Syndicated loan ratings – a growing phenomenon

Richard Smith-Morgan charts the success of the syndicated loans ratings market and shows how companies can benefit from participating in the arena.

Little on the face of it would appear to link HMV, JC Decaux, Avecia Holding plc and France Telecom. However, each of them has had bank loan credit ratings from Moody's Investors Services applied to their syndicated credit facilities. The purpose of this article is to explain the background to the development of the syndicated loan ratings market in Europe, and through the medium of case studies – JC Decaux and Avecia Holding – briefly outline the principal advantages. It should be noted that we are referring throughout to public, syndicated bank loan ratings and not rating estimates, private ratings typically used in CDO and CLO structures.

Historical perspective

Initially loan ratings tended to focus, on the leveraged loan market. It was here that they were perceived to have most value, principally due to the complexity of the capital structures involved and the wide range of protections available to the various levels of creditors. However, as the benefits and advantages of loan ratings became increasingly well understood, that perception began slowly to change. Today, the investment grade market is currently the fastest growing segment of the syndicated loan rating market.

A growing market – the key drivers

It is the simultaneous convergence of a number of factors, rather than any one factor individually, that is beginning to drive the development of the European loan rating market. In the leveraged finance arena, syndicated loan ratings can objectively reflect the advantages, in terms of collateral structures, that this group of creditors typically enjoys.

This is expected to increase, as the flood of private equity into Europe shows no sign of abating.

The case study of Avecia Holding (see box) emphasises the advantages of syndicated loan ratings in the context of a multi-layered capital structure.

The key factors that will determine the relative position of each class of creditor, and hence the degree of notching, as described in the case study, will be a combination of the following:

- the group structure itself;
- the capital structure, and the relative size of each class of debt within it;
- the collateral package; and
- the relevant jurisdictions which tend to vary significantly across different European countries.

The continuing consolidation of 'corporate Europe' and the related syndicated financing requirements is expected to continue to build demand for loan ratings in the investment grade market. These transactions – due to their size and purpose – are less relationship and more market driven and are therefore priced and structured accordingly. In addition to often being an integral part of the pricing structure (pricing grid related), the assignment of a syndicated loan rating is considered to be a key factor in assisting the development of this additional liquidity.

Richard Smith-Morgan

FIGURE 1

Furthermore, the banks themselves, driven by a combination of shareholder pressure, capital constraints and an increasingly sophisticated regulatory environment, are in the process of implementing portfolio management techniques proactively to manage their balance sheets. The availability of credit ratings for loans is increasingly becoming a key feature in that process, either as a direct feed or to validate internal rating systems.

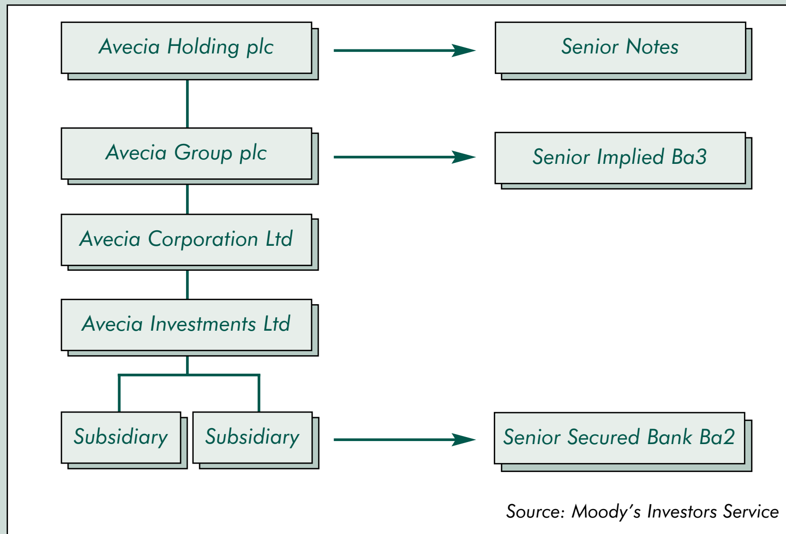
Finally, there is the increasing presence of the institutional investor. Already a key player in the US syndicated finance markets (many US syndicated facilities have for some time now included an institutional investor tranche), institutional investors are beginning to look at the European loan markets in their search for diversification and yield.

Once specific structural impediments (tax legal and accounting) can be overcome and familiarity with diverse and complex bankruptcy regimes[1] can be increased, their presence is expected to drive the market for loan ratings still faster.

