

Financial Analysis: A User Approach

Chapter 12

Credit Analysis

Credit Analysis can be accomplished through the following six-step process.

Step 1 – Loan Purpose

The lender needs to get an understanding of the reason or purpose for the business borrowing funds. This purpose will often determine the terms of the loan. Several examples are:

- Working Capital Loan to fund seasonal growth in receivables and inventory (that cannot be funded by payables). Often secured by the inventory and receivables.
- Lines of Credit to fund miss-matched cash inflow/outflow timing. Often not secured.
- Intermediate and Long-Term Loans to purchase equipment and facilities. Often secured by the assets purchased.
- Lease-based Financing.

Banks may require customers who have lending relationships to carry compensating balances in their accounts.

Industry focus and experience can speed up this process.

Step 2 – Corporate Overview

Larger corporations typically borrow (using commercial paper, lines of credit, and various secured borrowing) from large commercial banks. They also issue bonds that are actively traded in the bond markets.

Smaller businesses often work with lenders that are more regional and local in their nature. While a small business can shop around for loans and rates, many choose to focus their banking needs on one or a few banks.

Proper questions at this point would include the following:

- What are the macro and micro economic forces that bear on this business and its industry?
- What is the company's strategy and how does their strategy position them vis-à-vis their competitors?

Step 3 – Quantitative Financial Analysis

This step is accomplished using the tools we have covered in previous chapters. The focus is to examine the company to determine its creditworthiness – Will the company be able to pay back the loan under its original terms and/or if they default what collateral can the lender rely on to recover any unpaid amounts?

Relevant ratios include the liquidity and leverage ratios, but the profitability ratios are also relevant. Both annual and quarterly information can be used.

Once the creditworthiness has been assessed the lender and borrower can work on the terms of the loan including:

- Duration
- Interest rate (prime, prime + X, fixed rate)
- Collateral and/or compensating balances
- Debt Covenants

After ratios are calculated look for red flags and also consider areas of where management judgment may have inappropriately influence estimates and consider these areas in the next step.

Step 4 - Accounting Analysis and Forecasts

Here are some items to consider:

- Are there any unrecorded liabilities that need to be considered?
- What about off-balance sheet financing including operating leases?
- How confident that on-balance sheet liabilities based on estimates are reliable and fairly stated

Forecasts will typically start with a revenue forecast, followed by an income statement forecast, followed by a balance sheet forecast, followed by a statement of cash flows forecast. The forecast period should reflect the possible term or terms of the loan.

Step 5 – Comprehensive Analysis

In this step you are summarizing and integrating all of the work done in the previous steps. In addition you are now ready to propose potential loan parameters including term, interest rate, collateral and compensating balances, and debt covenants.

Step 6 – Loan Decision

For most commercial lenders there will be a process to follow to have the loan approved. As the loan grows larger higher levels of approval will be required.

Liquidity and Capital Resources

The following is a discussion of our principal liquidity requirements and capital resources.

We had approximately \$1.1 billion in cash, cash equivalents and short-term investments at June 27, 2008, which includes \$990 million of cash and cash equivalents, which was flat from fiscal year 2007. During fiscal year 2008, cash provided by operating activities and cash provided by employee stock option exercises and employee stock purchases were offset by capital expenditures, the repurchase of our common shares, dividends paid to shareholders and the acquisition of MetaLINCS, Inc. (“MetaLINCS”).

The following table summarizes results of statement of cash flows for the periods indicated:

(Dollars in millions)	Fiscal Years Ended		
	June 27,	June 29,	June 30,
Net cash flow provided by (used in):			
Operating Activities	\$ 2,538	\$ 943	\$ 1,457
Investing Activities	\$ (991)	\$ (402)	\$ (561)
Financing Activities	\$ (1,545)	\$ (463)	\$ (732)
Net increase in cash and cash equivalents	\$ 2	\$ 78	\$ 164

Cash Provided by Operating Activities

Cash provided by operating activities for fiscal year 2008 was approximately \$2.5 billion and included the effects of:

- net income adjusted for non-cash items including depreciation, amortization, and stock-based compensation;
- an increase of \$351 million in accounts payable, primarily as a result of outsourcing the manufacture of certain sub-assemblies to third parties;
- an increase of \$238 million in vendor non-trade receivables, primarily as a result of outsourcing the manufacture of certain sub-assemblies to third parties (see Note 2 to the Notes to Consolidated Financial Statements);
- an increase of \$151 million in inventories, principally raw materials and finished goods; and
- an increase of \$154 million in accrued expenses, employee compensation and warranty.

