ScotiaMcLeod

Investment Focus: Credit Ratings – A Bond Investor's Valuable Ally

Stewart Hunt, Director – Portfolio Advisory Group

One of the most useful tools available to the fixed income investor is the credit rating. Simply defined, a credit rating is the opinion of a recognized Credit Rating Agency of the general credit worthiness of an obligor, or the credit worthiness of an obligor with respect to a particular debt security or other financial obligation, based on relevant risk factors. Credit ratings do not constitute a recommendation to buy, hold, or sell a particular security, nor do they address the suitability of an investment for a particular investor. A credit rating is the result of extensive qualitative and quantitative analysis with the sole focus of appraising an issuer's ability to meet its underlying financial obligations. Since fixed income investments are primarily designed to preserve an investor's capital while paying interest income, the credit worthiness of the borrower is extremely important.

Credit Rating Agencies

In the Canadian fixed income market the two most commonly used rating agencies are Dominion Bond Rating Service (DBRS) and Standard & Poor's (S&P). Although Moody's Credit Rating Service has worldwide recognition, Canadian issuers do not broadly use it. The ability of a credit rating agency to successfully operate depends on the willingness of investors to accept their judgment. The basic principles that a rating agency must meet are: independence, objectivity, credibility, and disclosure. Canadian fixed income investors accept the opinions of Dominion Bond Rating Service and Standard & Poor's because both companies operate under these principles. Walter Schroeder established DBRS in 1976; it is a privately owed Canadian company that operates without affiliation to any financial institution or similar organization. Since its inception DBRS has worked to refine its expertise in the analysis of credit quality and has gained a reputation for accounting for the unique cyclical nature of many of Canada's major companies. Their particular focus on rating Canadian debt issuers in a consistent and objective manner has given DBRS a foundation of credibility that is valued by bond investors.

Standard & Poor's began rating corporate and government debt over 75 years ago. Standard & Poor's Rating Services is based in the United States and is a business unit of McGraw-Hill, a major U.S. publishing company. In matters of credit analysis and ratings, Standard & Poor's operates independently of McGraw-Hill. On October 31st, 2000 Standard & Poor's acquired Canadian Bond Rating Service (CBRS) and, as a result of this acquisition, gained coverage of 92% of the fixed income issuers in Canada. Prior to the takeover by S&P, Canadian Bond Rating Service and Dominion Bond Rating Service, both Canadian companies, dominated the market for credit analysis in Canada. Over the past year issuers that had both a Standard & Poor's and CBRS credit rating were moved solely to the S&P rating. Issuers that only had a CBRS rating were reviewed by S&P with their rating harmonized under Standard & Poor's rating criteria. The increased presence of S&P in the Canadian debt markets provides bond investors with access to the expertise of a rating agency that rates over U$11.0 trillion in bonds and other financial obligations of obligors in more than 50 countries.

Credit Rating Scale

Integral to the credit rating process is the creation of a rating scale. The rating scale is meant to provide an indication of the risk that the borrower (obligor) will not fulfill their obligations in a timely manner with respect to both interest and principal commitments. The rating scale also takes into account the protection afforded by, and the relative position of, the obligation in the event of bankruptcy or reorganization. For example, senior secured debt is often rated higher than unsecured obligations due to its prospects of ultimate recovery. The credit rating agencies also provide a rating scale for the various types of debt instruments. In Canada, both Dominion Bond Rating Service and Standard & Poor's provide a credit rating scale for short-term debt (less than 365 days to maturity), long-term debt, and preferred shares. They also provide "hybrid" ratings on issues that may have a debt structure with some form of equity component. It is important for investors to note that credit ratings do not take into account factors such as pricing or market risk and, therefore, a credit rating should be used only as one part of the investment decision.

