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Far from triple-A

Evan Lorenz writes:

JPMorgan Chase & Co. Chairman and CEO Jamie Dimon did *not* admonish his audience last week to stop worrying about the assets that climate change might leave stranded in the distant, uninvestable future. What he did advocate is more focus on the companies that interest rate change might render uneconomic. Now in progress is an examination of Moody's Corp. (MCO on the New York Stock Exchange) in the context of a new credit contraction. In preview, we're bearish on the ratings agency that did so well in the prior, long-running credit expansion.

For fixed-income markets, this year has been one for the record books, and not the kind of books in which you would like to see your name. Through May, the Bloomberg U.S. Aggregate Bond Index lost 8.9%, the worst such showing since it debuted in 1976. That may seem implausible, given that, in 1979–80, Paul Volcker hiked the federal funds rate to 20% from 10.5%. Of course, bonds came with coupons in those days. You could lose 12% to 15% of principal value per annum in the Volcker era and still break even. Coupons of 2% and 3% afford small price protection.

But some things remain the same, and now, as then, investors don't clamor for more of what's going down. Thus, according to the Securities Industry and Financial Markets Association, total U.S. fixed-income issuance fell by 24.7%, or $1.4 trillion, in the first five months of the year, to $4.36 trillion. While the drop was led by mortgage-backed securities (down 45.1% year over year), every debt category that SIFMA tracks decreased as well: municipal bonds (off 7.7%), corporate bonds (23.2%), federal agency debt (23.5%), Treasurys (3.6%) and asset-backed securitizations other than mortgages (38.6%).

On June 1, S&P Global, Inc. announced that it suspended guidance for full-year 2022 on account of the "macroeconomic conditions" that had somehow emerged after it provided guidance 29 days earlier, on May 3. "Debt issuance volumes have been extraordinarily weak year-to-date," said the press release. "Should similar trends continue through the end of 2022, market issuance could see year-over-year declines in the high teens. Rated, or billed, issuance could be approximately 30%–35% lower than the previous year, and leveraged loan volumes could be approximately 40% lower."

You rub your eyes, but, as recently as mid-March, the Fed was infusing dollars into the system via quantitative easing. Quantitative tightening began only on June 1. And starting Sept. 1, the monthly pace of that balance-sheet shrinkage is projected to quicken, rising to $95 billion, up from the $47.5 billion slated for June–August.

High-yield spreads above Treasurys, though quoted at 419 basis points, hit 494 basis points as recently as May 24. "They were half of that six to eight months ago," Christopher Whalen, the founder and creator of *The Institutional Risk Analyst*, reminds me. "The whole process of repricing for QT is going to imply less market access for these issuers than they had previously," and, of course, less raw material for the bond raters to rate.

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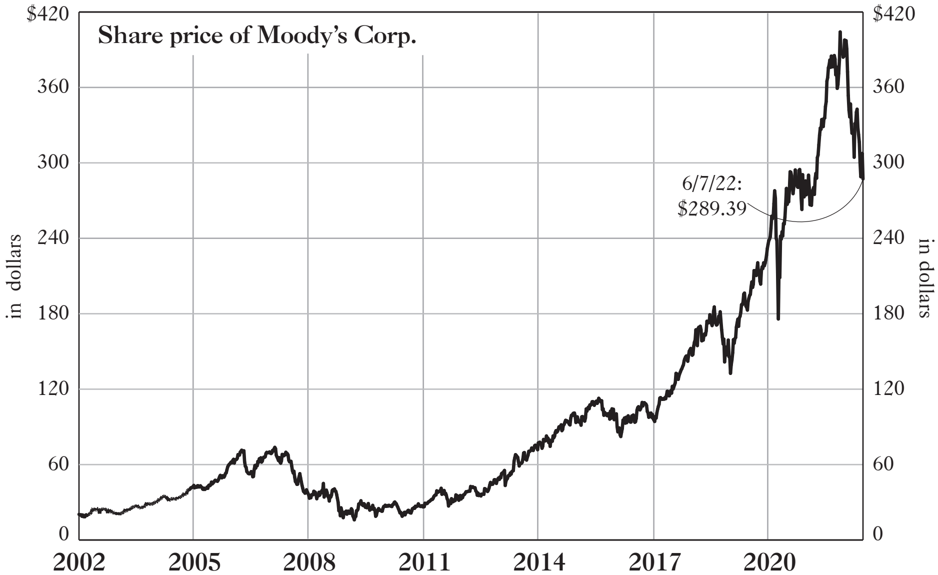
The first edition of *Moody's Manual of Industrial and Miscellaneous Securities* sold out in two months—this was in 1900—and, with the exception of a cyclical stumble around the Panic of 1907, John Moody's new bond-rating business was off to the races. By 1924, his team and he were rating nearly the entire U.S. bond market.