Cash provided by operating activities for fiscal year 2007 was approximately \$943 million and included the effects of:

- net income adjusted for non-cash items including depreciation, amortization, stock-based compensation and tax benefits related to a change in our valuation allowance for deferred tax assets;
- a decrease of \$391 million in accounts payable;
- a decrease of \$465 million in accrued expenses, employee compensation and warranty. A large part of this increase was due to variable performance-based compensation earned during fiscal year 2006 and paid in fiscal year 2007;
- the payment of accrued exit costs and retention bonuses related to the Maxtor acquisition; and
- a reduction of \$106 million in inventories.

Cash provided by operating activities for fiscal year 2006 was approximately \$1.5 billion and included the effects of:

- net income adjusted for non-cash items including depreciation, amortization and stock-based compensation;
- increases of \$190 million in accounts receivable and \$113 million in inventories; and
- increases of \$91 million in accounts payable and \$120 million in accrued expenses, employee compensation and warranty.

Cash Used in Investing Activities

During fiscal year 2008, we used \$991 million for net cash investing activities, which was primarily attributable to expenditures for property, equipment and leasehold improvements of approximately \$930 million and \$74 million for the acquisition of MetaLINCS. The approximately \$930 million we invested in property, equipment and leasehold improvements was primarily comprised of:

- \$88 million for manufacturing facilities and equipment related to our subassembly and disc drive final assembly and test facilities in the Far East;
- \$490 million to upgrade and expansion of our recording media operations in the United States, Malaysia and Singapore;
- \$184 million for manufacturing facilities and equipment for our recording head operations in the United States, the Far East and Northern Ireland;
- \$65 million for manufacturing facilities and equipment for alternative technologies in the United States; and
- \$103 million for research and development, information technology infrastructure and other facilities and equipment costs.

During fiscal years 2006 through 2008, we increased capacity to support increased unit shipments and additional capacity for the ramp-up and production of Seagate-designed disc drive products to replace legacy Maxtor-designed products and to continue with our planned media and substrate capacity expansions in Asia. For fiscal year 2009, we expect approximately \$1 billion in capital investment will be required to ensure continued alignment of our manufacturing capacity with of customer demand and to finish our planned recording media and substrate capacity expansions in Asia, while we continue to improve our utilization of capital equipment.

Cash Used in Financing Activities

Net cash used in financing activities of approximately \$1.5 billion for fiscal year 2008 was primarily attributable to the repurchases of our common shares totaling \$1.5 billion. Additionally, we paid approximately \$216 million in dividends to our shareholders, repaid \$34 million of our long-term debt and received approximately \$178 million in cash from employee stock option exercises and employee stock purchases.

Liquidity Sources and Cash Requirements and Commitments

Our principal sources of liquidity as of June 27, 2008, consisted of: (1) approximately \$1.1 billion in cash, cash equivalents, and short-term investments, (2) cash we expect to generate from operations and (3) a \$500 million revolving credit facility.

Our \$500 million revolving credit facility that matures in September 2011 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, we had used \$62 million for outstanding letters of credit and bankers' guarantees as of June 27, 2008, leaving \$438 million for additional borrowings, subject to compliance with financial covenants and other customary conditions to borrowing.

The credit agreement that governs our revolving credit facility contains covenants that we must satisfy in order to remain in compliance with the agreement. This 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, we are in compliance with all covenants.

Our principal liquidity requirements are primarily to meet our working capital, research and development, capital expenditure needs, and to service our debt. In addition, since the second half of fiscal year 2002 and through the June 2008 quarter, we have paid dividends to our shareholders.

On August 17, 2007, November 16, 2007, February 16, 2008 and May 16, 2008, we paid dividends aggregating approximately \$216 million, or \$0.42 per share, to our common shareholders of record as of August 3, 2007, November 2, 2007, February 1, 2008 and May 2, 2008. On July 15, 2008, we declared a quarterly dividend of \$0.12 per share that will be paid on or before August 15, 2008 to our common shareholders of record as of August 1, 2008. In deciding whether or not to declare quarterly dividends, our directors will take into account such factors as general business conditions within the disc drive industry, our financial results, our capital requirements, contractual and legal restrictions on the payment of dividends by our subsidiaries to us or by us to our shareholders, the impact of paying dividends on our credit ratings and such other factors as our board of directors may deem relevant.

