Q.96 ABC Corp's debt ranking is low because it doesn't have enough fixed assets to cover a respectable portion of the debt. To which one of the four Cs of credit analysis would you associate this statement?

A. Capacity

B. Collateral

C. Character

The correct answer is **B.**

Fixed assets are often put up as collateral on a debt.
The four Cs of credit analysis are: Capacity, Collateral, Covenants, and Character.
Collateral refers to the quality and value of assets put up against a debt as protection. Good quality assets will sufficiently cover the debt, thereby making it rank higher. The opposite is true.

A is incorrect. Capacity refers to a firm’s ability to repay principal and interest payments to its bondholders on time.

C is incorrect. Character is simply the quality of the management (its strategy, quality of earnings, and past treatment of bondholders)

Covenants are provisions in a bond indenture meant to protect lenders from default by borrowers by requiring borrowers to do some things (positive/affirmative covenants) or by forbidding them from doing some things (negative covenants)

Q.2024 The credit analysis of telecommunication by the number of participants in the market is an example of:

A. character.

B. capacity.

C. collateral.

The correct answer is **B.**

The number of participant in the market/level of competition is a component of the Porter five forces.
Option A) is incorrect because character refers to management's integrity and its commitment to repay loans.
Option C) is incorrect because collateral assesses the quality and value of a company's assets.

Q.2049 An analyst is studying a company's fundamentals, industry structure, and industry fundamentals. Which component of credit analysis is he *most likely* studying?

A. Collateral

B. Character

C. Capacity

The correct answer is **C.**

The analyst is studying Capacity. Capacity is the ability of a company to service its debt. Capacity is determined by carrying out an industry analysis (industry structure and industry fundamentals) and company analysis of the issuing company (Company fundamentals).
A is incorrect. Collateral is the amount of assets that a company could sell to cover its debt obligations. Analysis of collateral is simply looking at the quality and value of the assets pledged as collateral.

B is incorrect. Character refers to the judgment of a company's management (its strategy, quality of earnings, and past treatment of bondholders.)

Q.4710 Company A, B and C are peers with the following financial ratios:

	Company A	**Company B**	**Company C**
EBITDA/Interest	6.3	6.5	6.1
Debt/Capital	27%	25%	25%
EBITDA margin	17%	21%	20%
Debt/EBITDA	1.6	1.3	1.3

Using only the following financial ratios, which company *most likely* exhibits the lowest credit risk?

A. Company A

B. Company B

C. Company C

The correct answer is **B.**

EBITDA/Interest Ratio: Company B has the highest EBITDA/Interest ratio, indicating that it generates more than enough earnings before interest, taxes, depreciation, and amortization (EBITDA) to cover its interest expenses. This suggests a lower credit risk.

Debt/Capital Ratio: Both Company B and Company C have the same Debt/Capital ratio of 25%, which is lower than Company A's ratio of 27%. A lower Debt/Capital ratio indicates lower financial leverage and therefore lower credit risk.

EBITDA Margin: Company B has the highest EBITDA margin among the three companies, indicating stronger profitability and cash generation relative to revenue. This suggests better ability to handle debt obligations and lowers credit risk.

Debt/EBITDA Ratio: Company B has the lowest Debt/EBITDA ratio, indicating lower leverage compared to Company A and Company C. A lower Debt/EBITDA ratio suggests a lower credit risk.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (a): Describe the qualitative and quantitative factors used to evaluate a corporate borrower's creditworthiness.

Q.4711 All other factors being equal, a borrower will *most likely* possess a greater ability to repay its debt in an industry where:

A. barriers to entry is high.

B. intensity of competition is high.

C. bargaining power of buys is high.

The correct answer is **A.**

In an industry where barriers to entry are high, it is more difficult for new competitors to enter the market. When barriers to entry are high, existing companies face less competition from new entrants, which can lead to greater market stability, higher profitability, and stronger financial performance.

B is incorrect. A high intensity of competition typically indicates lower barriers to entry in the industry. When the intensity of competition is high, it suggests that there are many competitors vying for market share, which can lead to lower profitability and pricing pressure.

C is incorrect. The bargaining power of buyers primarily affects pricing and profit margins for firms within the industry. This can put pressure on firms' profit margins and reduce their pricing power.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (a): Describe the qualitative and quantitative factors used to evaluate a corporate borrower's creditworthiness.

