Do we really need all these different credit ratings?

Part III: Objective versus Subjective

Previously, an article in this space looked at the many gradations contained in the current rating scales to determine which one notch changes were the most significant.

This week, we'd like to take a look at the objective and subjective factors within the different ratings. Depending where you are on the rating scale, a one-notch change can be more an objective than a subjective decision (and vice versa).

Let's start at the top…

That little jump from double-A plus to triple-A is highly subjective. Since there are no plus/minus gradations within the triple-A category, you are either triple-A or you are not.

To repeat last week's question: How do you know if you are triple-A? If you have to ask, you're not.

Even with today's compressed spreads, triple-A's are a breed apart. These issuers can pretty much do as they please when it comes to raising funds.

The differences in the double-B category become more subjective at the upper end. This is partly due to the fact that there are only a limited number of double-A credits to begin with.

The ratings scale from the top of the single-A category to the bottom of the triple-B category is fairly objective. These two categories represent the largest number of rated entities and therefore provide more opportunities to directly compare issuers.

The ratings scale from double-B plus to double-B minus is fairly subjective. This top end of the "junk" category is more easily understood than lower ratings..

The ratings in the single-B range (and lower) become highly subjective. The line of demarcation between the B's and the C's is rating agency parlance for those issuers which can possibly meet their obligations (the B's) and those that probably cannot (the C's). In our opinion, as we said last week, "strong triple-C" is a misnomer".

****

The SEC and the Rating Agencies

As previously reported ,our comments have been submitted to the SEC and are posted on our website as well as the SEC website.

No date has been set for the SEC to propose changes to the current system.

If you need to refer back to the SEC concept release regarding the rating agencies as well as the responses thus far received, follow this link to the SEC website:

http://www.sec.gov/rules/concept/s71203.shtml

The responses by the individual rating agencies are posted on the SEC website as are the responses by other interested parties.

In the case of Moody's, S&P and Fitch, these responses are fairly detailed and will take some time to fully digest.

We will examine these responses in a future issue.

****

Ratings Comments

Parmalat – Major embarrassment for S&P which had the company at the lowest investment grade rating

(BBB-) before the bad news broke. Moody's and Fitch are grateful that they had not rated Parmalat.

There will be ample room for finger pointing on this one: S&P should have known about the €500mm investment in Fondo Epicurum; Deloitte & Touche's should never have given a clean opinion on the 2002 financials.

Although technically publicly listed, 98% of Parmalat's shares are reportedly in the hands of insiders. However, financial disclosure appears to have been adequate by local standards and the full financials (with footnotes) were available on the company website.

That having been said, Parmalat's current assets at year-end 2002 included €2.4 billion in "other securities" an amount equal to roughly 1.6x book equity of €1.5 billion (before minority interests). These securities are described in the footnotes as follows: "This item primarily includes other securities made up of government securities, bank securities and debenture loans."

Primarily? What does that mean?

Since this one line represents the bulk of Parmalat's liquidity as well as a multiple of its equity, we would have expected substantial inquiry into this item by S&P or any other party conducting due diligence.

Since Deloitte became uncomfortable with the June 2003 financials, there is a potentially legitimate question as to whether there was a major shift in investments during the first half of this year.

Toyota – Upgraded recently to triple-A by Moody's which matches the very long-standing triple-A rating from S&P. Factors cited were high liquidity, geographic diversity and expense control. Expect this rating change to remain for a long time. Toyota is not your typical auto manufacturer.

DVI – Filed for bankruptcy prompting the usual round of final downgrades. This secured lender ran into problems in its loan portfolio which is primarily secured by medial equipment. Initially rated five years ago (B1 by Moody's and B by S&P) the company's problems fully emerged in the last twelve months.

Eastman Kodak – Downgraded in twice in two months from high triple-B to low triple-B by S&P and Moody's while retaining negative outlook. Also downgraded from BBB to BBB- by Fitch which has been slightly ahead of the other agencies on this name. Given EK's acquisition ambitions and our expectation that debt financing will be heavily utilized, we expect EK to be non-investment grade by at least two of the three agencies within twelve months.

China (PRC) and Chinese Issuers – There seems to be a lot of action on the Chinese ratings scene and we wonder how much may be attributable to the "irrational exuberance" which often accompanies new issuers. The initial success of the China Life IPO does not diminish our cautiousness.

Russia – Now that the dust has settled, can someone please explain the Moody's upgrade to "Baa3" last October? Politics still seems to have the upper hand over economics and, until this is rectified, the overall situation seems less than investment grade. The banking system is the weak link.

It seems to us to be a very bad sign that new bond issuance is essentially on hold until the presidential elections in March. That doesn't seem appropriate for an investment grade issuer.

Whether S&P ("BB") or Fitch ("BBB+") has the better grip on the situation remains to be seen.

There is still significant risk that the whole system might implode as the politicians make a play for the assets. The break-up of the proposed Yukos-Sibneft merger appears far more related to political than economic issues.

****

Watching the Watchlists

FirstEnergy – Now the whipping boy for the big Northeast black-out of 8/14, this holding company and its subsidiaries already had significant credit issues. Moody's had actually put them on the watch list on 8/13, the day before the lights went out.