Processes and procedures

The process of undertaking a syndicated

Case study 1 – Avecia Holding plc



Source: Moody's Investors Service

- Avecia Holding plc is the £1.3bn buyout by Cinven/Investcorp of the speciality chemicals business of Zeneca plc, which in April 1999 merged with Astra AB to form AstraZeneca plc.
- Part of the acquisition financing comprised the issue of two debt instruments: $540m of senior unsecured notes, and $585m of senior secured syndicated bank facilities. Moody's undertook its usual two-stage analysis. First, it assigned a 'senior implied rating' – of Ba3 – not to any specific instrument in the capital structure but rather to that entity which best represented the risk profile of the Avecia Group. The Senior Implied reflects the expected loss of the entire capital structure and therefore incorporates both probability of default and severity of loss. In the second stage of analysis, Moody's then 'notched' each actual debt instrument up or down from the senior implied ratings to reflect the different levels of loss severity of each instrument within the capital structure. The issue of senior notes was rated at B2 – two notches below the senior implied, which reflected, in particular, the structural subordination to a significant amount of secured bank debt. The bank debt was rated at Ba2 – one notch above the senior implied – reflecting the benefit of the security package, as well as direct security in assets accounting for over 90% of the entire group's operating cashflows.
- In total, therefore, three notches separated the two debt instruments and demonstrated the clear advantages (in terms of pricing and therefore execution) from having the loan rated, rather than using the rating on the bond as a proxy. ■

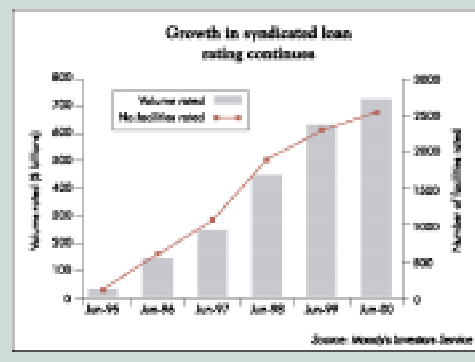
bank loan rating is almost identical to that for a bond rating and includes a detailed analysis of both business and financial risk, and an assessment of management capabilities and track record.

Within the European context, Moody's use the same analytical team – selected principally by sectorial expertise – that evaluates an issuer's bonds to analyse the syndicated bank loans and to communicate the ratings' rationale to the investor community. The rationale for both ratings changes and changes in ratings outlook is communicated in the normal way, via press release.

A meeting with management is an integral and important part of the process. The rationale for both rating changes and changes in the rating outlook is communicated in the normal way, via press release.

Syndicated loan ratings are monitored in the same way as bond ratings, including a full written research service, and full access to the relevant analyst. In addition, the service includes the publication of relevant market research, including default and recovery studies.

FIGURE 2



Case study 2 – JC Decaux

Founded in 1964, Jean-Claude Decaux pioneered the concept of providing cities with 'street furniture' such as bus shelters, maintained free of charge and financed through advertising. It is now the world's largest player with net sales in 1999 of FFr8bn.

In early September this year, as part of a reorganisation of its capital structure and prior to a potential IPO at the end of the year, Decaux organised a FFr10bn syndicated credit facility jointly arranged by Goldman Sachs, Barclays, BNP Paribas and HSBC.

Decaux and the joint arrangers together achieved a number of objectives. The affirmation of Decaux's investment grade status - the loan was rated Baa2 by Moody's (their only existing rating) – enabled Decaux and the arrangers to access potential pools of liquidity that would otherwise have been unavailable by facilitating primary distribution.

In addition, the transaction could be priced on an investment grade basis, at significantly more competitive levels than Decaux's previous transaction. In general terms it is the combination of these factors that helps ensure certainty of execution in the face of relatively volatile market conditions. ■

Progress

The loan rating market has clearly made substantial progress since its inception in 1995. Today, Moody's globally rates over 2,500 facilities for a total of over $750bn (see *Figure 1*). While 90% of this coverage relates to US names, the European market has got off to an encouraging start. Moody's now rates almost 50 European loan facilities for a total volume of over $90bn.

From facilitating relative value analysis to enhancing liquidity in both primary and secondary markets, syndicated loan rating appeals to issuers, intermediaries and investors alike. It is this breadth of appeal that is expected to continue to underpin the future growth of this market. ■

Richard Smith-Morgan is Vice President, European Loan Ratings at Moody's Investors Service in London and also sits on the LMA's Portfolio Management Committee.

Note

1 European insolvency issues in leveraged finance are discussed in more detail in Moody's Special Comment entitled *Bankruptcy and Ratings: A Leveraged Finance approach for Europe*, dated March 2000.