Moody died in 1958, at age 89, but the descendants of his team, 14,000 strong, operate in more than 40 countries. Standard & Poor's shares what amounts to a ratings duopoly with Moody's. Fitch Ratings, Inc. makes its living on the periphery as a distant, though well-respected, third.

Moody's Investors Service (62.2% of last year's revenues), which rates over 35,000 companies, governments and structured deals, is the first of two principal Moody's business units, followed by Moody's Analytics (37.8%), whose almost 15,000 customers pay for its data, research and advisory services. It's the bond and loan issuers themselves who buy the ratings, a detail of the ratings business model that came under heavy criticism in the wake of the Great Recession. With regard to data, research and advisory services, the more conventional payment arrangement pertains: Consumers write the checks.

Analytics is the more dynamic of the two Moody's units, posting top-line growth of 16% in 2021 and 23% in the first quarter of 2022, compared with the ratings division's 16% and minus 20% in the same periods. However, bond ratings punch above their weight

Down, yet still up



source: The Bloomberg

in operating margins, which came in at 62.2% last year versus 26% on the analytics side. Not such a paradox, then, that ratings delivered a whopping 79.8% of Moody's total operating income last year.

Moody's is a global presence, but the 50 states furnished 61% of its ratings revenue last year while foreign addresses accounted for 55% of analytics sales. With, in 2017, the €3.0 billion ($3.2 billion at current exchange rates) acquisition of Bureau van Dijk, an aggregator of data on millions of private businesses, the analytics segment is particularly strong in Europe.

As much as any financial business, Moody's Corp. must adapt to cyclicality, from credit and interest rates to government regulation. As long ago as 1936, banks were prohibited from investing in bonds rated below investment-grade. Then along came the 2010 Dodd–Frank Act to legislate steps to reduce the impact of ratings on the financial system. It's testament to the power of the MCO corporate brand, or to the utility of credit ratings, that Moody's has flourished alike through friendly and unfriendly regulatory regimes.

In 2017, Moody's paid an $864 million fine to draw a line under its many failures in the run-up to the credit collapse of 2007–09 (73% of mortgage-backed bonds that the agency rated triple-A in 2006 had turned to junk by 2010). But Mr. Market doesn't hold a grudge, and *Institutional Investor* has ranked John Moody's creation as the best credit-rating agency for the past 10 years.

"Moody's is a monopoly because you always use the lowest rating," Whalen, who was director of research for Kroll Bond Rating Agency from 2014 to 2017, tells me. In other words, users of credit ratings focus on the weakest credit score, and Moody's frequently comes in weaker than its peers. A case in point is SoftBank Group Corp., which is rated double-B-plus by S&P with a stable outlook, but two notches lower (Ba3) by Moody's with a negative outlook. In this instance, the company being rated did not pay for its own rating. Indeed, SoftBank, complaining that the Moody's judgment is based on "subjective assumptions and hypotheses," demands that the agency keep its unsolicited opinion to itself.

The Moody's brains trust does not deny that the ratings business is slowing, only that that deceleration is anything to worry about. On form, CEO Robert Fauber told dialers-in to the May 2 earnings call, the business "typically rebounds after periods of market disruption and has grown steadily over time."

To be sure, the gods have smiled on Moody's. The debt it rates has been expanding, and interest rates have been falling. Ratable corporate fixed-income securities have gained market share at the expense of bank credit. Besides, today, $731.4 billion of "dry powder" is burning a hole in the pockets of U.S. private equity funds and corporations must refinance $4 trillion's worth of maturing debt over the next four years.

