BEGINNERS' GUIDE TO RATINGS

A CREDIT RATING CAN BE A VALUABLE TOOL FOR COMPANIES LOOKING TO RAISE FUNDS IN THE CAPITAL MARKETS OR THROUGH SYNDICATED LOANS. **JAMES WHITWELL** OF BFINANCE EXPLAINS WHY.

A rating, in broad terms, indicates the probability of investors getting their money back in accordance with the terms on which they invested – that is, it reflects the likelihood of a borrower meeting their financial commitments.

The three main credit ratings agencies – Moody's, Standard & Poor's and Fitch – assess the likelihood of the debt issuer defaulting on its repayments. Their assessment, which comes in the form of a letter-based rating, provides investors and lenders with an objective and independent standard for analysing the credit risks associated with that issuer's debt. Consequently, the rating influences the interest rate the borrower pays.

Credit ratings can be applied to a variety of debt issues and issuers, but specific corporate issues rated include: long-term debt, medium-term notes (MTNs), commercial paper (CP), bank loans and preferred stock.

HOW YOU ARE RATED. The agencies assign letter grades to debt that reflect a range of credit risk. Moody's scale, for example, comprises 21 notches and is divided into investment and speculative grade (or junk grade) ratings. Investment grade ratings indicate a relatively low probability of default and high likelihood of timely repayment, while those in the speculative or non-investment grade categories either signal a higher probability of default or that a default has already occurred. Some regulated institutional investors, such as insurance companies, have not always been allowed to invest in speculative grade bonds.

Moody's scale runs from Aaa (low default risk) to C (higher default risk). Its lowest investment-grade rating is Baa3, while the highest speculative-grade rating is Ba1. Moody's modifies each rating class with a 1, 2 or 3 suffix to provide a finer gradation of ratings. Standard & Poor's and Fitch use scales that run from AAA to D and use + or – gradations. Agencies will also provide rating outlooks (positive, negative, stable, or developing) regarding the likely direction of an issuer's ratings over the medium term, generally 18 months.

Corporates or issues carrying the same rating are of similar but not necessarily identical credit quality since the rating categories do not fully reflect small differences in the degrees of credit risk. Ratings of different classes of obligations of the same issuer may vary based on expectations of recoveries in the event of a default or liquidation. Recovery expectations, which are the amounts expected borrower to be received by investors after a default, are a relatively minor consideration in investment grade ratings, while recoveries expectations gain in importance at lower rating levels, because of the greater likelihood of default.

Ratings do not imply a specific prediction of default probability: Fitch estimates that over the long term defaults on AAA rated US corporate bonds, for example, have averaged less than 0.10% a year, while the equivalent rate for BBB rated bonds was 0.35%, and for B rated bonds, 3%.

THE BASIS OF THE RATING. In rating the probability of a debt default, agencies make an initial assessment based on public information, which they obtain from issuers, other obligors, underwriters and other respected sources, such as experts in industry, government, academia or the media. To maximise the reliability, credibility and independence of the rating, the agencies rely heavily on financial and operational reports, as well as market and economic data. They may also use information from prospectuses, offering circulars or memoranda, trust deeds, or indentures of particular securities.

The agencies primarily look at the level and trend of some of the issuer's financial ratios, including coverage, leverage, liquidity, profitability and cashflow to debt ratios. The coverage ratios are the ratios of company earnings to fixed costs: low or falling coverage ratios indicate possible cashflow difficulties ahead. A too high leverage (debt to equity) ratio signals excessive indebtedness, sparking fears that the company will not be able to earn enough to satisfy its debt obligations. The two common liquidity ratios (current assets to current liabilities and current assets excluding inventories to current liabilities) measure the firm's ability to pay bills coming due with cash currently being collected. Profitability ratios are measures of assets or equity. They reflect a firm's overall health. Firms with higher return on assets should be better able to raise money in security markets because they offer prospects for better returns on the firm's investments.

In addition to analysing published data, an agency will also meet

FIGURE 1
Table of comparative credit ratings.

