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Credit Rating Insights

How can your company improve its relations with the rating agencies and bank credit analysts? How can you unlock an often unrealized but significant source of value?

The way companies manage their funding is about to change fundamentally, especially for many companies relying predominantly upon bank lending in the past. With major developments such as increasing banking regulations, growing refinancing needs and a pick-up in corporate transactions, debt capital markets and credit ratings are increasingly important for lenders of different sizes and credit qualities.

The purpose of this white paper is to provide both rated companies and those considering obtaining a first-time rating with some key points on how to optimize the results from dealing with rating agencies. This document outlines what rating agencies and credit analysts look out for, how to manage the rating process optimally, and what one needs to consider in terms of rating advice.

Despite being present in the capital markets for a considerable number of years, the leading rating agencies Fitch, Moody's and Standard & Poor's have only experienced a sharp increase in rating requests of European, including Swiss, companies since the late nineties with a marked pickup thereafter.

History and trend

This development is expected to continue with more and more issuers seeking additional funding sources, driven by increasing disintermediation and a very likely shift towards slowly increasing debt levels. These trends can be attributed to the convergence of a number of key factors such as:

- Increasingly stringent bank regulations that result in higher lending costs, lower lending appetite due to having to find the right business portfolio mix and meeting this with the required level of equity

- Following a period of slow growth and wide-spread restructuring activities, companies are increasingly considering options to shift gears and take investment opportunities such as M&A that allow them to support their strategy

- Many companies were forced to reduce their shareholder focus to some extent given the harsh market challenges since the start of the economic crisis. Since then a reverse has occurred resulting in a considerable increase in overall debt volumes stemming predominantly from higher capex, M&A, and share buybacks

- The increasing emphasis on diversifying funding sources by a growing number of companies

- A newly establishing and lower rated issuer segment such as mid-sized companies ("Mittelstands-unternehmen") that tends to rely heavily on bank lending and now feels signs lower bank debt supply in times of refinancing and expansion need
- Given the very low interest environment, many investors are seeking yield and thus are willing to step down the rating ladder to find their yield requirements.
- Strategic considerations and initiatives that target a lower WACC and thus growing the implied enterprise value

As a result of these developments, the awareness and importance of credit ratings has risen considerably. A large number of corporates have increasingly put ratings at the forefront of their strategic and financial positioning. This subsequently also pinpoints the importance of the relationship between the rated (or these considering obtaining a rating) company and the according rating agency.

"The best rating advice is not linked to any other follow-on services and therefore follows just one agenda – the client's"

The view of a rating agency

In order to fully understand the views and thinking of the rating agencies, it is worthwhile remembering what their role is and what it is not. S&P, Moody's, Fitch and the other rating agencies are not consultants, corporate finance advisors or auditors. Much rather they are specialized independent service providers focussed on assigning ratings based on high quality, objective and to the highest level possible "reliable" credit analysis. At the end of the day, a credit rating is an analyst's and the rating committee's opinion as to the relative and absolute credit strength of the rated company. Independence and integrity are the key pillars upon which their credibility and acceptance among investors and the capital market are built on. Even the development of the real estate crisis in the US and the questions surrounding the role the rating agencies played therein was not able to really diminish their position. Despite experiencing more opposition and requests for substituting agencies such as the initiative to create a European rating agency with the aim of reducing dependency on the established names, the three key rating agencies continue to dominate the market. The biggest hurdles for a new agency will undoubtedly be the lack of a sufficient track record, company and data portfolios, as well as the need to establish the sheer size and reach that can only build over a long time. Hence, investors will most likely continue to rely on the known and available ratings supplied by the established agencies to satisfy their rating information needs. Despite sharing the perspective of bond investors and aiming to serve their interests by providing them with high quality analysis, the rating agencies foster to strike an appropriate balance between the needs of both parties – investors and debt issuers.

Initial rating process

Based on these considerations, a company seeking to launch the process of obtaining an initial rating is well advised to treat the rating agency as a distinct constituency or an additional stakeholder with its own specific needs. Therefore understanding and knowing in detail the process by which the agencies assign ratings, and presenting and advising the company in a way tailored to meeting the rating agency's expectations and requirements, will help support the company in meeting its own rating objectives. Following list highlights some of the key elements of the agencies' approach when rating corporates, and how this deviates from the approach equity analysts take.

Rating agency's focus points

- Fundamental risks, trends, opportunities, structure, of the company's industry
- Competitive position relative to its peers
- Strategy and risk appetite
- Management track record
- Corporate governance
- Drivers of the business profile
- Downside risk compared to upside potential
- Bondholder vs. shareholder weighting
- Financial analysis composed of past and future results (cycle view) compared to sole focus on future results (considerable number of projected future years)
- Quality and sustainability of profitability compared to EPS growth
- Cash flow generation capacity compared to book profitability
- Capital structure and financial headroom
- Off-balance sheet liabilities

The selection of key elements outlined above allows for a number of conclusions as to how companies might consider presenting themselves towards the rating agency:

- A rating is composed of both qualitative and quantitative factors with the qualitative ones playing a very important role on the overall analysis
- Strategy, management's track record, risk appetite and the weighting of bondholder interests compared to shareholder interests are key points that require thorough consideration
- The key focus should be on demonstrating the quality and sustainability of the company's cash flow generation capacity

Therefore it becomes obvious, that the most effective way to deliver and perform this presentation is to have the CEO, CFO, divisional heads, the treasurer and the head of creditor relations forming the team. The nature of the credit analysis both in terms of very detailed information and information covering future developments and strategy mean that the rating agencies are very often provided with a considerable amount of material and non-public information. Companies new to the rating process have to thoroughly consider this requirement and thus have to be concerned about the disclosure of confidential information to the rating agencies.

