows:

Ratios	AAA	AA	A	BBB	BB	B
EBIT interest coverage	12.9	9.2	7.2	4.1	2.5	1.2
EBITDA interest coverage	18.7	14.0	10.0	6.3	3.9	2.3
Funds from operations / total debt	89.7	67.0	49.5	32.3	20.1	10.5
Free operating cash flow / total debt	40.5	21.6	17.4	6.3	1.0	(4.0)
Pre-tax return on capital	30.6	25.1	19.6	15.4	12.6	9.2
Operating income / sales	30.9	25.2	17.9	15.8	14.4	11.2
Long-term debt / capitalization	21.4	29.3	33.3	40.8	55.3	68.8
Total debt / capitalization	31.8	37.0	39.2	46.4	58.5	71.4

What do you think Ms. Andrews' recommendation will be with respect to the purchase of the bonds of Krane Products Inc.? Explain why.