

Corporate credit ratings: what information to give a credit rating agency?

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Which agencies?

These comments apply to credit rating agencies (CRAs) providing 'solicited'/subscriber pays' ratings and subject to a confidentiality agreement in respect of identified inside/price sensitive information relating to the issuer/rated entity provided to the CRA.

What is not disclosable to the CRA?

In most jurisdictions, there are no restrictions on disclosures by companies to CRAs provided that the recipient owes a duty of confidentiality.

To encourage issuer disclosure to and communications with CRAs a section in the International Organisation of Securities Commissions' (IOSCO's) 'Code of conduct fundamentals for credit rating agencies' December 2004 requires CRAs to adopt procedures and mechanisms to protect confidential information shared with them by issuers.

Mostly, exemptions from general disclosure rules are provided in local legislation and regulations¹. Exemptions are based on the concept that with the "widely available publication of the rating... the impact of non-public information of the creditworthiness of an issuer is publicly disseminated, without disclosing the non-public information itself"².

Companies need to document the duty of confidentiality in respect of matter falling within the definition of 'Inside Information' by agreements with the CRAs. This needs to be slightly extended in the UK³. The main CRAs are happy to explain their arrangements to ensure that they can honour the contracted confidentiality obligations.

What to provide?

Some CRAs give ratings based merely on a statistical analysis

of the published information about the company.

With a solicited rating however, the CRA also has access to top management of the company and to non-public information. That should lead to more appropriate and more stable ratings, and so a lower cost of capital for the company. This is what it is paying for.

Best practice is for CRAs to disclose whether the issuer participated in the rating process and to identify any rating not initiated at the request of the issuer⁴ and this is likely to be a requirement in some jurisdictions. Treasury associations further urge marking of solicited ratings where access to management and information has not been satisfactory⁵.

The 'Code of standard practices for participants in the credit rating process' issued by the ACT and other treasury organisations advises that issuers should co-operate actively with CRAs and provide adequate and timely information when a rating is solicited⁶.

While CRAs normally do a good job of handling information, companies should not assume that information provided has been digested, rather than filed. Or that the basic information provided when a first rating is made or when a matter first became important has been retained on file and read and understood by successive generations of analyst. Or that the analyst has explained it satisfactorily to the other members of the 'rating committee' in the CRA. Some reminders by the company may be needed over the years⁷.

Recent regulations requiring rotation of CRA analysts may mean more effort from the company to keep everyone up to speed.

Information for an initial rating

Before starting, look to see if the CRA rates similar companies. Read the rating reports. If there are important factors distinguishing your company from others in the industry, resolve to make them clear.

The easy part is to provide relevant publicly available information about the company. Care is needed even here.

¹ In the EU, under the Market Abuse Directive (MAD), disclosure of information likely to have a 'significant effect on the prices' of an issuer's financial instruments or related derivative financial instruments is permitted if the recipient 'owes a duty of confidentiality'.

In the UK the MAD is implemented by the FSA in the Disclosure Rules. Subject to this, market practice is for free disclosure to CRAs.

In the US, explicit provision for selective disclosure to CRAs of 'material information' about companies under Regulation FD ('Selective Disclosure and Insider Trading', Release No. 24-43154 (15 August 2000), 65 FR 51716 (August 24, 2000)) at 17 CFR 243.100(b)(2)(iii) was, seemingly

randomly, repealed in the Dodd-Frank Act, 2010 (111th Congress (2009-2010) H.R.4173.ENR). There remains however a general exemption for disclosure under a suitable confidentiality agreement (Reg FD (17 CFR 243.100(b)(2)(ii))).

² 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, as required by S. 702(b) of the Sarbanes-Oxley Act of 2002', US Securities & Exchange Commission, January 2003 (SEC Interim Report) in note 60 p22

³ In the UK the confidentiality agreement should be extended to cover relevant information not generally available (RINGA) covered by market

For example, there will be a lot of financial information: if particular accounting conventions etc. affect the company's business, provide covering explanations (even representations) with the material and additional matter too – don't let the analyst form false impressions at the outset.

You'll find the rating CRA's description of its methodology for corporate rating on its website helpful. Watch out for agencies consulting on changes of methodology or its application and any effected changes.