Longer term, the bull case on Moody's depends on its growing analytics unit. The key to achieving 10% per annum top-line growth through 2026, management divulged at its March 10 investor-day presentation, is for analytics to grow in the double digits and ratings to chip in low- to mid-single digits. While Fauber downgraded 2022 guidance, he held firm on medium-term prospects. In the first-quarter period, adjusted operating margins of the analytics business fattened to 32.1% from 26% for full-year 2021. Mid-30s margins are in store over the longer term, the front office predicted.

Not the least interesting feature at that investor day was a description by Stephen Tulenko, president of analytics, of what his group does for a living. He told a story about three Russians who had been subjected to international sanctions in the preceding seven days: "Those three individuals are associated with two banks. Those two banks own 40 other individual organizations, and then there is beneficial ownership that's greater than 50% for another 194 entities. So, those three individuals need to be related to 194 entities in order for you to comply with the sanctions that are being levied by the various organizations. And, just to give you a sense, we've had over 5,000 entities sanctioned this year."

To its credit—or detriment, depending on the future course of stock prices—Moody's is intent on returning cash to shareholders. In April, it repurchased 1.5 million shares for $500 million in an accelerated buyback program (for perspective, there are 184.5 million shares outstanding). On the May 2 earnings call, CFO Mark Kaye told analysts to expect at least another $1 billion's worth of buybacks this year on top of the regular dividend, which, at the current share price, works out to a 1% yield.

Moody's, too, has taken a seat on the environmental, social and governance bandwagon and will have issued more than 10,000 ESG credit-impact scores by year end, management says. Meanwhile, the Moody's Risk Management Solutions, Inc. subsidiary (acquired in September for a $2 billion consideration) supplies climate models to

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guide insurance underwriters in deciding how to price actuarial risk.

Moody's does not rate itself but peers S&P and Fitch have passed judgment. They call it a mediocre investment-grade credit: triple-B-plus. As of March 31, Moody's net debt summed to $5.9 billion, or two times trailing Ebitda. In the first quarter, operating income covered interest expense by 12.4 times.

Analysts, while penciling in a 2.7% decline in revenues and a 13.6% drop in earnings per share in calendar 2022, look across the valley to a strong 2023, when (they say) revenues will surge by 9.3% and EPS by 16.2%, both new all-time highs. Nor is Moody's yet on the bears' menu, to judge by the negligible short interest (just 2.2% of the equity float). Insiders strike the only negative note, with sales of 42,390 shares over the past 12 months for proceeds of $14.7 million.

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Even after the recent selloff, MCO trades at 27.4 times trailing earnings versus an average of 24.2 times in the five years before the pandemic. What the cash cow is not capitalized for is more-than-transitory trouble.

Threats on this score include the rapid rise of a category of credit known as "private" but which might as well be called "ratings-free." Business-development companies like SLR Investment Corp. (*Grant's*, May 27) are taking share from the public bond market. Mutual fund–like structures that allow individual investors to buy unrated loans and bonds are likewise helping themselves to portions of Moody's substantial lunch. Between 2016 and 2021, global private-credit assets under management doubled to $1.2 trillion from $572.9 billion. An additional $317 billion's worth was being marketed in April, according to Preqin.

Private equity promoters, wary of the volatility of public bond markets, deployed private credit in the recent buyouts of the TV-rating business of Nielsen Holdings plc and of the software firm CDK Global, Inc. Jake Mincemoyer, a partner at the law firm Allen & Overy, told Bloomberg last month that some private equity firms are simply bypassing leveraged loans (which are rated) in favor of private debt (which is not).

The contribution of the 40-year bull bond market to the prosperity of the bond-rating business, we suspect, is not widely appreciated. If so, the risk that interest rates have reversed course is one that, we similarly suspect, neither the stock market nor the Moody's C-suite has seriously addressed. In 1981, a nearly 16% yield on the U.S. Treasury's 10-year note marked the close of the preceding bear bond market. Over the course of its 35-year life, nonfinancial debt averaged 132.6% of U.S. GDP.

