PUTTING RATINGS IN PERSPECTIVE

LARS BJÖRKLUND OF STANDARD & POOR'S EXAMINES THE EXTENT OF THE RELATIONSHIP BETWEEN SHARE PRICE VOLATILITY AND ITS EFFECT ON A COMPANY'S CREDIT RATING.

Credit ratings from Standard & Poor's (S&P) are based on many different factors. These factors range from industry characteristics, business profile, competitive and regulatory environments, management and strategy, to a review of the financial profile. Share price and share price volatility are, however, not usually key factors in the rating decision. In fact, share price and credit ratings do not necessarily move in the same direction.

In many ways, the business risk analysis performed by equity and credit analysts is similar. In both cases the analysis is concentrated on industry fundamentals and the company's position within the industry. Therefore, where there is structural change within an industry, such as through the introduction of a substitute product or in the event of significant changes in a company's competitive position, the share price and rating are likely to move in tandem. However, although the share price should, at all times, reflect the value of a company, the perspective for ratings is different.

Credit ratings are a relative ranking of the ability to meet financial commitments on a timely basis. Therefore, although an unexpected large new order for a company can be translated into dollars and cents, and may well have an effect on the value of the company, it may not fundamentally change the company's ability to meet its payments on a timely basis in the medium to long term.

APPROACH TO RATINGS. Against this background, there should be no surprise that share prices are much more volatile than ratings, or that volatile share prices and stable ratings can be consistent with one another. This is particularly the case for companies in cyclical industries, where S&P's approach is to assign a rating that can be sustained through a normal business cycle. This approach is based on the assumption (in turn based on the study of historical patterns for a particular industry) that after a downturn comes an upturn and, since ratings measure viability over the medium to long term, it makes sense to include the normal business cycles in the ratings from the beginning.

Shareholders, on the other hand, tend to put more value on near-term earnings and, as a result, share prices often move with the cycle. However, for high-yield issuers (ratings of 'BB+' and below), the ability to bridge the downturn and to withstand adverse business, economic, and financial developments is more limited. As a result, volatility in these ratings tends to be higher than for investment-grade ratings, although not to the same extent as for share prices.

SHARE PRICE CONSIDERATIONS. Another reason for different volatilities between ratings and share prices can be access to confidential information. Sometimes credit ratings are based on information not generally known in the market place. Once this type of information becomes public, it may have an immediate impact on the share price, while the rating does not change as it has already factored in this information.

There are, of course, occasions when share price may be a consideration in determining a credit rating. For example, if a weakening of the share price causes the management of a company to take actions unfavourable to debt-holders to boost the share price, such as share buybacks, this could have an impact on the rating. Furthermore, a favourable share valuation and good relations with the stock markets may put a company in a better position to issue new shares, with a resulting positive impact on the company's financial flexibility.

This could also make it easier for a company to pay for acquisitions with its own shares. Therefore, for companies with a weak financial profile for their rating category, or for acquisitive companies, a favourable share valuation can prevent rating downgrades, provided there is a strong likelihood that the equity instrument will actually be used.

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In addition, market capitalisation is sometimes used by S&P to complement book values in capital structure measures. All capital structure measures have their limitations, however, and in S&P’s financial review of a firm, cashflow measures are of much greater importance.

Too much reliance on market capitalisation for ecommerce companies, for example, would lead a credit analyst in the wrong direction. While the market capitalisation for Amazon.com has gone from $39bn at its peak to about $3bn currently, S&P has rated the company ‘B’ since the first bond was issued at the beginning of 1998.

The divergence in the views taken for share price and credit rating is, of course, based on differences in the expected outcome for the various stakeholders. Whereas the downside outcome is the same for both equity and bondholders (namely, zero return on their investments), the upside scenarios can differ dramatically.

For the bondholder, the upside is capped and is equal to the principal amount plus contractual interest. For the shareholder, on the other hand, there is no cap on the upside. Provided the upside is large enough, therefore, even a relatively small likelihood of success may result in a high share price.

Sometimes the interests of shareholders and lenders are in direct conflict with one another. Share buybacks, for example, are often received by the equity market with increased share prices, reflecting expectations of higher earnings per share for the remaining shareholders. Similarly, debt-financed acquisitions can have a positive impact on share prices. From the point of view of the existing debt-holders, however, a weakening of the financial profile will reduce the cushion the company has to meet its financial obligations, including interest and amortisations.

If the impact is large enough and goes beyond what the company’s financial policies suggest, this could lead to a change in the rating. Indeed, a significant proportion of the downgrades made by S&P’s European Corporate Ratings Group over the past 18 months have been triggered by debt-financed acquisitions. Although acquisitions have often strengthened the business profile of the company, the negative impact from the increased debt burden has been more significant for the overall credit quality.

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