Improve your ratings – the key to better debt

How can your company improve its position with the rating agencies? Rupert Atkinson of Morgan Stanley Dean Witter gives us the lowdown.

The number of European corporates with debt ratings from the leading rating agencies (Moody's, Standard & Poor's, and Fitch) has grown significantly in recent years. The UK, which has a long-standing lead in terms of the acceptance and usage of ratings, mirrors this trend.

Growth in corporate ratings is expected to continue apace, driven by disintermediation and increasing usage of debt. These trends can be attributed to the convergence of a number of key factors:

- reduced bank appetite for corporate lending;
- investors' search for yield;
- the development of the euro market;
- globalisation and industrial restructuring leading to major M&A activity;
- increased emphasis by corporates on shareholder value;
- changes in the UK tax regime further favouring the issuance of debt over equity; and
- recognition of the benefits of diversified sources of funding.

As a result, the visibility and significance of credit ratings has risen. Many corporates now take the view that ratings play a key role at the centre of the company's wider strategic and financial positioning. This highlights the importance of the relationship between the company and rating agencies. The purpose of this article is to describe some of the background issues and establish a simple 'code of best practice' in order to optimise the company's relationship with the rating agencies. The intention is that this be applicable both to companies with existing credit ratings, and those considering going through the process of gaining ratings for the first time.

Rating agency perspective

In order to understand fully the perspective of the rating agencies, it is worth reminding ourselves what their role is and what it is not. Rating agencies are not consultants, financial advisors, or auditors. Rather, they are specialised independent entities focussed on the provision of high quality, objective credit analysis. Ultimately, a debt rating is an agency's opinion as to the relative and absolute credit strength of the company. Impartiality and integrity are the foundations upon which their credibility and market acceptance are built. Though sharing the perspective of bond investors, and aiming to serve their interests, the rating agencies strive to strike an appropriate balance between the needs of both sides – investors and debt issuers.

First time process

As a result, a corporate borrower embarking upon the process of seeking credit ratings has much to gain by treating the rating agencies as a distinct constituency or stakeholder group, with its own particular needs. Understanding in detail the process by which the agencies assign ratings, and presenting the company in a manner tailored to meet the agencies expectations and requirements, will help ensure that the company's rating objectives are met.

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FIGURE 1

The rating agencies' focus

- Fundamental risk of the company's industry
- Competitive position relative to peers
- Downside risk vs upside potential
- Quality of profitability vs EPS growth
- Cash flow generation vs book profitability
- Forward looking analysis
- Strategy, management track-record and risk appetite
- Capital structure and financial flexibility

Figure 1 highlights some of the fundamentals of the rating agencies' approach to rating corporates, and how this differs to the approach of equity analysts. A number of conclusions as to how companies might choose to present themselves can be drawn from this:

- qualitative factors such as industry risk and competitive positioning form a large part of the analysis;
- strategy, management track record and risk appetite are all key considerations; and
- the emphasis should be on demonstrating the quality of future cash flows.

It follows that the most effective team to deliver this presentation is a combination of chief executive, divisional heads, finance director/CFO, and treasurer. The forward looking nature of the analysis and the importance given to a discussion of the company's

FIGURE 2

Added value

What an effective ratings advisor will do:

- Provide an informed credit view at the outset
- Help design a ratings strategy
- Anticipate the agencies' key concerns and areas of focus
- Prepare a written presentation and conduct a rehearsal
- Act as the company's advocate and facilitate a positive relationship between the company and the agencies
- De-mystify and take the pain out of the initial process!
- Continue to provide advice and analysis on an ongoing basis

strategy mean that the agencies are very often provided with a significant amount of non-public information. Companies new to the rating process need not be concerned about the disclosure of confidential information to the agencies. Though the agencies will not 'demand' confidential information, it is in the company's best interests to treat the agencies as 'quasi-insiders' in a controlled manner.

Use of a ratings advisor

Most companies seeking ratings for the first time choose to employ the ratings advisory services offered by leading investment banks. This reflects the value of specialised experience and advice, and the fact that the rating process itself is often linked to capital markets, M&A, or corporate finance transactions.

Though the decision as to which ratings advisor to employ is not always taken in isolation, companies should be mindful of the fact ratings advisory teams vary significantly in terms of quality. A 'beauty parade' method of choosing a ratings advisor allows an objective appraisal of key variables such as credibility, effectiveness, and depth of experience.

Relationship management: 'ratings are for life, not just for Christmas'

Rather than representing a one-off exercise, going through the ratings process for the first time marks the beginning of an ongoing relationship. Having made their ratings public, the agencies obviously need to ensure that they remain current as long as rated debt remains outstanding. The lead analyst needs to stay abreast of company and industry developments in order to justify and explain the rating to investors, and to initiate a rating change if appropriate. More fundamentally, given the emphasis on management quality and credibility in their analysis, an opportunity exists to build a relationship based on mutual understanding and trust over time.

Such a relationship will serve the company well, particularly during times when the ratings might be under downward pressure as a result of major events, such as a debt-financed acquisition or a restructuring. The company's management team is much more likely to be given the 'benefit of the doubt' when presenting a scenario which shows a material deterioration in the near-term financial profile if they have previously explained the strategic direction of the company and established a track record of delivering on commitments.

Conversely, if the rating agencies are treated as 'outsiders' and offered little more than a recycled version of the annual results presentation by way of update meeting, the chances are greater that they will be surprised by unexpected events. Naturally, they are more likely to react in a conservative way under these circumstances.

An environment of 'no surprises' clearly works to the advantage of both sides of the ratings relationship. For the corporate borrower it means that major strategic or financial events can be discussed internally and with advisors with greater certainty as to rating impact and therefore debt capacity, cost of debt, and bondholder reaction. Moreover, the ability to co-ordinate the publication of a rating action press release immediately after a public announcement can be a supportive element of the wider investor/public relations exercise.

Figure 3 highlights some basic ground rules that can help to ensure a productive relationship with the rating agencies.

> Ultimately, a debt rating is an agency's opinion as to the relative and absolute credit strength of the company

FIGURE 3

Suggested code of best practice

- Communicate on a regular basis and in advance of major events
- Provide update meetings tailored to agency needs, delivered by senior management
- Deliver a consistent message
- Disclose selective non-public information
- Build a 'no surprises' environment, based on mutual understanding and trust
- Establish an informal 'covenant' as to tolerance levels of key financial ratios

Improve your ratings

The greater emphasis given to shareholder value within the corporate sector, and the development of a deeper credit culture within Europe, mean that the days when the objective of most companies was simply to achieve the highest possible rating are gone. This approach may have minimised the cost of debt, but potentially at the expense of greater strategic flexibility and acceptable shareholder returns. These days it is more common that a company will develop a rational ratings strategy, taking heed of, and forming part of, wider strategic and financial considerations.

There exists no magic wand that can be waved over the relationship with the rating agencies in order to deliver the impossible. However, following the systematic approach described above will lead to real benefits in terms of greater credibility and flexibility. Very often, this translates into a more favourable rating outcome than might otherwise be the case. ■

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