With respect to the closure of our Limavady and Milpitas facilities, we expect to pay cash restructuring charges aggregating approximately \$25 million to \$30 million in the next 12 months.

As a result of the acquisition of Maxtor, we assumed all of Maxtor's outstanding debts, including, without limitation, its outstanding convertible senior notes. Maxtor's 2.375% Convertible Senior Notes due August 2012 (the "2.375% Notes"), of which \$326 million were outstanding as of June 27, 2008, contain a cash conversion feature that will require Seagate to deliver the holders, upon any conversion of these notes, cash in an amount equal to the lesser of (a) the principal amount of the notes converted and (b) the as-converted value of the notes. We will also be required to deliver an additional amount equal to the difference between the as-converted value of the notes and the principal amount in either cash or stock at our election. To the extent holders of the Maxtor notes choose to convert their notes, Seagate may require additional amounts of cash to meet this obligation. 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, we may be required to book an increased amount of interest expense.

In December 2007, we completed our acquisition of MetaLINC'S, in an all cash transaction valued at approximately \$74 million. MetaLINC'S provides enterprise level E-Discovery software that helps companies respond to litigation and regulatory issues which requires them to search large volumes of electronic data for relevant information.

During fiscal year 2008, we repurchased approximately 65 million of our common shares through open market repurchases at an average price of \$22.89 for a total of approximately \$1.5 billion. We

repurchased approximately \$974 million under the \$2.5 billion August 2006 stock repurchase plan and approximately \$500 million under a new plan announced on February 4, 2008, to repurchase up to an additional \$2.5 billion of our outstanding common shares over 24 months. As of June 27, 2008 we had no amounts remaining under the August 2006 stock repurchase plan and had approximately \$2.0 billion remaining under the February 2008 stock repurchase plan.

As part of our strategy, we may selectively pursue strategic alliances, acquisitions and investments. Any material future acquisitions, alliances or investments will likely require additional capital. We may enter into more of these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all. We will require substantial amounts of cash to fund scheduled payments of principal and interest on our indebtedness, future capital expenditures, any increased working capital requirements and share repurchases. If we are unable to meet our cash requirements out of existing cash or cash flow from operations, we cannot provide assurance that we will be able to obtain alternative financing on terms acceptable to us, if at all.

We believe that our sources of cash will be sufficient to fund our operations and meet our cash requirements for at least the next 12 months. Our ability to fund these requirements and comply with the financial covenants under our debt agreements will depend on our future operations, performance and cash flow and is subject to prevailing economic conditions and financial, business and other factors, some of which are beyond our control.

Contractual Obligations and Commitments

Our contractual cash obligations and commitments as of June 27, 2008, have been summarized in the table below (in millions):

	Total	Fiscal Year(s)			
		2009	2010-	2012-	Thereafter
Contractual Cash Obligations:					
Long term debt	\$ 2,037	\$ 361	\$ 446	\$ 630	\$ 600
Interest payments on long-term debt	560	113	190	114	143
Capital expenditures	289	243	46	—	—
Operating leases	281	42	77	54	108
Purchase obligations	3,783	3,257	517	—	9
Subtotal	6,950	4,016	1,276	798	860
Commitments:					
Letters of credit or bank guarantees	89	88	1	—	—
Total	\$ 7,039	\$ 4,104	\$ 1,277	\$ 798	\$ 860

Off-Balance Sheet Arrangements

As of June 27, 2008, we did not have any material off-balance sheet arrangements (as defined in Item 303(a)(4)(ii) of Regulation S-K).

Project Assignment:

1. Review the MD&A section related to Liquidity and Capital Resources. Summarize this section highlighting (1) significant upcoming cash needs and (2) significant cash and liquidity resources can be tapped to meet these needs?
2. Using your project work from Chapter 4 perform a comprehensive analysis of your company that is designed to answer the following questions:
 - a. From a short term perspective (12-24 months) what evidence would you offer that your company is creditworthy? Alternatively, if you think your company is not creditworthy from a short term perspective what evidence supports this view?
 - b. From a long term perspective (5-10 years) what evidence would you offer that your company is creditworthy? Alternatively, if you think your company is not creditworthy from a long term perspective what evidence supports this view?