Welcome!

Does the world need another newsletter?

What are we trying to accomplish?

This is the first issue of a weekly newsletter which will focus on what we believe to be the most important issues in the world of credit ratings.

In addition to providing our own independent opinions on ratings related developments, this newsletter will summarize and integrate key rating information which is now available only from many sources.

We are firm believers that combining fundamental credit analysis with common sense is the first step in making sound fixed income investments.

Changes in credit ratings and interest rates are the primary drivers of valuation changes in the bond market. Although there are techniques to hedge interest rate and credit risk exposures, the usefulness of these techniques is diminished if the underlying assumptions as to credit rating are wrong.

From our perspective, a lack of common sense is frequently on the other side of the often voiced complaint that the rating agencies are too slow to make changes.

What will we cover?

Ratings of the most prominent issuers: We believe that this is what the market finds most interesting. This includes anything that might effect how these ratings are interpreted or used.

Ratings industry developments: Items which are not issuer specific but which are important in fully understanding the ratings environment.

What will we not cover?

Interest rate forecasts and market timing: There are already enough qualified people trying to do that.

Structured finance: How a deal is structured is the primary determinant of the rating.

Municipal finance: The market is simply much too fragmented from our perspective.

However, to the extent that something significant captures our interest, we reserve the right to comment on these markets.

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Samplecopy

Suggestions, comments and questions?

Comments

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Who are the largest borrowers and/or issuers of debt?

Some of the names might surprise you…

Editor's note: These lists include some of the names you will likely be reading about in future issues, but not necessarily in the order in which they will be reviewed.

Our screening criteria was simple: Using publicly available stock screening methods, we searched for entities with shares listed on the NYSE or NASDAQ. This insures that there will be meaningful financial information readily available. Entities were then ranked based upon what the database showed as the amount of long-term debt outstanding. The level of short-term debt and other financial liabilities (e.g. deposits and insurance reserves) varied widely among the issuers listed and may not be totally consistent among the names included (especially the financial institutions).

Names are listed with reported debt (in billions) and senior unsecured debt rating as of June 15, 2003.

Top 15 Financial Institutions ($ billions)

Issuer	LTD Amount	Rating
Fannie Mae	478	Aaa
Freddie Mac	401	Aaa
Credit Suisse	261	Aa3
Allianz Holding	144	Aa2
Prudential (UK)	143	A2
ABN Amro	139	Aa3
Citigroup	133	Aa1
UBS	105	Aa2
Deutsche Bank	101	Aa3
ING	97	Aa3
Banco Santander	95	A1
Banco Bilbao	91	Aa2
Barclays	89	Aa1
Merrill Lynch	77	Aa3
Bank of America	63	Aa2

Note: Deposits are included with debt. Moody's senior LTD rating shown.

Top 15 Non-Financial Institutions ($ billions)

Issuer	LTD Amount	Rating
General Motors	212	BBB
Ford	159	BBB
General Electric	156	AAA
Deutsche Telekom	56	BBB+
Daimler Chrysler	51	BBB+
France Telecom	49	BBB
Verizon	43	A+
Nippon Telegraph	43	AA-
Comcast	30	BBB
SUEZ	30	A-
AOL Time Warner	29	BBB+
Toyota	28	AAA
Vivendi	25	BB
BT Group	24	A-
Telefonica (Spain)	23	A

Note: Finance subsidiaries included in totals. S&P senior LTD rating shown.

What is immediately apparent is that the overall credit quality of the fifteen largest financial issuers is considerably higher than that of the comparable industrial group.

Within the industrial listing, most of the top names are what I would call "old line" companies, albeit with some mergers or new lines of business.

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The SEC and the Rating Agencies

Get ready to send in your comments!

On June 4, 2003, the SEC put forth a concept release entitled "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws".

The purpose is clearly stated in the "Summary" of the release:

"As part of the Commission's review of the role of credit rating agencies in the operation of the securities markets, the Commission is seeking comment on various issues related to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under the federal securities laws, and, if so, the process of determining whose ratings should be used, and the level of oversight to apply to such credit rating agencies."

In other words, everything is up for grabs.

The release then sets forth a series of fifty-six goups of questions and invites public comment. The questions run the gamut of relevant topics from alternatives to the present system all the way to conflicts of interest.

View the full text of the release on the SEC website: **www.sec.gov/rules/concept/33-8236.htm**

We recommend that the above release should be read in conjunction with the January, 2003 report: "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets…". This can be found at: **www.sec.gov/news/studies/credratingreport0103.pdf**

From our perspective, the key issues in these discussions are:

Confidentiality: Issuers can provide information to nationally recognized rating agencies without incurring an on-going disclosure requirement. This conflicts with the spirit of the disclosure requirements of the Sarbanes-Oxley Act of 2002.

