

**Financial Analysis: A User Approach**  
**Chapter 11**  
**Capital Structure and Credit Risk**

Capital Structure refers to the relative amounts of debt vs. equity financing. It also refers to the relative amounts of short-term vs. long-term borrowing.

Credit Risk includes both default risk (a borrower failing to make a payment on time) and bankruptcy risk (a borrower becoming insolvent)

Capital Structures vary significantly between industries – Companies with relatively high capital needs combined with relatively predictable and stable cash flows are good candidates for taking on significant debt. On the other hand, if a company has only limited capital needs and/or has highly variable cash flows they would not be a good candidate for significant amount of borrowing, especially long-term borrowing.

Consider the following:

Company	DUK	TGT	STX	AAPL	MSFT
Current Assets	10%	40%	54%	82%	57%
Non-Current Assets	90%	60%	46%	18%	43%
Total Assets	100%	100%	100%	100%	100%
Current Liabilities	8%	24%	43%	34%	36%
Long-Term Liabilities	52%	45%	31%	12%	12%
Total Liabilities	60%	69%	74%	46%	48%
Total Stockholders' Equity	40%	31%	26%	54%	52%
Total Liab. & Stockholders' Equity	100%	100%	100%	100%	100%

Even within the same industry, some companies will pursue different capital structures. Consider the following:

Company	STX	WDC	MSFT
Current Assets	54%	58%	45%
Non-Current Assets	46%	42%	55%
Total Assets	100%	100%	100%
Current Liabilities	43%	30%	22%
Long-Term Liabilities	31%	12%	24%
Total Liabilities	74%	41%	46%
Total Stockholders' Equity	26%	59%	54%
Total Liab. & Stockholders' Equity	100%	100%	100%

SEAGATE TECHNOLOGY

CONSOLIDATED BALANCE SHEETS

(In millions, except share and per share data)

	June 27, 2008	June 29, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 990	\$ 988
Short-term investments	151	156
Accounts receivable, net	1,410	1,383
Inventories	945	794
Deferred income taxes	274	196
Other current assets	502	284
Total current assets	4,272	3,801
Property, equipment and leasehold improvements, net	2,464	2,278
Goodwill	2,352	2,300
Other intangible assets, net	111	188
Deferred income taxes	616	574
Other assets, net	305	331
Total Assets	<u>\$ 10,120</u>	<u>\$ 9,472</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,652	\$ 1,301
Accrued employee compensation	440	157
Accrued restructuring	80	21
Accrued expenses	519	532
Accrued warranty	226	233
Accrued income taxes	10	75
Current portion of long-term debt	360	330
Total current liabilities	3,287	2,649
Accrued restructuring	7	21
Accrued warranty	219	197
Other non-current liabilities	351	135
Long-term debt, less current portion	1,670	1,733
Total Liabilities	5,534	4,735
Commitments and contingencies (See Notes 8 and 9)		
Shareholders' equity:		
Preferred shares, \$0.00001 par value per share—100 million authorized; no shares issued or outstanding	—	—
Common shares, \$0.00001 par value per share—1,250 million authorized; 485,127,434 issued and outstanding at June 27, 2008 and 534,981,463 issued and outstanding at June 29, 2007	—	—
Additional paid-in capital	3,501	3,204
Accumulated other comprehensive income (loss)	(16)	(4)
Retained earnings	1,101	1,537
Total Shareholders' Equity	4,586	4,737
Total Liabilities and Shareholders' Equity	<u>\$ 10,120</u>	<u>\$ 9,472</u>

See notes to consolidated financial statements.

