The ratings game

WITH EU REGULATIONS COMING INTO FORCE FOR THE RATING AGENCIES, THE ACT HELD A TIMELY BREAKFAST MEETING – SPONSORED BY S&P – TO LOOK AT THE LATEST ISSUES IN RATINGS. **PETER WILLIAMS** REPORTS.

Peter Kernan, S&P's team leader corporate ratings in Europe, reminded the audience at the September meeting in London that the basic purpose of a rating was assess the willingness and ability of a borrower to repay its debts as they fell due, or the ability and willingness of a borrower to respect the financial terms of a particular debt security or other financial obligations. Issuers, he said, were in the best position to say why they chose to be rated. However, he added that it was clear that ratings had expanded and diversified the borrowing universe and that ratings helped borrowers anticipate the cost of debt and provided benchmarks so they could compare themselves to their peers in similar businesses and sectors.

As for lenders/investors, he suggested that they used ratings to provide a risk benchmark supplementing their own in-house credit research, so that the ratings provide input into decisions on whether to extend credit and if so on what terms. As for intermediaries such as bankers, ratings facilitate pricing against other deals.

Kernan said that rating services offered an effective measure of the relative risk and were independent, objective and credible. Credit rating grades run from AAA to D, with BBB- and above considered investment grade by market participants, and everything else from BB+ down seen as speculative grade.

S&P's default studies have repeatedly found a clear correlation between ratings and default risk. In general the higher the rating, the lower the observed frequency of defaults and vice versa. Kernan said that this held true for every region across the globe. A look at the charts suggest that the risk of AAA defaults is negligible, even looking at a time horizon of 20 years; over the same period CCC can expect a default rate of nearly 60%.

THE MECHANICS To produce a rating, two main risk types are considered, business risk and financial risk, both of which are familiar to treasurers (see Box 1). The agencies also look carefully at standard ratios such as FFO/debt, debt/EBITDA and debt/capital, assigning categories which range from minimal to highly leveraged depending on the precise multiple involved.

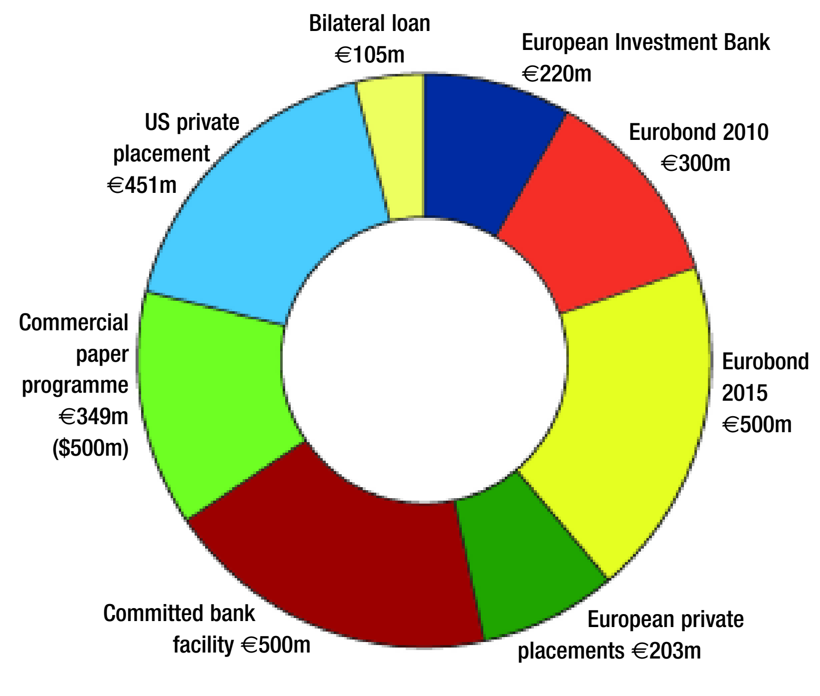
One of the factors that has gained prominence over the last two or three years has been the focus on liquidity, although the rating agencies maintain that liquidity has always been a part of financial risk analysis. Kernan said: "Unlike most other rating factors, a lack of liquidity could precipitate the default of an otherwise healthy entity."