Competition: The current arrangement is an oligopoly at best and, some would claim, really a duopoly. Is this good or bad? What should be the criteria for certifying additional rating agencies?

Conflicts of interest: This maybe what really started things going. There are certainly potential conflicts within the agencies which need to be addressed.

We will be preparing our own response to this "concept release" and will post it on our website. We encourage our subscribers to consider submitting a their comments as well.

Responses to the SEC are due July 28, 2003 and can be submitted in hard copy or by e-mail. All responses will be open to the usual public inspection (hard copy responses) or posted on the SEC website (e-mail responses).

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Ratings News of Note

General Motors – GM has announced a global bond offering of up to $17 billion to fund a large portion of its un-funded pension liabilities. On 6/13/03, Moody's announced a one-notch downgrade of the senior long-term debt of GM to Baa1 and GMAC to A3. S&P had downgraded both GM and GMAC to BBB last October. Both GM and Ford were mid-single-A by both agencies as recently as October 2001. Analysis: The additional borrowings should be slightly negative to neutral from a ratings standpoint. The additional debt will memorialize on the balance sheet what is already a well disclosed, but "softer" liability. Moody's may seem a bit late in the timing of its recent downgrade and a bit liberal with the one notch premium to GMAC given the presumably substantial (but undisclosed) level of subvention income currently being paid and likely to be paid in the near future. We'd be more concerned about what Moody's might do with the Ford rating since GM has generally better numbers. DBRS's April downgrade of Ford from low A to high BBB seems too little and too late.

Editor's note: "Subvention income" is the marketing subsidy from the parent company which allows captive finance companies to write profitable contracts at the same the manufacturer is offering below market rate or zero interest rates. The subsidy is generally paid to the dealer which then sells the installment contract to the finance company at a discount. The parent company typically also provides support in terms of the residual values on leases.

Ford - We'd be a little more concerned about what Moody's might do with the Ford (Baa1) and Ford Motor Credit (A3) ratings since GM (see above) has somewhat better numbers. S&P has had both Ford and FMCC at BBB since October 2002. DBRS's April downgrade of Ford from A (low) to BBB (high) seems too little and way too late. The April 2003 comments by Egan-Jones that Ford would be bankrupt if it weren't for the name seem dramatic at best. This company is a long way from going bankrupt and, remembering the Chrysler precedent, would never be allowed to come close to filing.

Daimler Chrysler – Both Moody's (A3) and S&P (BBB+) have the ratings under review for a downgrade which seems almost inevitable given what is happening with GM and Ford.

Koninklijke KPN – S&P has upgraded KPN, the Dutch telecom company, to BBB+ and Moody's has given KPN its second upgrade this year (to Baa1). The articles on these upgrades were clearly positive with one on-line service (eFinancial News) even headlining "Rating agencies back KPN's debt reduction strategy". At least one analyst was quoted as saying that the upgrades did not effect trading levels and that KPN's bonds were already trading at a premium to its ratings which showed that the rating agencies were too slow in upgrading this issuer. No argument from this corner about the upgrades, either the timing or the extent. KPN's progress is good, but keep in mind that it was a high double-A credit just three years ago. Don't (or shouldn't) upgrades usually take longer than downgrades?

Sony – Moody's recent downgrade from Aa3 to A1 brings its rating in line with S&P's long-standing A+ rating. Not a big surprise given the existence of a "split rating" and the well publicized intermediate-term prospects for consumer electronics.

Oracle – The announced bid for PeopleSoft caused the WSJ on 6/12 to headline the fact that Moody's had lowered Oracle's outlook to negative. While Oracle is clearly high-profile, this is not that big a deal given their current level of debt and the size of the potential transaction.

This leads us to the question of exactly whether a rating is just the letter grade or whether it includes an issuer's outlook and/or watch-list status.

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What Actually Constitutes a Rating?

The financial press has seemingly grabbed hold of the idea that a change in an issuer's "outlook" is a rating change.

The current rating scales give over twenty rating levels (letter grade and the plus/minus gradations). If one factors in the ratings "outlook" (positive, stable and negative), we quickly get to sixty plus "ratings".

This seems to imply a degree of precision which simply doesn't exist. Are changes in outlook a change in an issuer's rating? Is it a rating change if you get posted on a watch-list? Agree? Disagree? Send in your thoughts and comments:

Comments

More on this in future newsletters.

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Ratings Spotlight

This is the first in a series of weekly comments on the credit ratings of various issuers. A scorecard which will track our prognostications will be attached to each newsletter.

