

# Corporate Credit Analysis and Capital structuring

A disruptive business environment creates uncertainty, so what are the some of the factors to consider in reviewing companies' capital structure?

In a chart ( Figure 1.8) on valuations of Corporate Bonds in the IMF Global Financial Stability report\* comments were that.....

\*(<http://www.imf.org/en/Publications/GFSR/Issues/2018/04/02/Global-Financial-Stability-Report-April-2018>)

A still-high share of negative yield assets...

.....has supported demand for risky assets and compressed credit spreads.

This has spurred the new issuance of risky bonds in lower-credit quality buckets

Profitability has helped reduce debt ratios

As a result, interest coverage ratios have dipped, except for the United States and China

Highly levered firms are more likely to be impacted by the US Corporate tax reform

# So what are the questions and implications for corporate credit analysis?

Overall level of leverage

Understanding the true extent of a company's leverage

Interest rate exposure

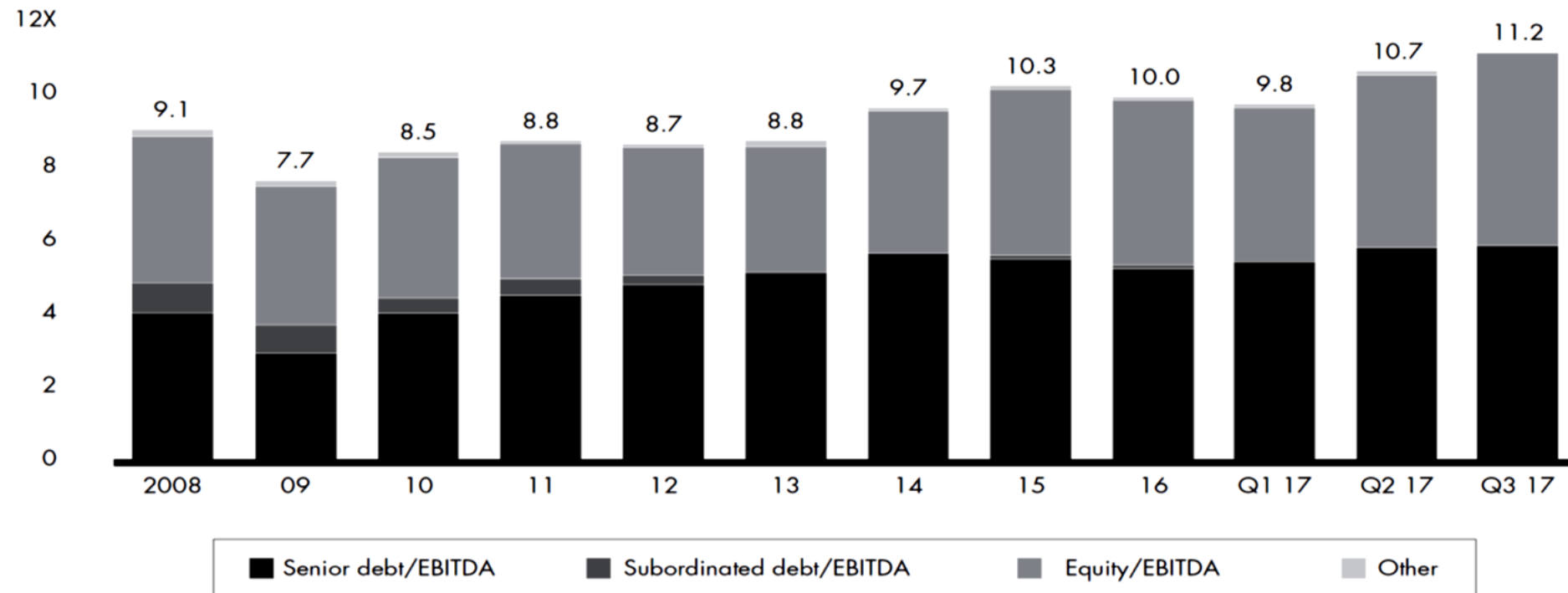
FX rate exposure

Credit pricing, financial covenants and structure of finance

# Point 1 - Leverage

In the chart below in the Bain and Company Global Private Equity Report 2018 it can be seen that purchase price multiples for US LBO transactions has been rising

