Question #1 of 17

Question ID: 1574400

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) ¥247 billion.

C) ¥149 billion.

Explanation

FFO is defined as net income from continuing operations plus depreciation, amortization, deferred taxes, and other noncash items.

FFO = ¥503 + ¥256 = ¥759 billion.

(Module 64.1, LOS 64.b)

Question #2 of 17

Question ID: 1577402

Which of the following covenants would the issuer of unsecured investment-grade bonds *most likely* have in their bond indenture?

A) The issuer cannot issue additional classes of debt.

B) The issuer must not declare/pay dividends to shareholders.

C) The issuer must pay taxes in full and on time.

Explanation

Debt covenants of unsecured investment-grade issuers typically include affirmative (positive) covenants. Affirmative covenants prescribe what an issuer *must* do; for example, it must pay taxes, or must follow generally accepted accounting principles. By contrast, covenants of secured high-yield bonds typically state what the issuer *cannot* do; for example, it cannot issue new debt, pay dividends to shareholders, or enter into certain business agreements.

(Module 64.1, LOS 64.a)

Question #3 of 17

Question ID: 1574401

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) 3.6x.

B) 4.6x.

C) 7.6x.

Explanation

EBITDA = Operating income + depreciation + amortization

Year 1: 262 + 201 = €463 billion

Year 2: 361 + 212 = €573 billion

Year 3: 503 + 256 = €759 billion

Debt/EBITDA ratio:

Year 1: 2,590 / 463 = 5.6x

Year 2: 2,717 / 573 = 4.7x

Year 3: 2,650 / 759 = 3.5x

Three-year average = 4.6x.

(Module 64.1, LOS 64.b)

Question #4 of 17

Question ID: 1577408

Derek Steele is a corporate credit analyst at a credit rating agency. He currently rates the 2043 maturity senior secured bonds of BBD Enterprises at A+. BBD has now requested a corporate family rating as well. The *most likely* rating that Steele would recommend in a rating committee for the corporate family rating is:

A) lower than A+. ✓

B) higher than A+. ✗

C) A+. ✗

Explanation

Credit ratings can be assigned both to an issuer's corporate family ratings and to specific bond issues. The corporate family rating is usually based on the issuer's senior unsecured bonds. Since BBD's A+ rated senior secured bonds have higher priority of claims than senior unsecured bonds, BBD's corporate family rating would most likely be rated *below* the senior secured bonds.

(Module 64.1, LOS 64.c)

Question #5 of 17

Question ID: 1577410

A portfolio manager notes to a colleague that recovery rates are the highest for debt with the highest priority of claims. She further notes that during bankruptcy proceedings, courts strictly observe the priority of claims to ensure fairness across different classes of creditors. The manager is correct with respect to:

A) priority of claims only.

B) bankruptcy proceedings only.

C) both priority of claims and bankruptcy proceedings.

Explanation

The manager is correct with respect to recovery rates. Recovery rates are the highest for debt with the highest priority of claims. The lower the seniority ranking, the lower the recovery rates and the higher the credit risk.

The manager is incorrect with respect to bankruptcy proceedings. Courts will often deviate from the priority of claims and allow (larger) payments to lower priority debtholders as well, in order to expedite an otherwise lengthy and uncertain bankruptcy process.

(Module 64.1, LOS 64.c)

Question #6 of 17

Question ID: 1577407

Colleen Hock is a buy-side investor. She is looking to add a new bond to a bond portfolio to enhance yield. Which of the following corporate bonds would offer her the highest yield?

A) Junior secured.

B) Senior subordinated.

C) Senior unsecured.

Explanation

The three bonds can be ranked by seniority ranking, with junior secured ranking most senior, followed by senior unsecured, and senior subordinated ranking least senior. Senior subordinated bonds have the lowest seniority of claim and the highest credit risk, therefore offering the highest yield among the three bonds.

(Module 64.1, LOS 64.c)

Question #7 of 17

Question ID: 1576509

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

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

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

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

Explanation

An issuer credit rating reflects the borrower's overall creditworthiness. Senior unsecured debt is usually the basis for an issuer credit rating. Notching of issue ratings can be upward or downward relative to an issuer credit rating.

(Module 64.1, LOS 64.c)

Question #8 of 17

Question ID: 1576510

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) has a lower priority of claims to a subsidiary's cash flows than the subsidiary's debt.

C) ranks pari passu with a subsidiary's debt with respect to the subsidiary's cash flows.

Explanation

Structural subordination means that cash flows from a subsidiary are used to pay the subsidiary's debt before they may be paid to the parent company to service its debt. As a result, parent company debt is effectively subordinate to the subsidiary's debt.

(Module 64.1, LOS 64.c)

Question #9 of 17

Question ID: 1576508

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.

Explanation

Subordinated debt has a lower priority of claims than unsecured debt. Second lien is a form of secured debt, which has a higher priority of claims than unsecured debt. "Pari passu" refers to the equal priority of claims for different debt issues in the same category.

