44 FUNDAMENTALS OF CREDIT ANALYSIS

1. When calculating credit ratios, an analyst should increase a company's reported total debt if the company has:
   (A) a debt guarantee from a parent or third party.
   (B) a net pension asset on its balance sheet.
   (C) operating lease obligations.

2. Loss severity is most accurately defined as the:
   (A) amount a bondholder will lose if the issuer defaults.
   (B) percentage of a bond's value a bondholder will receive if the issuer defaults.
   (C) probability that a bond issuer will default.

3. Jequa is a Japanese company with the following selected financial information:

	V billions
Net income from continuing operations	503
Depreciation & amortization	256
Capital expenditures	140
Cash flow from operations	361
Dividends	72

   Jequa's funds from operations (FFO) is closest to:
   (A) ¥247 billion.
   (B) ¥149 billion.
   (C) ¥759 billion.

4. Fraud and malfeasance, soundness of strategy, and prior treatment of bondholders are criteria to evaluate a borrower's:
   (A) character.
   (B) covenants.
   (C) capacity.

5. The risk of receiving less than market value when selling a bond is referred to as:
   (A) recovery rate risk.
   (B) loss severity risk.
   (C) market liquidity risk.

6. Analysis of a firm's intellectual capital, equity market capitalization, depreciation, and intangible assets is associated with which aspect of credit analysis?
   (A) Capacity.
   (B) Collateral.
   (C) Covenants.

7. Which of the following statements about municipal bonds is least accurate?
   (A) A municipal bond guarantee is a form of insurance provided by a third party other than the issuer.
   (B) Bonds with municipal bond guarantees are more liquid in the secondary market and generally have lower required yields.
   (C) Revenue bonds have lower yields than general obligation bonds because they are backed by specific projects.

8. Yield spreads tend to widen when equity market performance is:
   (A) stable.
   (B) strong.
   (C) weak.

9. Bond investors should not rely exclusively on credit agency ratings because:
   (A) credit ratings may change over time.
   (B) default rates are higher for lower-rated bonds.
   (C) market pricing tends to lag changes in credit ratings.

10. The yield spreads between corporate bonds and government bonds are most likely to decrease if:
   (A) a credit rating downgrade on the corporate bonds becomes more likely.
   (B) investors increase their estimates of the recovery rate on the corporate bonds.
   (C) liquidity decreases in the market for the corporate bonds.

11. One notable difference between an issuer credit rating and an issue credit rating is that an:
   (A) issue credit rating applies to the issuer's senior unsecured debt.
   (B) issue credit rating is always notched below the issuer rating.
   (C) issuer credit rating reflects the borrower's overall creditworthiness.

12. Which of the following best describes risks in relying on credit agency ratings?
    (A) Event risk is difficult for rating agencies to assess.
    (B) Changes in credit ratings tend to cause market prices to change.
    (C) Credit ratings are assigned only at issuance.

13. The "four Cs" of credit analysis include:
    (A) capacity and character
    (B) circumstances and covenants.
    (C) collateral and capital.

14. An increase in net income is most likely to decrease a borrower's:
    (A) debt-to-EBITDA ratio.
    (B) FFO-to-debt ratio.
    (C) operating margin.

15. Steven Company has EBITDA/interest and debt-to-capital ratios that are both higher compared to Joseph Company to a degree consistent with one level of issuer credit rating. Based only on this information, the credit rating of Steven is most likely to be:
    (A) higher than Joseph.
    (B) lower than Joseph.
    (C) the same as Joseph.

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16. If investors expect greater uncertainty in the bond markets, yield spreads between AAA and B rated bonds are most likely to:
    (A) widen.
    (B) slope downward.
    (C) narrow.

17. The factors that must be considered when estimating the credit risk of a bond include:
    (A) only the bond rating and the recovery rate.
    (B) only the bond rating.
    (C) the bond rating, the recovery rate, and the yield volatility.

18. Which of the following is the most appropriate strategy for a fixed income portfolio manager under the anticipation of an economic expansion?
    (A) Sell corporate bonds and purchase Treasury bonds.
    (B) Sell lower-rated corporate bonds and buy higher-rated corporate bonds.
    (C) Purchase corporate bonds and sell Treasury bonds.

19. What is the most likely effect on yield spreads when demand for bonds is high and supply of bonds is low?
    (A) The effect on yield spreads will depend on whether supply or demand is the stronger influence.
    (B) Yield spreads are likely to narrow.
    (C) Yield spreads are likely to widen.

