Reading 64

CREDIT ANALYSIS FOR CORPORATE ISSUERS

1. (A) **¥759 billion.**

   Explanation

   FFO is defined as net income from continuing operations plus depreciation, amortization, deferred taxes, and other noncash items.

   FFO = ¥503 + ¥256 = ¥759 billion.

   (Module 64.1, LOS 64.b)

2. (C) **The issuer must pay taxes in full and on time.**

   Explanation

   Debt covenants of unsecured investment-grade issuers typically include affirmative (positive) covenants. Affirmative covenants prescribe what an issuer must do; for example, it must pay taxes, or must follow generally accepted accounting principles. By contrast, covenants of secured high-yield bonds typically state what the issuer cannot do; for example, it cannot issue new debt, pay dividends to shareholders, or enter into certain business agreements.

   (Module 64.1, LOS 64.a)

3. (B) **4.6x.**

   Explanation

   EBITDA = Operating income + depreciation + amortization

   Year 1: 262 + 201 = €463 billion

   Year 2: 361 + 212 = €573 billion

   Year 3: 503 + 256 = €759 billion

   Debt/EBITDA ratio:

   Year 1: 2,590 / 463 = 5.6x

   Year 2: 2,717 / 573 = 4.7x

   Year 3: 2,650 / 759 = 3.5x

   Three-year average = 4.6x.

   (Module 64.1, LOS 64.b)

4. (A) **lower than A+.**

   Explanation

   Credit ratings can be assigned both to an issuer's corporate family ratings and to specific bond issues. The corporate family rating is usually based on the issuer's senior unsecured bonds. Since BBD's A+ rated senior secured bonds have higher priority of claims than senior unsecured bonds, BBD's corporate family rating would most likely be rated below the senior secured bonds.

   (Module 64.1, LOS 64.c)

5. (A) **priority of claims only.**

Explanation

The manager is correct with respect to recovery rates. Recovery rates are the highest for debt with the highest priority of claims. The lower the seniority ranking, the lower the recovery rates and the higher the credit risk. The manager is incorrect with respect to bankruptcy proceedings. Courts will often deviate from the priority of claims and allow (larger) payments to lower priority debtholders as

well, in order to expedite an otherwise lengthy and uncertain bankruptcy process. **(Module 64.1, LOS 64.c)**

6. (B) **Senior subordinated.**

Explanation

The three bonds can be ranked by seniority ranking, with junior secured ranking most senior, followed by senior unsecured, and senior subordinated ranking least senior. Senior subordinated bonds have the lowest seniority of claim and the highest credit risk, therefore offering the highest yield among the three bonds.

(Module 64.1, LOS 64.c)

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7. (C) **issuer credit rating reflects the borrower's overall creditworthiness.**

Explanation

An issuer credit rating reflects the borrower's overall creditworthiness. Senior unsecured debt is usually the basis for an issuer credit rating. Notching of issue ratings can be upward or downward relative to an issuer credit rating.

(Module 64.1, LOS 64.c)

8. (B) **has a lower priority of claims to a subsidiary's cash flows than the subsidiary's debt.**

Explanation

Structural subordination means that cash flows from a subsidiary are used to pay the subsidiary's debt before they may be paid to the parent company to service its debt. As a result, parent company debt is effectively subordinate to the subsidiary's debt.

(Module 64.1, LOS 64.c)

9. (C) **subordinated.**

Explanation

Subordinated debt has a lower priority of claims than unsecured debt. Second lien is a form of secured debt, which has a higher priority of claims than unsecured debt. "Pari passu" refers to the equal priority of claims for different debt issues in the same category.

(Module 64.1, LOS 64.c)

10. (B) Miko's bonds are structurally subordinated to BluTech's bonds.

Explanation

Based on this scenario, BluTech's bondholders have priority of claims to its cash flows. As a result, Miko's bonds are effectively structurally subordinated to BluTech's bonds with respect to BluTech's cash flows. Therefore, the two bonds would not rank equally to each other (pari passu).

(Module 64.1, LOS 64.c)

11. (C) The issuer must not enter into transactions with certain affiliates.

Explanation

Covenants of secured high-yield bonds typically state what the issuer cannot do. It cannot issue new debt, pay dividends to shareholders, or enter into certain business agreements (e.g., entering into transactions with affiliates). The other covenants are examples of affirmative (positive) covenants, which prescribe what an issuer must do. Affirmative covenants are typically found in agreements between lenders and unsecured investment-grade issuers.

(Module 64.1, LOS 64.a)

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12. (A) A2/A.

Explanation

Both the priority of claims and the covenants suggest this issue has less credit risk than the issuer and therefore its issue credit rating may be notched upward. The issuer's credit rating (corporate family rating) is based on its senior unsecured debt. This issue is a secured bond, and therefore has a higher seniority ranking. A change of control put protects lenders by requiring the borrower to buy back its debt in the event of an acquisition. A limitation on liens limits the amount of secured debt that a borrower can carry. Both covenants reduce the credit risk of the issue.

(Module 64.1, LOS 64.a)

13. (A) Both POD and LGD.

Explanation

Unlike unsecured investment-grade bond investors who are mainly concerned with an increase in the POD, secured high-yield investors would be concerned with both the increase in POD and the increase in LGD.

(Module 64.1, LOS 64.a)

14. (B) The action may lead to a credit downgrade because it evidences preferential treatment of equity investors over debt investors.

Explanation

Investors want to ensure that a bond issuer (especially of high-yield bonds) does not disadvantage bondholders at the expense of shareholders (that is, the issuer does not show a preferential treatment of equity investors over debt investors). Issuing new bonds increases leverage and increases risk to existing bondholders. Using the proceeds for a share buyback would reduce shares outstanding and reduce dilution, benefitting existing shareholders. As a result, issuing high-yield bonds to finance a stock buyback program would be credit negative, potentially leading to a rating downgrade of the issuer.

(Module 64.1, LOS 64.a)

15. (C) Senior unsecured debt.

Explanation

All unsecured debt ranks in lower priority to any secured debt (including first lien, second lien, and junior secured debt).

(Module 64.1, LOS 64.c)

16. (A) debt-to-EBITDA ratio.

Explanation

An increase in net income is likely a result from increases in earnings before interest, taxes, depreciation and amortization (EBITDA) and operating income. An increase in net income is also likely to result in an increase in funds from operations (FFO). The only ratio listed that has earnings or operating cash flow in the denominator is the debt-to-EBITDA ratio. As the denominator increases, the ratio will decrease.

(Module 64.1, LOS 64.b)

17. (A) hybrid approach.

Explanation

The analyst is using a hybrid approach, which is a combination of the bottom-up approach (idiosyncratic factors relating to the issuer, like assets vs. liabilities and future cash flows) and the top-down approach (factors relating to the market, including market size, market share, and external shocks).

(Module 64.1, LOS 64.a)