Managing your credit rating relationships

Joseph E Cantwell of Cantwell & Co looks at how the market is fundamentally changing the way issuers manage their relationships with the ratings agencies.

In 1991, there were probably just over 1,000 rated 'issuers'[1] of debt worldwide. Today, the number easily surpasses 3,000. It is therefore not surprising that many issuers may feel they are being forced to 'compete' for a satisfactory rating, which is seen in our survey data[2]. Those issuers which do not feel this pressure are ignoring, or are oblivious to, fundamental changes in how issuers 'manage' their relationships with the ratings agencies.

Two ratings today, but probably three tomorrow

The importance of actively managing these relationships has been underscored by the acquisition-fuelled growth of Fitch-IBCA-Duff & Phelps into a much more viable alternative to the traditional duopoly[3] of Moody's Investors and Standard and Poor's (S&P). I believe that rather than becoming a simple alternative to Moody's and S&P, the Fitch rating will develop as a true third rating in a worldwide capital market that will increasingly demand more than two ratings.

Understand the rating agency point of view

Ratings agencies approach their work from what I refer to as the 'debt-holder perspective', and the resulting ratings reflect the agency's estimate of the potential of an issuer to pay its obligations as agreed. Simply stated, the principle is, if things go well for the issuer, the bondholders do not participate on the upside. However, if things do not go well, the bondholder may be forced to participate on the downside by not being paid on time or not being paid in full.

The key difference, therefore, is that, unlike equity analysts, the ratings analysts are not overly concerned with the upside since, from their perspective, there is no upside. Even in the case of convertible securities, the rating applies only to the debt. The agencies do not rate the convertibility of the issue and do not give an issuer 'credit' for the equity unless, and until, the issue is actually converted.

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A reasonable expectation that an issue will not be paid on time is the classic dividing line between 'investment grade' (bonds rated BBB or better) and 'junk' bonds. The expectation that an issue will not be paid in full is generally the difference between a rating starting with a 'C' and one starting with a 'B' or higher. This analytical 'debt-holder' approach closely parallels bank credit analysis.

Ratings analysts do not generally think in terms of 'per share' calculations, and such numbers are probably best left out of rating presentations.

Given their analytical approach, do not expect them to give too much weight to market capitalisation (unless it is substantially below book value). Convertible securities are counted as equity only after they are converted, and are not fully counted even when they are 'in the money'.

Meet your peer group

You are indirectly competing with your rating 'peers', not all of whom you may view as your direct business competitors. Beyond the financial statements, the rating agencies also look at an issuer's industry position and its overall size.

While there are no quota systems at the ratings agencies, or limits on the number of ratings that can be issued in a given rating category, there are certainly practical pressures to differentiate among issuers.

In every industry, there are leaders and there are laggards. It is also true that in most industries all of the key players are already rated.

This does not mean that the distribution of ratings for a given industry must approximate the 'bell-curve' we all remember from academia. For each issuer, the creation of a list of 'peer' companies generally begins with the list of obvious competitors.

Going beyond industry boundaries, the ratings agencies attempt to ensure comparability of their ratings across industry lines. It is not expected that banks and industrial companies will have comparable, much less the same, ratios. An issuer's peer group could be a rather extended list of companies.

Choose your battles carefully

Quantitative factors are obviously important and will be an important factor in 'ball-parking' the rating. While some information may be subject to interpretation, the bulk of what is presented in financial reports is generally straightforward. This is not to say, however, that the qualitative factors cannot be important. Many of our survey respondents complain that the agencies do not understand their concerns about their ratings. It is possible that there may be legitimate differences of opinion on what is your most important business(es)

or who are your staunchest rivals.

Choose your generals even more carefully

Similar to most analysts, ratings analysts have become accustomed to hearing policy statements delivered by policymakers. An inherent conflict often arises since the perspective of some issuers is that credit rating presentations are less important than equity presentations.

