Robert S. Kricheff

A Pragmatist's Guide to Leveraged Finance

Credit Analysis for Bonds and Bank Debt

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*I would like to dedicate this book, with love,
to my wife and my parents, all of whom
I am blessed to have.*

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About the Author

Robert S. Kricheff is a Managing Director and Head of the Americas High Yield Sector Strategy for Credit Suisse. He has more than 20 years of experience doing credit analysis. In his career he has followed numerous industries, including media, cable, satellite, telecom, gaming, entertainment, healthcare, and energy. He has worked with emerging-market corporate debt as well as strategy and portfolio analysis. His work has covered investment vehicles including bonds, converts, loans, preferred stocks, and credit default swaps. He has a BA from New York University in economics and an MSc from the University of London SOAS in financial economics.

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Introduction

What's in this chapter:

- What the market is
- How companies become part of the leveraged finance market
- Unique aspects of leveraged finance credit analysis
- The two starting points of credit analysis

The high-yield leveraged bond and loan market is over $2.3 trillion in North America, about € 650 billion in Europe, and $600 billion in emerging markets—and it's still growing. Perhaps you want to manage money in this sector, sell, trade, work as a banker, be a credit analyst, work in capital markets or credit default swaps, or work as an advisor. Or maybe you work in the finance department of a company that issues this debt. Whatever the case, the basic skills of credit analysis are key to being able to operate effectively.

This skill set is also exceptionally valuable for those operating in the equity markets, especially if you ever have to focus on distressed or leveraged equities.

The market is unique. It has certain features of traditional investment-grade fixed income, but it also has the event-driven volatility typically associated with equities. Furthermore, it has structural features within the securities and among the participants that are unique to the leveraged market.

For these reasons, the analysis involved in evaluating these investments is unique. This book covers the major practical aspects of doing that analysis. It does not delve into theory. Instead, it focuses on how people in these markets work as they prepare and utilize leveraged finance credit analysis, using explanatory examples.

Although leveraged loans and bonds have been issued in several currencies, including U.S. dollars, Canadian dollars, British sterling, and euros, the issuers are still predominantly based in the U.S. But the Eurozone and emerging markets are growing quickly. This book primarily uses examples from the U.S. dollar markets.

The core of the market are bonds and loans issued by corporations that generally are rated below investment grade by the major rating agencies or sometimes are never rated at all. The market encompasses a wide spectrum of credit risk, from fairly stable BB-rated securities that are close to investment grade all the way down to those in bankruptcy.

The companies that make up this market join the market in a few ways. Some are known as "fallen angels." These companies were investment-grade debt issuers, but as operations weakened or some specific event occurred, they were downgraded and became part of the leveraged market. This happened to General Motors for a period of time. The existence of the leveraged finance market allows these fallen angels to still have access to public and private financing and gives first-time issuers the flexibility to finance growth projects.

Other companies issued debt that was initially rated below investment grade by the major agencies. Typically the funding was raised for expansion or acquisition that added leverage. Leveraged buyouts are another common way in which an issuer comes to the leveraged debt market. Usually this is where private equity firms or individual investors add debt to buy out a company. Sometimes developmental companies issue in the debt markets. These are fairly early-stage companies. This type of funding was key for the development of the cable and satellite television industries and the mobile telephone industry. Many of these companies got most of their early funding through the leveraged finance markets and probably would not have developed as quickly without financial innovations in this market. New casinos and oil refineries have also come to this market to be financed as start-ups. For many years, some of the stalwarts of the investment-grade market were part of the below-investment-grade market. These include issuers such as Comcast and Viacom.

A company's ability to access funding in the leveraged finance markets can be a key to survival and can lead to great growth and job creation. Many companies that have grown dramatically were greatly helped in this process by access to this source of debt financing:

- One company had $24 million in revenue and 225 employees when it first accessed the leveraged finance debt market to fund expansion. By the end of 2010 it had over $300 million in revenue and more than 800 full-time employees.
- Another company grew from about $100 million in revenue and 975 employees to $1.9 billion in revenue and 1,700 employees.
- Yet another company first accessed the high-yield market as a leveraged buyout with $1.2 billion in revenue. It grew 20% over 5 years and added about 900 employees.