S&P has five standard descriptors for corporate liquidity ranging from exceptional to weak, which either bolster or weigh on an issuer credit rating (ICR). Producing a rating involves a standard procedure from the internal request for a rating through to the rating being issued and then ongoing monitoring of the company and its finances by the rating agency.

Kernan said that a typical timescale was three to six weeks after the agency and management met formally. Prior to that, a team conducts preliminary research. When a rating is issued, the company can appeal to the ratings committee against the decision.

The ongoing monitoring falls into two categories: outlook and credit watch. Investment grades are assessed over two years for potential direction, speculative for one year with four options (positive, negative, stable or developing). A change in outlook is not necessarily a precursor to rating change or creditwatch, which is a warning of possible near-term change – positive, negative, developing – over the next 90 days.

Figure 1: Urenco's finance facilities at 31 December 2009



THE TREASURER'S PERSPECTIVE Alan Dick, group treasurer of Urenco, explained that his company – a manufacturer of enriched uranium which is privately owned one-third each by the UK government, the Dutch government and RWE/E.ON – saw itself as in a strong position in a growing market with a long-term order book that is helping to drive expansion. On average Urenco contracts last 10 years; a base price is agreed, as are price escalations. Even though the company's business is the enrichment of uranium it has no direct exposure to the metal.

The figures certainly suggest a strong financial performance: Urenco's turnover rose from €730.2m in 2005 to €1,121.0m in 2009, with EBITDA rising from €458.6m to €669.7m over the same period. The other figure of note is capital expenditure, which has increased in five years from €313.4m to €843.0m. Urenco is positioned in the high-value part of the nuclear fuel cycle, using what Dick called "world-leading centrifuge technology".

Until 2004 the group was primarily financed by bank debt and private placements, but the growth strategy demanded significantly higher levels of capital expenditure, which in turn required higher levels of funding. The anticipated level of funding required could be achieved only through accessing the public debt market and therefore it was decided that a rating was required.

A key driver of this new approach to financing, especially in the current financial and credit climate, was to reduce the group's reliance on bank funding. This has been achieved and Dick said that the group had now significantly diversified its source of funding (see Figure 1). The group has sufficient forward funding cover well into 2011, having improved its financing even further with a successful €500m Eurobond issue in January (not included in Figure 1). The current financial profile has an average maturity of seven years and Dick said that the company took the approach that it would review funding opportunities as and when they arose. He also noted that he viewed the current bank facility primarily as a backstop to the commercial paper programme.

With the growth and funding strategy in place, in 2005 the company initially went to Moody's for an inaugural rating and subsequently also approached S&P. At the start of his session Dick asked the breakfast audience how many knew of Urenco and only a smattering of hands went up. (Eagle-eyed Treasurer readers will be familiar with the company if they recall Alan Dick's How to Do a Eurobond article in the April 2010 issue.)

The show of hands proved his point and Dick suggested that given the company is private and lacks name recognition getting away its first Eurobond for €300m would have been a much tougher job without the rating. Having secured a Moody's and S&P rating, the company also brought in Fitch in 2009 due, according to Dick, to "potential concerns over rating direction and access to public markets".

But recognition does eventually come. Having issued two subsequent Eurobonds (2008 and 2010), Dick said the company now had a credit curve in the market. Urenco has a rated €2bn euro medium-term note (EMTN) programme from which the 2008 and 2010 bonds were issued. In addition to the corporate rating it has an actively used and rated $500m commercial paper programme.

Dick said: "We will still look at other sources of funding for diversity but accessing public markets is a key part of our funding strategy going

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forward." He added that the retention of an A rating was key for the group, an ambition which it has achieved to date and which also includes a stable outlook from all three agencies.

