Reading 55: Fundamentals of Credit Analysis

Question #1 of 39

Question ID: 415687

The "four Cs" of credit analysis include:

A) collateral and capital.

B) circumstances and covenants.

C) capacity and character.

Question #2 of 39

Question ID: 460707

Structural subordination is *most likely* to be a credit rating consideration for:

A) high-yield corporate bonds.

B) emerging market sovereign bonds.

C) general obligation municipal bonds.

Question #3 of 39

Question ID: 415677

The type of credit risk that is defined as the possibility that a borrower will fail to pay interest or repay principal when due is:

A) default risk.

B) credit spread risk.

C) downgrade risk.

Question #4 of 39

Question ID: 415676

Expected loss is greatest for a corporate bond with a low:

A) recovery rate and a high probability of default.

B) loss severity and a high probability of default.

C) recovery rate and a low probability of default.

Question #5 of 39

Question ID: 415693

Which of the following is the most appropriate strategy for a fixed income portfolio manager under the anticipation of an economic expansion?

A) Purchase corporate bonds and sell Treasury bonds.

B) Sell corporate bonds and purchase Treasury bonds.

C) Sell lower-rated corporate bonds and buy higher-rated corporate bonds.

Question #6 of 39

Question ID: 485814

The factors that must be considered when estimating the credit risk of a bond include:

A) the bond rating, the recovery rate, and the yield volatility.

B) only the bond rating.

C) only the bond rating and the recovery rate.

Question #7 of 39

Question ID: 415685

Bond investors should not rely exclusively on credit agency ratings because:

A) market pricing tends to lag changes in credit ratings.

B) credit ratings may change over time.

C) default rates are higher for lower-rated bonds.

Question #8 of 39

Question ID: 415686

Bond X and Bond Y have the same par value, coupon, maturity, and credit rating, but Bond X trades at a higher price than Bond Y. A possible reason for this difference is that:

A) Bond Y has a higher expected recovery rate in a default.

B) the market expects a downgrade to Bond Y's credit rating.

C) Bond X has a higher expected loss in a default.

Question #9 of 39

Question ID: 415695

If a U.S. investor is forecasting that the yield spread between U.S. Treasury bonds and U.S. corporate bonds is going to widen, then which of the following is most likely to be CORRECT?

A) The economy is going to contract.

B) The U.S. dollar will weaken.

C) The economy is going to expand.

Question #10 of 39

Question ID: 696231

Jequa is a Japanese company with the following selected financial information:

	¥ billions
Net income from continuing operations	503
Depreciation & amortization	256
Capital expenditures	140
Cash flow from operations	361
Dividends	72

Jequa's funds from operations (FFO) is *closest to*:

A) ¥759 billion.
B) ¥149 billion.
C) ¥247 billion.

Question #11 of 39

Question ID: 434427

Analysis of a firm's intellectual capital, equity market capitalization, depreciation, and intangible assets is associated with which aspect of credit analysis?

A) Collateral.
B) Capacity.
C) Covenants.

Question #12 of 39

Question ID: 415683

Structural subordination means that a parent company's debt:

A) has a higher priority of claims to a subsidiary's cash flows than the subsidiary's debt.
B) ranks pari passu with a subsidiary's debt with respect to the subsidiary's cash flows.
C) has a lower priority of claims to a subsidiary's cash flows than the subsidiary's debt.

Question #13 of 39

Question ID: 415680

Recovery rates are greatest for classes of debt with the highest:

A) priority of claims.
B) default rates.
C) loss severity.

Question #14 of 39

Question ID: 485815

Which of the following *best* describes risks in relying on credit agency ratings?

A) Credit ratings are assigned only at issuance.
B) Event risk is difficult for rating agencies to assess.
C) Credit ratings tend to lead market prices.

Question #15 of 39

Question ID: 485816

Which component of traditional credit analysis includes evaluation of industry structure, industry fundamentals, and company fundamentals?

A) Capacity.
B) Collateral.
C) Covenants.

Question #16 of 39

Question ID: 415692

When calculating credit ratios, an analyst should increase a company's reported total debt if the company has:

A) a net pension asset on its balance sheet.
B) operating lease obligations.
C) a debt guarantee from a parent or third party.

Question #17 of 39

Question ID: 415689

An increase in net income is *most likely* to decrease a borrower's:

A) debt-to-EBITDA ratio.
B) FFO-to-debt ratio.
C) operating margin.

Question #18 of 39

Question ID: 415697

What is the *most likely* effect on yield spreads when demand for bonds is high and supply of bonds is low?

A) Yield spreads are likely to widen.
B) The effect on yield spreads will depend on whether supply or demand is the stronger influence.

C) Yield spreads are likely to narrow.

Question #19 of 39

Question ID: 415691

Becque Ltd. is a European Union company with the following selected financial information:

€ billions	Year 1	Year 2	Year 3
Operating income	262	361	503
Depreciation & amortization	201	212	256
Capital expenditures	78	97	140
Cash flow from operations	303	466	361
Total debt	2,590	2,717	2,650
Dividends	70	70	72

Becque's three-year average debt-to-EBITDA ratio is *closest to*:

A) 4.6x.

B) 3.6x.

C) 7.6x.

Question #20 of 39

Question ID: 415704

Support for revenue bonds comes from:

A) the full faith and credit of the issuing municipality.

B) property taxes based on the project.

C) income generated by the underlying project.

