



Module 3

The Role of Global Capital Markets

Rating Agencies
(A company quality assessment)

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Due diligence...

Why do markets need rating agencies?

To provide investors with objective analysis and independent assessment of companies and countries that issue debt securities to determine whether they will be able to meet their obligations within a certain timeframe.

Standard & Poor's

Moody's

Fitch ... others

What about the auditors?

Just for the debt market?



Due diligence...

S&P	Moody's	Fitch	Quality
<i>Investment Grade</i>			
AAA	Aaa	AAA	Highest quality
AA	Aa	AA	High quality
A	A	A	Upper medium grade
BBB	Baa	BBB	Medium grade
<i>Speculative Grade</i>			
BB	Ba	BB	Lower medium grade
B	B	B	Speculative
CCC	Caa	CCC	Poor
D	C	D	Highly speculative

Moody's rating action on Feb 12, 2014 on **Kellogg's**: Baa2 rating to EUR\$500m notes and Commercial paper at Prime-2.

S&P	Moody's	Fitch	Quality
A-1	Prime-1	F1+	Very best quality
A-2	Prime-2	F1	Best quality
A2/A-3	Prime-2/Prime-3	F2	Good quality
A3	Prime-3	F3	Fair quality
B	Not prime	B	Speculative grade
C	Not prime	C	High possibility of default
D	Not prime	D	In default

How do they arrive at a rating?

Business risk

- Political risk
- Industry risk
- Company risk
- Profitability risk

+

Financial risk

- Accounting risk
- Risk tolerance, financial policy risk
- Cash flow adequacy risk
- Capital structure risk
- Liquidity and short-term risks

= Rating



How do they arrive at a rating?

Using benchmarks and default experience:

- Risk of default – at a particular risk horizon
- Risk of loss given default – not all is lost
- Issuer credit rating – capacity and willingness to meet commitments
- Issue credit rating – specific to the instrument.

Disappearing 'quality'

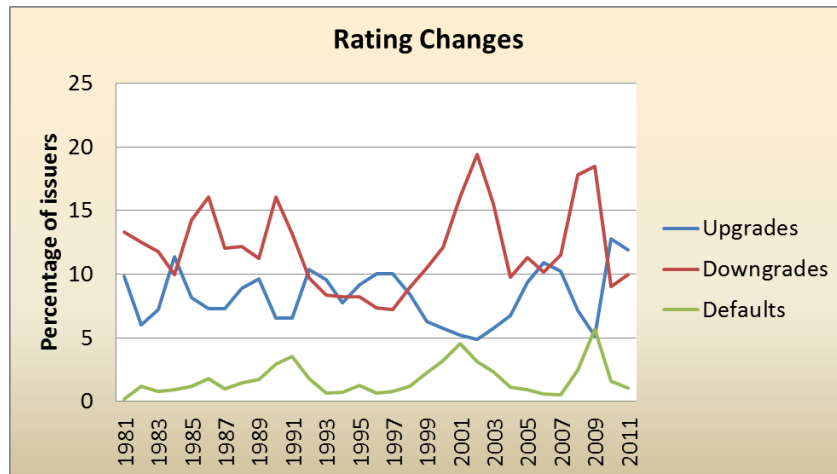
In the early 1970s, over 60 US companies had AAA ratings, but that number dropped to 15 by 2000. In 2015 it is just 4!

1. Microsoft Corp.
 2. Exxon Mobil
 3. Johnson & Johnson
 4. Automatic Data Processing
- Companies are much more indebted
 - Growth companies are dominant (50% are speculative grade issuers)
 - Higher risk environment
 - ...?



