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Rating Transitions for Investment Grade Issuers Subject To Event Risk

Request for Comment

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In this Request for Comment, we discuss how Moody's proposes to handle ratings transitions for investment-grade issuers that, after undertaking a transforming event, become exposed to the likelihood of a sudden shift in capital structure and, by extension, sudden and sizeable ratings downgrades from investment grade to speculative grade.

Transforming events typically result from strategic undertakings such as a decision by a company to:

- decapitalize materially using debt to finance a substantial stock buyback; or
- spin off a material business to shareholders and leverage the remaining business; or
- accept a largely debt-financed buyout offer from another company, management, or financial or private equity investors.

In such situations, Moody's proposes transitioning the ratings via a series of interim rating actions as opposed to a significant one-off, multi-notch rating adjustment after the consummation of the event. The progression of these sequential rating actions will be based on two interrelated factors:

- the expected degree of migration from the current rating to the potential final rating; and
- Moody's ongoing assessment of the probability that the transaction will be consummated. This determination will be informed by the cumulative occurrence of transaction-related milestones.

This approach balances a number of objectives, including the need to weigh accuracy, timeliness and market relevance against the possibility of having to reverse the rating action - particularly at the cross-over point between investment grade and speculative grade. Although we recognize the possibility that a particular rating action might be reversed in the event that the underlying transaction does not consummate, the likelihood of a reversal taking place at the cross-over point from investment grade to speculative grade is small. This is because we propose moving a rating from investment grade to speculative grade only when the percentage probabilities that the underlying transaction will be consummated are high (please see Tables 1 and 2). Our ultimate goal is to improve the consistency and timeliness of ratings. However, we wish to do so without prescribing required actions because we appreciate that circumstances will vary and that norms differ from region to region.

Moody's welcomes comments or suggestions on this proposal from market participants. Please send comments on or before August 18, 2006, to cpc@moodys.com.

Summary Rating Approach

The proposed rating approach is based on the underlying principle that Moody's can provide added value by making interim, reasoned rating assessments based on highly probable outcomes in cases of clear and likely event-driven risk. This may differ from our traditional approach of typically changing a rating only after an unfolding situation has been fully resolved.

In making such an assessment, we attempt to balance the following objectives:

- the need to weigh accuracy, timeliness and market relevance against the risk of having to reverse a rating action - particularly at the cross-over point from investment to speculative grade; and
- the need to ensure a consistent approach to assessing a rated entity's event risk across Moody's global CFG franchise

In so doing, we also acknowledge:

- the need to understand and address the possible credit impact of a Moody's rating action on notes that may benefit from a Change of Control clause (associated with a downgrade to speculative grade); and
- the need to determine when - or if - put clauses (either contractual or non-contractual) contained in the indentures covering affected securities should have an effect on Moody's rating for that particular security.

Our proposed new rating approach considers two interrelated factors:

- the likely degree of ratings migration from the current rating to the estimated final rating; and
- the cumulative probabilities that the transaction will be consummated as gauged by specified milestones. When assessing the significance of such milestones, we use a continuum of escalating probabilities.

With this approach Moody's is able to take some rating actions even in advance of total certainty as to the outcome of an unfolding or potential event.

Moody's Step-by-Step Approach to Transitioning a Rating

Following a company's announcement of an event that may trigger an action, Moody's will use the rating action guidelines described in Table 1 to determine whether a rating action is warranted. Separately, Table 2 illustrates how certain milestones might be used in that process. To frame a recommendation, we will assess:

- the credit implications of the potential event and its likely implications for the rating; and
- the milestones in the transaction and, for each of these milestones, the associated level of probability that its completion will increase the likelihood of the underlying transaction being consummated.

We recognize the possibility that a particular rating action might be reversed should the underlying transaction not occur. Accordingly, in order to minimize market confusion at the critical investment-grade cross-over point, we propose moving a rating from investment grade to speculative grade only when we believe that the probability of the underlying transaction being consummated is high.