20. A non-callable bond with 18 years remaining maturity has an annual coupon of 7% and a $1,000 par value. The current yield to maturity on the bond is 8%. Using a 50bp change in YTM, the approximate modified duration of the bond is:
    (A) 9.63.
    (B) 11.89.
    (C) 8.24.

21. A restricted payment covenant in a high yield bond indenture protects lenders by:
    (A) limiting the amount of cash paid to equity holders.
    (B) making a parent company's debt rank pari passu with a subsidiary's debt.
    (C) requiring the borrower to buy back its debt if the company is sold.

22. Becque Ltd. is a European Union company with the following selected financial information:

€ billions	Year 1	Year 2	Year 3
Operating income	262	361	503
Depreciation & amortization	201	212	256
Capital expenditures	78	97	140
Cash flow from operations	303	466	361
Total debt	2,590	2,717	2,650
Dividends	70	70	72

Becque's three-year average debt-to-EBITDA ratio is closest to:
    (A) 3.6x.
    (B) 4.6x.
    (C) 7.6x.

23. Structural subordination means that a parent company's debt:
    (A) Ahas a higher priority of claims to a subsidiary's cash flows than the subsidiary's debt
    (B) has a lower priority of claims to a subsidiary's cash flows than the subsidiary's debt.
    (C) ranks pari passu with a subsidiary's debt with respect to the subsidiary's cash flows.

24. Structural subordination is most likelyto be a credit rating consideration for:
    - (A) emerging market sovereign bonds.
    - (B) general obligation municipal bonds.
    - (C) high-yield corporate bonds.

25. Consider three municipal bonds issued by the Greater Holmen Metropolitan Capital Improvement District, a local authority that carries an issuer rating of single-A from the major debt rating agencies. All three bonds have the same coupon rate and maturity date.
    - Series W was issued to finance the rebuilding and expansion of local schools and is backed by the District's authority to levy property tax.
    - Series X was issued to build a water purification plant for the region. The District charges fees to the surrounding municipalities for their use of the plant. These fees are the only source of the interest and principal payments on the bonds.
    - Series Y was issued to raise funds for the general use of the District in its ordinary maintenance projects and is backed by the District's authority to levy property tax. These bonds carry a third party guarantee of principal and interest payments.

    What is most likely the order of the market yields on these three bond issues, from highest to lowest?
    - (A) Series X, Series W, Series Y.
    - (B) Series X, Series Y, Series W.
    - (C) Series Y, Series W, Series X.

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26. Which of the following bonds from the same corporate issuer has the lowest priority of claims?
    - (A) Collateral trust bond.
    - (B) Equipment trust certificate.
    - (C) Senior unsecured debenture.

27. Debt with a lower priority of claims than a firm's unsecured debt is best described as:
    - (A) subordinated.
    - (B) pari passu.
    - (C) second lien.

28. Which component of traditional credit analysis includes evaluation of industry structure, industry fundamentals, and company fundamentals?
    - (A) Covenants.
    - (B) Capacity.
    - (C) Collateral.

29. If a U.S. investor is forecasting that the yield spread between U.S. Treasury bonds and U.S. corporate bonds is going to widen, then which of the following is most likely to be CORRECT?
    (A) The economy is going to contract.
    (B) The economy is going to expand.
    (C) The U.S. dollar will weaken.

30. A firm with a corporate family rating (CFR) of A3/A- issues secured bonds. Covenants to these bonds include a limitation on liens and a change of control put. If credit rating agencies notch this issue, its credit rating is most likely to be:
    (A) Baa2/BBB.
    (B) Baal/BBB+.
    (C) A2/A.

31. For bonds of the same credit rating, compared to corporate bonds, the default rate for municipal bonds has historically been:
    (A) the same.
    (B) higher.
    (C) lower.

32. Bond X and Bond Y have the same par value, coupon, maturity, and credit rating, but Bond X trades at a higher price than Bond Y. A possible reason for this difference is that:
    (A) Bond Y is putable.
    (B) the market expects a downgrade to Bond Y's credit rating.
    (C) Bond X is callable.

33. Compared to corporate bonds with the same credit ratings, municipal general obligation (GO) bonds typically have less credit risk because:
    (A) default rates on GOs are typically lower for same credit ratings.
    (B) GOs are not affected by economic downturns.
    (C) governments can print money to repay debt.