## Long-Term Debt and Credit Facilities

The carrying amount of long-term debt consisted of the following:

	June 27, 2008	June 29, 2007
	(In millions)	
Floating Rate Senior Notes due October 2009	\$ 300	\$ 300
6.375% Senior Notes due October 2011	599	599
6.8% Senior Notes due October 2016	599	598
6.8% Convertible Senior Notes due April 2010	135	135
5.75% Subordinated Debentures due March 2012	41	45
2.375% Convertible Senior Notes due August 2012	326	326
LIBOR Based China Manufacturing Facility Loans	30	60
	<u>2,030</u>	<u>2,063</u>
Less current portion	(360)	(330)
Long-term debt, less current portion	<u>\$ 1,670</u>	<u>\$ 1,733</u>

In September 2006, Seagate Technology HDD Holdings (“HDD”), the Company’s wholly-owned direct subsidiary, issued senior notes totaling \$1.5 billion comprised of \$300 million aggregate principal amount of Floating Rate Senior Notes due October 2009 (the “2009 Notes”), \$600 million aggregate principal amount of 6.375% Senior Notes due October 2011 (the “2011 Notes”) and \$600 million aggregate principal amount of 6.8% Senior Notes due October 2016 (the “2016 Notes”). These notes are unsecured and rank equally in right of payment with all of HDD’s other existing and future senior unsecured indebtedness and senior to any present and future subordinated indebtedness of HDD.

*\$300 Million Aggregate Principal Amount of Floating Rate Senior Notes due October 2009.* The 2009 Notes bear interest at a floating rate equal to three-month LIBOR plus 0.84% per year, payable quarterly on January 1, April 1, July 1 and October 1 of each year. Interest payments commenced on January 1, 2007. The 2009 Notes will mature on October 1, 2009. The Company may not redeem the 2009 Notes prior to maturity.

*\$600 Million Aggregate Principal Amount of Fixed Rate Senior Notes due October 2011.* The 2011 Notes bear interest at the rate of 6.375% per year, payable semi-annually on April 1 and October 1 of each year. The 2011 Notes are redeemable at the option of the Company in whole or in part, on not less than 30 nor more than 60 days’ notice at a “make-whole” premium redemption price. The “make-whole” redemption price will be equal to the greater of (1) 100% of the principal amount of the notes being redeemed, or (2) the sum of the present values of the remaining scheduled payments of principal and interest on the 2011 Notes being redeemed, discounted at the redemption date on a semi-annual basis at a rate equal to the sum of the applicable Treasury rate plus 50 basis points.

*\$600 Million Aggregate Principal Amount of Fixed Rate Senior Notes due October 2016.* The 2016 Notes bear interest at the rate of 6.8% per year, payable semi-annually on April 1 and October 1 of each year. The 2016 Notes are redeemable at the option of the Company in whole or in part, on not less than 30 nor more than 60 days’ notice at a “make-whole” premium redemption price. The “make-whole” redemption price will be equal to the greater of (1) 100% of the principal amount of the notes being redeemed, or (2) the sum of the present values of the remaining scheduled payments of principal and interest on the 2016 Notes being redeemed, discounted at the redemption date on a semi-annual basis at a rate equal to the sum of the applicable Treasury rate plus 50 basis points.

*\$135 Million Aggregate Principal Amount of 6.8% Convertible Senior Notes due April 2010 (the "6.8% Notes").* As a result of its acquisition of Maxtor on May 19, 2006 (see Note 10), the Company assumed the 6.8% Notes. The 6.8% Notes require semi-annual interest payments payable on April 30 and October 30. The 6.8% Notes are convertible into common shares of Seagate Technology at a conversion rate of approximately 30.1733 shares per \$1,000 principal amount of the notes. Commencing May 5, 2008, the Company may redeem the 6.8% Notes at 100% of their principal amount, plus accrued and unpaid interest, if the closing price of the common shares for 20 trading days within a period of 30 consecutive trading days ending on the trading day before the date of the mailing of the redemption notice exceeds 130% of the conversion price on such trading day. If, at any time, substantially all of the common shares are exchanged or acquired for consideration that does not consist entirely of common shares that are listed on a United States national securities exchange or approved for quotation on the NASDAQ National Market or similar system, the holders of the notes have the right to require the Company to repurchase all or any portion of the notes at their face value plus accrued interest.