Specifically, we typically look for two situations that imply a higher likelihood of closure. They are:

- a cumulative probability of a principal negative credit event (or alternative negative event) occurring greater than 80% (see Table 1); and/or
- shareholders' approval of the underlying transaction (see Table 2 for illustration of a practical case).

Consideration 1: Assessing the Likely Overall Degree of Migration

The grid we use to assess the degree of interim rating adjustments considers the cumulative probability that the underlying transaction will be consummated together with the expected final rating, as well as the distance of the latter to the current rating.

In positioning the rating at any step along the transaction timetable, we consider:

- the nature of the underlying transaction: whether it is, for instance, a company-initiated corporate activity (buyout or decapitalization) or a private equity bid;
- the likely rating after the transaction is completed and the magnitude of the migration from the current rating to the expected final rating;
- the probability that the underlying transaction, or an alternative transaction, will be consummated;
- the transaction timeline (see Table 2 for illustration), including the steps to be completed to close the transaction and conditionality at any point in time; and
- the protection provided by the terms of the indentures covering the specific securities/or specific circumstances (see below).

Table 1

Transitioning Grid / Choosing the Rating Positioning

Cumulative Probability	Heavy Migration from A	Heavy Migration from Baa	Moderate – 1 to 2 Notches
25%-50%	Issuer comment or outlook change	Issuer comment or outlook change	Issuer comment or outlook change
>50%	Consider Baa1 under review or Baa3 if B scenarios > 50%	Consider Baa3 under review	Review
>70%	Consider mid to low Baa under review	Baa3 under review	Consider interim rating step
>80%/90%	Ba1 under review if final rating is Ba; Consider Ba2 or Ba3 if final level is B	Ba1 under review if final rating is Ba; Consider Ba2 or Ba3 if final level is B	Interim rating step likely
100%	Final rating – could be B	Final rating – could be B	Final rating

Notes:
1) "Heavy Migration" is defined as 3 notches and more from the current rating to the potential final rating
2) "Cumulative Probability" refers to the sum of all scenarios that may lead to a downgrade
3) We try to assess the individual probability of each scenario, eg: if an A2 rating can move down one notch with 50% probability and with 40% into B, we will probably position the rating as A3 under review

Consideration 2: Possible Milestones for a Rating Action

The second, interrelated consideration is an evaluation of the transaction timetable and associated milestones.

The sequence of events typically required to complete an underlying transaction is mapped in the grid to cumulative probabilities that the underlying transaction will close. In Table 2 below we have provided a typical timeline according to which a succession of rating actions may occur as the transaction progresses and the cumulative probability of closure increases.

Although we are willing to take interim rating actions without full certainty regarding the outcome of an event, we do establish heavy hurdles for the cross-over from investment grade to speculative grade and therefore see limited potential for rating reversals across that rating boundary.

As indicated in Table 1 above (and further illustrated in Table 2 below), we would typically look for 80-90% likelihood of closure and/or shareholder approval to move a rating to speculative grade. Trigger events described in Table 2 are illustrations of probability thresholds rather than necessary hurdles for an action. In other words, Moody's may move a rating to speculative grade if the probability of cumulative scenarios is higher than 80-90% regardless of whether shareholder agreement has been obtained. On the other hand, if shareholder agreement has been obtained, it is highly likely that we will take such action.

The events and milestones that may trigger a rating action include those listed below. We do not intend to suggest that a rating will be moved at each of these stages. A number of the milestones reflect situations in which the rated issuer could be either the initiator or target of the proposed action.

