What Does Debt Capacity Tell Us?

1. How much additional leverage can be supported by the business
   - Potential strategic acquisition
   - Leverage buyout (LBO)
   - Share buyback/special dividend (for higher rated credits)
2. How much room for a company to struggle
   - Useful for companies in turnaround or
   - Cyclical or seasonal companies going into troughs
   - Smaller companies or weaker credits
3. What would it take for a company to lose its current rating and/or lose an investment grade rating (to be discussed in ratings portion)
   - How much is the bank comfortable with
   - How much is too much for the company to handle (worst case)

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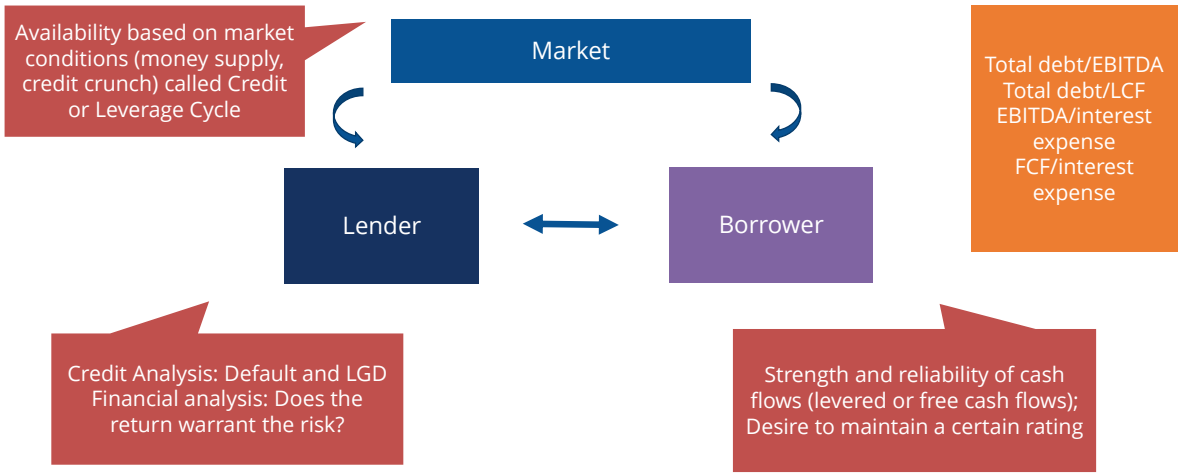
Debt Capacity



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Multiple Based Debt Capacity Analysis

Multiple		x or ÷	Value driver		=	
	Min or max Cash flow adequacy or interest coverage Market driven			LTM or forecast Usually EBITDA		Multiple based debt capacity

Multiple	Value Driver	Debt Capacity
Debt / LTM EBITDA = 5.5x	LTM EBITDA = 1,200.0	Max debt capacity = 6,600.0 (1,200.0 * 5.5x = 6,600.0)
FWY 1 EBITDA / interest expense = 3.0x	FWY 1 EBITDA = 1,260.0 Current interest rate = 6.0%	Max interest expense = 420.0 (1,260.0 / 3.0x = 420.0) Max debt capacity = 7,000.0 (420.0 / 6.0% = 7,000.0)

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Dangers of Using Multiples

The publisher has high cash conversion due to positive OWC cash flow and relatively low capex

	Media company Univision	**Manufacturer** Lockheed Martin
EBITDA	1,249.0	6,292.0
Operating profit	1,077.2	5,438.0
Tax rate	35.0%	35.0%
NOPAT	700.2	3,534.7
Depreciation & amortization	171.8	854.0
Change in OWC	25.9	(894.0)
Capex	(126.8)	(939.0)
Free cash flow / cash flow available for debt service	771.1	2,555.7
FCF / EBITDA (%)	61.7%	40.6%

The manufacturer has a low cash conversion from EBITDA due to high capex requirements and negative OWC cash flow

