Credit Risk Analysis I
FIN 242f
Fall 2018

Tuesdays, 6:30 pm to 9:20 pm
September 4th to October 23rd
Location: International Hall

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Overview
The purpose of Credit Risk Analysis I is to introduce students to credit risk (the possibility that a borrower will fail to perform as agreed), the use of credit analysis to make sound investment recommendations, and the consequences of credit mistakes. Topics will include asset-based and cash flow bank loans, the syndicated loan market, and the debt capital markets.

Workload
Success in this two-credit course is based on the expectation that students will spend a minimum of 9 hours of study time per week in preparation for class (readings, papers, discussion sections, etc.).

Learning Goals & Outcomes
- Ability to think and analyze credit risk
- Articulate the role of credit research in the investment process
- Understand both qualitative and quantitative components of credit analysis
- Define different loan structures and their appropriate uses
- Communicate an effective investment recommendation, both verbally and in written form

Course Requirements

Prerequisite: FIN 212a or equivalent

Required Reading:
I have created a course area on the Harvard Business Online website where you can order required materials for the course. Click on the link to order: https://hbsp.harvard.edu/import/551711

If you have not registered with Harvard Business Online, you will be required to do so.

Recommended Reading:
In addition to the Required Readings, I have posted on LATTE several readings that you may wish to read (or at least skim) to gain a deeper insight into how U.S. credit rating agencies, bank regulators and commercial bankers think about credit risk:
- From Standard & Poor's (one of the three primary NRSROs that rate publicly-traded loans and bonds), you will find the September 2013 edition of "A Guide to the U.S. Loan Market";
- From the Office of the Comptroller of the Currency (the principal regulator of U.S. banks), you will find the handbook, "Rating Credit Risk". NOTE – While this Handbook appears dated (April 2001), it is still the primer for bank regulators used today;

- From Markit Group Limited, you will find the April 2012 "Markit Credit Indices, A Primer." Just read Section 1, which is an introduction to Credit Default Swaps; and
- From a former JP Morgan Chase commercial banker and credit officer, you will find "A Primer on Deals for Middle Market Bankers."

While these readings are not required, they are highly recommended as background for topics we will cover over the course of this module. I will assume everyone is familiar with the information in the readings and will only provide a cursory review in our discussions.

Class Participation:
Lively class participation is expected of everyone in this course and **class attendance is required**. Each week, there will be a new case assigned, and each student should be prepared to discuss the case in detail, including a thorough analysis of the financial statements. To facilitate participation, please place a name card on your desk.

Written Assignments:
Team assignments must be done in groups of four students. Grades on each assignment are assigned to all members of the team (*although I reserve the right to alter individual grades in certain circumstances*, e.g., when it is clear to me that an individual did not contribute to the assignment in a consistent and meaningful way). Students may form different teams at any point in the course, so long as the affected students are given at least four (4) days to find a new team.

Grading:

Class Participation*		INDIVIDUAL	30%
Short-Form Analysis for	Hampton Machine case	INDIVIDUAL	10%
Long-Form Analysis for	Clarkson Lumber case	TEAM	15%
Long-Form Analysis for	Dollar General case	TEAM	15%
Short- and Long-Form Analysis for	Final Project	TEAM	30%

*Class Participation Rules
- You are permitted one absence for any reason. However, **attendance at Class One and Class Six is mandatory**.
- Each additional absence results in a reduction in the grading element (B+ to B, and so on).
- If you come to every class (or miss one) but do not regularly participate, your participation grade will be **C-**. Participation is when you raise your hand to contribute, not if I "cold call" on you.
- If I "cold call" when there is a team assignment, I expect you to be able to answer for any part of the assignment, not just the section you may have worked on.
- **The ability to communicate an investment idea or recommendation is a key attribute of a successful credit analyst.** This is why Class Participation is heavily weighted in grading for this course, and why I expect everyone to be active in our discussions.