Average EBITDA purchase price multiple for US LBO transactions

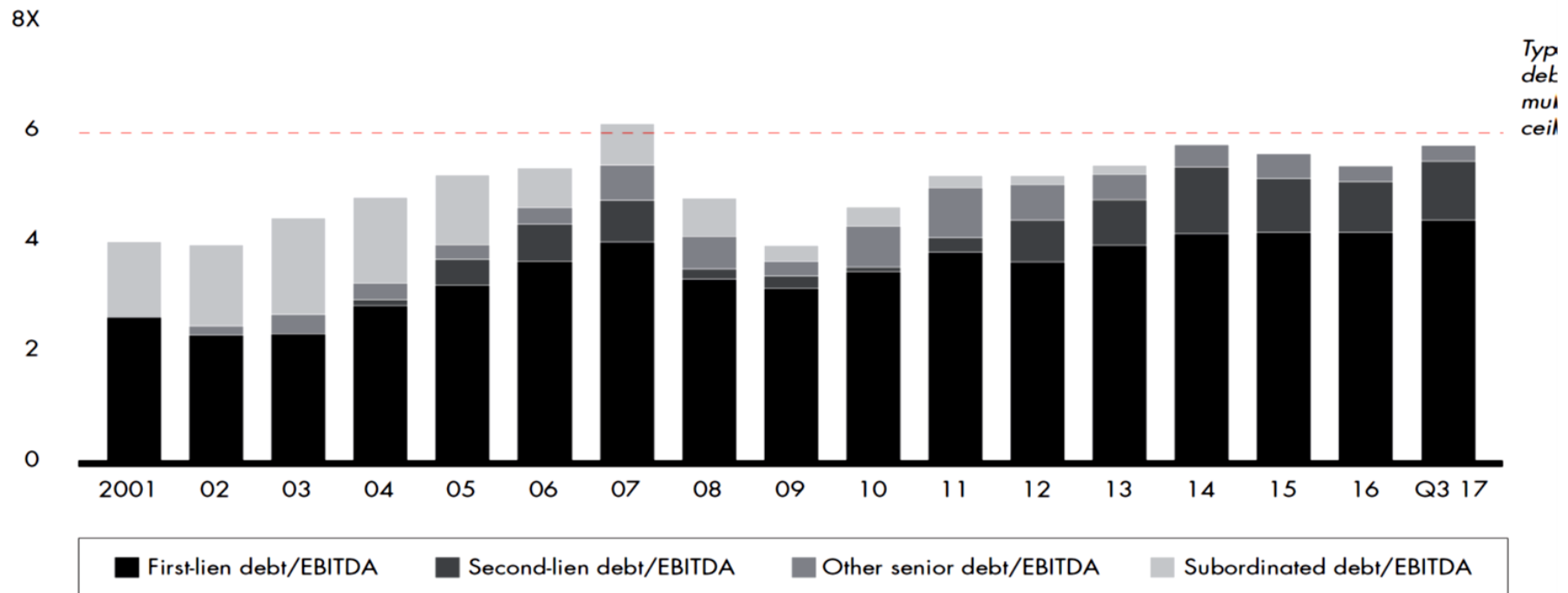


Source: S&P Capital IQ LCD

## Point 1: Leverage

Also in the chart below from the Bain and Company Global Private Equity Report 2018 it can be seen that leverage for large US LBO transactions has been rising

Average debt/EBITDA multiple for large US LBO transactions



Note: Large LBO transactions defined as issuers with EBITDA greater than \$50 million  
Source: S&P Capital IQ LCD

# Point 1: Leverage

Disruption creates uncertainty, so close attention needs to be given to access to finance

- Particularly for high growth companies or mature companies facing disruption how strong is their access to finance?
- Maturity structure of financial liabilities

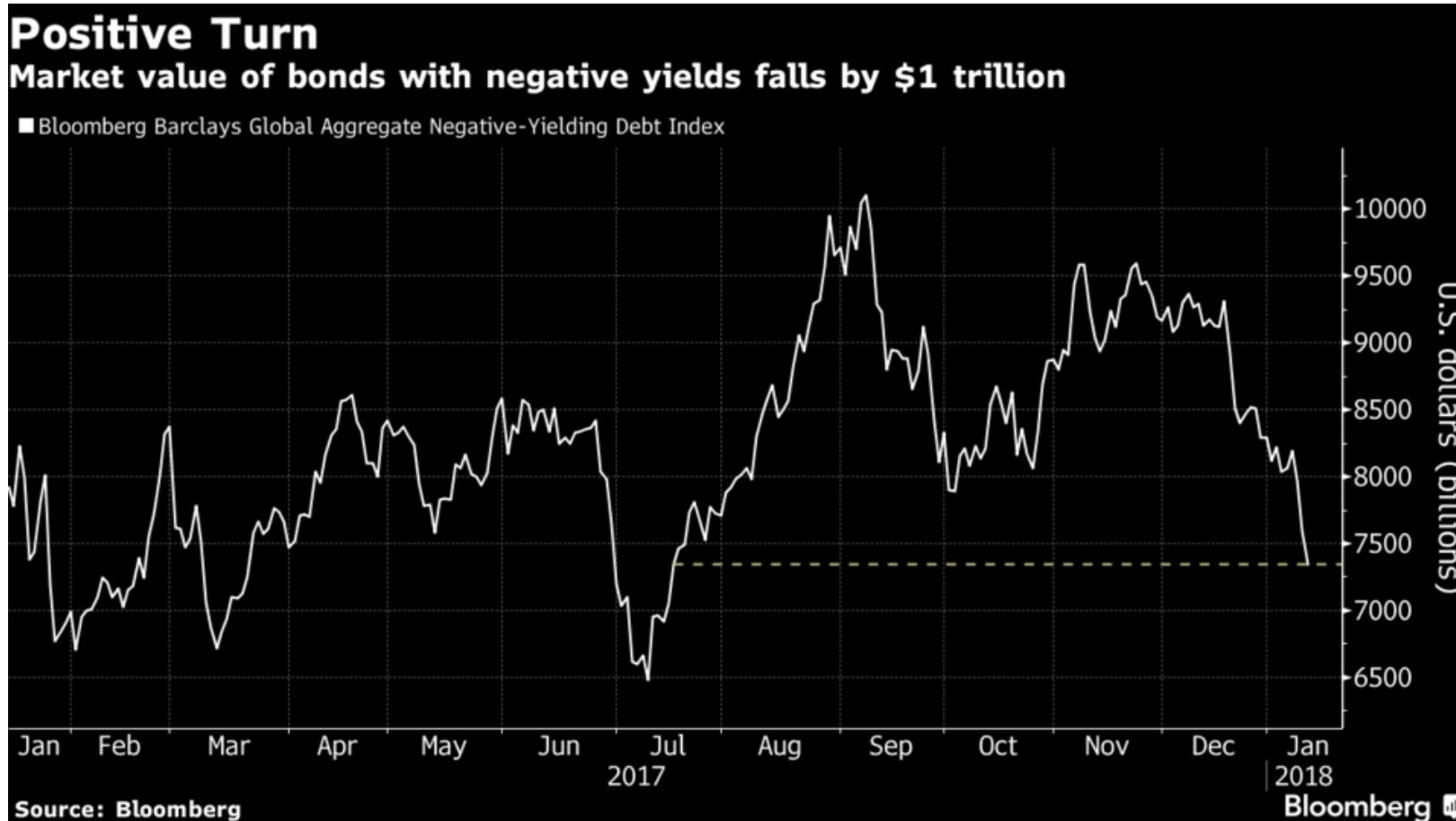
## Point 2: Understanding the true extent of a company's financial leverage

