Basics of Credit

Definition of Credit Research and Analysis

- Credit Research and Analysis
  - Research to assess the overall credit quality for Investments into its fixed income related instruments

- Fixed Income is an Investment that has an up-front capital Investment and pays interest on a regular basis

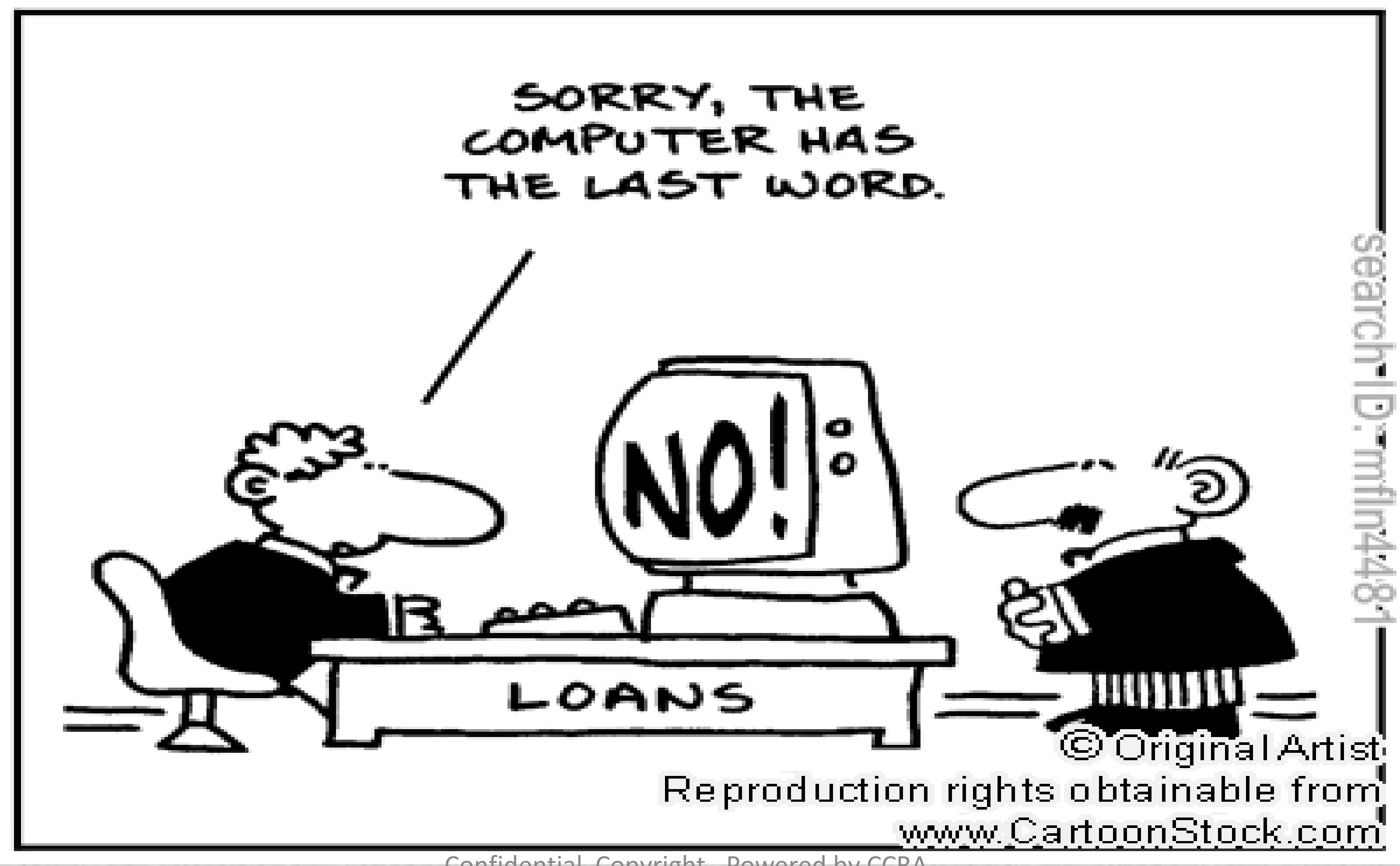
- Credit research, usually includes credit analysis, fixed income valuation, credit rating. Credit assessment, formulating credit strategy and credit enhancement

Use of Ratings…Input for decision making, not recommendation

"Frankly, your credit score concerns me."