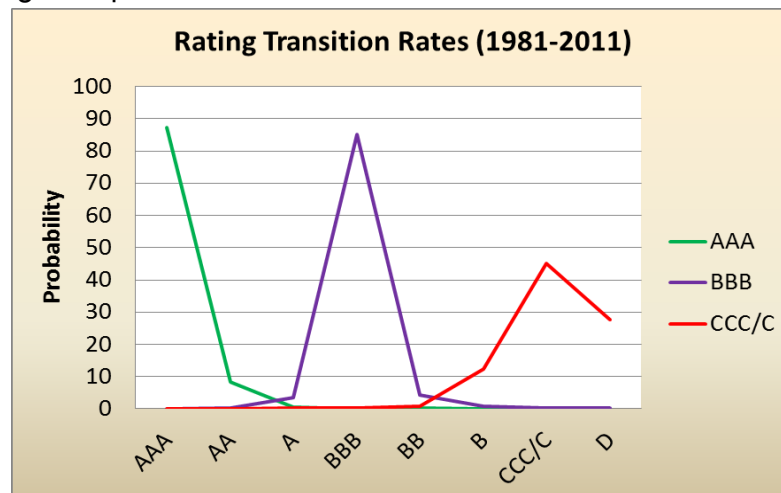
Rating transitions

1 in 5 issuers changes rating every year



Rating transitions

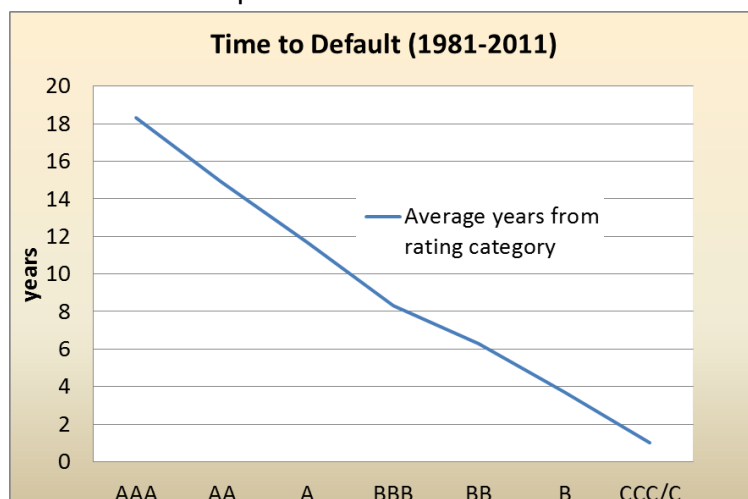
Ratings change “stepwise”





Eventually....

Creative destruction catches up with the best...



Rating performance

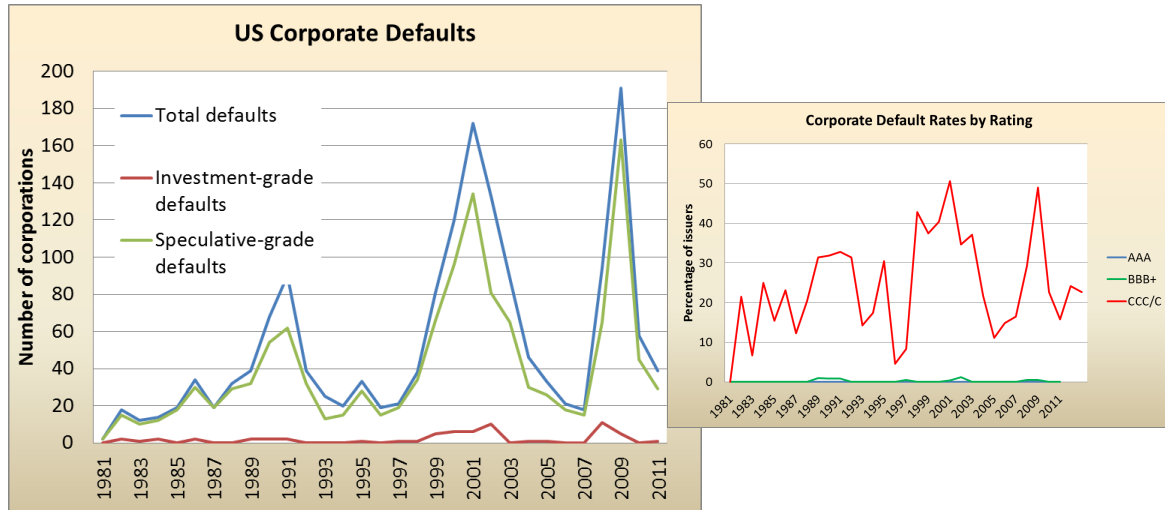
Are the ratings merely tracing financial statements, or are they somewhat predictive?

Some even suggest that rating downgrades cause problems...

There does seem to be a probability “cliff” at the CCC-rating.



Rating performance



Are they independent...?

Rating agencies have been criticized for not detecting the problems with collateralized debt obligations - for AAA rated financial institutions.

Critical discussion focused on the independence of rating agencies (similar to auditors).

Are rating agencies "captured" by their corporate clients?

Are there too few rating agencies?

Should there be unsolicited ratings?



Source list

Slide 7:

Summary Of U.S. Net Annual Corporate Rating Activity* (%) graph. Prepared by Paul Kofman from data sourced from 2011 Annual U.S. Corporate Default Study And Rating Transitions, Standard & Poor's Financial Services (<http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245331026864>).

Slide 8:

Rating Transitions Rates (1981-2011) graph. Prepared by Paul Kofman from data sourced from 2011 Annual U.S. Corporate Default Study And Rating Transitions, Standard & Poor's Financial Services (<http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245331026864>).

Slide 9:

Time to Default (1981-2011) graph. Prepared by Paul Kofman from data sourced from 2011 Annual U.S. Corporate Default Study And Rating Transitions, Standard & Poor's Financial Services (<http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245331026864>).

Slide 11:

U.S. Corporate Defaults and Corporate Default Rates by Rating graphs. Prepared by Paul Kofman from data sourced from 2011 Annual U.S. Corporate Default Study And Rating Transitions, Standard & Poor's Financial Services (<http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245331026864>).

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