Office Hours:
Students can meet with me individually by appointment.

Academic Honesty:
You are expected to be honest in all your academic work. Please consult Brandeis University Rights and Responsibilities for all policies and procedures related to academic integrity. Students may be required to submit work to TurnItIn.com software to verify originality. Allegations of alleged academic dishonesty will be forwarded to the Director of Academic Integrity. Sanctions of academic dishonesty can include failing grades and/or suspension from the university. Citation and research assistance can be found at LTS – Library guides.

Special Accommodation:
If you are a student with a documented disability on record at Brandeis University and wish to have a reasonable accommodation made for you in this class, please see me immediately. Please keep in mind that reasonable accommodations are not provided retroactively.

Class One – Introduction

Tuesday, September 4th

This class is intended to introduce students to the credit investment process and the role of the credit analyst in that process. Banks traditionally provided credit training programs to new hires in their lending programs, but budget cut-backs, along with an explosion of alternative lenders (asset managers, CLOs, hedge funds), has created the need for the development of credit analysts outside of the traditional channels.

Tonight, we will look at the current state of lending markets in the U.S., and start to develop an understanding of a core building block of that market, the senior bank loan. Tonight's session will also include a discussion on the syndicated bank loan market.

- Course Overview and Syllabus Review
- Student Objectives and Introductions
- 5C's of Credit
- Loan Purposes and Structures
- Financial Ratio Analysis
- Historical Financials versus Projections
- The Credit Rating Agencies and Their Role
- Introduction to templates for Short- and Long-Form assignments

Class Two – The Basics

Tuesday, September 18th

Tonight's class will explore the basics of credit, including the purpose of the loan. What is the primary source of debt repayment (hint – think Cash, not Earnings)? What is our fallback if the primary source of repayment does not work out? Class will also include a lecture on asset-based lending, where the primary source of repayment is liquidation of company assets rather than corporate cash flow, and a discussion on where/when this loan structure is appropriate.

> **READINGS:** **Hampton Machine Tool Co. (280-103) <u>plus</u> spreadsheet supplement <u>plus</u> cash flow supplement on LATTE**
>
> **Note on Bank Loans (291-026)**

> *Please consult LATTE for the specifics of this assignment. Please submit at the beginning of class a **short-form** analysis of the Hampton Machine Tool Co. case. Be sure to propose a loan structure that meets the needs of the firm. Please use (and include as an attachment) the template on LATTE to present the near-term cash flow. This is an **individual** assignment; **as such, you may not discuss your cash flow or analysis with anyone.** I will "cold call" often today to discuss various aspects of this case.*

Class Three – The Environment

Tuesday, October 2nd

Companies don't operate in a vacuum, and credit decisions are not made in one either. Tonight's class will look at the role and impact of industry on a company's performance and outlook. What are critical success factors for a particular industry? What are the industry challenges that can impact credit performance? This class will look at a case involving a company experiencing strong sales growth. What are the funding challenges for a growth company when the working capital needs of a company outpace the cash generating capabilities of the business?

> **READINGS:** **Clarkson Lumber Company (297-028) <u>plus</u> spreadsheet supplement**
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> **M. Porter, "The Five Competitive Forces That Shape Strategy", HBR #R0801E**

*Please consult LATTE for the specifics of this assignment. Please submit at the beginning of class a **long-form** analysis of the Clarkson Lumber Company case in which you propose a loan structure that meets the needs of the firm. This is a **team** assignment. Be sure to incorporate Porter's Five Forces analysis into your Business & Strategy section, **and in every assignment from now on**. Do **not** use the 90-day note structure mentioned in the case; instead propose a one (or more) year working capital line of credit.*

Class Four – Issuer Value

Tuesday, October 9th

Entrepreneurs and corporate titans alike are eventually faced a dilemma: Do I keep on running this business that I've built or should I sell it to realize value (i.e., vast riches) for myself/my shareholders? Tonight's case looks at Kohlberg Kravis Roberts & Co. ("KKR") leveraged buy-out of Dollar General in 2007. To understand where KKR saw value, you will need to fully grasp the company's operations, business strategy and competitive position in an overlooked niche of the U.S. retail segment.