	MOODY'S Long term	MOODY'S Short term	S&P Long term	S&P Short term	FITCH-IBCA Long term	FITCH-IBCA Short term	
Investment Grade	Aaa		AAA		AAA		Highest
	Aa1		AA+	A-1+	AA+	F1+	
	Aa2	Prime-1	AA		AA		
	Aa3		AA-		AA-		
						F1	
	A1		A+	A-1	A+		
	A2		A		A		
	A3		A-		A-		
		Prime-2		A-2		F2	
	Baa1		BBB+		BBB+		
	Baa2		BBB		BBB		
	Baa3	Prime-3	BBB-	A-3	BBB-	F3	
Non-Investment Grade	Ba1		BB+		BB+		
	Ba2		BB	B	BB		
	Ba3		BB-		BB-		
						B	
	B1		B+		B+		
	B2	Not prime	B		B		
	B3		B-		B-		
				C			
	Caa		CCC		CCC		
	Ca		CC		CC	C	
	C		C		C		Lowest
			D	D	D	D	

with an issuer to extract additional information. As such, it is often privy to confidential, non-public information about companies' finances. However, the possibility that companies will conceal true positions always exists – as the Enron fiasco demonstrated last year. Often corporates fear giving too much away and opening themselves up to the agency's interpretation.

RATINGS CHANGES. On an ongoing basis, the agency will monitor the issuer to determine whether the rating should be changed. An agency will conduct a formal review of an issuer's rating roughly every six months. However, it can call a review if events occur in the intervening period that might influence the issuer's credit quality. The agencies will normally attempt to conclude the formal review within 60 days. Once the agency has gathered sufficient information and concluded on an appropriate rating, it will inform the market. If after the review, a rating committee decides not to change a rating, the rating is said to be 'confirmed'.

Ratings can be changed at any time, however, not just after a formal review as a result of changes in, or the unavailability of, information, or for other reasons.

MAINTAINING DIALOGUE. Managing relationships with agencies is important for treasurers since downgrades can have a significant negative impact on a company's cost of capital. In extreme cases, such as that of Enron, a downgradable can trigger default clauses in loan agreements, leading to funds being withdrawn from a company just when it is most reliant on its financings. Ratings agencies considering putting firms on ratings watch (that is, on alert for an up/down grade) would usually contact them first for a discussion. Ideally, agencies will not spring surprises on issuers but will consult them in advance and draw their attention to factors that might affect the rating. Agencies should not be acting on market whims – that is, reacting to changes in risk already priced in by markets.

While its credit rating affects an issuer's cost of capital, the rating is just one part of a strategy and should not dominate a corporate's strategy. Indeed, some firms are willing to sacrifice a rating notch or two to accommodate their expansion plans. Two years ago, for instance, a number of European telecoms companies threw their credit ratings to the wind by amassing huge debts in order to purchase the much-coveted third generation (3G) mobile telephone licenses.

Often a corporate's attitude to ratings is proportional to its dependence on the capital markets: firms that regularly tap the debt markets to sustain growth will be more conscious of seeing their cost of capital rise than firms that occasionally take advantage of markets to get cheap capital.

A HELPING HAND. With the increasing importance of credit ratings for corporates, many companies retain consultants or ratings advisors to assist them in managing their interface with ratings agencies and and the wider investment communities. These consultants can help companies to manage the impact of strategy on credit ratings, to make positive presentations to ratings agencies and to plan for a transition where a change in rating is inevitable. The rating agencies themselves can also often expect input to companies concerned that a shift in business strategy or a particular transaction may affect its ratings. The agencies have consulting teams, acting wholly independently of their main corporate ratings services, who can provide confidential indicative reports on the rating which would be likely to apply if the company's plans were to be implemented.

ENRONITIS. Following the collapse of Enron, a watershed appears to be afoot in the ratings industry, the extent of which is not yet clear. Since being censured for not spotting the problems at Enron, the three main agencies have understandably been readier to downgrade. Moody's, Standard & Poor's and Fitch all rated Enron investment-grade as recently as four days before the firm made a record bankruptcy court protection filing on 2 December 2001. They blamed fraud, saying the information Enron provided was faulty. After all, the agencies role is not to revalue a firm's assets – that is up to the auditor.

Since Enron, Standard & Poor's has acknowledged that there are limits to the extent to which a single set of symbols can convey information and is working in a number of ways to provide investors and risk managers with a more explicit assessment of fundamental credit factors. The initial focus in this regard is on recovery, liquidity, and business continuity.

Recovery assessments will initially be targeted to bank loans. Expansion to other sectors, including unsecured speculative-grade rated corporate bonds and the subordinate tranches of certain structured securities, is also under review. Liquidity risk assessments are being considered in light of increased fragility of short-term credit markets and the increasing credit and liquidity implication of contingent claims. Agencies will be looking to see if a firm has adequate back-up facilities and diversified funding sources. Business continuity assessments have already been utilised in the banking sector, particularly with respect to an institution's ability to provide certain business operations in supporting structured financings.

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More information on ratings and ratings agencies can be found in *The Treasurer's Handbook* 2002, pp273.