BEATING THE SQUEEZE

A CREDIT RATING HAS A PROVEN AND POSITIVE IMPACT ON CORPORATE LEVERAGE IN TOUGH ECONOMIC CONDITIONS, WRITE AMRIT JUDGE AND ANNA KORZHENITSKAYA

By providing access to the public debt markets, a credit rating can bring considerable benefits to a company. Not only does it widen the company's investor base and improve debt pricing, it also enables entry to foreign bond markets and the opportunity to gain international visibility, thereby reducing reliance on local banks.

It is well known that since the start of the financial crisis, banks have attempted to repair their balance sheets and have consequently cut back significantly on their lending commitments to the corporate sector. The Bank of England reported that between the fourth quarter of 2007 and the end of 2008, there was a significant tightening of price and non-price terms on loans to companies. This made raising bank loan finance extremely difficult for creditworthy companies and consequently limited the availability of debt-based finance for companies that were heavily reliant on banks for their debt capital.

In the UK, the problem has been potentially more acute because banks have traditionally been the main source of capital for the private sector. Research by Standard & Poor's (S&P) in 2010 found that 76% of debt is provided by banks. Data suggests that corporate bond issuance by UK businesses with a credit rating has increased substantially since the onset of the crisis, however. S&P's 2010 research revealed that since the events of September 2008, UK corporate bond issuance had increased by £22.1bn.

The role of ratings

A survey of CFOs and treasurers of UK companies by the ACT's Gerry Bacon, John Grout and Martin O'Donovan in 2009 found that the possession of a credit rating, and the resulting access to public debt markets, became especially important during the 2007-2009 financial crisis. That same year, the Bank of England reported that rated companies were raising capital market debt to pay back bank loans and issuing bonds, rather than accessing new bank loan facilities. But the bank also suggested that while those companies with bond market access had turned to arm's-length sources of finance, smaller businesses without access still remained severely financially constrained. According to the ACT research, many firms that did not have a rating during the crisis were seeking to obtain one.

The financial crisis provides a unique opportunity to investigate the role of access to public debt markets in determining companies' leverage during a period of reduced bank loan supply. Here, we examine whether the effect of having a credit rating on companies' leverage is influenced by credit market conditions. We employ data for the top 500 UK-listed non-financial companies by market capitalisation for the period from 1989 through to 2008. For credit ratings, we use a company's long-term S&P or Fitch credit rating.

To examine whether the effect of a credit rating on leverage varies over our sample period in a manner consistent with the tightening and/or loosening of credit markets witnessed during this period, we conduct regression analysis whereby we interact our rating variable with year dummies to create a separate rating coefficient for each year of our sample period. We estimate the model in equation 1 as below.

Leverage measures the amount of total debt in the capital structure of a firm. *Rating* is a dummy that equals to one if a company possesses an S&P or Fitch credit rating and zero otherwise. X_{it} is a vector of company-specific control variables (company size, profitability, asset tangibility, etc) to control demand-side factors. ID_i is a vector of industry-specific control variables. GDP_t and $FTSEALLSH_t$ are macroeconomic control variables.

To illustrate the variation over time in the effect on leverage of having a credit rating, we plot the rating coefficients ($a_{2t}Rating*Year_t$) obtained from estimating equation 1 in figure 1 (see opposite).

Looking at leverage

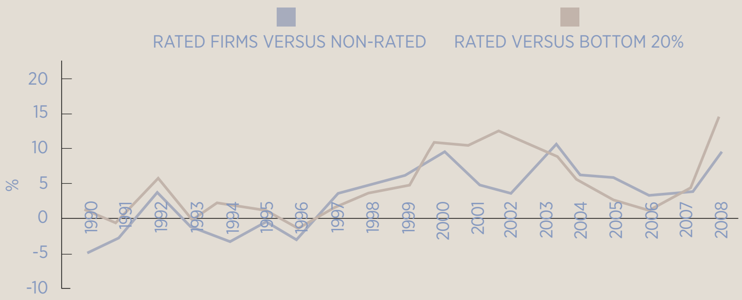
Our results show that the rating coefficient is relatively high and statistically significant in the years corresponding to periods of credit market tightening (1992, 1999-2003, and 2008), and relatively low during the years before and after these periods (1991, 1993-1998, and 2004-2007).