- Announcement by an issuer that it is conducting a comprehensive strategic review of its operations and capital structure
- Public acknowledgement by a potential buyer that it is interested in making an acquisition
- Public announcement by a potential purchaser of a formal and detailed bid to undertake an acquisition
- Approval by the board of directors of a material transaction
- Regulatory filings in connection with the transaction (e.g. S-4 in the US)
- Approval by the shareholders of the target company of a proposed acquisition
- Satisfaction of contingencies contained in the financing agreements for a proposed transaction
- Approvals by relevant stock exchanges for listing new shares to be issued in connection with the transaction
- Completion of due diligence by the purchaser
- Approvals by competition/antitrust/regulatory authorities
- Closing

How It Would Work In Practice

The following examples illustrate how the two considerations outlined above may interact as cumulative probabilities increase and/or certain milestones are passed to prompt consideration by Moody's of certain rating actions.

The first example is of a company that is currently rated A2. If we determine the cumulative probability of a particular transaction occurring to be greater than 50%, we will consider taking an interim action:

- to Baa1 (continuing review for downgrade); or
- to Baa3 (continuing review for downgrade) if we believe there is a 50% probability that the likelihood of the final rating is B1 or below.

In any event, by the time the cumulative probability of the transaction occurring is greater than 70%, we will consider taking an interim action to Baa3 (continuing review for downgrade).

When the cumulative probability of the transaction occurring increases to 80-90%, we will consider moving the rating to Ba1 (continuing review for downgrade) if the final rating is Ba3, or to Ba2 or Ba3 if the final rating is B.

When the transaction closes or becomes unconditional, the rating is moved to its final level, in this example B1.

Another illustration of how we might migrate a rating as certain events unfold and/or as probabilities increase is described in Table 2 below.

Table 2

Illustration Milestone Grid / Timing of Rating Actions

Cumulative Probability	25%	50%	70%	80/90%	100%	
Event	Strategic review or potential bid	PE bid launched or recap announced	Board approval	Shareholder approval	Transaction unconditional	Closing
Action	Issuer comment	Rating review or rating action if > 3 notches migration	Continue review	Consider Ba1 or Ba2/3 if rating expected is B	Final rating	No action
	Rating Remains Investment Grade			**Speculative Grade Rating Likely**		

Note:
Action is determined independently by two interrelated drivers, event and/or cumulative probability

Assessing the Impact of Financial Covenants

An important factor in assessing the impact of event risk on ratings is the possible presence of certain covenants in the indentures.

We undertake a detailed analysis of the terms of the indentures covering the notes for any rated security and evaluate any provisions that may affect the rights of the noteholders at the cross-over level between investment grade and speculative grade. Based on our assessment of the existence and quality of protective covenants and/or non-legally binding offers to buy securities out at par, it is possible that we will differentiate the ratings for instruments that are well protected (e.g. those that include a well constructed change of control clause) from those instruments that do not benefit from such protection.

Contractual Change in Control Provisions

If a contractual obligation protects the holders of an investment-grade security by ensuring a prompt and full buy-out at par as a result of the event, we would generally maintain the rating at Baa3 for the protected securities under review. This assumes that in our judgment the clause is enforceable and effective and that the company has liquidity or we are comfortable that refinancing lines have been arranged to support the exercise of puts. Any stub portion of the debt that does not elect to put would generally be lowered to the rating for securities of its class. If the stub portion of the debt is "covenant stripped" in connection with the put or buyout offer (see below), it would likely be rated as subordinated debt.

Non-contractual Offers to Repurchase Securities

If a potential buyer of a rated issuer has made a public non-legally binding promise to buy the investment-grade securities at par and the rating committee considers the probability of that offer being implemented to be high (>75%), we would generally maintain the rating at Baa3 under review (with the same proviso regarding liquidity arrangements as above).

Limitation of Contractual Change in Control Provisions

If a change of control clause is not operative because of its wording (for instance, a trigger may require both change of control plus a rating of below investment grade within 90 days *after* closing), we generally would move the rating according to the guidelines provided by Tables 1 (and as illustrated by Table 2), i.e. when there is a high likelihood, but not a total certainty, of the transaction closing. This may result in the notes being downgraded to below investment grade prior to closing.

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