*\$326 Million Aggregate Principal Amount of 2.375% Convertible Senior Notes due August 2012 (the "2.375% Notes").* As a result of its acquisition of Maxtor on May 19, 2006 (see Note 10), the Company assumed the 2.375% Notes. The 2.375% Notes require semi-annual interest payments payable on February 15 and August 15. The 2.375% Notes are convertible into common shares of Seagate Technology at a conversion rate of approximately 58.6938 shares per \$1,000 principal amount of the notes, at the option of the holders, at any time during a fiscal quarter if, during the last 30 trading days of the immediately preceding fiscal quarter the common shares trade at a price in excess of 110% of the conversion price for 20 consecutive trading days. Upon conversion, the 2.375% Notes are subject to "net cash" settlement whereby the Company will deliver cash for the lesser of the principal amount of the notes being converted or the "conversion value" of the notes which is calculated by multiplying the conversion rate then in effect by the market price of the Company's common shares at the time of conversion. To the extent that the conversion value exceeds the principal amount of the 2.375% Notes, the Company will, at its election, pay cash or issue common shares with a value equal to the value of such excess. If the 2.375% Notes are surrendered for conversion, the Company may direct the conversion agent to surrender those notes to a financial institution selected by the Company for exchange, in lieu of conversion, into a number of the Company's common shares equal to the applicable conversion rate, plus cash for any fractional shares, or cash or a combination of cash and the Company's common shares in lieu thereof. The 2.375% Notes are classified as a current liability on the consolidated balance sheets because they are currently convertible as the Company's share price was in excess of 110% of the conversion price for at least 20 consecutive trading days during the last 30 trading days of the fourth quarter of fiscal year 2008. The payment of dividends to holders of the Company's common shares have in certain quarters resulted in upward adjustments to the conversion rate of the 2.375% Notes and may continue in the future. If the conversion rate continues to increase, the Company may be required to book an increased amount of interest expense.

*\$55 Million Aggregate Principal Amount of 5.75% Subordinated Debentures due March 2012 (the "5.75% Debentures").* As a result of the Maxtor acquisition (see Note 10), the Company assumed the 5.75% Debentures. The 5.75% Debentures require semi-annual interest payments on March 1 and September 1 and annual sinking fund payments of \$5 million or repurchases of \$5 million in principal amount of debentures in lieu of sinking fund payments. The 5.75% Debentures are currently convertible for a cash payment of \$167.50 per \$1,000 principal amount of debentures.

*\$60 million LIBOR Based China Manufacturing Facility Loan.* As a result of the Maxtor acquisition (see Note 10), the Company assumed an outstanding plant construction loan in the amount of \$30 million and an outstanding project loan in the amount of \$30 million. In fiscal year 2008, the Company repaid the \$30 million project loan. The

interest rate on the plant construction loan is LIBOR plus 70 to 80 basis points, with the borrowings repayable in two installment payments of \$15 million each, one due in October 2008 and the other due in April 2009. Interest payments on the construction loan are made semi-annually on October 15 and April 15. The loan requires annual financial covenants, including a maximum liability to assets ratio and a minimum earnings to interest expense ratio, with which the Company is currently in compliance.

In accordance with APBO No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, (“APBO 14”), the Company determined the existence of a substantial premium for both the 2.375% Notes and 6.8% Notes and recorded the notes at par value with the resulting excess over par (the substantial premium) recorded in Additional Paid-In Capital in Shareholders’ Equity. All other debt assumed in the Maxtor acquisition was recorded at fair market value (see Note 10).

*\$400 Million Aggregate Principal Amount of 8% Senior Notes Previously due May 2009.* In October 2006, the Company redeemed its 8% Senior Notes due May 2009 (the “8% Notes”) at a redemption price of \$1,040 per \$1,000 principal amount of Notes for a total amount paid of \$416 million. The redemption premium of \$16 million as well as approximately \$3 million of unamortized issuance costs were recorded as interest expense in the Company’s Consolidated Statement of Operations for fiscal year 2007.

The Company has guaranteed all Senior Notes on a full and unconditional basis (see Note 14).

*Revolving Credit Facility.* HDD has a senior unsecured \$500 million revolving credit facility that matures in September 2011. The credit agreement that governs the Company’s revolving credit facility contains covenants that must be satisfied in order to remain in compliance with the agreement. The credit agreement contains three financial covenants: (1) minimum cash, cash equivalents and marketable securities; (2) a fixed charge coverage ratio; and (3) a net leverage ratio. As of June 27, 2008, the Company is in compliance with all covenants.