The holding company is currently Baa2/BBB/BBB- with various negative watches and outlooks. (Note: Although S&P has assigned FE a triple-B issuer rating, its outstanding senior unsecured notes are rated triple-B minus.) Underneath the holding company, there are numerous rated entities with the important operating subsidiaries (Ohio Edison, Cleveland Electric, Toledo Edison, etc.) mostly rated in the middle of the triple-B category. Jersey Central P&L is rated highest, even getting into the single-A's (A2) at Moody's.

The regulators are on JCP&L's case in New Jersey and the continuing problems at three nuclear plants is a drag on earnings.

The accounting system is a mess with required restatements delayed by the need to re-audit prior year results since the original auditor (Arthur Andersen) no longer around. If the second quarter 10-Q had not been filed on time, FirstEnergy's S-3 shelf would have expired and it would have had to go the S-1 route for future public deals.

In our opinion, the operating subsidiaries will likely face a round of one-notch downgrades and remain on negative watch/outlook. The holding company ratings seem likely to go to junk status, especially at S&P where there is somewhat less "room" between the holding company and the average rating of the operating companies.

El Paso Corp. – S&P apparently didn't like what it saw in EP's new business plan, downgrading the company from "B+" to "B". Moody's has rated EP at "B3" since February 2003. Both agencies had rated the company investment grade as recently as 11/02. *(Note: All ratings are for senior unsecured bonds.)*

Is this situation really that bad? We'll take a more detailed look at El Paso in the next issue. With $22b in debt, El Paso is a major borrower.

Ford – An article in the December issue of **credit** began with the catchy title "S&P drive-by hits Ford" and kept on rolling with the header: "Analysts have reacted to S&P's decision to downgrade Ford with a mixture of bafflement and surprise, with questions asked about the rationale and timing of the move…"

Maybe these analysts should have read our August fifth comments when we observed: "The captive finance arms of **General Motors** and **Ford** had their ratings affirmed by S&P, but with negative outlooks and very negative comments in the respective write-ups. GM had been the "spotlight" company in our 7/14 issue and we have previously made other comments on both firms. *Our view is unchanged that another downgrade is likely but that both will remain investment grade." (Editor's note: Emphasis added)*

****

Ratings Spotlight

A series of more detailed comments on the credit ratings of the most prominent issuers.

Comcast

Comcast's sale of its interest in the QVC network has prompted Moody's to change the outlook on its Baa3 rating to positive. Moody's might not make any rating change until it sees what Comcast will do on the acquisition front (see below).

S&P and Fitch have a slightly higher rating (BBB) but with a stable outlook.

You might ask: "What's going on here?"

Our answer would be: "Nothing right now."

This is clearly an issuer in transition…

Comcast is the largest cable television operator in the U.S. and holds this rank by wide margin over its nearest competitor (Time Warner Cable) in which it also holds a 21% economic interest.

The big news was obviously the agreement for Comcast to sell its interest in QVC to **Liberty Media** (Baa3/BBB-/BBB-). The three agencies currently view Liberty Media as stable.

Comcast has recorded a huge gain ($6.2b pre-tax) on the sale, but the consideration received ($7.9b) was mostly paper ($1.3b cash; $4.0b in 3-year notes; $2.6b in Liberty Media stock). $3.0b of the notes have been sold and Comcast has sold 40% of the stock in a complicated ten-year forward transaction.

The initial market reaction to the QVC sale had been lukewarm.

Ignoring QVC, Comcast's remaining operations are clearly improving.

Although basic cable services have shown minor declines in penetration rates, this has been offset by increases in value added services. Customer churn is down and the integration of the AT&T Broadband acquisition appears to be progressing smoothly. Premium cable services (digital cable and pay per view are showing good growth).

Internet services are growing very rapidly, but from a small base. Although the success of these services has been remarkable, its sustainability is being questioned as the ROCs (especially Verizon) are expected to provide strong competition. Internet access has become a commodity type product.

Debt reduction continues, but the balance sheet still carries a heavy load ($25-30b depending on how you measure it). As reported in our first issue, Comcast is among the largest non-financial borrowers.

The big question is what does Comcast do next?

As credit analysts, we don't see this company simply using its cash flow to reduce debt.

One could easily foresee other acquisitions involving media content and/or other cable systems.

Given that Comcast is already the largest cable operator, the content end of the industry is probably more attractive than the delivery systems.

What is out there now?

Time Warner is probably too big. **Viacom** and **NewsCorp** are probably too tightly controlled by incumbent management. **Vivendi** is now part of **General Electric**.

MGM appears to be in play again, but this might turn into a bidding contest with Time Warner.

How about **Disney**? Not impossible size-wise given what Comcast was able to pull off with the AT&T cable systems. Even a moderate amount of debt in the transaction would make it extremely difficult for Comcast to remain investment grade.

****

Next issue: **El Paso Corp.**

Comments and Suggestions

We believe 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 the stability of the credit ratings are wrong. Current methods to hedge credit risk exposures seem very expensive.

Readers are encouraged to offer their comments on what appears on these pages.

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

Send all comments and suggestions to:

Comments

Follow this link to subscribe:

Subscribe

Joseph E. Cantwell

Cantwell & Company, Inc.

One Main Street

Chatham, NJ 07928

1-973-635-9888

To learn more about us, visit our website:

http://www.askcantwell.com/