EBITDA is a proxy for cash flow BUT not cash flow itself

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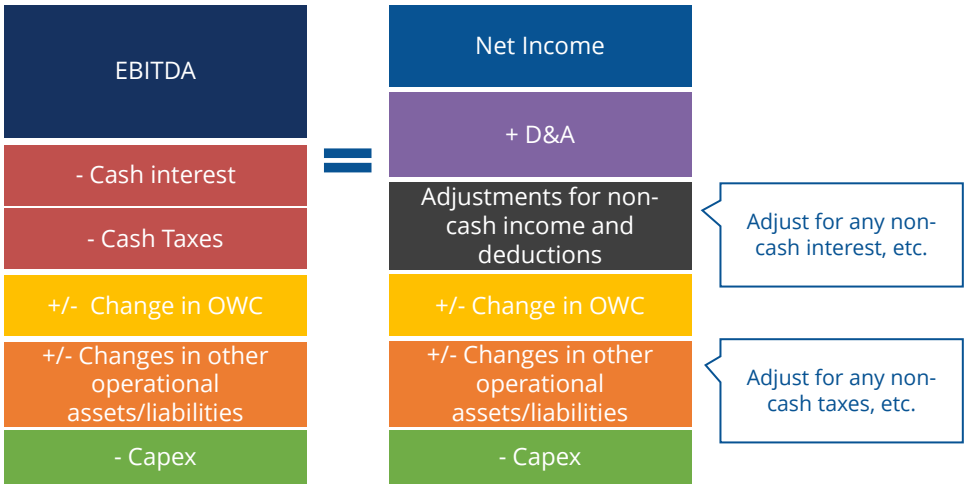
How to Get to Free Cash Flow



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Cash Flow-based Debt Capacity Analysis

		Year 1	Year 2	Year 3	Year 4	Year 5
Bank Case free cash flows		100.0	105.0	110.0	118.0	124.0
Term	5.0					
After-tax cost of debt	5.0%					
PV of future bank case cash flows	479.7					
Debt amortization schedule						
Beginning balance		479.7	403.7	318.9	224.9	118.1
Accrued interest		24.0	20.2	15.9	11.2	5.9
Interest paid		(24.0)	(20.2)	(15.9)	(11.2)	(5.9)
Debt repayment		(76.0)	(84.8)	(94.1)	(106.8)	(118.1)
Ending balance	479.7	403.7	318.9	224.9	118.1	0.0

Debt capacity established by NPV at post tax cost of debt
A haircut can also be used

The repayment is the amortization of the loan

Debt is paid off by year five assuming all cash flows are used

Cash flow-based capacity lending is based on the free cash flows forecast and current interest rates

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Creating Scenarios for EBITDA and Cash Flow Analysis

Look for drivers to sensitize

Look at what has happened historically and think about what can go wrong

	Year -2	Year -1	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Sales growth - company case		12.8%	3.9%	5.5%	7.5%	7.5%	6.0%	5.0%
Sales growth - conservative or "bank" case				3.5%	3.5%	3.0%	3.0%	3.0%
Sales growth - downside case				3.0%	3.0%	2.5%	2.5%	2.5%
Operating costs (clean) - company case	81.0%	78.9%	77.5%	77.0%	76.5%	76.0%	75.5%	75.0%
Operating costs (clean) - conservative or "bank" case				78.0%	78.0%	78.0%	78.0%	78.0%
Operating costs (clean) - downside case				82.0%	82.0%	82.0%	82.0%	82.0%
EBITDA - company case	88.8	111.4	123.0	132.9	146.0	160.2	173.4	185.8
EBITDA - conservative or "bank" case				124.7	131.6	140.7	151.3	160.4
EBITDA - downside case				101.5	105.1	110.3	118.0	126.9

For downside, we want to reduce EBITDA or cash flow by 20 % to 30%

Other drivers to sensitize can be Capex, OWC (especially AR and inventory)

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Then Compare the Ratios

	Year 1	Year 2	Year 3	Year 4	Year 5
Company case					
Total debt/EBITDA	2.6 x	2.2 x	1.7 x	1.2 x	0.5 x
(EBITDA-capex)/interest	6.5 x	6.3 x	7.8 x	10.7 x	18.4 x
Conservative or "bank" case					
Total debt/EBITDA	2.8 x	2.5 x	2.0 x	1.3 x	0.6 x
(EBITDA-capex)/interest	5.9 x	5.4 x	6.5 x	8.9 x	15.0 x
Downside case					
Total debt/EBITDA	3.4 x	3.1 x	2.5 x	1.7 x	0.8 x
(EBITDA-capex)/interest	4.3 x	3.8 x	4.5 x	6.1 x	10.5 x

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Amortization Example 1

The company is projected to struggle in the first to years, which often happens after an acquisition

Cash flows do stabilize and margins expand by year 3 of the loan

Are we giving enough room for the company to breath in the early part of the loan?