When do you need credit rating?

Ratings : Art vs Science



Four C’s of Credit Analysis

Character

This refers to the ethical reputation, business qualifications and operating record of the directors, managers and executives responsible for borrowing and repaying the funds. It addresses the borrower's willingness to pay irrespective of ability. For many lenders, the borrower's character is the most important variable.

Moody's considers the following factors when assessing management quality:

- **Strategic direction**
- **Financial philosophy**
- **Conservatism**
- **Track record**
- **Succession planning**
- **Control systems**

NATIONAL INSTITUTE OF SECURITIES MARKETS
An Educational Initiative by SEBI

CERTIFIED CREDIT RESEARCH ANALYST

Association of International Wealth Management of India

Four C's of Credit Analysis

Capacity

This addresses the cash flows or the ability of the issuer to repay its financial obligation. Without sufficient capacity, it is unlikely that the lender will ever consider lending the borrower money unless there is sufficient net worth (i.e. other liquid assets) or high collateral in an asset that has liquidity and strong market value. The capacity, or ability to pay, reflects the funds flow from the organization and the generation of cash sufficient to meet the interest and principal repayments.

Four C's of Credit Analysis

Capacity

Moody's considers the following factors in assessing the ability of an issuer to pay:

- **Industry trends**: the vulnerability of the company to economic cycles, the barriers to entry, and the exposure of the company to technological changes.
- **The regulatory environment:** proposed changes in regulations are analyzed to assess their impact on future cash flows of firms in regulated industries.
- **Basic operating and competitive position**: diversification of the product line and the cost structure should be examined.
- **Financial position and sources of liquidity:** financial ratios should be examined to assess a company's financial position over the past three to five years. An analyst should also look at the capacity of a firm to obtain additional financing and back-up credit facilities.
- **Company structure** (including structural subordination and priority of claim)
- **Parent company support agreements:** if such a financial guarantee exists, the analyst must undertake a credit analysis of the parent company.
- **Special event risk**.

Four C's of Credit Analysis

Collateral

High quality collateral provides the lender an additional cushion against poor operating performance or management decisions. Assets which provide the best collateral include raw materials or other assets which trade in a commodity environment. By contrast, assets which have high obsolescence risk such as fashion or high technology equipment may provide very poor collateral or protection for a loan.

A debt obligation can be secured or unsecured. In theory, proceeds from a bankruptcy should be distributed to creditors based on the absolute priority rule. However, in the case of a reorganization, the absolute priority rule rarely holds and the final distribution depends on the bargaining ability of the parties involved. Therefore, some analysts place less emphasis on collateral compared to the other factors.

NATIONAL INSTITUTE OF SECURITIES MARKETS
An Educational Initiative by SEBI

CERTIFIED CREDIT RESEARCH ANALYST

Association of International Wealth Management of India

Four C's of Credit Analysis

Covenants

They deal with limitations and conditions on the borrower's activities and provide protections to the lender. They are important because they impose restrictions on how management operates the company and conducts its financial affairs in a variety of scenarios.

For example, there may be limitations on further indebtedness or limitations on liquidation of key assets without prior approval from the debt-holders. Other covenants may specify restrictions on the payment of dividends or describe situations in which the firm is technically in default.

- **Negative Covenants**
- **Affirmative Covenants**
- **Restrictive Covenants**
- **Financial Covenants**

Debt covenants

- Covenants protect creditors by restricting activities of the borrower.
  - Affirmative covenants
  - Negative covenants
- If a borrower violates a debt covenant, depending on the severity of the breach and the terms of the contract, lenders may
  - choose to waive the covenant,
  - be entitled to a penalty payment or higher interest rate,
  - renegotiate, or
  - call for immediate repayment of the debt.