Agencies usually set out their favourite ratios, based on one GAAP or another – and if you are unclear how your particular company's figures would be treated in calculations, meet and talk it through with the rating analyst using actual numbers from your published accounts (supplemented by internal analyses if need be) before providing any information – otherwise you will be unsure of where the reassurances or problems may arise.

You'll also need to provide a lot of unpublished information about the business, strategies, plans and projections, governance and risk management.

Companies usually make a major presentation to the rating analysts. Ensure that 'hard copies' of presented material are available with supplementary material as necessary. All of it must be labelled and indexed or it will be mostly useless.

Careful selection of material for a written submission to the CRA in good time before the meeting enables the CRA to bring the right experts and make best use of costly meeting time.

■ 'Macro' (whole economy) and Meso (industry level) factors

Start with the big picture. CRAs will usually be experienced in reviewing the company's industry, but it is unwise to assume their knowledge is encyclopaedic, current, correctly selected or relevant to exactly what you do and where you do it.

The CRA needs a summary of how the company sees the risk factors affecting its industry, and how they will develop. Capital intensiveness, maturity (technological and market), cyclicality, competition, barriers to entry, substitutes for the industry's products, demand factors, under/over capacity, growth/decline and what is happening to customers and among your wider stakeholders, the operating models (national, regional, multi-national or global, comprehensive or niche and how the products are delivered), environmental impact and 'social responsibility' issues should all be addressed. It may be necessary to deal with separate major product sectors.

A similar run-down on the environment in which the company operates is needed – geographical, social,

regulatory and technical/technological.

CRAs who field experienced analysts are a valuable source of insight for your company. Don't be afraid to ask the analyst what they think, for example, of your ranking of macro risks⁸. A difference of opinion is more usefully flagged before the conference call discussing a pending rating action.

■ 'Micro' (firm level) factors

With the wider picture established, start to deal with the company's particular situation.

Outline very briefly the management and legal structure of the group, major shareholders or other important stakeholders, etc.

Cover the market position of key products, ability to differentiate the product and provide competitive advantages, with a review of specific product life-cycle positions and sales/distribution patterns in various geographies.

Relative costs and how sourcing arrangements are advantaged/disadvantaged, the implications of single/multiple sourcing of key components/materials/skills, and the impact of the company's relative size in its industry need to be explored.

Access to/ownership of necessary intellectual property ('know-how' as well as protectable matter), trademark/copyright or regulatory privilege must be explained. If the company operates in a regulated business or, in certain markets, under price regulation or particular orders of restrictive-practices courts or competition authorities, point this out.

The principal risks – and opportunities – arising from the story so far must be outlined and related to the industry risk profiles discussed previously. Don't forget litigation risk. Consider too risks from dependence on particular customers and suppliers or particular end uses for intermediate products.

This leads naturally to strategy. Outline the company's strategic processes, and current strategy and its approach to risk management/risk financing. An important aspect will be the company's balance sheet and cashflow profile and how it is related to the risk financing task. Cover business continuity plans too.

Show how current strategy relates to past strategies – are strategies the Chairman's current whim, or deeply thought out and tested and measured against the real world and a range of future external developments?

If they are not already clear, outline the main drivers of profitability and (with emphasis) cashflow.

Provide copies of the company's business plan. If there are identifiable risks or developments ahead, model their effects and how management will react to deal with these

abuse considerations dealt with in the Financial Services and Markets Act in s. 118. RINGA is a wider concept than the inside information used in the EU Directive.

⁴ IOSCO Code of conduct fundamentals for credit rating agencies, December 2004, clause 3.9 (<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf>).

⁵ ACT response (www.treasurers.org/actcommentssec.pdf) to the SEC's Concept Release: Credit Ratings under the Federal Securities Commission, [Release Nos. 33-8236; 34-47972; 12-03] RIN 3235-AH28, June 2003.

⁶ E.g. 'Code of standard practices for participants in the credit rating process' issued by the ACT, the Association of Finance Professionals and L'Association Française des Trésoriers d'Entreprise on behalf of the International Group of Treasury Associations, March 2005, section 7. See www.treasurers.org/technical/papers/resources/cspfinal_mar05.pdf.

⁷ Rated company frustration with failure of rating agencies to retain information prompted France to introduce a requirement for rating agencies to retain some information for three years. See also under 'Managing the relationship', below.

changes. If it is not self-evident, explain the link between the business plan and the strategy.

The business plan and cash flow and compliance with loan covenants and other limiting factors should be "stress tested" in a variety of scenarios⁸.