		Year 1	Year 2	Year 3	Year 4	Year 5	
EBIT		200.0	210.0	240.0	260.0	290.0	
EBIT margin		15.0%	17.0%	21.0%	22.0%	22.0%	
Bank Case free cash flows		90.0	110.0	120.0	130.0	150.0	
Term	5.0						
After-tax cost of debt	5.0%						
PV of future bank case cash flows	513.6						
Debt amortization schedule							
Beginning balance		513.6	449.3	361.8	259.9	142.9	
Accrued interest		25.7	22.5	18.1	13.0	7.1	
Interest paid		(25.7)	(22.5)	(18.1)	(13.0)	(7.1)	
Debt repayment		(64.3)	(87.5)	(101.9)	(117.0)	(142.9)	
Ending balance	513.6	449.3	361.8	259.9	142.9	0.0	
Amortization %		12.5%	17.0%	19.8%	22.8%	27.8%	**100.0%**

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Amortization Example 2

		Year 1	Year 2	Year 3	Year 4	Year 5	
EBIT		200.0	210.0	240.0	260.0	290.0	
EBIT margin		15.0%	17.0%	21.0%	22.0%	22.0%	
Bank case free cash flows		90.0	110.0	120.0	130.0	150.0	
Term	5.0						
After-tax cost of debt	5.0%						
PV of future bank case cash flows	513.6						
Adjusted amortization %		10.0%	15.0%	20.0%	25.0%	30.0%	**100.0%**
Revised debt amortization schedule							
Beginning balance		513.6	462.3	385.2	282.5	154.1	
Accrued interest		25.7	23.1	19.3	14.1	7.7	
Interest paid		(25.7)	(23.1)	**(19.3)**	**(14.1)**	**(7.7)**	
Debt repayment		(51.4)	(77.0)	**(102.7)**	**(128.4)**	**(154.1)**	
Ending balance	513.6	462.3	385.2	282.5	154.1	0.0	

The amortization schedule is lighter in the earlier years

We are aware that based on the Bank case that by allowing some breathing room early in the loan we are taking the risk that cash will be available for later repayments. This is accomplished via a cash sweep.

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Debt Tranching

		Year 1	Year 2	Year 3	Year 4	Year 5
Free cash flows		100.0	105.0	110.0	118.0	124.0
Term	5 years					
After tax cost of debt	5.0%					
Principal	479.7					

Total amount of one tranche of debt with 5 year term

Other lenders could be willing to lend against cash flows in year 6 at a higher interest rate

		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Free cash flows		100.0	105.0	110.0	118.0	124.0	127.0
Cash flows available for 2nd tranche		7.2	7.2	7.2	7.2	7.2	127.0
2nd tranche term	6 years						
After tax cost of debt	6.0%						
Principal	119.8	0.0	0.0	0.0	0.0	0.0	119.8
Interest		7.2	7.2	7.2	7.2	7.2	7.2
Cash flows available for 1st tranche		92.8	97.8	102.8	110.8	116.8	
1st tranche term	5 years						
After tax cost of debt	5.0%						
Principal	448.6						
Total debt borrowed	568.4						

2nd loan requires cash flows to pay cash interest for 6 years and is a bullet repayment

Cash flows in year 6 should cover interest and principal repayment for 2nd loan
(127.0 = 119.8 + 7.2)

Cash flows available for 1st loan are reduced by the amount of 2nd loan interest
e.g. year 5 (116.8 = 124.0 - 7.2)

Individual tranches are reduced but the total amount of borrowing is increased

Debt tranching allows the issuer to increase the total amount of debt by appealing to investors with different risk profiles

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