Article Title: ARCHIVE | Criteria | Corporates | General: Acquisition Risk And Its Effect On Ratings Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by the article titled, "General Criteria: Use Of CreditWatch And Outlook," published Sept. 14, 2009.) Virtually any company can become a takeover target. Because Standard & Poor's Ratings Services recognizes that the potential for an outside entity launching a takeover bid is so broad and cannot be predicted, our ratings do not focus on this risk; the potential for the acquisition of a rated company therefore is, treated as a random event. By contrast, the propensity for certain companies to take on risk and transform the existing financial profile can be very predictable. In such situations, the credit rating should always have reflected that risk. Sponsor-owned companies fall into this group: please see "Credit FAQ: Knowing the Investors in a Company's Debt and Equity Securities," published April 4, 2006, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis. But takeover activity has been very robust of late. Fixed-income investors increasingly are growing nervous about lending to companies--especially investment-grade companies--that may be transformed into weak credits in the wake of a buy-out. Typically, acquisition-related debt is placed on the company—and the new owners aggressively take on still more debt in order to extract cash. Some recent bond issues have incorporated protective 'change-of-control' covenants in order to alleviate such concerns. Examples include: Cintas Corporation and Carlisle Cos. We expect use of such covenants will become more commonplace, if not standard. We here discuss our policies for both corporate ratings and individual debt issue ratings with respect to takeovers and related covenants. Stages Of The Deal At what point and to what extent should ratings incorporate takeover potential? As long as there is no specific indication that an acquisition transaction is in the works, we deem the risk of a takeover as event risk, which is outside the scope of rating analysis. Takeover risk applies broadly to corporate entities, and a spate of recent, very large deals underscores the ubiquitous nature of this risk. (If there were an unusual level of transactions involving a particular industry, such as industry consolidation, we might reflect that in the rating outlook.) (Some equity analysts have proposed methodologies for assessing relative vulnerability to hostile takeovers, but the predictive power of those approaches has yet to be determined. Even if they are validated to some extent, they might fall short as tools for assigning credit ratings—since ratings require a very specific basis for differentiating risk. Such techniques likely would be more appropriate for portfolio management purposes. Ironically, one generalization does seem valid: Companies that enjoy strong credit ratings may be more vulnerable. Since these companies follow conservative financial policies, they typically possess excess liquidity or debt capacity that can be used to help finance a leveraged buyout.) Once there is specific evidence of an acquisition transaction, we will affirm the ratings--if it is apparent that there will be no rating implications--or place them on CreditWatch. The trigger might be a company announcement or credible media reports. The CreditWatch listing should spell out the potential rating impact of the proposed transaction and the likelihood of that coming to pass. We try to be as specific as possible about the expected rating outcome, the rationale for that expectation, and what might transpire that would alter our conclusions. And we update the CreditWatch listing to reflect any changes in prospects. Our analysis and conclusions are often informed by confidential information regarding the transaction--but we never place a company on CreditWatch based on confidential information or otherwise divulge such information. We choose the avenue of CreditWatch--as opposed to immediately changing ratings based on preliminary information--given the uncertainties that pertain. The buyout may fail to materialize if the parties' negotiations break down, or if shareholders balk, or if regulators do not grant approval. The cost of the transaction may change, financing plans may change, or interest rate changes could alter the affordability of the deal. Sometimes we want additional input from management about the deal or about other pending developments, prior to making a decision. We want to make thoughtful decisions--not shoot from the hip. And we do not believe the users of our ratings will be well served if ratings frequently are in flux. Once the major uncertainties surrounding the pending acquisition are resolved, we change the ratings to reflect the future profile of the company. We do not wait until the deal closes, unless meaningful, last-minute uncertainties remain. Both the corporate and individual issue ratings are changed once the implications for each are clear. With this approach, determining the appropriate moment to take rating action involves judgment. For example, we might feel confident that one particular deal would pass regulatory muster--and change the ratings prior to an official ruling, while feeling insufficiently confident in the case of another deal or another regulatory body to act before official clearance. Sometimes we take ratings actions in steps, to reflect what is already known. For example, it may be certain that the corporate rating will fall out of investment grade, but less clear what the ultimate level will be. We could then lower the rating to 'BB+', and maintain the CreditWatch listing until the determination of whether the rating deserves to go still lower, say, to 'BB' or 'BB-' is made. (In this example, 'BB+' is the highest outcome that could eventually be maintained.) Similarly, some of the company's issues might have their ratings resolved, while other issues await greater clarity regarding security or subordination provisions that could affect the rating they will ultimately deserve. We face criticism that our actions are too early--from some who believe that we should always wait until a transaction is fully consummated. And we face criticism that our actions are too late--from others who want the risks to be reflected in the ratings even while there is great uncertainty about the outcomes--notwithstanding full communication of our views in CreditWatch commentary. But our policy is based on providing analytical insight as soon as possible—without resorting