Q.4712 Which of the following *most likely* indicates higher corporate creditworthiness?

A. Low profit margins

B. High debt-to-equity ratio

C. Strong cash flow position

The correct answer is **C.**

A strong cash flow position typically indicates higher corporate creditworthiness because it reflects the company's ability to generate sufficient cash to cover its operating expenses, debt obligations, and other financial commitments.

A is incorrect. Low profit margins can be a sign of financial strain or inefficiency within a company. It may indicate that the company's revenues are not sufficient to cover its operating expenses and debt obligations, which could raise concerns about its ability to meet its financial commitments.

B is incorrect. A high debt-to-equity ratio suggests that a company has a significant amount of debt relative to its equity. This can raise concerns among lenders and creditors about the company's ability to manage its debt load and meet its financial obligations, especially in times of economic downturn or financial distress.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (a): Describe the qualitative and quantitative factors used to evaluate a corporate borrower’s creditworthiness.

Q.4713 Which bond in the capital structure of a company *most likely* has the lowest risk of bankruptcy?

A. First lien debt

B. Subordinated debt

C. Junior subordinated debt

The correct answer is **A.**

First lien debt typically has the lowest risk of bankruptcy among the options provided because it is secured by specific assets of the company. In the event of bankruptcy, holders of first lien debt have priority claim over the assets that secure their debt.

B is incorrect. Subordinated debt typically carries a higher risk of bankruptcy compared to first lien debt. Subordinated debt holders have a lower priority claim on the company's assets compared to first lien debt holders. In the event of bankruptcy, holders of subordinated debt are only paid after the claims of senior creditors, including first lien debt holders, are satisfied.

C is incorrect. Junior subordinated debt typically carries even higher risk compared to subordinated debt and first lien debt. Junior subordinated debt holders have the lowest priority claim on the company's assets in the event of bankruptcy. They are paid only after the claims of senior creditors, including first lien debt holders and subordinated debt holders, are satisfied.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (c): Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.4714 Which of the following factors is *least likely* considered a qualitative factor in corporate creditworthiness?

A. Profitability

B. Business risk

C. Corporate governance

The correct answer is **A.**

Profitability, typically measured by metrics such as net income margin, return on assets, and return on equity, is often considered a quantitative factor rather than a qualitative factor in corporate creditworthiness assessment. Quantitative factors are those that can be expressed numerically and are based on financial data, such as profitability ratios, liquidity ratios, and leverage ratios.

B is incorrect. Business risk, is typically considered a qualitative factor in corporate creditworthiness assessment. Business risk encompasses various non-financial factors that can impact a company's ability to generate stable revenues and cash flows.

C is incorrect. Corporate governance refers to the system of rules, practices, and processes by which a company is directed and controlled. Corporate governance is generally classified as a qualitative factor in corporate creditworthiness assessment, as it involves subjective judgments based on the quality of governance practices rather than purely numerical metrics.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (a): Describe the qualitative and quantitative factors used to evaluate a corporate borrower’s creditworthiness.

Q.4715 The goal of quantitative analysis is to identify key factors that drive a corporate issuer’s probability of default. Which of the following factors *most likely* measures a company’s relative reliance on debt financing in its operations?

A. Leverage

B. Coverage

C. Liquidity

The correct answer is **A.**

Leverage measures a company's relative reliance on debt financing by assessing the proportion of debt in its capital structure compared to equity. It is typically calculated as the ratio of debt to equity or debt to total capital. A higher leverage ratio indicates that a company relies more heavily on debt to finance its operations.

B is incorrect. Coverage ratios, such as interest coverage ratio or debt service coverage ratio, assess a company's ability to meet its debt obligations using its operating income or cash flows. These ratios provide insights into the company's ability to service its existing debt commitments, but they do not directly measure the extent to which the company relies on debt financing in its operations.

C is incorrect. Liquidity ratios, such as the current ratio or quick ratio, assess a company's ability to meet its short-term financial obligations using its liquid assets. They provide insights into the company's short-term solvency and its ability to cover its immediate liabilities with its available liquid assets.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (a): Describe the qualitative and quantitative factors used to evaluate a corporate borrower’s creditworthiness.

Q.4716 Which of the following statements regarding shareholders and debtholders is *most likely* false?

