Chapter 26

Investing Issues: Preparing a Credit Snapshot

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BECAUSE MARKET PRICES can move rapidly, and news events can happen very fast, requests for a quick credit analysis after such an event are quite common. It is therefore best to have an analysis template in place for this credit snapshot. Each situation will require some unique aspects in the structure of the snapshot, depending on the events driving the request, but there should also be some commonality in what should be prepared. A consistent format for these snapshots can make it easier for the investment team to review the information

Prioritization

To prepare a credit snapshot, there should be a clear understanding of why it is being requested and what the goal of the project is. This should help to narrow the amount of work needed to be done. Common reasons for such a quick summary may include a sudden offering of new debt or breaking news on a company.

When the reason for the project is understood, it is easier to triage the situation. (*Triage* is a medical term referring to the process of determining which patients should be prioritized for treatment.) In these situations, the prioritization of work can be critical to arriving at a rapid response. The priorities of the snapshot will vary. Is there interest in looking at a credit because the bonds just dropped twenty points in the market? Or is a quick snapshot on a company being requested because it just announced it is making a large acquisition? Whatever the reasons, two basic credit questions will need to be addressed: 1) can the credit service its debt obligations and 2) is there enough asset value to pay off the debt if necessary? Typically the analysis will try to determine if the news improves or weakens a company's ability to address these two issues.

The Basics of a Credit Snapshot

Basic company information should be the first step and should include what the company does. Then comes the reason for the snapshot. This section should include whatever is notable about the company's competitive position within its industry. It should also include whether the company is private or public, and whether there is any meaningful ownership of the company. If the company has a major fatal flaw or outstanding strength, it can be helpful to include that information in this section. It is best to use bullet points and worry less about sentence structure.

One of the quickest ways to assess a company's ability to pay its debt and its leverage is to look at the statement of cash flow from operations and examine the cash flow from operations for the trailing twelve months. This accounting figure of free cash generation can rapidly be compared to the interest expense, capital expenditures, and the short-term liabilities where debt due in less than a year is listed. Then, the total debt outstanding, net of cash on hand, should be provided. These six financial statement items can give a very quick assessment of the credit and guide an analyst to the next step. If the company's finances appear challenged, a review of available borrowings might be required. If this is not the case, there should be time to look at the capitalization and business trend analysis.

The next more detailed data to gather is usually from the balance sheet: debt structure and maturity schedule. When doing this, liquidity sources should be laid out as well, which usually means cash and any available borrowing facilities. Just because a revolving loan agreement or other short-term borrowing facility shows it has availability does not always mean that it can be drawn. Limits on drawing revolving facilities can be in the covenants of the other debt instruments but are more likely to be in the actual revolver agreement. Sometimes short-term borrowings have a borrowing base, meaning the company can borrow up to a certain amount of receivables or inventory.

The absolute minimum that is needed on the debt capitalization is total debt, cash, and any upcoming maturities. If time permits, and the company's equity is publicly traded, it is helpful to include the market value of the company and the value to EBITDA ratio.

The next step should be to begin building the adjusted EBITDA calculation for the latest twelve-month period (often abbreviated as LTM). Then run some of the most basic ratios using EBITDA. These would include debt-to-EBITDA and EBITDA - capital expenditures/interest expense.

Pricing data on the debt securities must also be included in any snapshot, including, at a minimum, price, YTW, and STW.

This data would be the bare minimum that an analyst would want to pull from financial statements and should indicate whether the company is facing a liquidity crisis or is in sound financial condition.

Templates

Analysts often have templates for preparing credit snapshots. Because analysts tend to focus on a few industry sectors rather than being generalists, they can build and maintain a list of debt and equity comparables that can be quickly used in a snapshot. The template may also have some meaningful KPIs common to an industry.

Trends

The next step in building a snapshot will often be to get a sense of operational trends. The quickest way is to look at revenue trends from the income statement over the last three to five years. Then do the same with either cash flow from operations or EBITDA over the same time frame and the respective operational margins. If time permits, changes in debt and capital spending can be plotted in as well.

If the stock of the company is public, it can be helpful to see if there have been large stock movements in the past year—and if so, check for news stories around that time. A review of the last earnings release can also be insightful.

From that point onward, there are many directions in which the analysis can go, including the following:

- ownership and any changes to the ownership
- divisional performance and trends in operating expenses
- upcoming potential events, such as step-downs in maintenance covenants
- how competitors are performing

Pro Forma

When the request for a credit snapshot is driven by the announcement of an event, it is good to prepare a very quick pro forma analysis of the event: an estimate of what the company will look like after the event. Many times, not all of the information about the event will be available. For example, the company may have announced a major acquisition but not explained how it will be funded, or the company may be selling an asset but does not yet know the price. In all of these cases, the analyst will have to make assumptions based on the information available. If time permits, running a few different scenarios can prove to be helpful in the pro forma analysis as well.