Financial analysis uses ratios

	Year	1	2	3	4	5	6	7
Debt / EBITDA		4.13	3.99	3.83	3.65	3.45	3.23	2.99
EBITDA / interest		4.41	4.56	4.74	4.98	5.27	5.62	6.08
cash before debt service / interest		1.98	2.07	2.18	2.31	2.47	2.66	2.89
Debt / equity		0.75	0.72	0.69	0.66	0.62	0.58	0.54
Cash before debt service / debt service		1.98	0.56	0.58	0.59	0.61	0.63	0.65

But.....are the company's financial liabilities fully reflected?—  
leases, pension liabilities, off balance sheet finance, guarantees

## Point 3: Interest rates have been at historically low levels but have since started to rise, so what will be the impact on companies?



## Point 4: How will the company be affected by FX fluctuations?



“...The airline reported pre-tax losses of £212m for the six months to the end of March, compared to an average Reuters analyst estimate of £195.75m. Some £82m of the company’s losses were down to a weaker pound and £45m were due to the timing of Easter, the company said....” Source: Article in the Independent, 16 May 2017





## **Points 3 and 4: What is the company's financial risk management policy**

Companies are faced with the impact of fx and interest rate exposures, both in terms of how it affects operating performance, as well as capital investment costs in addition to debt service.

At a time when interest rates in some major economies are starting to rise and when there have been significant fx movements in some major currencies in recent years , corporate credit analysis should attempt to assess companies use of derivatives to manage currency and interest rate exposures, or trading in currencies and other financial instruments that are unrelated to the company's core operating and investment activities

## Point 5: Is pricing reflecting risk?

One impact of the Global Financial Crisis is that pricing has become very competitive for companies that are considered to be financially strong.

In the desire to get higher yields , there are questions about whether pricing is reflecting risk

“One loose proxy for how starved investors are for yield is in the comparison between the riskiest European corporate bonds and the secure 10-year yield. According to Bank of America Merrill Lynch's Euro High Yield Index, the 10-year yielded just 4 basis points more than the benchmark Treasury note on Friday.... Source: Business Insider article October 13 2017 (<http://uk.businessinsider.com/bitcoin-not-biggest-bubble-negative-yielding-bonds-2017-10>)

## Point 5: Terms and conditions of finance



- Compliance with financial and other covenants and covenant headroom
- “Covenant-lite loans, an issuer-friendly feature that offers less protection for lenders and investors than traditionally structured credits, now account for a record 75% of the roughly \$970 billion in outstanding U.S leveraged loans, according to LCD....” \*
- Ranking of creditors?
  - Legal and structural subordination?

\*Source: <https://www.forbes.com/sites/spleverage/2018/02/08/covenant-lite-credits-continue-to-dominate-u-s-leveraged-loan-market/#4843074b4400>

# The Capital structure also has to be considered

Lowest Risk  
Lowest Cost  
Highest priority  
in  
Liquidation

Highest risk  
Highest cost  
Lowest priority in  
liquidation

Secured Debt ( Corporate and / or  
Structured Finance

Unsecured Debt, including hybrids

Subordinated Debt (e.g. Mezzanine  
Debt)

Preferred Equity

Common Equity

# What's next?

Sometimes companies financial difficulties, so the next presentation will be on warning signs.

I hope you found this presentation useful. I'd welcome your comments and suggestions and please feel free to contact me at [malcolm@m-training.co.uk](mailto:malcolm@m-training.co.uk)