Although there are always circumstances where such information will not be disclosed and rating agencies are not in a position to "demand" to receive such information, companies fair well to consider rating agencies as "special insiders" in a discretionary and controlled manner.

Leveraging value with a rating advisor

Most companies seeking an initial rating request the support of a rating advisor to benefit from the following value add:

- Provide an informed initial view of the credit profile
- Support in designing a rating strategy
- Anticipate and outline the rating agency's key concerns and focus areas
- Advise on the most suitable rating agency
- Support and advise on preparing a presentation and rating report
- Conduct rehearsals and coach involved parties
- Act as the company's advocate and facilitate a positive relationship between the company and the rating agency
- Act as access point and supporter all along the process
- Provide advice and analysis on an ongoing basis thereafter

Clients benefit the most from rating advisors that are not part of a larger corporate finance business also providing capital market products, M&A advice, or other related services. These products and services should ideally be considered in a second step once the rating goal has been accomplished to maintain completely independent advice throughout.
Though the decision as to which rating advisor to employ is not always looked at in insolation, companies should be mindful that rating advisors vary significantly in terms of quality, track record and least but not last thorough independency. An objective appraisal of key elements therefore is often required.

Check-list: Finding the right rating advisor

- ✓ Independence - no links to other services that could distract from the client's agenda (follow-on services related to projects and corporate finance transactions need to be clearly separated)
- ✓ Sufficient track record allowing him to base his advice on thorough experience
- ✓ Ideally a rating advisor has worked on both sides of the table, thus as a credit analyst and internally in charge of the rating
- ✓ Experience in effective in-house implementation
- ✓ Thorough understanding and knowhow of rating agencies and their methodologies
- ✓ Ideally good contacts to rating agency representatives and lead analysts
- ✓ Deep insight and understanding of the debt capital market / investors / lenders needs and requirements

Ratings are a lifelong dialog

Compared to many other projects, the initial rating process is not a one-time exercise, but rather the beginning of a continuous relationship with no maturity attached to it. Once the ratings have been made public, the agencies need to ensure that their assigned ratings are up to date and reflect the current credit assessment as long as rated debt is outstanding and investors rely on this. The rating agency's lead analyst has to remain in the loop of company and industry developments so as to justify and elaborate on the rating to investors, and to be able to alter the rating or its outlook if appropriate. Even more crucial, given the importance of the evaluation of management quality and credibility in their credit analysis, there is an opportunity to build a thorough and valuable relationship resting on mutual understanding, appreciation and above all trust over time.

"Never underestimate the human factor – a trust-based relationships often shows its true value when it's most needed"

A trust-based relationship will offer considerable value to the company, especially during times, when the ratings might be under pressure as a result of economic uncertainties or other major events, such as a debt-financed acquisition or a restructuring. The company's management team is much more likely to be given the "benefit of the doubt" when presenting a scenario that shows a material weakening of the financial profile in the near-term, if management has previously explained the strategic direction of the company, has been in contact with the lead analyst on a continued base to exchange views and insights, and especially has a track record of delivering on commitments. These relationships are of uttermost importance and can prevent unwanted actions and give additional headroom at times companies are most vulnerable.

"Rating agency and debt investor interaction requires a new way of thinking"
(CFO SMI listed company)

On the contrary, when rating agencies are treated as "outsiders" and are offered not much more than recycled versions of the annual reports during the annual rating meeting, chances are high that the lead analyst will be surprised by unexpected events. This again results in the analyst having to justify himself for previous assessments in front of the rating committee. The result being that the lead analyst will take a step change in his analysis and turn more conservative under these circumstances.
An environment of openness works to the advantage of both sides of the rating relationship. For the company it means that major strategic, business or financial events can be discussed internally with greater certainty as to the impact on the rating and therefore debt capacity and financial headroom, cost of debt and market reaction. Additionally, the ability to coordinate the publication of a rating action or affirmation press release immediately following a public announcement can be a supportive element of the wider investor and public relations exercise. Following overview offers some insights as to the basic rules that can help to ensure a productive and trustworthy relationship with the rating agencies.

Proposed code of best conduct

- Interact and communicate on a regular base and proactively in the event of major developments
- Provide annual update meetings tailored to rating agency needs with the attendance of top management
- Deliver consistent messages
- Disclose selective non-public information and view the rating agency as "insiders"
- Build a "no surprise" environment based on mutual understanding and trust
- Establish an informal "covenant" as headroom levels of key financial metrics
- Actively follow-up on the day of results and events announcements to clear any resulting questions

Manage your ratings

The greater the emphasis paid to shareholder value, and the development of a culture where minimum rating levels are targeted, mean that the days when the ultimate goal of achieving the highest rating as part of the corporate strategy are gone. While this approach might have minimized the cost of debt, this potentially came at the expense of more strategic flexibility and higher acceptable returns to shareholders. Nowadays it is more common for a company to develop a rational rating strategy that forms part of the overall strategy. Hence it is appropriate to say "rating follows strategy" in the interest of a balanced development of the company. Not even magic can bend the relationships with rating agencies to achieve the impossible that would make things a lot easier at certain times for companies. However, following the outlined approach above will result in real benefits in terms of higher credibility and flexibility.

PILFOR AG
Fürstensteinerstrasse 9
CH - 4053 Basel
+41 61 511 42 40
info@pilfor.com
www.pilfor.com