The \$500 million revolving credit facility is available for cash borrowings and for the issuance of letters of credit up to a sub-limit of \$100 million. Although no borrowings have been drawn under this revolving credit facility to date, the Company had utilized \$62 million for outstanding letters of credit and bankers’ guarantees as of June 27, 2008, leaving \$438 million for additional borrowings. The credit agreement governing the revolving credit facility includes limitations on the ability of the Company to pay dividends, including a limit of \$300 million in any four consecutive quarters.

At June 27, 2008, future minimum principal payments on long-term debt were as follows (in millions):

Fiscal Year	
2009	\$ 361
2010	441
2011	5
2012	630
2013	—
Thereafter	600
	<u>\$ 2,037</u>

Included in future minimum principal payments on long-term debt for fiscal year 2009 is the principal amount of \$326 million related to our 2.375% Notes, which are payable upon conversion and are currently convertible, as the Company’s share price was in excess of 110% of the conversion price for at least 20 consecutive trading days during the last 30 trading days of the fourth quarter of fiscal year 2008. Unless earlier converted, the 2.375% Notes must be redeemed in August 2012.

## Ratio Analysis to Identify Default and Bankruptcy Risk

Ratios we previously used that can be useful:

- Debt/Equity
- Long-Term Debt to Equity
- Interest Coverage (Times Interest Earned)

Two additional ratios:

$$\text{Financial Leverage Index (FLI)} = \frac{\text{ROE}}{\text{ROA}} = \frac{\text{Net Income/Average SHE}}{\text{Net Income/Average Total Assets}}$$

$$\text{Financial Structure Leverage Index (FSLR)} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}}$$

For Seagate:

	2008	2007
FLI	2.10	1.91
FSLR	2.10	1.91

## Altman's Z-Score

A generalized model to predict bankruptcy

$$\begin{aligned} Z &= 6.56 X (\text{Working Capital/Total Assets}) \\ &+ 3.26 X (\text{Retained Earnings/Total Assets}) \\ &+ 6.72 X (\text{EBIT/Total Assets}) \\ &+ 1.05 X (\text{Book Value of Equity/Book Value of Debt}) \end{aligned}$$

Generally the lower your Z-Score the more likely you are to go bankrupt.

Range	Interpretation
< 1.1	Bankrupt
1.1 to 2.6	Gray Area
> 2.6	Healthy

For STX

	2008	2007
Current Assets	4,272	3,801
Current Liabilities	3,287	2,649
Working Capital	985	1,152
Total Assets	10,120	9,472
Retained Earnings	1,085	1,533
EBIT	1,282	1,212
Total SHE	4,586	4,737
Total Liab.	5,534	4,735
WC/TA	0.097	0.122
RE/TA	0.107	0.162
EBIT/TA	0.127	0.128
SHE/TL	0.829	1.000
Z-Score	2.71	3.23

While still healthy, STX has declined from 2007 to 2008.

## Bond Ratings

Several companies provide a rating for company debt. The rating should help an investor to understand the riskiness of the borrower/borrowing.

	Standard & Poors	Moody's	Category
Highest Rating	AAA	Aaa	Investment Grade
Very High Quality	AA	Aa	Investment Grade
High Quality	A	A	Investment Grade
High Quality	BBB	Baa	Investment Grade
Speculative	BB	Ba	Below Investment Grade
Speculative	B	B	Below Investment Grade
Very Poor	CCC	Caa	Below Investment Grade
Very Poor	D	C	Below Investment Grade

Standard and Poor's has rated STX as BB-, in contrast, DUK is rated A-

The bond rating agencies have come under heavy criticism during the recent credit crisis. Generally the criticism has focused on:

- Bond rating changes have not been timely (Downgrades after a company had defaulted or declared bankruptcy)
- Lack of an independent perspective (Bond rating agencies are paid a fee by the debt issuer)