LM16 · FIXED INCOME · CFA LEVEL I

Credit Analysis for Corporate Issuers

Qualitative factors, key ratios (leverage, coverage, profitability), seniority rankings, recovery rates, and notching.

Learning Outcomes

LOS a Describe qualitative factors used in corporate credit analysis

LOS b Calculate and interpret key ratios used in corporate credit analysis

LOS c Describe seniority rankings, recovery rates, and the practice of notching

Exam Tip: Know: debt/EBITDA, EBITDA/interest, FFO/debt, RCF/net debt. First-lien > senior secured > senior unsecured > senior sub > sub. Structural subordination = parent bonds subordinated to subsidiary bonds.

LOS A · QUALITATIVE FACTORS

Qualitative Credit Factors

1. **Business model** — stable, predictable cash flows; resilience to long-term changes.
2. **Industry competition** — less intensive competition is favorable for credit quality.
3. **Business risk** — risk of unexpected deviations from forecast revenues and margins.
4. **Corporate governance** — fair treatment of debtholders, watch for aggressive accounting, dilutive debt issuance, or preferential treatment of equity investors.

LOS B · CREDIT RATIOS

Key Credit Ratios

Profitability & Coverage

$$\mathrm{EBIT}/Interestexpense\mathrm{EBITDA}/InterestexpenseFFO(fundsfromoperations)/Debt$$

Leverage

$$Debt/\mathrm{EBITDA}Debt/CapitalFFO/NetdebtRCF(retainedcashflow)/Netdebt$$

- **EBITDA** = operating income + D&A. Drawback: ignores CapEx and WC changes.
- **FFO** = net income from continuing operations + D&A + deferred taxes + non-cash items. Similar to CFO but excludes WC changes.
- **RCF** = operating cash flow – dividends.
- **Net debt** = total debt – available cash.

Higher Debt/EBITDA → more leverage → higher credit risk. Higher RCF/Net debt → lower leverage → lower credit risk. Compare ratios to industry average and credit-rating peers.

CHECKPOINT 1

Quiz 1: Qualitative & Ratios

Answer all questions to test your understanding. Your score updates on the final step.

Q1. “EBITDA / Interest expense” is *best* described as a:

Q2. “RCF / Net debt” focuses on:

Q3. A drawback of EBITDA as a credit measure is that it:

Q4. Qualitative corporate credit analysis focuses on:

Q5. Which ratio is *least* useful for gauging a company’s ability to service debt?

LOS C · SENIORITY RANKINGS & RECOVERY

Seniority Rankings (Priority of Claims)

1. **First lien / mortgage** (specific asset or property pledged).
2. **Senior secured** (“second lien”).
3. **Junior secured**.
4. **Senior unsecured**.
5. **Senior subordinated**.
6. **Subordinated**.
7. **Junior subordinated**.

All debt within the same category ranks **pari passu**. Senior secured has the highest recovery rate; junior subordinated the lowest. Secured debt is backed by specific collateral (first lien / mortgage); unsecured debt has a general claim on the issuer’s assets.

LOS C · NOTCHING AND STRUCTURAL SUBORDINATION

Notching and Structural Subordination

Notching

Rating agencies assign different ratings to bonds of the **same issuer** based on seniority. For example, senior secured may be rated higher than senior unsecured of the same issuer.

Issuer (corporate family) rating is based on senior-unsecured debt. *Issue (corporate credit) ratings* can be notched up or down.

Structural subordination

In a holding-company structure, a subsidiary’s covenants can prevent cash transfers to the parent until the subsidiary’s debt is serviced. Parent-level bonds are therefore **structurally subordinated** to the subsidiary’s bonds — and notched accordingly.

CHECKPOINT 2

Quiz 2: Seniority & Notching

Answer all questions to test your understanding. Your score updates on the final step.

Q6. The *highest* seniority rank in a typical capital structure is:

Q7. Two bonds of the same issuer have different ratings. This practice is called:

Q8. In a holding-company structure, parent-level bonds are *most likely*:

Q9. All bonds within the same seniority class rank:

Q10. The corporate family rating from a rating agency refers to:

LOS B · SPREAD-DURATION MATH

Impact of Spread Changes on Bond Price

We can reuse the duration-convexity framework with *spread change* in place of yield change:

EXAMPLE **Spread widens by 50 bp**

GIVEN

EffSpreadDur = 6.25, EffSpreadCon = 48, Δspread = +50 bp = +0.005.

SOLUTION

CHECKPOINT 3 · SYNTHESIS

Quiz 3: Synthesis

Answer all questions to test your understanding. Your score updates on the final step.

Q11. A 50 bp widening in the credit spread with EffSpreadDur = 6.25 and EffSpreadCon = 48 produces a price change of *closest* to:

Q12. Which ratio is *most* focused on cash flow rather than accounting earnings?

Q13. Recovery rate in a default is *highest* for:

Q14. Compared with analyzing GO muni bonds, corporate credit analysis *most likely*:

Q15. In a holding-company structure, structural subordination is a concern because:

MODULE COMPLETE

Your Scorecard

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LM16 Key Takeaways — Exam-Ready Cheat Sheet

Qualitative (4)

Business model · industry competition · business risk · corporate governance.

Key ratios

Coverage: EBITDA/Interest, EBIT/Interest. **Leverage:** Debt/EBITDA, FFO/Debt, RCF/Net debt.

Seniority

First lien → senior secured → junior secured → senior unsecured → senior sub → sub → jr sub. Pari passu within each class.

Notching & structural subordination

Issuer rating = senior unsecured. Issues can be notched. Parent-level bonds are structurally subordinated to subsidiary bonds.

Step 1 of 10