

THE IMPORTANCE OF CREDIT ANALYSIS IN TODAY'S CORPORATE LANDSCAPE

Over the past several years, U.S. corporations have enjoyed a substantial run of global economic expansion, improved earnings growth, and replenished balance sheets. This environment, combined with unprecedented market liquidity and historically low default rates, has created what appears to be a relatively benign credit environment. However, we believe there are three considerations other than traditional balance sheet and income statement analysis that should be at the forefront of investors' minds: financial policy, idiosyncratic risk, and possible defensive postures.

Financial Policy

As the corporate sector struggles to maintain organic earnings growth and shifts its attention away from balance sheet repair, bondholders watch in trepidation as mergers and acquisitions and equity-friendly announcements flood the markets. While this behavior should be a concern to bondholders, it must be considered within the context of the entire corporate structure. Free cash flow directed to stock buybacks may ultimately be a positive influence as the resulting equity performance could hold corporate raiders at bay. Additionally, free cash flow directed at acquisitions could provide the basis for earnings growth for many years to come. While this systematic risk persists at different levels for different industries, it is important to determine at what level this activity is truly detrimental to the bondholder. In this environment, where balance sheets are healthy and earnings growth is difficult to come by, a balance of both creditor and equity concerns may be warranted. We must understand managers' long-term views and aspirations for their organizations and their industries to understand how they may deploy current and future cash flows.

Idiosyncratic Risk

Part of the strong liquidity mentioned previously can be attributed to the emergence of nontraditional investments, such as hedge funds and private equity firms. While these sources can be credited with spread tightening, as money is put to work in traditional cash bonds, they can also be attributed to spread widening, as private money looks to exploit under-leveraged companies with weak equity performance and large cash balances. Companies with this profile often become targets for leveraged buyouts. While Wall Street firms have developed various screening methods to determine which companies may be attractive to private equity firms, determining this type of idiosyncratic event risk often requires a more fluid analysis that incorporates the financial policy of the companies discussed above, as well as an understanding of the cash needs for the company and the cyclical nature of the industry and the specific business. Holding a large cash balance or holding less debt than capacity may not leave a company exposed to a leverage buyout, but determining whether this is truly a risk is an emerging and critical role for credit analysts. Finally, company-specific characteristics, such as family ownership or community presence, may also play a part in these analyses.

Defensive Postures

A final focus in this low-yielding and decelerating growth environment is the consideration of defensive posturing. While pure alpha players such as hedge funds and equity houses search for yield, so too do traditional long-term holders. Inherently, incremental yield has become increasingly difficult to



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► achieve, and many investors reach for yield without full consideration of the underlying fundamentals. As the proverbial tide lifts all boats, downside risks increase as investors get paid less for growing event risk and the potential for a slowing economy. Market inefficiencies are difficult to find as investors shun the cyclical nature of the economy, the market, and individual companies. Thus investors push up the valuations of companies, sometimes regardless of their potential. Selection of companies that offer competitive yield premiums and the potential for fundamental improvement then becomes crucial.

Summary

The confluence of historically tight yield spreads, heightened event risk, and the entrance of additional financial players such as hedge funds points to the critical importance of an experienced credit research team. We believe there is an asymmetric risk/reward profile in the current environment. Therefore we believe that the prudent approach is to maintain a cautious stance until the market prices risk more favorably. ■

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