Fixed Income

Credit Analysis for Corporate Issuers

Exam Focus

- Evaluating likelihood and impact of default
- Financial ratios
- Seniority rankings

Likelihood and Impact of Default

Qualitative factors

- Business model
- Competition
- Business risk
- Corporate governance

Likelihood and Impact of Default

Quantitative factors

- Top down (macroeconomic cycle, size of industry)
- Bottom up (revenue, assets, cash flows)

Credit Quality Analysis

- Companies are deemed to be of higher credit quality if the issuer has the following:
  - Strong operating profits and recurring revenues
  - Low levels of leverage and less reliance on debt in the capital structure
  - High coverage of debt service payments with periodic income
  - High levels of liquidity to meet short-term debt payments

Quantitative Factors: Example

Which of the following statements about shareholders and debtholders is not true?

A. Both shareholders and debtholders benefit from higher profitability.

B. Shareholders generally benefit from higher leverage, while debtholders prefer lower leverage.

C. Both shareholders and debtholders benefit from lower coverage.

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Financial Ratios

Ratio Type	Ratio Name	Calculation	Indication of Higher Credit Quality
Profitability	EBIT margin	EBIT/revenue	Higher
Coverage	Interest cover	EBIT/interest expense	Higher
Leverage	Debt to EBITDA	Debt/EBITDA	Lower
Leverage	RCF to net debt	RCF/(debt – cash & mark securities)	Higher

Financial Ratios: Example

Comment on Bowstream's projected and reported ratios:

	Reported Y0	Projected Y1	Projected Y2
EBIT margin	25%	20%	15%
Interest cover	51.9	32.9	23.0
Debt to EBITDA	0.36	0.43	0.54
RCF to net debt	379%	271%	191%

Source: CFA Institute. Used with permission.

Financial Ratios: Example

	Reported Y0	Projected Y1	Projected Y2
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- Worsening profitability signaled by EBIT margin
- While interest cover is still high, it is expected to decline significantly
- Leverage is expected to increase looking at debt/EBITDA and RCF/net debt
- All signal more risk for debtholders, so wider credit spreads and potential ratings downgrades

Source: CFA Institute. Used with permission.

Seniority Rankings

1. First lien/mortgage
2. Senior secured (second lien)
3. Junior secured
4. Senior unsecured
5. Senior subordinated
6. Subordinated
7. Junior subordinated

Issuer Credit Ratings

- Corporate family ratings
- Corporate credit ratings
- Notching
- Structural subordination

Credit Rating: Example

An issuer credit rating assigned by the rating agencies reflects the:

A. recovery rate of a specific debt of the issuer.

B. expected credit loss of all the issuer’s outstanding debt.

C. probability of default of the issuer’s senior unsecured debt.

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Solutions

Quantitative Factors: Example

Which of the following statements about shareholders and debtholders is not true?

A. Both shareholders and debtholders benefit from higher profitability.

B. Shareholders generally benefit from higher leverage, while debtholders prefer lower leverage.

C. Both shareholders and debtholders benefit from lower coverage.

Both shareholders and debtholders benefit from higher coverage, which is the income or cash flow available to pay debt service.

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Credit Rating: Example

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B. expected credit loss of all the issuer's outstanding debt.

C. probability of default of the issuer's senior unsecured debt.

An issuer credit rating usually applies to the issuer's senior unsecured debt and is meant to address the issuer's overall creditworthiness in the form of probability of default (and for some rating agencies, both probability of default and expected recovery).

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