(Module 64.1, LOS 64.c)

Question #10 of 17

Question ID: 1577409

Miko Corp. (Miko) is an electronics manufacturer which frequently issues senior unsecured bonds. Miko's largest subsidiary, BluTech Inc. (BluTech), also issues senior unsecured bonds. BluTech's debt covenants prohibit transferring cash to the parent before BluTech's debt obligations are satisfied. Based on this scenario:

A) Miko's and BluTech's bonds would rank pari passu given that the two entities are related, regardless of the restriction. ✗

B) Miko's bonds are structurally subordinated to BluTech's bonds. ✓

C) BluTech's bonds are structurally subordinated to Miko's bonds. ✗

Explanation

Based on this scenario, BluTech's bondholders have priority of claims to its cash flows. As a result, Miko's bonds are effectively structurally subordinated to BluTech's bonds with respect to BluTech's cash flows. Therefore, the two bonds would not rank equally to each other (pari passu).

(Module 64.1, LOS 64.c)

Question #11 of 17

Question ID: 1577403

A bond agreement between a lender and the issuer of secured high-yield bonds would *most likely* include which of the following covenants types?

A) The issuer must pay all taxes on time. ✗

B) The issuer must maintain compliance with certain financial ratios. ✗

C) The issuer must not enter into transactions with certain affiliates. ✓

Explanation

Covenants of secured high-yield bonds typically state what the issuer *cannot* do. It cannot issue new debt, pay dividends to shareholders, or enter into certain business agreements (e.g., entering into transactions with affiliates).

The other covenants are examples of affirmative (positive) covenants, which prescribe what an issuer *must* do. Affirmative covenants are typically found in agreements between lenders and unsecured investment-grade issuers.

(Module 64.1, LOS 64.a)

Question #12 of 17

Question ID: 1576507

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) A2/A. ✓

B) Baa1/BBB+. ✗

C) Baa2/BBB. ✗

Explanation

Both the priority of claims and the covenants suggest this issue has less credit risk than the issuer and therefore its issue credit rating may be notched upward. The issuer's credit rating (corporate family rating) is based on its senior unsecured debt. This issue is a secured bond, and therefore has a higher seniority ranking. A change of control put protects lenders by requiring the borrower to buy back its debt in the event of an acquisition. A limitation on liens limits the amount of secured debt that a borrower can carry. Both covenants reduce the credit risk of the issue.

(Module 64.1, LOS 64.a)

Question #13 of 17

Question ID: 1577401

Davis Corp. recently issued secured high-yield bonds. With respect to increases in the probability of default (POD) and loss given default (LGD), bondholders of this bond would *most likely* be concerned with:

A) Both POD and LGD. ✓

B) POD but not LGD. ✗

C) LGD but not POD. ✗

Explanation

Unlike unsecured investment-grade bond investors who are mainly concerned with an increase in the POD, secured high-yield investors would be concerned with both the increase in POD and the increase in LGD.

(Module 64.1, LOS 64.a)

Question #14 of 17

Question ID: 1577404

The management of HHB Corporation (HHB) recently approved issuing $200 million in high-yield bonds to finance its stock buyback program. What is the *most likely* credit implication as a result of management's actions?

A) Because shareholders have lower seniority than bondholders, the action would have no credit implications on bondholders.

B) The action may lead to a credit downgrade because it evidences preferential treatment of equity investors over debt investors.

C) The action would be considered credit positive because it raises new funds while avoiding share ownership dilution.

Explanation

Investors want to ensure that a bond issuer (especially of high-yield bonds) does not disadvantage bondholders at the expense of shareholders (that is, the issuer does not show a preferential treatment of equity investors over debt investors). Issuing new bonds increases leverage and increases risk to existing bondholders. Using the proceeds for a share buyback would reduce shares outstanding and reduce dilution, benefitting existing shareholders. As a result, issuing high-yield bonds to finance a stock buyback program would be credit negative, potentially leading to a rating downgrade of the issuer.

(Module 64.1, LOS 64.a)

Question #15 of 17

Question ID: 1577406

Assuming all bonds are issued by the same issuer, which bond would have the lowest priority of debt repayment?

A) Junior secured debt.

B) Second lien debt.

C) Senior unsecured debt.

Explanation

All unsecured debt ranks in lower priority to any secured debt (including first lien, second lien, and junior secured debt).

(Module 64.1, LOS 64.c)

Question #16 of 17

Question ID: 1574399

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.

Explanation

An increase in net income is likely a result from increases in earnings before interest, taxes, depreciation and amortization (EBITDA) and operating income. An increase in net income is also likely to result in an increase in funds from operations (FFO). The only ratio listed that has earnings or operating cash flow in the denominator is the debt-to-EBITDA ratio. As the denominator increases, the ratio will decrease.

(Module 64.1, LOS 64.b)

Question #17 of 17

Question ID: 1577405

A fixed income analyst is assessing key factors relating to a corporate bond issuer, including the issuer's assets relative to the size of its liabilities, expected future cash flows, the issuer's potential market share, and event risk related to market shocks. The analyst is *most likely* using a:

A) hybrid approach.

B) bottom-up approach.

C) top-down approach.

Explanation

The analyst is using a *hybrid approach*, which is a combination of the bottom-up approach (idiosyncratic factors relating to the issuer, like assets vs. liabilities and future cash flows) and the top-down approach (factors relating to the market, including market size, market share, and external shocks).

(Module 64.1, LOS 64.a)