All these companies accessed the leveraged debt markets multiple times as they grew their businesses.

Ever since Michael Milken and his team at Drexel Burnham Lambert helped the modern high-yield market evolve, it has been a place driven by innovation and events. Few companies in the high-yield market are stagnant or stable. Some produce steady improvements as they evolve toward investment grade, and others go through transitions, evolving through new ventures or acquisitions. Still others may be for sale or are looking to refinance to return capital to shareholders. Finally, some companies are struggling and may be slipping toward default and bankruptcy. It is unlikely that any below-investment-grade companies are in a state of equilibrium.

It is often said that for your analysis to be proven right when you buy a bond, you just need to wait to maturity, but for your analysis to be proven right when you buy a stock, you must convince others that you are right. This is true. Correct credit analysis in buying a bond will eventually reap the yield at which the bonds were bought, or sometimes greater if an early takeout occurs. When you buy a stock, the only way the price goes up is when more people become convinced that they should pay more for it than you just did.

In leveraged finance, if you buy a bond or loan and it goes along just fine and pays off at maturity, the return usually outperforms many other assets because of the high coupon. Because of this investment's ability to outperform just by fulfilling its obligations, a credit analyst in this market always looks to protect his downside in an investment and considers how things could go wrong. Therefore, when analyzing scenarios for a credit, a good analyst must take a cynical approach and constantly ask himself how he could get hurt. Additionally, in the interim between buying a bond/loan and its being retired, the prices can move about fairly wildly. So an analyst must keep in mind the investment time frame within which he is working.

When doing credit analysis, you must remember that the work that is being done is heading toward a conclusion. Your approach may vary depending on whether your goal is to decide to buy, sell, or hold a security or to underwrite a new financing.

Analyzing these companies and their credit quality is a dynamic process. The tools described in this book are just that—tools. No quantitative model can give a complete answer of whether a debt security for a company will default, or whether one loan will outperform another. The tools covered in this book are used every day and are valuable in determining a security's value. However, making a decision about a credit involves numerous subjective aspects. That's what makes it much more of an art than a science.

Leveraged finance credit analysis borrows tools that are typically associated with many other fields. Some of these tools come from traditional fixed income markets, as well as equity markets and probability and game theory. It is often said that the leveraged finance market has characteristics of both fixed income and equity. This fact is evident in the tools used to analyze credits in this market.

Credit analysis starts from two basic items:

- The first is financial liquidity. You want to analyze whether the company that is being looked at has liquidity from cash generated by operations or elsewhere, to pay the investors interest and principal over the life of the loan.
- The second item is asset protection. The asset value is key. If the liquidity is not there to repay the investor in the debt, the holder of the loan or bond must look to the value of the underlying asset from which it can be repaid. Almost all the other aspects of the credit analysis derive from these two fairly basic ideas.

This book spends a good amount of space on a few topics. Two chapters are on financial ratios and metrics, because these are often key determinants of credit quality and are strong tools to use when comparing the relative value of various investment options. A significant amount of space is also devoted to structural issues and the basics of bankruptcy analysis. Understanding these factors can be key in protecting your downside. Understanding these issues also is critical in explaining how various investments in the same capital structure should be valued relative to each other. One chapter gives examples of how you can use these tools to react to breaking news events, as analysts must do every day. Some concepts, such as spreads, floating-rate notes, and deferred pay coupons, are repeated in a few places in different ways, because new market participants often ask about them.

When you get to the chapters on ratio analysis, modeling, and structural issues, go online and find financial results for several companies. Read through them and try the analysis as shown in the examples in this book.

Keep in mind that nothing is a constant in the analysis of leveraged finance securities. Many examples in this book might seem to be followed by a contradiction. It is important for you to always be aware of exceptions to the norm. When doing credit analysis, remember that nothing is always true, and nothing is ever certain.

The volatility caused by companies in transition and the unique nature of almost every security in the market make leveraged finance credit analysis frustrating but also challenging and fun. But you cannot become complacent in this market. With that point in mind, I end this chapter with a great Oscar Wilde quote that is a good creed for anyone who wants to do leveraged finance credit analysis:

> To believe is very dull. To doubt is intensely engrossing. To be on the alert is to live; to be lulled into security is to die.

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