A commentary on any divergences between the last year's plan and the new one and on actual variances can stand you in good stead with the CRA. It can convey a powerful sense of management competence and continuity. A divergence against prior plans (or budgets) surfacing as a major discussion point at a rating committee without the analyst having heard the company's view of it can be damaging.

A CRA's evaluation of the management's abilities and the suitability of the management structure are important to the eventual rating. Partly derived from the strategic expositions given, the evaluation will also look at the management's track-record: what does the record show? Set it out for the CRA. Has the business been on an improving track or a muddled/declining one (operationally as well as strategically). Has there been delivery of past strategic plans? How has the company performed against previous shorter-term plans? How has it coped with previous unexpected developments with significant impact for good or ill?

The rating attempts to be forward looking, so it is impossible to overstress how important it is that the CRAs understand and respect the management's approach.

The CRA will be interested in the company's Enterprise Risk Management and approach to risk generally⁹.

Cashflow is inevitably important. In presenting past and projected financials (after the first delivery of published information), ensure that cashflow is highlighted, together with the quantitative aspects of the major cashflow drivers previously identified. The CRA's favourite ratios will look at cashflow coverages as well as conventional measures of gearing. Trends in the ratios will be important. The impact of financial transactions (share issuance, share buy-backs, etc) must be made clear, especially in projections. Equally highlight and adjust out flattery of operating cash flows by receipt of exceptional advanced payments or similar distorting items.

Take further the discussion of the balance sheet under 'risk financing' previously, explaining the overall approach to the balance sheet, target duration of debt, etc as well as dividend policy/objectives. If "net debt" has been flattered by unusual items (exceptional advanced payments again?), make that clear.

CRAs are more interested than ever in the location and form of cash and marketable securities holdings. Are they concentrated or distributed around the group? What currencies and instruments? Are any restricted for any purpose? How does all that square with the group policy on cash levels – are the latest balance sheet and the projected picture abnormal for any reasons and what about seasonal effects?

Consider the impact of the legal structure of the Group on rated obligations (structural subordination) as well as their

formal priority/subordination in the issuing company/guarantors and the impact of, for example, exchange controls, controls on inter-company transactions etc which may shut off obligor companies/guarantors from resources elsewhere in the Group.

Consider contingent liabilities – noted in the report and accounts and those not so mentioned. Pension and medical benefits and environmental obligations can loom large here. And consider relationships with any "off balance sheet" companies, SPVs, etc. Highlight any "onerous" contracts.

Set out the company's 'strategy for financial mobility'¹⁰: how aggressive is gearing (however defined); how flexible are capital/major revenue project expenditures; how disposable/re-deployable are assets; how strong are banking relationships; how fragile are roll-overs of drawn facilities; what multi-year facilities are un-drawn – and what might make them unavailable for drawing; how receptive might equity markets or bond markets be (given that in this context some corporate stress is assumed)?

With the experience of the last few years, CRAs will pay more attention to liquidity issues for a rated entity and the outlook for liquidity. A lack of liquidity could precipitate the default of an otherwise healthy entity, whatever its underlying performance. One agency says "Adequate" liquidity (B+ and above) is defined as that which would protect a company's credit quality from reasonably adverse financial market circumstances, with lower ("Less than adequate" and "Weak") and higher categories ("Strong" and "Exceptional") for less or more insulation from market perturbation.

The treasurer, the main on-going routine contact for the CRA analyst, needs to be on top of all of the foregoing and in any case treasurers should be anyway as part of their general responsibility for financial strategy.

By planning the pre-meeting provision of information and the actual presentation/meeting carefully, the treasurer can make best use of the time of top management colleagues and the CRA's analysts.

When you let the analysts ask their questions, they will raise aspects you have not covered at all or which require further explanation. It is vital that the management team do not blow it all away at this stage. Giving wrong answers off the cuff can weaken the excellent impression built up so far. A good team will be able to give full, correct answers immediately to some questions – but be sure to follow all of these up in writing after the meeting. For other questions, while pointers can be given immediately, analysis or research may be needed and a written answer be given later. Don't let your colleagues try to bluff their way through. There is no shame in "getting back to them". Credit analysts inevitably look at the world through different eyes from businessmen and their worries are not always top of mind for company executives, even the treasurer.