to speculation regarding major uncertainties. Of course, market prices for securities change instantly, so our ratings can often be out of synch with the market during the period of uncertainty. We do not believe that makes ratings lagging indicators: Ratings should be timely with respect to recognizing the underlying change once objective analysis is feasible--not in relation to transient market sentiments. In addition, it is in the nature of markets for prices to fluctuate--and prices will backtrack if the deal collapses; in contrast, rating products are designed, as mentioned earlier, to avoid up-and-down swings. In this same vein, we eschew an approach that takes the rating down in steps over the period of uncertainty regarding the outcome. This approach would downgrade the rating by one category in cases that have a 50% chance of ultimately being downgraded by two categories. Such interim ratings (as opposed to our stepped actions, described above) are set at a level that is, by definition, not expected to stand: half the time, there will be another downgrade, half the time the rating change will be rescinded. This approach represents a statistical 'halving the baby', and is similarly unsatisfying. Apart from the confusion this might cause, practical problems could be created for both companies and investors. For example, a downgrade might trigger a collateral call or force the holder to sell out of portfolio. While the rating action can be reversed a short time later, the consequences for the company or investor will not reverse: The damage already will be done. Déjà vu? "Since bondholders' angry reaction to RJR Nabisco's LBO proposal…issuers have been experimenting with more substantial protective provisions." This is what we wrote in 1989, when the LBO phenomenon was threatening to close down the U.S. corporate bond market. (See CreditWeek, July 24, 1989, "Event Risk Covenant Rankings".) For a while, investors took comfort in the belief that very large companies were beyond the reach of LBO transactions. But then--as now--they were rudely awakened by previously inconceivable deals being announced. The answer to which they turned was protective covenants, or 'event-risk covenants' as they were then called. We continued to assign our regular ratings, without incorporating event risk. As stated at the beginning of this article, event risk was—and remains--deemed beyond the scope of rating analysis. (Other agencies asserted they did take event risk into consideration, but it was not evident from their rating actions how this was implemented.) We introduced, instead, a new analytical product: Event-risk covenant rankings. The covenants that purported to protect against 'a sudden and dramatic decline in credit quality' were not all the same. From the outset, it was clear that some had more teeth than others. We used a scale of E-1 to E-5 to indicate the relative expected efficacy of the various covenant packages. The focus was on protecting the investment-grade status of the bonds, or, alternatively, providing compensation. Over time, improved versions of such covenants were developed--in large part because of the analytical spotlight we shined on the deficiencies that abounded in the original versions. The several types of covenants--and how effective they would be in the context of the specific issuer's situation--were all assessed on our scale. Because the company situation could change, we also provided surveillance of these rankings. We assigned 165 covenant rankings over the course of the following year: The junk bond market then suffered near collapse, and takeover financing dried up. Investors concluded that takeover risk had passed--and stopped demanding covenants. Our covenant-ranking product became moribund. If covenants become popular in the future, we can always re-introduce this product, or a variation thereof. Covenant protection The vast majority of yesteryear's event-risk covenants left something to be desired, because they did not cover many of the scenarios that might play out in a takeover. For example, many did not allow the investor to put the bonds in the event of a friendly buyout--defined in terms of the agreement by the target's board to be acquired. This was a glaring technical flaw, because, at the dénouement of even the most fiercely resisted takeovers, boards virtually always formally voted for the transaction. Moreover, some companies reacted to a takeover bid by putting themselves up for sale, or conducting their own management-led LBO. In this respect, today's change-of-control covenants seem more comprehensive. (Indeed, in the past, the concern was more about hostile takeovers, whereas today's equity sponsors can find many acquiescent target companies.) Some change-of-control covenants require a rating downgrade in conjunction with the change of control—and define the proximity and sequence of this combination. The called-for pattern does not always work out in real life: Sometimes the covenant is poorly conceived because of lack of understanding of ratings policies; other times, there may be unusual circumstances that cannot be anticipated. Either way, investors have been disappointed if a rating agency acts too soon or too late to trigger the covenant. Change-of-control protection is limited in other ways. For example, as a defensive response to a takeover attempt or to preempt one, a company may initiate credit-harming actions--such as a leveraged recapitalization--without involving a breach of any of the covenants. (Note that companies are repurchasing their own stock in record amounts--without any change in control. In the latest quarter alone, companies that make up the S&P; 500 repurchased $116 billion of their own shares.) In any event, our ratings on individual debt issues with covenants will reflect the protection for that issue, to the extent that takeover risk is a rating factor in the first place. In other words, if a company were downgraded as a consequence of takeover risk (for example, once a takeover was in the works or announced), the specific bond with put protection could retain the original rating, while non-protected issues would be downgraded. We would still need to assess the effectiveness of the covenant(s) in relation to the specific fact pattern and/or scenarios of concern that were incorporated in the corporate rating (including the possibility of defensive actions). Remember that ratings, in general, do not incorporate takeover/event risk, so covenants would not benefit the run-of-the-mill situation.