Advanced Corporate Credit – Warning Signals of Distress

Learning Objectives

The aim of this **two-day workshop** is to refine the analytic skills needed to identify the early warning signals of credit deterioration. It will also help participants to determine a company's ability to improve performance or repair the existing capital structure. The workshop will draw upon lessons learned from credit crisis to determine sustainable levels of indebtedness, the robustness of deal structures, and how best to respond to problems facing a corporate client. This workshop is highly interactive allowing participants to practice the key learning points on several case studies and exercises.

Specifically, participants will be equipped to:

- Uncover the early warning signs or red flags during the life span of the loan or bond: Financial, non-financial, and market indicators
- Identify companies most susceptible to credit deterioration and the factors that will impact the likelihood of default or the need for distressed exchange of debt
- Evaluate the options available to lenders or investors when signs of credit deterioration become apparent
- Determine the strengths and weaknesses of an existing loan structure to improve loan structures going forward
- Set the minimum level of transparency acceptable to make a responsible credit decision

Content Outline

Case studies and exercises are drawn from a range of industries and regions to highlight the earlier stages of deteriorating corporate credits.

This Deteriorating Corporate Credit workshop is aimed at those already familiar with corporate credit analysis.

Analytic Overview

Apply a structured approach to evaluate the credit standing of a company, specifically looking for signals of weakness or potential danger.

Causes of distress

- Macroeconomic forces and concerns surrounding current issues
- Sector issues: Sectors most vulnerable to cyclicality, macroeconomic sensitivities and structural changes
- Company specific factors: Why certain companies are more vulnerable than others to credit deterioration
- **Application:** Debrief of pre-read; participants come prepared with own examples of failed companies

Early warning signals

- Symptoms of a deteriorating credit: Non-financial indicators, financial indicators, and market indicators
- Potential external warning signals from external credit ratings and market pricing (Bond, CDS and share prices)

Analytic Overview (cont.)

Structured analytic approach

- Application of the four-step approach to credit to expose key early warning signals: Purpose, payback, risks and structure
- Risks to repayment: Current market conditions and their impact on risk
- **Application:** Identify possible purposes and sources of repayment

Themes of Distress

This section aims to identify the themes of distress. The action(s) taken by the companies and/or lenders are explored through discussion and many real-life examples of actual or potential distress. The focus is on concluding upon lessons learned to avoid future problems.

External macroeconomic and sector indicators

- Economic cyclicality in various markets and the potential disastrous effect on company performance
- Vulnerability to foreign exchange movements and the effect of sudden fluctuations
- Exposure to commodity price instability and the effect on profitability and cash flow
- Disruptive events that can change the outlook for the sector
- Emerging market risk and issues specific to small, young economies
- **Application:** The impact of the economic cycle on a variety of sectors/the impact of changing commodity prices or FX rates

Challenged business models

- Lack of sufficient scale in an increasing competitive environment; weak part of the supply chain; low added value
- Excessive growth with inability to finance externally; timing of expansion
- Higher operating leverage; inability to transfer increased costs
- Dependency on a small numbers of customers and/or suppliers
- Financially impaired customers, price competition, CAPEX requirements, reliance on other sectors in distress
- **Application:** Changing business models and identifying red flags

Management and ownership strategy and behaviour

- Poor management decisions and risk management
- Deficient financial disclosure or reporting
- Complex group structures and cross shareholdings
- Lack of corporate governance, control of executive management
- Failing of succession planning, management style
- Lack of integrity: Behavior, relationships, social responsibility
- Inability of shareholder to support during turbulent times
- **Exercise:** Assessment management strength and weaknesses and shareholder structure/support.
- **Illustration case study:** Identify early indicators of deteriorating performance in earnings, asset management and cash flow

Disproportionate leverage

- Excessive leverage at the top of the economic cycle
- Debt servicing capability: Anticipating the problem
- New money needed to restructure or recapitalize
- Hidden leverage: Off balance sheet obligations
- **Application:** Hidden leverage and inappropriate funding structures

Themes of Distress (cont.)

Poor loan structure and choice of financial instruments

- Debt denominated in a ‘hard currency’ while domestic currency weakens
- Illiquid debt instruments
- Structural subordination
- **Application:** Anticipate refinancing problems
- **Illustration case study:** Review the financial structure and debt instrument(s)

Crossing the Threshold: Triggers for Action

This segment focuses on the most common events that trigger corporate distress and the need to act.

Cash shortfalls and liquidity problems

- Define and assess liquidity
- Quantify the degree of refinancing risk and the potential challenges and costs of raising new capital
- Reliance on existing ‘committed’ bank facilities or cash as the sole source of liquidity

Covenant breaches

- Characteristics of effective covenants
- Financial vs. non-financial covenants: Ability to quantify and assess the degree of protection
- **Exercise:** Identify alternatives when companies face refinancing problems