NOTE – Final Project assignments will be handed-out at the end of tonight's class; it is imperative that at least one member from each team be present at tonight's session to receive the final project assignment.

> **READINGS:** **Dollar General (A) & (B) (607-140, 607-156)**
> **Dollar General Going Private (108-015)**
> **Dollar General Going Private, Spreadsheet (108-703-XLS)**
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> **The High-Yield Debt Market (UV6756)**
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> **Dollar General 2017 Form 10-K (on LATTE)**
> *Please note: I do not expect you to read the entire 10-K filing. Familiarize yourselves with the contents, with a focus on: Item 1 - Business; Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations; and the Notes to Consolidated Financial Statements.*

*Please consult LATTE for the specifics of this assignment. Please submit at the beginning of class a **modified short-form** analysis of the Dollar General Going Private case in which you propose a $75mm participation in the overall bank credit. This is a **team** assignment.*

Class Five – Problem Loans

Tuesday, October 16th

Not every credit decision works out as planned. Tonight's class will examine what are the warning signs of imminent credit problems. When a company's credit deteriorates, what options do lenders have to try to bring that loan back on-sides? What options do borrowers have to avoid bankruptcy? Time will be reserved at the end of class for Q&A about the Final Projects.

> **READINGS:** **SureCut Shears, Inc. (297-013) plus spreadsheet supplement**
> *Please note: There is an error in the case – there is no indication of interest expense.*
> *Assume it's included in SG&A Expense.*

There is no written assignment. Consult LATTE for study questions. I will "cold call" often today to discuss various aspects of this case.

Class Six – Credit Committee

Tuesday, October 23rd

Credit analysts do the heavy lifting of gathering, processing and distilling all information necessary to form a credit opinion and an investment recommendation. However, it is rare that the credit analyst will have the authority to act upon that recommendation without the approval of the firm's credit or investment committee. The credit committee, comprised of experienced senior credit leaders from across the firm, seeks to ensure that credit analysts have adequately considered ALL the potential risks of the proposed loan, before adding it to their portfolio of loans.

In tonight's class, we will act as credit committee for your Final Projects. Each team will prepare a long-form analysis and a short-form analysis of their assigned Final Project company. **All Final Projects must be submitted by 1:00 PM on Saturday, October 20th**. Final Project teams will be split into separate groups based on the industry segment of their assigned company. The short-form write-ups prepared by each team will be posted to LATTE by 1:00 PM on Sunday, October 21st. Members of each team will be responsible for reading the short-form credit write-ups of the companies in their industry group.

Each team will have 10 minutes to present their credit to the 'Credit Committee', followed by 10 minutes of Q&A to respond to questions from Committee members prior to a final Committee vote to accept the loan proposal, reject the proposal or send it back for additional analysis. Members of teams from each of the industry groups are expected lead the credit discussions for credits presented in their areas of expertise. Given the importance of an active Committee discussion, class participation will be weighted more heavily tonight than in all other classes.

> *Please consult LATTE for the specifics of this assignment. The Final Project involves looking at a potential participation in a bank loan facility for a publicly-traded company. Each team will be assigned a different company and credit request, and will need to rely on publicly available information for the analysis: SEC filings, annual reports, investor presentations, etc.*

> *Remember that these are **team** assignments; every member of the team is expected to contribute during the presentation to the Credit Committee and the Q&A responses in order to receive a grade for that portion of the Final Project. In addition, everyone is expected to have read the short-form credit write-ups of the Final Projects assigned to their team for the Credit Committee and to be active participants in the Committee discussion in order to receive a grade for that portion of the Final Project.*