Reading 47 Fundamentals of Credit Analysis

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# READING 47. Fundamentals of Credit Analysis

* 1. Describe credit risk and credit-related risks affecting corporate bonds
  2. Describe default probability and loss severity as components of credit risk
  3. Describe seniority rankings of corporate debt and explain the potential violation of the priority of claims in a bankruptcy proceeding
  4. Distinguish between corporate issuer credit ratings and issue credit ratings and describe the rating agency practice of “notching”
  5. Explain risks in relying on ratings from credit rating agencies
  6. Explain the four Cs (Capacity, Collateral, Covenants, and Character) of traditional credit analysis
  7. Calculate and interpret financial ratios used in credit analysis
  8. Evaluate the credit quality of a corporate bond issuer and a bond of that issuer, given key financial ratios of the issuer and the industry
  9. Describe factors that influence the level and volatility of yield spreads
  10. **Yield spread** = liquidity premium + credit spread. Yield on corporate bond = real risk-free interest rate + expected inflation rate + maturity premium + liquidity premium + credit spread
  11. Explain special considerations when evaluating the credit of high yield, sovereign, and non-sovereign government debt issuers and issues

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Credit risk: default risk, loss severity - loss given default

Expected loss = default risk \* loss severity

Recovery rate: % of a bond's value an investor would receive if the issuer defaults.

Yield spread: credit-risky bond and credit-risk-free bond of similar maturity; bond prices inversely related to spreads

Spread risk: credit migration risk/downgrade risk, market liquidity risk

Seniority rankings for debt repayment priority - priority of claims:

* + First lien or first mortgage
  + Senior secured debt
  + Junior secured debt
  + Senior unsecured debt
  + Senior subordinated debt
  + Subordinated debt
  + Junior subordinated debt

Pari passu - have same priority of claims

**Notching is a difference between a issuer credit rating and an issue credit rating.**

Corporate family ratings (CFR): issuer credit ratings

Corporate credit ratings (CCR): issue-specific ratings

Risks on ratings from credit rating agencies:

* + Credit ratings are dynamic
  + Rating agencies are not perfect
  + Event risk Is difficult to assess
  + Credit ratings lag market pricing

4 Cs of traditional credit analysis:

* + **Capacity**:
    - Industry structure
    - Industry fundamentals
      * Industry cyclicality
      * Industry growth prospects
      * Industry published statistics
    - Company fundamentals
      * Competitive position
      * Operating history
      * Management's strategy and execution
      * Ratios and ratio analysis
  + **Collateral**:
    - Intangible assets
    - Depreciation
    - Equity market capitalization
    - Human and intellectual capital
  + **Covenants** 
    - Affirmative covenants
    - Negative covenants
  + **Character** 
    - Soundness of strategy
    - Track record
    - Accounting policies and tax strategies
    - Fraud and malfeasance record
    - Prior treatment of bondholders

Yield spread = liquidity premium + credit spread by 5 interrelated factors:

* + Credit cycle
  + Economic conditions
  + Financial market performance
  + Broker-dealer capital
  + General market demand and supply

High yield debt = non-investment grade = junk bonds = below Baa3/BBB:

* + High leverage
  + Unproven operating history
  + Low or negative free cash flow
  + High sensitivity to business cycles
  + Low confidence in management
  + Unclear competitive advantages
  + Large off-balance-sheet liabilities
  + Industry in decline
  + Liquidity
  + Financial projections
  + Debt structure
  + Corporate structure
  + Covenants
    - Change of control put
    - Restricted payments
    - Limitations on liens
    - Restricted vs. unrestricted subsidiaries

* + Sovereign Debt
    - Institutional effectiveness
    - Economic prospects
    - International investment position
    - Fiscal flexibility
    - Monetary flexibility
  + Non-Sovereign Government Bond/Municipal
    - General obligation (GO)
    - Revenue bonds