

Credit 101

Credit Analysis (and why it's different from equities)

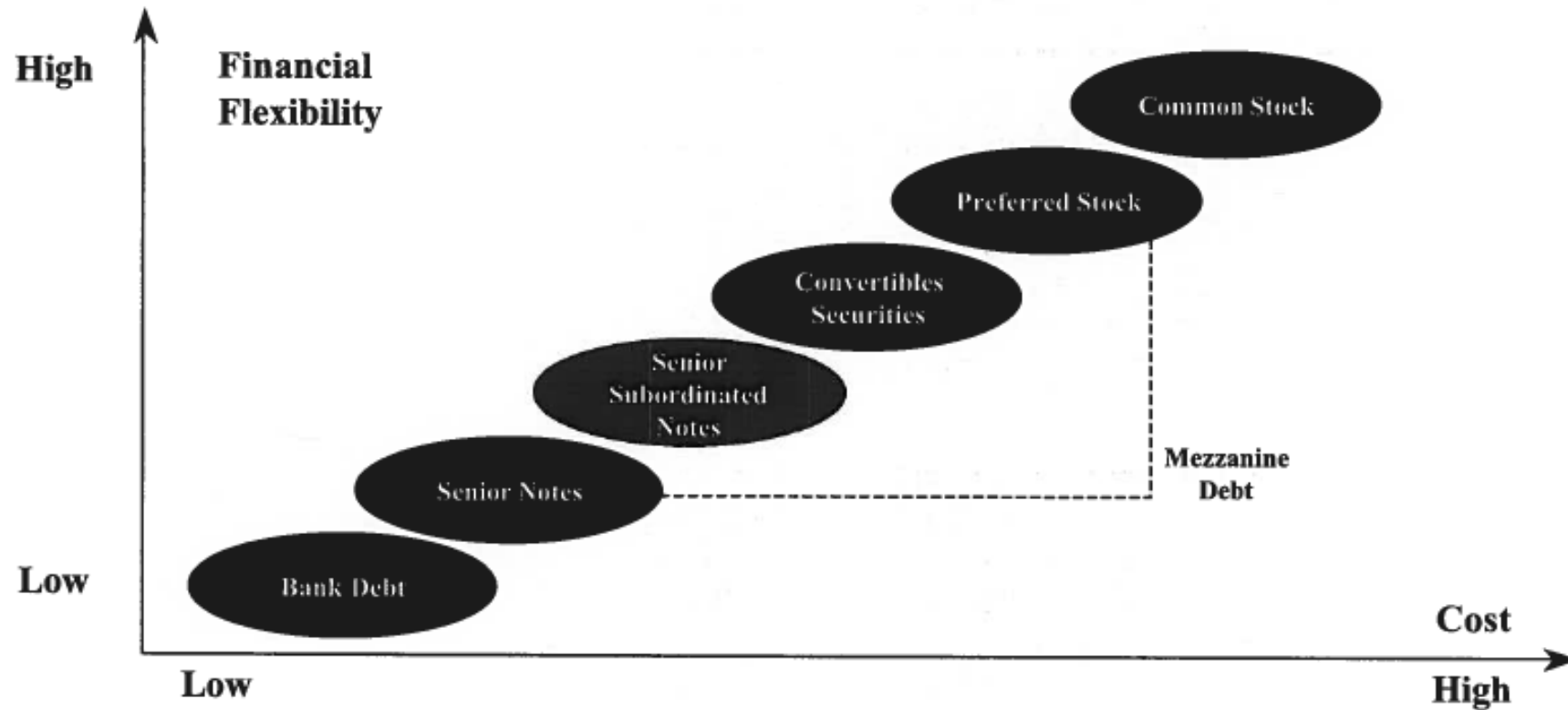
Brain teaser

Problem:

- A scientist puts a bacteria in a petri dish at exactly noon. Every minute, the bacteria divides into two. At exactly 1 pm, the petri dish is full. At what time was the dish half full?

Credit Overview – What is Credit?

- How do you finance a business? Why does this matter? What's a bond? What's a loan?



- How does a company think about which source of financing to use?

A Few Basics

Capital Structure and Seniority

Ranking of all Corporate Obligations by Security and Seniority

<u>Payment Priority</u>	<u>Ranking of Corporate Obligations</u>
Highest	Taxes Owed
	Senior Secured Debt
	Senior Unsecured Debt
	Senior Subordinated Debt ⁽¹⁾
	Subordinated Debt ⁽¹⁾
	Preferred Stock
	Common Stock
Lowest	

Trade Payables and Other Unsecured Claims

More Basics

Price – Yield Relationship, Spreads, Terminology

- How are bonds issued? How are they priced?
- What is “yield”? Why is that different from coupon?
- What’s the relationship between price and yield? Why?
- How do we compare yield? Required Return? Spreads? What does this all mean?
- How is debt paid down? What if you don’t have enough cash or liquidity on hand?

How do we measure credit quality?

Leverage Ratios, Interest Coverage, Projections...?

- Leverage Ratio – Net Debt / EBITDA
 - Is this really fair? Should we use something else? Why not Net Debt / Earnings?
- Interest Coverage Ratio – EBITDA / Interest Expense
 - Same questions as above... what else can we use that makes sense?
- How do we decide how much leverage a business can handle?
- What type of business would you want to lend to? An oil & gas exploration and production company or a movie theater?
 - A metals & mining company or Boeing?

Credit – A Different Perspective

How do you think differently about credit?

- What does a creditor care about a business having?? One word answer.
 - Cash!!!!
- How can things be good for an equity holder but bad for a creditor?
 - Buybacks / Dividends
 - Asset Sales
 - Sale / Leasebacks
 - More debt?
- How can we trade credit and express our view?

How does a creditor protect him / herself?

Always think about downside!

- Covenants!
 - What's a covenant?
 - What types of covenants are there?
 - Carve-outs??
 - Affirmative vs. Negative
 - Maintenance vs. Incurrence
- Where do we find covenants? (Aka what should you always read??)

Investment Grade vs. High Yield

And Distressed? Real money trading vs. Fast money

- What's the threshold?
 - S&P / Fitch?
 - Moody's?
- What's the difference between the two? Is a BBB- Bond really much more risky than a BB+ bond?
 - Does the market agree with you?
 - Why is there a dislocation?
- Keep in mind that there's a difference between High Yield and Distressed! A high yield bond will still probably be paid down.

Bankruptcy

When shit hits the fan.. Like for real

- What defines distressed? How long can companies avoid bankruptcy? How can you think about distressed credit investing?
- Can a good business have distressed credit? How is this possible?
- Two relevant types of individual bankruptcies open to the company – Ch. 7 and Ch. 11:
 - Chapter 7: Orderly liquidation
 - Chapter 11: Business Reorganization – Debt exchanges, new equity, preservation of business value, everyone is a winner and a loser (with seniority garnering the most protection)
 - Fulcrum security and its power

Credit Default Swaps

Derivatives ain't so scary!

- What are CDS? How do they work?
 - When would you want to trade CDS vs. bonds? Why?
 - Is there a difference between CDS spreads and bond spreads?
- Terminology / Market Quotes
- “Points up front” vs. spread quotes
- CDS Curve Interpretations – how does this differ from a bond yield curve?
- IG vs. HY CDS