Article Title: ARCHIVE | Criteria | Corporates | General: Camouflaged Share Repurchases: The Rating Implications Of Total-Return Swaps And Similar Equity Derivatives Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled, "Corporate Methodology: Ratios And Adjustments," published on Nov. 19, 2013.) Company XYZ wants to buy back some of its shares; it is reluctant to do so, however, in the ordinary fashion, involving debt issuance and outright purchases, for any one of a number of reasons: The company may feel that it will have better access to capital markets several months hence. Or it may be concerned about negative rating agency reaction to new debt financing. Or it may be restricted from borrowing by loan covenants. The solution: Instruct a bank to buy the shares, and contract to purchase those shares from the bank in several months' time. The arrangement can take different forms: A forward purchase contract; Put and call option contracts, with physical settlement; or A total-return swap, with physical settlement. Standard & Poor's treats these transactions analytically just as it would treat debt-financed share repurchases. The economic impact of such a transaction is precisely equivalent to that of a debt-financed share repurchase—and it is the precursor of just such an outcome. Bankers refer to the arrangement as an "off-balance-sheet repurchase with deferred funding." Disclosure has been minimal, at least until now, allowing such transactions to remain below the radar screen of the financial community—including rating agencies. Such derivative transactions will probably become less commonplace—in light of new accounting requirements that increase disclosure, force some deals onto the balance sheet, and may also require marking to market—that is, unless bankers can devise structures that sidestep the new accounting rules. In any event, Standard & Poor's will increase its vigilance to identify companies that undertake these camouflaged repurchases. In each of these equity derivatives, the company compensates the bank for the time value of the money that the bank is tying up to purchase the shares—just as it would for a straightforward loan. (To the extent that the derivatives' carrying cost is not tax deductible, the financial expense is even greater than that of an ordinary loan—that is, for the period until settlement.) And the parties have locked in the price, avoiding the need for the bank to hedge the risk of fluctuation of the shares' market price. The company must come up with the funds—just as it would with any loan maturity. (In one way, it would be preferable to finance the repurchase with conventional long-term debt, since that at least would put the near-term funding requirement behind it.) Similarly, Company XYZ could arrange for such a transaction with respect to another company's shares or certificates of participation in a partnership. The economic risks and benefits would be precisely the same in that case as a debt-financed equity investment in those entities! Moreover, the eventual outcome of these arrangements is to bring the transaction onto the balance sheet. Of course, since the transaction is private, the parties can always choose to settle in cash, rather than consummate the repurchase. Indeed, most such arrangements provide from the outset for net share settlement—allowing the shares to be sold back into the marketplace, with the difference in value to be paid in cash or shares. But that is not the intent. The object of the exercise is to carry out the repurchase! For this reason, it is appropriate to presume that that will be the outcome—rather than to ignore such a repurchase until it stares the analyst in the face. Some argue for analytical treatment as a "contingent liability"—since the company can share-settle if a stress situation emerges and avoid the need to fund a full purchase. But how likely is that to occur in the relatively short period until settlement? What is more important is that in such a scenario the company's share price would probably be depressed. The company would wind up with a potentially large differential to pay—making the "contingent liability" itself quite burdensome. Also, the company would wind up without having any shares to show for its derivatives deal. The analogy is that of a company's issuing new shares to reverse a share repurchase—but at a lower price than it paid. A company generally has this option—but the disincentive is huge. Only the company's ability to act in the dark—because of the lack of disclosure—might make this course of action more palatable in the case of equity derivatives! A company might insist that it has no intention of ever settling physically—but merely wants to garner a payment for the stock appreciation it anticipates. If management were to convince the analysts that this is the case, the rating implications would still be quite negative! Speculating in the stock market is typically very risky—even given management's insider knowledge of the company's prospects. And, apart from the specific financial risk of a given transaction, such speculation—as opposed to ordinary operation of the business—would raise serious questions about the appropriateness of management's conduct.