It would stand to reason that four decades of persistently falling interest rates would facilitate an expansion of ratable public debt, and so it happened. By the fourth quarter of 2007, the ratio of nonfinancial debt to GDP had exploded to 228%, on its way to 271% by the final quarter of 2021.

It strikes us that the factors that enabled the buildup in borrowing and lending are now reversing, ultralow interest rates not least. From 1981 to the present, federal debt held by the public increased by $21.1 trillion, to $24.4 trillion, or to 98% of GDP from 24.1% of GDP. Yet, thanks to the decline in borrowing costs over that span, the government's net interest expense as a share of GDP actually decreased, to 1.6% from 2.2%.

With federal interest-bearing debt nearly identical to U.S. GDP, each 1%

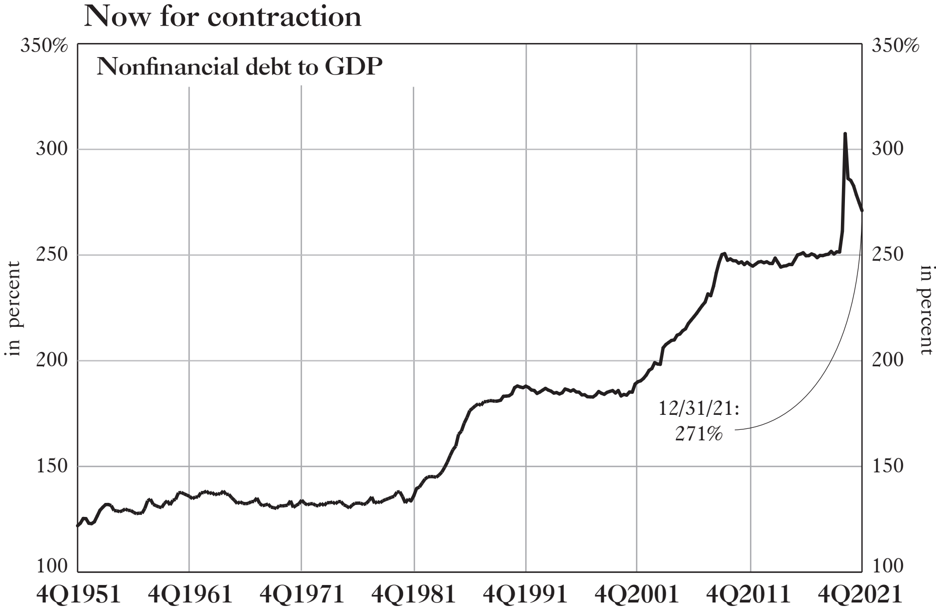
Moody's Corp. at a glance
all figures in $ millions except per share data

	TTM*	2021	2020	2019	2018
revenue	$6,140.0	$6,218.0	$5,371.0	$4,829.0	$4,443.0
operating income	2,647.0	2,844.0	2,388.0	1,998.0	1,868.0
net income	1,976.0	2,214.0	1,778.0	1,422.0	1,310.0
earnings per share	10.56	11.78	9.39	7.42	6.74
shares outstanding	186.1	187.9	189.3	191.6	194.4
cash	1,853.0	1,902.0	2,696.0	1,930.0	1,818.0
debt	7,786.0	7,413.0	6,422.0	5,581.0	5,676.0
total assets	14,739.0	14,680.0	12,409.0	10,265.0	9,526.0

* 12 months ended March 31, 2022

source: company reports

Now for contraction



sources: Bureau of Economic Analysis, Federal Reserve increase in Treasury borrowing costs equals a 1% levy on American production. Treasury Secretary Janet Yellen, who has not always excelled in the prescience department, performed a public service in terming-out the average maturity of marketable debt to 72.6 months, from a 42-year average of 60.5 months.

The CEO of a heavily encumbered business might be forgiven for wishing that there was a Federal Reserve for him, as well as for the government. A May 31 Bloomberg dispatch points out that 620 of the 2,751 component companies of the Russell 3000 failed to cover interest expense out of operating income in the prior 12 months. Stock jockeys must have seen that coming, since the Bloomberg-identified zombies had suffered a 36% plunge in share prices in the prior year versus a 4.3% slip in the Russell index.