NATIONAL INSTITUTE OF SECURITIES MARKETS
An Educational Initiative by SEBI

CERTIFIED CREDIT RESEARCH ANALYST

Association of International Wealth Management of India

Example 1. Industry and Company Analysis

1. Given a hotel company, a chemical company, and a consumer products company, which is *most likely* to be able to support a high debt load over an economic cycle?

A. The hotel company. People need a place to stay when they travel.
B. The chemical company. Chemicals are a key input to many products.
C. The consumer products company. Consumer products are recession-resistant.

2. Why do heavily-regulated monopoly companies such as utilities carry high debt loads?

A. Regulators require them to.
B. They generate strong and stable cash flows, enabling them to support high levels of debt.
C. They are not very profitable and need to borrow heavily to maintain their plant and equipment.

3. XYZ Corp. manufactures a commodity product in a highly competitive industry, with no company that has significant market share, and there are low barriers to entry. Which of the following *best* describes XYZ's ability to take on substantial debt?

A. Very limited. Companies in industries with those characteristics generally cannot support high debt loads.
B. Strong ability. Companies in industries with those characteristics generally have high margins and cash flows that can support significant debt.
C. We don't have enough information to answer the question.

- *Solution to 1*. C is correct. Consumer products companies are considered non-cyclical, while hotel and chemical companies are more cyclical, and thus more vulnerable to economic downturns.
-
- *Solution to 2*. B is correct. As regulated monopolies, they generate consistent cash flows and are therefore able to support high debt levels.
-
- *Solution to 3*. A is correct. Companies in industries with those characteristics typically have low margins and limited cash flow, and thus cannot support high debt levels.

Example 2. The Four C's

1. Which of the following would not be a bond covenant?

A. The issuer must file financial statements with the bond trustee on a timely basis.
B. The company can buy back as much stock as it likes.
C. If the company offers security to any creditors, it must offer security to this bond issue.

2. Why should credit analysts be concerned if a company's stock trades below book value?

A. It means the company is probably going bankrupt.
B. It means the company will probably incur lots of debt to buy back its undervalued stock.
C. It's a signal that the company's asset value on its balance sheet may be impaired and have to be written down, suggesting less collateral protection for creditors.

3. If management is of questionable character, how can investors incorporate this assessment into their credit analysis and investment decisions?

A. They can choose not to invest based on the increased credit risk.
B. They can insist on getting collateral (security) and/or demand a higher return.
C. They can choose not to invest or insist on additional security and/or higher return.

NATIONAL INSTITUTE OF SECURITIES MARKETS
An Educational Initiative by SEBI

CERTIFIED CREDIT RESEARCH ANALYST

Association of International Wealth Management of India

Example 2. The Four C's

Solution to 1. B is correct. Covenants describe what the borrower is 1) obligated to do; or 2) limited in doing. It's the absence of covenants that would permit a company to buy back as much stock as it likes. A requirement that the company offer security to this bond issue if it offers security to other creditors (answer C), is referred to as a "negative pledge."

Solution to 2. C is correct.

Solution to 3. C is correct. Investors can always say "no" if they cannot get comfortable with the credit risk presented by a bond or issuer. They may also decide to lend to a borrower with questionable character only on a secured basis and/or demand a higher return for the perceived higher risk.

Market Structure/size

- Bond markets (incl. IRD) - $600 TN (ISDA – Jan 15)
- Equity market size globally - ~$60 TN
- Mutual Fund Industry – 75% Debt AUM (~INR 20 TN)
- Insurance Industry – 80% Debt AUM ((~INR 40 TN))
- Globally equity is only about 10-20% of the total capital available while the debt remains 80-90%.