Consider the implications of the fact that ratings agencies never (or rarely) get to meet your CFO, much less your CEO. Our survey data clearly shows that the most common practice is for either the CEO or CFO to head the issuer delegation at credit rating presentation meetings[4].

My 20 years of advising issuers has also shown that when the CEO is present, the CFO is usually also in attendance. So, when a company's CEO and CFO cannot make time in their schedules to attend these meetings, it often conveys a negative message. Consequently, that organisation may suffer by comparison, and, unfortunately, several big firms fall into this category. This is a potential problem that can be easily fixed.

You can speak freely

Although it is currently a hot topic in financial circles, 'selective disclosure' is generally not a problem when dealing with the ratings agencies since these organisations have been granted 'insider' status by the Securities and Exchange Commission (SEC) and similar regulatory organisations outside the US. For most issuers, nothing that is told to the ratings agencies should create an ongoing disclosure requirement on the part of the issuer.

The ratings agencies also have an excellent record of maintaining the confidentiality of the information that is entrusted to them. In my experience, I am not aware of any breaches of confidentiality. If that were not the case, issuers would simply stop talking to them.

Almost everybody is willing to give out projections

Relying upon 'insider' status, most issuers[5] routinely provide detailed financial projections (income statement, balance sheet and funds statement) to the ratings agencies. The typical industrial company submits projections in the three- to five-year range, usually with some business segment details in addition to the consolidated results. I believe that the 80:20 rule often applies in the use of projections. In the debt markets, roughly 80% of the rating is based on current and recent past performance. Only 20% of the rating is prospective. In the equity markets, these percentages are reversed.

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The exact percentages will, of course, vary on a case-by-case basis and there is evidence to suggest that the ratings agencies have recently been giving somewhat more weight to projected results in their analyses.

Not meeting projections does not necessarily get you downgraded, just as exceeding projections does not guarantee an upgrade. The kind of variances that can cause a major swing in share prices may be more like rounding errors on the debt side.

The rating process has to be managed

With new names entering the debt markets every week, even well-established issuers must clearly take the initiative in managing their dealings with the ratings agencies.

For most organisations, presentations to equity analysts are not isolated events, but rather the culmination of a much larger process involving all aspects of investor relations and communications. While unlikely to be accorded the same status as an equity roadshow, the rating presentation should be subjected to many of the same disciplines, including level of preparation and consistent communication of corporate goals and objectives.

The key word here is 'presentation'. The rating meetings are not simple Q&A sessions, but rather an opportunity for the issuer to deliver a tailored message as to its financial goals and objectives. The bottom line is that the rating meeting should not be viewed as a necessary nuisance for senior management, but rather as part of a much larger co-ordinated effort to communicate your organisation's message.

The bigger picture

Managing ratings agency relationships must be put into proper perspective as an important part of an organisation's overall financial public relations. By merely averting a downgrade or accelerating an upgrade, most organisations can experience real cost savings.

The credibility gained from a consistent long-term effort in addressing issues important to the credit analyst can have significant benefits to your company's financial success. ■

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Footnotes

1 'Issuer' is defined as a family of related entities with similar or identical credit characteristics. A parent company and its guaranteed (or otherwise supported) subsidiaries would therefore count as one 'issuer'. Not included are municipalities, securitisations and other special purpose issuing vehicles.

2 Cantwell & Company has completed four annual surveys of credit ratings of issuer perceptions about the ratings agencies and the ratings process. A fifth survey is scheduled to commence in November 2000. Survey results can be freely downloaded from our website www.askcantwell.com

3 Our data indicates that over 90% of the most prominent issuers have ratings from both Moody's and Standard & Poor's. The largest non-bank issuers often have three ratings, while most banks have four ratings.

4 Almost 40% of our survey participants report that the CEO routinely chairs the rating meeting and an additional 50% report that the CFO assumes that role.

5 Over 90% of our survey respondents reported that they provided projections.