It can also be useful to take the analyst to see convenient, important or example company sites, etc. Seeing the attention to hygiene in a food or electronics factory or the

⁸ The rating agencies publish from time to time the main macro scenarios they use in evaluating and stress testing ratings

⁹ E.g. 'Standard and Poor's to Apply Enterprise Risk Analysis to Corporate ratings', 7 May 2008, <http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/2,1,1,4,1204836988994.html>.

application of unique technologies or the differentiation in use of the company's products in the real world can give reassurance for which there is no substitute. But be aware that analyst time is the major CRA overhead and don't do visits just for the sake of it.

■ Managing the relationship

CRA's will need updates on all the above as developments and changes occur not just in "actual" but in plans and projections too.

Remember that, for sub-investment grade issuers, CRA's will inevitably tend to focus on the next year or two's survival (financial issues probably dominating) while business factors and long term projections will be more important for investment grades.

Normally, analysts are well on top of the job, but careful reading of a CRA's rating report on your company may throw up matters to focus on. There can be minor misunderstandings by the analyst or important ones. Sometimes, while you thought the analyst understood something, it is clear they failed to convince the rest of the rating committee.

A treasurer's maintaining a dialogue with lead analysts and other contacts at a CRA on a regular basis through the year is important. Checking the CRA's absorption levels of background information is not best done had while it is responding to, for example, a profit warning from the company.

CRA's usually review the ratings formally each year. This provides an opportunity for updating them and dealing with worries, and for them to meet and hear from top management again. Try to economise on your top management's time by running through most material with the analyst without them. Then they can be brought in to go over particularly important points and for general questions.

Published information should be provided to CRA's as it is issued. Minor corporate announcements can be handled similarly and the treasurer should call the analysts to answer any questions and to ensure they are happy. Usually, results announcements would fall into this category.

Major announcements will often be about matters considered in strategic plans. Even in such cases, it is sensible to give the analysts a bit of notice and, if need be, access, so that, where possible, they can, after a rating committee, quickly issue a firm 'no change' or a firm change, rather than putting the company on 'credit watch' (perhaps with 'negative implications'). Of course, the company should have thought through the implications of the matter of the major announcement on all the factors relevant to the credit rating as discussed above. Thus the contact with the CRA can be fruitful and use least time when corporate executives, including the treasurer, may be very busy.

The analyst is the primary conduit of contact between the company and the CRA, but have in mind that the credit committee plays an important role in determining a rating. Treasurers do well to ensure that they have some element of relationship with the team leader of their sector at the CRA.

Regulations in flux: Impact on issuers

Legislation relating to credit ratings is still in flux at the time of writing. Readers are urged to monitor Technical Update in The Treasurer magazine for further information. Below are a few points so far.

CRA staff may not be able to accept invitations to investor days, meals after meetings and so on and may require to pay for or to reimburse the company for any gifts or food provided in the course of meetings etc. Companies should not take offence at this.

European Union

Many elements of the recent and proposed regulation of CRA's to build market confidence in ratings will impact rated issuers. Among them:

- A revised analyst rotation policy means over time changes in the analysts with whom they are in contact
- Ratings business segregation resulting in a change in the name of the legal entity issuers contract with for the ratings process
- A minimum 12-hours' notice issuers are given to review rating actions before their publication.

Another rule requires investors in the EU who use ratings for regulatory purposes to draw only on ratings from EU-approved or, in the case of foreign-issued ratings, EU-endorsed credit rating agencies (CRA's).

United States

CRA's will need to put confidentiality agreements in place where these are not existing given the withdrawal of the specific CRA exemption in Regulation FD I.

Other changes may mean CRA's may need to restrict references to credit ratings in prospectuses etc.

Conclusion

Remember that the reason you are paying for a 'solicited rating' is so the rating analyst has a good appreciation of material matters. Ensure that you get full value in this. And if you allow what you think might be an inappropriate rating of a listed security to persist by failing to communicate effectively with the CRA, reflect not just on your ethical position and the code for issuers⁶ (above) but also on the company's obligations under the securities and market abuse laws and regulations in your country/countries of listing.

The rating process should be a useful experience for a company and the published rating help its communications generally as well as to ratings users.

¹⁰ Donaldson G (1969). 'Strategy for financial mobility', Harvard Graduate School of Business Administration, Division of Research (available in the Harvard Business School Classics series ISBN 10: 0875841279 ISBN 13:

9780875841274, 1986.).