Market Players for Credit

- Credit Rating and Credit Information Agencies
- Banks/NBFC - Fixed income trading desks, Research – Retail and institutional Loans, Other Credit products
- Insurance – Life and Non life Debt Products , ALM
- Mutual Funds – Debt AUM Management
- Banks – Treasury dept. Buying and selling G-Sec
- Investment Banking, Loan Syndication, M&A Fund Raising
- KPO's – Tracking international Bond markets
- Big 4 Accounting Firms Due Diligence/Fin Tech Firms

NISM NATIONAL INSTITUTE OF SECURITIES MARKETS An Educational Initiative by SEBI

CCRA™ CERTIFIED CREDIT RESEARCH ANALYST

aiWM Association of International Wealth Management of India

CCRA Competitive Landscape – Select names

Source: logo's are taken from the respective company's website and are not for marketing purpose.

Recent Regulatory updates: +ve

- NSE/BSE Launched its Debt trading segment recently and trying to promote it, other key exchanges are planning as well
- SEBI recently mandated Corporate bond database for all bond issuances along with allowing FII's to invest in selected bond markets
- There are New AIF regulations allowing Debt Hedge funds to invest in Indian markets along with regulations for Infrastructure funds etc.
- RBI Announced/approved CDS Guidelines in 2012 and all regulators, including PFRDA, IRDA, SEBI etc. Allowed mutual funds to trade in the same
- RBI is actively changing competitive landscape for debt/debentures etc. with changing guidelines, rules
- 20+ corporates applied for banking license and that will open up banking jobs in 2014/beyond plus Nationalized banks are expanding, 11 payment banks approved, more to come..

NATIONAL INSTITUTE OF SECURITIES MARKETS
An Educational Initiative by SEBI

CERTIFIED CREDIT RESEARCH ANALYST

Association of International Wealth Management of India

Mandatory Capacity Building

- In reference to Reserve Bank of India's letter DBR.No.BP.BC.4/21.03.009/2016-17 dated August 11, 2016 addressed to all commercial banks and all Indian financial institutions, a high-level "Committee on Capacity Building" has been set up by RBI under the chairmanship of Shri G. Gopalakrishnan, **it has been recommended that the Banks should identify specialized areas for certification of the staff manning key responsibilities.**
- The Reserve Bank of India had requested IBA to identify in consultation with RBI, a list of courses and certification that will meet the certification requirements in Credit Management & Risk Management
- **The Certified Credit Research Analyst (CCRA) certification offered jointly by AIWMI and NISM has been recommended/Mandated by IBA in this regard as one of the premier most professional certification for Credit, Treasury and Risk Professionals.**
- **Existing Bankers in Credit needs to complete the certification by March 2018 and All new joiners need to have it from April 2018**

Role of a Credit Analyst

- Long Hours (less hours than Investment Banking)
- Life will revolve around companies
- A lot of phone time / meetings with clients, other banks, lawyers, & internal colleagues
- Credit analysis
  - Financial Statement Analysis / Modeling and Industry Studies
- Must know your clients better than the competition
  - Investor Calls / Presentations
  - Company press releases as well as reports in the media
  - 10-Ks, transcripts, sell-side research etc.,
- Broad product experience / limited understanding of each product
- Competitive / High Pressure Environment
  - Can be said about any position at a bank. Especially front office but also middle and back.

Certified Credit Research Analyst (CCRA^{TM}) Program

- Advanced international professional certification for credit research, strategy and ratings professional, developed by industry experts.
- Has Corporate acceptance and examination is conducted across 180 countries. Passing Score - 60% without negative marking.
- A program developed by highly qualified academics & practitioners; skillfully combines both theory & practice.

Queries

Follow our blog for free Webinars at
http://ccraprogram.wordpress.com

Thank You

Association of International Wealth Management India (AIWMI)

Level 9, Platina, G Block, Plot C-59, BKC, Mumbai-51

Email: info@aiwmindia.com ; Certifications@aiwmindia.com Web: www.aiwmindia.com