A. Shareholders and debtholders benefit from lower coverage.

B. Shareholders and debtholders benefit from higher profitability.

C. Shareholders prefer higher leverage, while debtholders prefer lower leverage.

The correct answer is **A.**

Lower coverage ratios such as interest coverage ratio or debt service coverage ratio may benefit shareholders by reducing the company's financial obligations, but they generally pose higher risk for debtholders. Lower coverage ratios indicate that the company may have difficulty meeting its debt obligations, which increases the risk of default for debtholders.

B is incorrect. For shareholders, higher profitability usually leads to higher dividends, capital gains, and an overall increase in the value of their investment. This enhances shareholder wealth and returns. For debtholders, higher profitability implies that the company is better positioned to meet its debt obligations. It indicates stronger cash flows and financial health, reducing the risk of default.

C is incorrect. Shareholders often prefer higher leverage because it can amplify returns on equity. When a company uses debt financing to fund its operations or expansion projects, it can increase its return on equity. Debtholders typically prefer lower leverage because it reduces the risk of default. Lower leverage means that the company has less debt relative to its equity, reducing the likelihood of financial distress.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (a): Describe the qualitative and quantitative factors used to evaluate a corporate borrower’s creditworthiness.

Q.4717 Which of the following financial ratios is *most likely* used to measure a corporation's profitability?

A. EBIT margin

B. Debt to EBITDA

C. EBIT to Interest Expense

The correct answer is **A.**

The EBIT margin, or Earnings Before Interest and Taxes margin, is a financial ratio that measures a corporation's profitability by expressing its earnings before interest and taxes as a percentage of its total revenue or sales. It is calculated as:

$$\text{EBIT Margin} = \left(\frac{\text{Total Revenue}}{\text{EBIT}}\right) \times 100\%$$

B is incorrect. The Debt to EBITDA ratio is a leverage ratio that measures a company's ability to pay off its debt obligations with its earnings before interest, taxes, depreciation, and amortization (EBITDA). It is calculated by dividing the company's total debt by its EBITDA.

C is incorrect. The EBIT to Interest Expense ratio assesses a company's ability to cover its interest expenses with its earnings before interest and taxes (EBIT). It is calculated by dividing the company's EBIT by its interest expenses.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (b): Calculate and interpret financial ratios used in credit analysis.

Q.4718 Which of these financial ratios *most likely* evaluates the extent to which operating profit meets regular financial obligations?

A. EBIT Margin

B. Debt to EBITDA

C. EBIT to Interest Expense

The correct answer is **C.**

The ratio EBIT to Interest Expense assesses the extent to which a company's operating profit (EBIT) covers its periodic interest payments. It provides insights into the company's ability to meet its interest obligations using its operating income. A higher EBIT to Interest Expense ratio indicates that the company's operating profit is sufficient to cover its interest expenses comfortably.

A is incorrect. EBIT Margin measures the percentage of earnings before interest and taxes (EBIT) relative to total revenue or sales, rather than assessing the extent to which operating profit covers periodic interest payments. A higher EBIT Margin generally indicates stronger profitability and operational efficiency.

B is incorrect. The Debt to EBITDA ratio assesses a company's leverage or its ability to manage its debt burden by comparing its total debt to its earnings before interest, taxes, depreciation, and amortization (EBITDA).

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (b): Calculate and interpret financial ratios used in credit analysis.

Q.4719 Calculate FFO/debt given the following information:

Capital expenditure	(2,050,000)
Net income from continuing operations	8,500,000
Depreciation	700,000
Other non-cash items	90,000
Debt	12,500,000

A. 51.6%

B. 73.6%

C. 74.3%

The correct answer is **C.**

FFO/debt, also known as Funds from Operations to Debt ratio, is a financial metric used to assess a company's ability to cover its debt obligations using its funds from operations (FFO).

FFO is calculated as:

$$\text{FFO} = \text{Net income from continuing operations} + \text{Depreciation} + \text{Deferred income taxes} + \text{Other no}$$

$$\text{FFO} = 8,500,000 + 700,000 + 90,000 = 9,290,000$$

$$\frac{\text{FFO}}{\text{Debt}} = \frac{9,290,000}{12,500,000} = 0.743 = 74.3\%$$

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (b): Calculate and interpret financial ratios used in credit analysis.

Q.4720 Which of the following competing companies has higher credit risk given the following information.