Question #21 of 39

Question ID: 415696

Which of the following is the reason why credit spreads between high quality bonds and low quality bonds widen during poor economic conditions?

A) indenture provisions.

B) interest risk.

C) default risk.

Question #22 of 39

Question ID: 415679

Senior subordinated bonds have a priority of claims over:

A) subordinated bonds.

B) secured bonds.

C) first lien debt.

Question #23 of 39

Question ID: 415702

Which of the following statements about municipal bonds is *least* accurate?

A) A municipal bond guarantee is a form of insurance provided by a third party other than the issuer.

B) Revenue bonds have lower yields than general obligation bonds because there are more revenue bands and they have higher liquidity.

C) Bonds with municipal bond guarantees are more liquid in the secondary market and generally have lower required yields.

Question #24 of 39

Question ID: 434426

Which of the following bonds from the same corporate issuer has the lowest priority of claims?

A) Senior unsecured debenture.

B) Collateral trust bond.

C) Equipment trust certificate.

Question #25 of 39

Question ID: 415707

Compared to corporate bonds with the same credit ratings, municipal general obligation (GO) bonds typically have less credit risk because:

A) GOs are not affected by economic downturns.

B) governments can print money to repay debt.

C) default rates on GOs are typically lower for same credit ratings.

Question #26 of 39

Question ID: 599005

The risk that a bond issuer will fail to make an interest or principal payment when due is *most accurately* described as:

A) default probability.

B) credit risk.

C) expected loss.

Question #27 of 39

Question ID: 415682

One notable difference between an issuer credit rating and an issue credit rating is that an:

A) issue credit rating is always notched below the issuer rating.

B) issue credit rating applies to the issuer's senior unsecured debt.

C) issuer credit rating reflects the borrower's overall creditworthiness.

Question #28 of 39

Question ID: 415705

A restricted payment covenant in a high yield bond indenture protects lenders by:

A) requiring the borrower to buy back its debt if the company is sold.

B) making a parent company's debt rank pari passu with a subsidiary's debt.

C) limiting the amount of cash paid to equity holders.

Question #29 of 39

Question ID: 415706

In a sovereign debt credit rating, a country's foreign reserves, its external debt, and the status of its currency in foreign exchange markets are key factors for evaluating the country's:

A) monetary flexibility.

B) fiscal flexibility.

C) international investment position.

Question #30 of 39

Question ID: 415703

Consider three municipal bonds issued by the Greater Holmen Metropolitan Capital Improvement District, a local authority that carries an issuer rating of single-A from the major debt rating agencies. All three bonds have the same coupon rate and maturity date.

- Series W was issued to finance the rebuilding and expansion of local schools and is backed by the District's authority to levy property tax.
- Series X was issued to build a water purification plant for the region. The District charges fees to the surrounding municipalities for their use of the plant. These fees are the only source of the interest and principal payments on the bonds.
- Series Y was issued to raise funds for the general use of the District in its ordinary maintenance projects and is backed by the District's authority to levy property tax. These bonds carry a third party guarantee of principal and interest payments.

What is *most likely* the order of the market yields on these three bond issues, from highest to lowest?

A) Series Y, Series W, Series X.

B) Series X, Series W, Series Y.

C) Series X, Series Y, Series W.

Question #31 of 39

Question ID: 415678

A non-callable bond with 18 years remaining maturity has an annual coupon of 7% and a $1,000 par value. The current yield to maturity on the bond is 8%. Using a 50bp change in YTM, the approximate modified duration of the bond is:

A) 9.63.

B) 8.24.

C) 11.89.

Question #32 of 39

Question ID: 415698

Yield spreads tend to widen when equity market performance is:

A) strong.

B) weak.

C) stable.

Question #33 of 39

Question ID: 604670

Loss severity is *most accurately* defined as the:

A) amount a bondholder will lose if the issuer defaults.

B) probability that a bond issuer will default.

C) percentage of a bond's value a bondholder will receive if the issuer defaults.

Question #34 of 39

Question ID: 434425

The risk of receiving less than market value when selling a bond is referred to as:

A) loss severity risk.

B) market liquidity risk.

C) recovery rate risk.

Question #35 of 39

Question ID: 492025

Steven Company has EBITDA/interest and debt-to-capital ratios that are both higher compared to Joseph Company to a degree consistent with one level of issuer credit rating. Based only on this information, the credit rating of Steven is *most likely* to be:

A) higher than Joseph.

B) the same as Joseph.

C) lower than Joseph.

Question #36 of 39

Question ID: 415694

If investors expect greater uncertainty in the bond markets, yield spreads between AAA and B rated bonds are *most likely* to:

A) slope downward.

B) widen.

C) narrow.

Question #37 of 39

Question ID: 415688

Fraud and malfeasance, soundness of strategy, and prior treatment of bondholders are criteria to evaluate a borrower's:

A) capacity.

B) covenants.

C) character.

Question #38 of 39

Question ID: 415684

A firm with a corporate family rating (CFR) of A3/A- issues secured bonds. Covenants to these bonds include a limitation on liens and a change of control put. If credit rating agencies notch this issue, its credit rating is *most likely* to be:

A) Baa1/BBB+.

B) A2/A.

C) Baa2/BBB.

Question #39 of 39

Question ID: 415681

Debt with a lower priority of claims than a firm's unsecured debt is *best* described as:

A) second lien.

B) pari passu.

C) subordinated.