Example of a Snapshot

Exhibit 26.1 shows what a simple snapshot of a credit can look like. The first section is a descriptive section. It includes, in the Recent News section, the reason for the snapshot request: an acquisition was announced, and the bond prices dropped. The second box is the very easy take on the credit quality of the company, using the cash flow from operations from the financial statements. The third box includes more detailed information. This section includes both cash flow and balance sheet information, as well as some trend analysis. The capitalization section includes market pricing information on the debt securities.

Since the company in this example has publicly traded stock, there is a section to analyze the market value of the company. Notice this analysis does not use the most recent stock price but a three-month average to give a longer-term view of how the market views value. The total enterprise value takes the equity market value and adds the total debt.

The final section of this snapshot offers a very simple view of how the announced acquisition may impact the credit. In this example, it is assumed that the acquisition will be financed with debt at an average cost of 6% for the company. Software Co. was leveraged 4.3× prior to the acquisition. Since the company is paying $3.5 billion for the acquisition and the acquired company has $400 million of EBITDA, the company is paying 8.75× EBITDA (8.75=3500/400) for NewSoftware Co. The assumption is that this will be paid with debt, which results in this transaction increasing the leverage of the company to 5×. So, it is understandable that the bonds traded down. However, with an equity valuation of about 8.4×, there still appears reasonable asset protection for the debt and adequate liquidity as seen in the FCF/debt ratio. To examine the acquisition further, an analyst would have to look at the growth potential and potential cost savings of the acquisition.

Exhibit 26.1: Simple Credit Snapshot after an Acquisition Announcement

Company Name: SOFTWARE CO.

Data in $000,000s (unless noted)

Business description:	Designs employee management software; uses subscription model
Business positives:	Large installed customer base, recurring revenue, minimal capital spend
Fatal flaw (biggest risk):	Several new competitors, few new wins; concern over obsolescence
Ownership:	Public; founder and CEO owns 15%, pays dividends, has retired debt
Recent News:	Bonds dropped ~ 5 points since company announced acquisition

Latest 12 Months Data:	12/31/XX		
CFFO*	1,500	Debt/CFFO + interest	3.3×
Total debt	6,200	CFFO + interest/interest	5.0×
Interest expense	372	CFFO − capital expenditures	1,400
Capital expenditures	100	Debt due in one year − cash on hand	100
Debt due in one year	300	CFFO/net det due in one year	5.0×
Cash on hand	200		

Latest 12 Months Data Ended:			Current
	12/31/XX	12/31/XX	12/31/XX
Revenue	6,375	6,325	6,250
Growth		−0.8%	−1.2%
EBITDA	1,530	1,486	1,453
Growth		−2.9%	−2.2%
Margin	24.0%	23.5%	23.3%
Interest expenses	438	397	372
Capital expenditures	110	105	100
Simple FCF	983	985	981
Total debt	7,000	6,400	6,200
EBITDA-cap. exps/interest exps.	3.2×	3.5×	3.6×
Debt/EBITDA	4.6×	4.3×	4.3×
Simple FCF/debt	14.%	15.4%	16%

Equity Market Value:	
Shares (in millions)	500
Avg. stock price over 3 months	$12.00
Equity market value	6,000
Total enterprise value	12,200
TEV/EBITDA	8.4×

Debt Amortization:	
Year 1	300
Year 2	200
Year 3	200
Year 4	3,700
Year 5	2,500

		Recent Pricing			
Debt capitalization		Price	YTW	STW	OAD
L + 450 senior secured term loan	2,200	98.00	5.50%	450	
6% senior notes	2,500	97.00	6.25%	540	4.6
7% senior-subordinate notes	1,500	94.00	9.00%	700	3.8

Pro Forma for Acquisition of NewSoftware Co.			
Price for NewSoftware Co.	3,500		
EBITDA of NewSoftware Co.	400		
	Software Co.	New Software Acquisition	Pro Forma Software Co.
EBITDA	1,453	400	1,853
Debt	6,200	3,050	9,250
Est. interest expense	372	183	555
		(~6%)	
Debt/EBITDA	4.3×		5.0×
EBITDA/interest	3.9×		3.3×

* Cash Flow From Operations

Closing Comment

Creating snapshots can be very helpful not only when news is breaking, but also when learning how to analyze a new industry, or as a way to monitor credits that might be actively followed but are on a watch list. Technology can be used to pull selected data from various sources to rapidly populate this type of snapshot.