	Company A	**Company B**	**Company C**
Debt/EBITDA	2.3	1.9	2.6
EBITDA/Interest Expense	1.6	2.3	1.2
FCF before dividends	600,000	(1,200,000)	850,000

A. Company A

B. Company B

C. Company C

The correct answer is **C.**

Debt/EBITDA: This ratio measures a company's ability to repay its debt using its earnings before interest, taxes, depreciation, and amortization (EBITDA). A higher ratio indicates higher debt relative to EBITDA, which could pose greater credit risk.

EBITDA/Interest Expense: This ratio evaluates the company's ability to cover its interest payments with its EBITDA. A higher ratio suggests stronger coverage and lower credit risk.

Free Cash Flow (FCF) before dividends: This metric measures the cash generated by the company from its operating activities after deducting capital expenditures. Positive FCF indicates the company generates more cash than it spends on operations, while negative FCF suggests the opposite.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (b): Calculate and interpret financial ratios used in credit analysis.

Q.4721 Which of the following *most likely* describes a situation where debt issuer ratings differ due to the loss given default differences?

A. Notching

B. Recovery rates

C. Priority of claims

The correct answer is **A.**

Notching typically refers to the practice of assigning different credit ratings to different tranches or classes of debt issued by the same issuer. It involves adjusting the credit rating based on specific characteristics or features of each tranche, such as seniority, subordination, or security.

B is incorrect. Recovery rates refer to the percentage of the outstanding debt that creditors can expect to recover in the event of default and subsequent liquidation or restructuring. These rates are influenced by factors such as the seniority of the debt, the presence of collateral, the financial health of the issuer, and overall market conditions.

C is incorrect. Priority of claims refers to the order in which different classes of creditors are repaid in the event of a default. While the priority of claims can influence the recovery prospects for creditors, it is not the primary factor that directly determines differences in debt issuer ratings.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (c): Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.4722 Which of the following is *least likely* a reason for differences in a debt issuers loss given default?

A. Seniority

B. Issuer rating

C. Sources of repayment

The correct answer is **B.**

While issuer rating can indirectly influence the cost and availability of debt, it does not directly determine the loss given default. The issuer rating reflects the creditworthiness of the issuer and may affect the interest rate and terms of the debt, but it does not directly determine the loss experienced by creditors in the event of default.

A is incorrect. Seniority is indeed a significant factor influencing differences in a debt issuer's loss given default. Seniority refers to the priority of debt repayment in the event of default. Senior debt holders have a higher claim on the assets of the issuer compared to subordinated debt holders.

C is incorrect. Sources of repayment refer to the various means by which a borrower can fulfill its debt obligations. Each debt’s repayment source may vary depending on the agreement with the debtholders. Guaranteed sources of repayment can potentially reduce loss given default (LGD) for creditors in the event of a borrower's default.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (c): Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.4723 Blue Limited faces impairment on its net current assets of £350 other than cash. Using the information provided below, what is the *most likely* potential recovery of the company's secured bank loans in the event of a default according to the priority of claims?

Asset	**Amount (£)**
Common shares	£120
Retained earnings	£80
Subordinated bonds	£160
Unsecured bonds	£40
Secured bank loans (secured by cash collateral)	£60

A. Unsecured bondholders face partial recovery.

B. Subordinated bondholders face partial recovery.

C. Unsecured bondholders will receive zero recovery.

The correct answer is **B.**

To determine the potential recovery of the company's secured bank loans in the event of default according to the priority of claims, we need to consider the hierarchy of claims in the liquidation process.

The priority of claims is:

i. Secured loans
ii. Unsecured loans
iii. Subordinated loans
iv. Equity (common shares and retained earnings)

The £350 impairment will be absorbed by equity, i.e. common shares and retained earnings, a total of £200.

The remaining £150 impairment balance will be borne by the entire subordinated loans amount of £160. They will have a partial recovery of £10.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (c): Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.4724 The issuer credit rating provided by rating agencies *most likely* signifies?

A. The recovery rate for a particular debt issued by the entity.

B. The likelihood of default for the entity's senior unsecured debts.

C. The anticipated credit loss across all the entity's outstanding debts.

The correct answer is **B.**

An issuer credit rating primarily reflects the likelihood of default on the issuer's senior unsecured debt. This rating is intended to provide investors with a gauge of the issuer's overall creditworthiness, which primarily considers the probability of default. Additionally, some rating agencies may also incorporate expected recovery rates in the event of a default.