Lush profit margins also seem to invite incremental borrowing, though perhaps those margins are becoming less lush. Corporate profits slumped to an average of 7.7% of GDP in the 1980s from an average of 10.8% in the go-go 1960s, but post-millennial profitability has eclipsed even that Johnson-era showing. Thus, profits as a percentage of GDP soared to 11.5% in the 2010s before touching 12.2% in 2021.

It would be no good news for Moody's if profit margins have peaked. In the first quarter, constituents of the S&P 500 reported a blended net margin of 12.3% versus 12.8% in the March 2021 quarter. In April, an 11% leap in the Producer Price Index was paired with an 8.3% rise in the CPI. It was the 16th consecutive month in which "business inflation," as we might style the PPI, out-legged consumer inflation, the CPI.

The near-record volume of dry powder available to private equity promoters may or may not translate into a new burst of deal-making. According to PitchBook Data, Inc., unspent commitments to private equity funds rose to $385.1 billion in 2008 from $325.9 billion in 2006. Yet private equity–led buyouts fell by 49% in 2009 from 2008 and did not return to their 2008 mark until 2011, which happened to follow two rounds of quantitative easing.

Private equity managers fancy themselves the agents of business transformation, a constructive work, they say, for which they need discretion and not the spotlight of public ownership. However, low interest rates are what facilitate both high leverage and toppy exit multiples. It's probably closer to the truth to see the buyout business as a kind of interest rate derivative rather than a corporate-efficiency movement, one not so different from the savings and loan business.

Notably, the median buyout multiple increased to 14.6 times Ebitda last year from 10.4 times in 2007, the peak of the last buyout cycle. No wonder, according to CEPRES Market Intelligence, that 56% of industry returns between 2016 and 2021 derived from expanding multiples rather than operational improvements.

In the run-up to the housing bust, Moody's did a land-office business in rating structured-credit products—and such revenues made up 49% of the ratings division's top line in 2007. After that high-water mark, revenues declined by 20.4% over the ensuing two years while earnings per share plunged by 34.5%.

Today, structured credit contributes just 14.1% of the rating's unit top line, though bulls can find little solace in that fact. A decade of EZ money has helped push corporate debt to 48.5% of GDP from 43% in the fourth quarter of 2007. If the door to the debt markets slams shut on highly leveraged, barely profitable borrowers, a multiyear drag to Moody's bond-rating revenues could be in the offing.

Granted, the analytics group did report a 23% year-over-year jump in first-quarter revenue, but the organic share of that rise barely topped the 8.5% spurt in March CPI. More acquisitions or a better performance from legacy businesses are what Moody's needs, but may not find, in the drive to achieve double-digit corporate revenue growth.

Nor is it clear that operating margins for the analytics unit in the mid-30% range—towards which management is currently guiding—are within reach. "Yes, the total addressable market is big, but what level of investment needs to be made to realize that opportunity?" is a question that Russell Quelch, who rates MCO a hold for Redburn Ltd., asks and then answers. "It may be bigger than some think," he says. "It's not just about acquiring a bunch of assets and immediately taking market share. It is integration. It is getting into the workflows of some of the industries they are targeting. There are multiyear contracts that they are trying to replace from their peers and take market share. You can't just do that instantly. You have to wait for the opportunity."

One might wonder, too, how much more ESG ratings and research have to give. The raid last week by German prosecutors on the Berlin headquarters of Deutsche Bank A.G. and its majority-owned asset manager, DWS, to investigate a whistleblower's charges of greenwashing, is only one, and not the most striking, sign of green fatigue. A longtime stalwart of environmental causes is itself reconsidering its commitment.

Last week, BlackRock Investment Stewardship, a BlackRock, Inc. subsidiary, announced that it would be voting down more shareholder proposals designed to fight climate change, finding many "unduly prescriptive" and not conducive to "long-term shareholder value."

Regardless of whether you take a position in Moody's, you can monitor the raw material for the rating agency on page seven of every issue of *Grant's*. There we report the monthly number of CUSIP requests, i.e., nine-digit security codes, for prospective issues of American stocks and corporate bonds. You may not be surprised to learn that the numbers are falling.

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