Dick gave some sound advice to treasurers who are considering seeking a rating for their corporate or who are new in any way to the issue of rating. Perhaps it is a given that it is best to be open and honest with the agencies. Certainly communication is a key issue and Urenco's minimum level of communication with the agencies is a face-to-face meeting after the year-end in addition to another meeting to go through the half-year-end results and the business plans. Dick praised the credit analysts as generally being insightful and understanding the business, although they seem to struggle to place Urenco, with some treating it as a utility, while others treated it more as a chemical company.

In between those results-driven events, Dick now supplies quarterly management accounts in an effort to show the trends. Recently Urenco has given credit investors, who are more demanding, more information than was traditionally the case to debt investors. Dick works on the principle that it is best if there are no surprises, which is why credit investors are given forward-looking information covering areas such as capex, order book, market views on pricing and competitive threats. The accounting is almost irrelevant for the rating agencies; instead, the main driver is understanding the present and likely future cash position of the group.

THE INVESTOR'S PERSPECTIVE Jeremy Baldwin, managing director and head of European credit research at AIG Asset Management (Europe), a buyer of corporate bonds, said there was some similarity between a trapeze artist hanging on grimly to the trapeze and the debt investor hanging on grimly to a company to see if they can enjoy a return. He suggested that from an issuer's perspective the current situation didn't look too bad. He took a random example of one A- rated company where the yield on a corporate bond had slipped from just over 8% in the late 2008 to just under 3.4% today.

That may be good news for treasurers looking to raise funds in the bond market but it is bad news for investors trying to match yields with liabilities. So there is a dichotomy between what issuers and investors are looking for. When things go well, investors can enjoy a little bit of upside; when things go badly, they can go horribly wrong and the investor is in danger, in Baldwin's words, "of losing his shirt". When returns are low, coupons are typically around around 5%, so if there is a default in an investor's portfolio – even representing as little as 0.5% of the total holding – then that is a lot of relative performance that has to be made up. Baldwin recommended that treasurers be very aware of that backdrop when talking to investors and potential investors.

On the investment side, according to Baldwin, the views of portfolio managers, traders and research analysts all have an equal part to play in constructing the portfolio. There is a top-down and bottom-up process in constructing the portfolio. Investment portfolio guidelines determine the maturity and credit risk that can be taken, driven by external regulation.

The research process begins for AIG by assigning its own rating through a model independent of, but similar to, that used by the credit rating agencies, with limits relating to country, issue and issuer. Although there is a small appetite for unrated paper, asset managers are hard-wired to look to external rating agencies. The fund runs its own ratings because it has found it often takes a different view from rating agencies, the agencies can be late in upgrading or downgrading, and the size of the portfolio forces it to understand risk exposure and to think ahead.

As a debt investor, Baldwin defended the performance of the ratings agencies and said that although there had been problems in one part of the ratings landscape – structured products – the attacks in the media were not accurate. "In general terms in both the bank and the corporate market, the rating agencies have done the job you would have expected."

Every decision that Baldwin and his colleagues make is driven by a two-dimensional question: what is the return or reward for the risk being taken? The market isn't always right and Baldwin is constantly looking for the difference between price and value.

Box 1: The main influences on ratings

Business risks
- Country risk
- Industry characteristics
- Company/competitive position
- Profitability/peer group comparison
- Management and strategy

Financial risks
- Accounting
- Governance, risk tolerance, financial policy
- Cashflow adequacy
- Capital structure, asset protection
- Liquidity/short-term factors

Box 2: European Union regulation

EU regulation of ratings firms started on 7 September 2010 and S&P is one that has applied for registration. While the ratings agencies have always had in place policies and procedures to ensure the integrity and independence of the ratings process and to manage potential conflicts of interest, the EU rules will add to that. Two key areas are analyst rotation (time on any one client is to be limited to a certain number of years depending on the job title) and prepublication notices (PPN) where issuers are now to be given a minimum of 12 hours for a factual review of PPN. Information on S&P's approach can be downloaded from **bit.ly/aHeGDL**

Peter Williams is editor of The Treasurer.
editor@treasurers.org