A is incorrect. The issuer credit rating does not specifically address the recovery rate for individual debt issues. Recovery rates are usually considered separately and may differ significantly between secured and unsecured debts or due to other specific terms of the debt issuance.

C is incorrect. While the issuer credit rating takes into account the entity's ability to meet its financial obligations, it does not directly represent the expected credit loss for all outstanding debts. Instead, it evaluates the overall risk of default without specifying expected losses across all debts.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (c): Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.4725 A credit analyst is analyzing the financial information of ABC Limited. He has gathered the following information:

	20X3	**20X4**
Total equity	$250	$400
Total debt	$190	$310
EBITDA	$92	$135
Interest expense	$35	$46

The Debt/capital ratio for ABC Limited for the year 20X4 is *closest to*?

A. 0.436

B. 0.775

C. 0.619

The correct answer is **A.**

To calculate the Debt/Capital ratio, we need to find the proportion of total debt to the total capital of the company. Total capital is the sum of total equity and total debt.

For the year 20X4:

- Total equity = $400
- Total debt = $310
- Total capital = $400 + $310 = $710

Now, we can calculate the Debt/Capital ratio:

$$\text{Debt/Capital ratio} = \frac{\text{Total debt}}{\text{Total capital}}$$
$$\text{Debt/Capital ratio} = \frac{\$310}{\$710}$$
$$\text{Debt/Capital ratio} \approx 0.4366$$

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (c): Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.4726 A situation where a corporation with a holding company structure has debt at both parent holding company and operating subsidiaries and the subsidiaries’ cash flows are used to pay debt before being passed to the holding company is *most likely* referred to as?

A. Notching

B. Priority of claims

C. Structural subordination

The correct answer is **C.**

In a holding company structure, where the parent company (holding company) owns subsidiary companies, structural subordination arises when the debt of the operating subsidiaries takes precedence over the debt at the holding company level. This means that the subsidiaries' cash flows are used to service their own debt obligations before any remaining funds are passed up to the holding company to service its debt.

A is incorrect. Notching refers to the practice of assigning different credit ratings to different debt instruments issued by the same entity, based on specific characteristics of each instrument. This differentiation in ratings may occur within the same entity's capital structure or across different entities within a corporate group.

B is incorrect. The priority of claims refers to the order in which different classes of creditors are repaid in the event of a company's liquidation or bankruptcy. Creditors with higher priority claims are typically entitled to receive repayment before those with lower priority claims.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (c): Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.4731 Which of the following factors is *least likely* a primary factor in assigning credit ratings?

A. Recovery rates

B. Loss given default

C. Probability of default

The correct answer is **A.**

Recovery rates, while important in assessing credit risk and determining potential losses in the event of default, are typically not primary factors in assigning credit ratings. Recovery rates refer to the percentage of the principal amount of a debt instrument that creditors are expected to recover in the event of default and subsequent liquidation or bankruptcy proceedings.

B is incorrect. Loss given default (LGD) is indeed a primary factor in assigning credit ratings. LGD measures the expected loss on a debt instrument in the event of default. It considers factors such as the percentage of the debt that can be recovered after default, the seniority of the debt, and any collateral or security backing the debt.

C is incorrect. The probability of default is a primary factor in assigning credit ratings. It reflects the likelihood that an issuer will fail to meet its debt obligations within a specified time frame. Credit ratings agencies assess PD by analyzing various factors such as the issuer's financial health, industry dynamics, business model, management quality, and economic conditions.

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (c): Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.4732 A credit analyst has g:athered the information below on a company she is evaluating:

Issuer rating	**B+**
Probability of default	1.2%
Recovery rate	62%
Loss given default	38%

Using the information above, the company's debt expected loss is *closest to*?

A. 0.456%

B. 0.744%

C. 0.235%

The correct answer is **A.**

Expected loss is a key metric used by lenders, investors, and credit rating agencies to evaluate the risk of default on debt instruments such as loans, bonds, and other credit products. It represents the average amount of money that is expected to be lost if the borrower defaults on its debt obligations. It is calculated as:

$$\text{Expected loss (EL)} = \text{POD} \times \text{LGD}$$
$$\text{EL} = 1.2\% \times 38\%$$
$$\text{EL} = 0.456\%$$

CFA Level I, Topic 7 - Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers. LOS (c): Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.