The coefficient on our credit rating variable reaches a small peak in 1992, a little after the 1991 recession during which bank lending to UK private non-financial companies

EQUATION 1

$$Leverage_{it} = a_0 + a_1 Rating + \beta_1 X_{it} + \beta_2 GDP_t + \beta_3 FTSEALLSH_t + \beta_4 ID_i + a_{2t} Rating*Year_t + \varepsilon_{it} \quad (1)$$

FIGURE 1: LEVERAGE DIFFERENCE BETWEEN RATED AND NON-RATED FIRMS OVER TIME (1990-2008)



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weakened significantly. But this period was not characterised by a financial crisis. During the 1993-1998 period, when credit markets were relatively loose, the effect of possessing a rating is relatively low and mainly insignificant, suggesting no discernible difference in leverage between rated and non-rated firms. This period witnessed several years of positive year-on-year growth in sterling lending to UK firms with an average nominal growth rate of 8.8% during the four years between 1995 and 1998, according to calculations made using Bank of England data. Annual real GDP growth averaged 3.2% per annum during this period and interest rates fell to relatively low levels over these years.

For the period covering 1999-2003, the effect of having a rating is relatively high and statistically significant, and it is at its highest during the years 2000 and 2003. These years coincide with the bursting of the 'dot-com bubble', the terrorist attack on the Twin Towers in 2001, a string of audit scandals in 2001 and 2002, the Iraq War and rising commodity prices, leading to a significant tightening of UK credit markets and the availability of credit for UK companies from the banking sector.

In 2002, *The Treasurer* interviewed Pippa Mason, managing director, head of UK and Ireland corporate debt capital markets, Citigroup, who argued that the accounting scandal at energy giant Enron in October 2001, and the bankruptcy of telecommunication company WorldCom in July 2002, contributed to a decline in corporate credit quality and difficult credit market conditions during 2002 and 2003. That year, *The Treasurer* also interviewed Ian Fitzgerald, director and head of distribution and syndication at Lloyds TSB Capital Markets, who suggested that banks had become increasingly more selective about the types of structures in which they would invest, and this had led to the credit market being only open to good-quality, well-rated companies, while other companies became credit-constrained.

During the pre-crisis years (2004-2007), the effect of having a rating is lower than in 2008 and during the 1999-2003 period, indicating that possession of a credit rating had a lower material impact on companies' leverage levels in these years. Bank of England data shows that the three-month growth rate in the stock of lending was rapidly increasing during 2004-2007, peaking in October 2007. Furthermore, according to central bank loan officer surveys, credit market conditions in the UK, EU and US were relatively loose during the 2004-2007 period, implying that bank credit was readily available at attractive rates of interest. Since the 2007-2009 financial crisis is associated with a severe banking credit crunch, resulting in a substantial reduction in loan supply to the corporate sector, we find that the effect of having a rating rises sharply in 2008.

The Bank of England has reported that smaller companies suffered disproportionately in terms of the cost and availability of bank credit during the financial crisis. Consistent with this, we found the most positive effects on access to leverage when we compared companies with a rating against the smallest companies in our sample. The average leverage difference between rated and non-rated companies was 8.8%. When we restricted our non-rated companies to those in the bottom 20% according to size, however, the average leverage difference increased to 14.9%.

In summary, our analysis shows that the effect of possessing a rating varies according to conditions in the bank credit markets. The leverage difference between companies with and without a rating is greater during periods of credit market tightening and smaller when credit conditions are loose. Our results show that debt market segmentation did not matter when credit conditions were loose, such as the period 2004-2007, as banks willingly supplied the UK corporate sector with the credit it needed. But in 2008, at the height of the financial crisis, non-rated companies found that they were severely financially constrained.


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