Article Title: ARCHIVE | Criteria | Corporates | General: Credit FAQ: Knowing The Investors In A Company's Debt And Equity Data: (EDITOR'S NOTE: — This article has been fully superseded by the articles titled, "Corporate Methodology," published on Nov. 19, 2013, and "The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities," published April 29, 2014. In addition, for entities outside the scope of Corporate Methodology, the section that discusses ownership by a financial sponsor has been superseded by the article titled, "Companies Owned By Financial Sponsors: Rating Methodology," published on March 21, 2013.) Ownership of a company's stock long has been an important rating consideration for Standard & Poor's Ratings Services, regularly leading to a rating that diverges from the stand-alone profile of the rated entity. If an owner or parent company has the resources and incentives, it can provide support to a weaker owned-entity; conversely, it may look to the rated entity to support its own obligations or those of affiliates. Moreover, owners dictate company policies regarding risk-taking, financial management, and corporate governance. Even so-called temporary owners--such as financial sponsors--regularly cause major changes at the companies they acquire, all of which have rating implications. Especially in the current market environment, introducing more leverage and financial risk-taking is the norm for their portfolios of companies. Additionally, holders of a rated entity's debt and hybrid instruments can have varying strategies and incentives with respect to their investments--all of which can affect the entity's default-risk profile. The increasing diversity of debt investors has made this consideration more important than before. Frequently Asked Questions When does Standard & Poor's rate a company on a stand-alone basis? Never. The potential impact on the credit profile that pertains to a company's owners and investors must always be analyzed, whether the company is owned by private investors or families, financial sponsors, or a parent company that itself may be publicly held. The owners or investors need not themselves be rated; however, a general appreciation of the financial health, resources and requirements, track record, and strategies of the owners (and, by extension, affiliates) is critical. When does your analysis consolidate the financials of a rated entity with those of its owner/affiliates? The consolidated methodology is limited to instances of significant entanglement, usually involving either strategic business ties or dependence on the owned entity's cash flow to service the debt of the owner or group. This approach often leads to situations in which subsidiaries that are weaker on their own achieve ratings that reflect the strength of their parent; in many cases, the ratings of the group and the subsidiary are equalized. While there recently have been several prominent instances of companies abandoning investments in subsidiaries once deemed strategic, there have been even more instances where support was forthcoming: The key is to comprehend the degree of strategic, economic, and reputational linkages and the potential risks that could undermine the relationship, and monitor these in a dynamic fashion. Factors contributing to our understanding of the relationship include integration; percentage ownership (current and prospective); management control; shared name; common sources of capital; common country of domicile; and management's stated posture. Following the same approach, the owner normally would rely on its owned operating subsidiary (or the operating subsidiaries collectively) to service holding-company debt, including acquisition-related financing. When the operating subsidiary is the rated entity, we would attribute to it, or consolidate, the holding company debt, because the owner may come to rely on the subsidiary to service that debt. In this analysis, covenants and other restrictions on inter-company activity can play an important role. Regulation also can create barriers that insulate a company from its owners. In taking account of regulation, we analyze the specifics of the regulatory framework and track records as they apply to each company: Bank regulators, telecom regulators, and power company regulators may behave quite differently. (The consolidated methodology is an analytical approach, not to be confused with the potential for consolidation in a bankruptcy proceeding.) Does it matter whether the ownership represents a strategic or a financial investment? Strategic investors--e.g., companies that invest for the sake of vertical or horizontal integration--are more likely to have the resources and incentives to support that investment. Financial investors likely will be diversified, and neither in a position to bail out individual holdings nor inclined to do so. They typically have shorter time frames associated with their investment; as temporary investors, their direction and management of the investment will be a function of their exit strategy. Taken together, there is greater potential for siphoning away cash and/or assets from the investment than putting in additional capital to support it. How do you view companies owned as part of an equity sponsor's portfolio? There is some overlap of incentives to potentially benefit both the credit profile and shareholder returns: A savvy investor who actively manages the owned entity may be able to strengthen the business for the benefit of all constituencies. However, these investors normally are aggressive; typically, shareholders are enriched at the expense of creditors. Improvements to the business will not translate into longstanding improvement of the credit profile; rather, they would create the opportunity to increase debt and/or extract cash. Moreover, we are concerned about additional leveraging, even in the absence of any improvement to the business. We are influenced by the many instances that seem to follow a predictable pattern of these investors cashing out in various ways that leave the company saddled with greater financial risk. Accordingly, ratings assigned to companies upon their being acquired by equity sponsors ordinarily reflect some