Ignoring the rankings above (which show only LTD), let's start with what is actually the largest industrial borrower…

General Electric (GE)

GE, when consolidated with its "independent" finance subsidiary General Electric Capital Corp. (GECC) is, by most common measures, the largest non-financial borrower in the market. GE gets to this position when its short-term debt and insurance liabilities are added to the LTD tables above.
Editor's note: For rating agency purposes, GECC is viewed as an "independent" finance company because it derives only a limited amount of its business from parent company related activities.

GE is also one of the few remaining triple-A's from both Moody's and S&P and the inevitable question is how long can this last. (Editor's note: Fitch does not have a public rating on GE. The others with triple-A from both Moody's and S&P are ADP, Exxon, Merck, Pfizer and UPS.)

Reading between the lines, we believe that GE may have come very close to some form of negative ratings action (downgrade or watch-list) last November. On 11/21, both Moody's and S&P affirmed their ratings after GE had agreed to commit more capital to GECC over a three year period. S&P quoted a figure of $17 billion, but this was not mentioned at that time by either Moody's or GE.

However, the press releases containing the affirmations also had a few barbs attached:

Moody's stated that GE's moves addressed "a concern that Moody's has had for some time - that GE Capital is under-capitalized on a stand-alone basis" and that this was "…a factor which has placed stress on the rating."

S&P noted that "GE's acknowledgment of $17 billion of total parent support to GECC and a timetable for how that capital will be generated to be an important underpinning of the 'AAA" rating" and that "…(it) expects that any large acquisition would be structured to preserve financial flexibility."

<u>In ratings-speak, this looks like a very close call for GE and GECC</u>.

The primary issue is obviously the leverage at GECC and the parent's ability to provide sufficient capital to control that leverage while, at the same time, not overly restricting GECC's growth.

GECC has grown so large versus its parent that this may have become a case of the tail wagging the dog.

Any change in ratings will not be a criticism of GE but more a realization that GE will be forced to relinquish its triple-A in order to maintain its growth.

GE is currently the largest company as measured by market capitalization. Interestingly, if one were to look at the next ten companies with the largest market capitalization, most do <u>not</u> appear to be direct competitors to GE:

Company (LTD Rating)	GE Competitor?
Pfizer (Aaa/AAA)	No
Microsoft (Aa2/AA)	No
Exxon Mobil (Aaa/AAA)	No
Wal-Mart (Aa2/AA)	No
Citigroup (Aa1/AA-)	Yes

BP (Aa1/AA+)	No
Johnson & Johnson (Aaa/AAA)	No
AIG (Aaa/AAA)	Yes
IBM (A1/A+)	No
Merck (Aaa/AAA)	No

Aside from the fact that GE appears to compete directly with only two of the other very largest companies ranked by market capitalization, it is interesting to note that virtually all of these large companies are, as a group, very highly rated.

Does GE therefore need to maintain its triple-A for purely competitive reasons?

Although having a triple-A certainly helps, the short answer is that it is probably not necessary. While we plan to examine Citigroup and AIG in future issues, Citigroup does not appear to be on the verge of another upgrade while AIG's ratings may be vulnerable to downgrade, particularly as it acquires additional insurance businesses (including some GE operations). GE could thus be very comfortable from a competitive standpoint if it operates with a high double-A.

Years ago, the common wisdom was that it was very "expensive" to maintain a triple-A rating. Although borrowing costs were obviously low, financial flexibility was hindered. Many companies chose to "spend" or lose their triple-A in order to achieve corporate objectives. DuPont was probably one of the earliest when it bought Conoco back in 1981.

GE has moved aggressively to create greater financial disclosure in its publicly available reports and has succeeded in providing a great deal of useful information. There is almost too much detail and the trick is to summarize what is presented. Given the complexities of the business, GE's rating meetings are probably quite long.

While GE is a very well managed company, it is also a very large and fully leveraged company. While we can only assume that many decisions at GE are mostly on a micro-economic basis, the sheer size of the company means that it cannot avoid macro-economic problems of a global nature.

We believe that GE may ultimately have to sacrifice its triple-A in the interest of maintaining increases in its shareholder value. The timeframe is in the next 18 to 24 months.

There is nothing wrong with being a strong double-A.

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Comments and Suggestions

Readers are encouraged to offer their comments on what appears on these pages. We reserve the right to publish comments but guarantee no author's name will ever be published (unless you specifically request that we do so).

Suggestions regarding future topics or issuers to be covered are also welcomed and encouraged.

Send all comments and suggestions to:

Comments

The Scoreboard

Future issues of this newsletter will contain a "scoreboard" summarizing previous analytical comments and observations.