presumed deterioration of credit quality. It is very unlikely for sponsor-owned companies to receive ratings above the 'B' category. Even if the company balance sheet indicates otherwise at the time the deal gets financed, the rating incorporates the risk of subsequent leveraging. As long as the current market environment--exceptionally liquid and risk-tolerant—continues, we anticipate that sponsor-owned companies will face such risks. In fact, some recent transactions indicate that aggressiveness is, if anything, increasing. (Of course, there are exceptions to every rule. For example, if the owned entity is a bank or financial institution, it cannot be over-leveraged without impairing its value.) Is that not just event risk? Why penalize companies before it occurs? Virtually any company can become a takeover target. Because the potential for an outside entity launching a takeover bid cannot be predicted, ratings do not focus on this risk; it is a random "event". (Some equity analysts have proposed methodologies for assessing relative vulnerability to hostile takeovers, but the validity of those approaches has yet to be determined. One generalization that can be made: Companies following conservative financial policies, that otherwise would have strong credit profiles, may be more vulnerable--e.g., cash they amassed could be used to finance an LBO.) By contrast, the propensity for certain companies to change financial profiles can be very predictable. In such situations, the credit rating should reflect that risk all along. As noted, sponsor-owned companies fall into this group. Do you differentiate between the various equity sponsors? While individual sponsors could, at least theoretically, employ different degrees of aggressiveness, it has been difficult to discern such distinctions to any meaningful degree. Some financial sponsors have asserted to us that they are more conservative or credit-sensitive than their peers. This may be so, but we have no real basis for substantiating the claim. In any event, the savvy, prestige, or success of a particular sponsor is certainly not a key consideration. Rather, a company's good results often reflect the willingness to take on outsized risks. What about hedge funds? The thousands of existing hedge funds are hardly monolithic in their investment strategies; they more accurately can be characterized as following many diverse strategies. Still, some of the most aggressive tactics can be found among the hedge funds, so both companies and investors should pay heed if certain of these funds are taking a position in the company's securities. (In practice, this can be difficult information to obtain: Disclosure requirements generally are too loose for timely availability of such data, and the more aggressive companies place a premium on secrecy.) One alleged hedge-fund strategy works as follows: The fund buys debt securities of a company facing stress, while shorting its common stock. If any debt covenants are breached, the hedge fund plays hardball, attempting to sabotage the company's prospects and force it into Chapter 11. Meanwhile, the hedge fund profits on its short position in the common stock. While we never have verified the truth of such alleged behavior, investors that short a company's securities have motives that conflict with those of the company: Therefore, the potential for mischief should not be ruled out. So who owns a company's debt securities matters? Absolutely. When the owners are permanent, and their main economic investment is in the common equity, the debt they hold regularly is viewed as equity. These owners have no incentive to enforce their creditor rights, because in bankruptcy they would forfeit their ownership. Such owners choose to invest in debt form or equity form for tax or other considerations, but this has little impact on the company's credit risk. In the case of temporary owners, the incentives may be very different. And, in the extreme example described above, the holders of the short position have a negative ownership in the company, which creates special risks if they also own company debt securities. What about equity hybrid instruments? Aggressive takeover investors can take advantage of the equity features to the detriment of the investors in hybrid instruments. Normally, issuers of equity hybrids are not expected to exercise the right to defer payments unless they experience distress. However, in the context of a takeover or LBO, new owners would be more prepared to defer payments (since this could reduce the financing needed to effect the acquisition). The recent genre of equity hybrids--with enhanced equity features--could play even more into the hands of investors prepared to use these tactics. These features include longer deferral periods and/or noncumulative payment deferral rights. Moreover, the 30- to 60-year maturities of these instruments provide cheap, permanent financing, while incorporating these exceptionally flexible terms. How are hybrid-equity investors approaching these risks? Many investors have yet to appreciate the extent of their exposure; even once they do realize the risks, many choose to ignore them. Such is the market climate today. Given the recent exceptional liquidity of the capital markets, risk aversion seems like a quaint relic of past markets. Still, some investors are concerned--and take comfort in change-of-control provisions. But we believe loopholes exist in these provisions that may undermine their effectiveness. Indeed, notwithstanding the overall market sentiment about risk, the level of concern over event risk has been increasing. In 1989, when the takeover phenomenon posed a serious threat to all investment-grade corporate bonds, investors started to demand that new bond issues include event-risk covenants: At that time, we provided assessments of the relative effectiveness of these covenants with rankings of 1-5, and published assessments of about 165 bond issues with purported protection. The majority of such protections left gaping holes: For example, the change-of-control definition made it easy to evade the covenant protection. But it does not seem likely that there will be a repeat of such demand in the current market environment.