Although their opinions may vary regarding the credit worthiness of a particular issue or issuer, both DBRS and S&P use a very similar rating scale for long-term credit ratings. Listed below is the credit rating scale used for long-term debt, ranging from the highest quality credit to default, with a brief definition of the credit worthiness associated with the rating:

- **AAA** – Bonds rated "triple A" are of the highest credit quality. The obligor's ability to meet its financial commitment on the repayment of principal and interest is extremely strong. Issuers achieving the "AAA" rating have stable earnings, operate a dominant position in a strong and profitable industry, show strong liquidity and coverage ratios, and have established a track record of superior performance. Due to the extreme criteria very few entities are able to achieve the "triple A" rating.
- **AA** – Bonds rated "double A" are of superior credit quality and only differ from obligations rated "triple A" to a small degree. The obligor's ability to meet its financial commitments is very strong. Issuers achieving the "AA" rating are considered strong credits, offer above average strength in areas of profitability and liquidity, and are unlikely to be affected by foreseeable market conditions.
- **A** – Bonds rated "single A" are of satisfactory credit quality. The obligor's ability to meet its financial commitment is strong. However, issuers receiving the "A" rating are more susceptible to the adverse effects of changes in circumstances and economic conditions.
- **BBB** – Bonds rated "BBB" are of adequate credit quality. The obligor's ability to meet its financial commitment is considered adequate. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.
- **BB** – Bonds rated "BB" are defined as speculative. The obligor's ability to meet its financial commitment is considered uncertain. Issuers in the "BB" category have limited access to capital markets and additional liquidity support. They face ongoing uncertainties or exposure to adverse business, financial, or economic conditions that reduce their capacity to meet commitments on their obligations.
- **B** – Bonds rated "B" are highly speculative. The obligor's ability to meet its financial commitment on an ongoing basis is highly uncertain. Although the obligor is currently meeting its financial commitment, adverse business, financial, or economic conditions greatly reduce the issuer's capacity or willingness to meet its obligations.
- **CCC / CC / C** – Bonds rated in any of these categories are very highly speculative. The obligor, without the presence of favourable business, financial, and economic conditions, is in danger of not meeting its financial commitments.
- **D** – Bonds rated "D" are in default of either interest or principal. Unlike other ratings, "D" is not prospective. It is only used where a default has occurred.

As an additional enhancement to an issuer's credit rating, credit rating agencies also modify each rating to show the issuer's relative standing within the major rating categories. In the case of Dominion Bond Rating Service, a borrower may be further classified as being high or low within the rating category. An example would be Loblaws Cos., which is rated "single A high" (A (high)) by DBRS. Standard & Poor's also provide modification to their ratings, however, they tack on a plus (+) or minus (-) symbol.

To further assist fixed income investors in determining the credit worthiness of an issue or issuer, creditrating agencies will provide a rating outlook or place the issuer on a "watch list." This happens when an event or deviation from an expected trend has occurred and further information is required to provide an accurate appraisal of the issuer's credit worthiness. Subsequent to an issuer being placed on watch, a rating agency will perform a rating review and release the results in a timely fashion (usually 90 days). Both DBRS and Standard & Poor's use the same rating outlook terminology: negative (potential downgrade), positive (potential upgrade), and stable (rating unchanged).

Investment and Speculative Grades

AAA	**Investment Grade**
AA	**Investment Grade**
A	**Investment Grade**
BBB	**Investment Grade**
BB	Non-Investment Grade
B	Non-Investment Grade
CCC	Non-Investment Grade
CC	Non-Investment Grade
C	Non-Investment Grade
D	Non-Investment Grade

Source: DBRS; Standard & Poor's

To reassure depositors and investors, regulatory bodies created the term "investment grade" to describe obligations that would be eligible for investment by institutions such as banks, insurance companies, and trust companies. The term has gained widespread use in the investment community. An obligation that is recognized as investment grade falls within the four highest rating categories, AAA, AA, A and BBB. The lowest accepted investment grade rating is BBB (low) or (-). However, many conservative investors will not allow for BBB (low /-) issues to be held in their portfolio fearing that a further reduction in the credit rating will move the obligation into speculative grade.

Issues that are rated BB or lower are referred to as "high yield" or "speculative" grade. High yield bonds are not investment grade and therefore can be considered "buyer beware." Market liquidity in these issues does not have the same depth as investment grade bonds. Investors who participate in the high yield market will attempt to maintain smaller positions, spreading them out across a variety of sectors and issues. Retail investors who do not have the magnitude to broadly diversify their holdings would be advised to participate in high yield investments through a mutual fund offering this service.

Rating Process

Issuer requests rating → Rating agency assigns analytical team to conduct research → Rating agency meets issuer → Rating committee meets with issuer → Rating agency issues rating → Ongoing surveillance of company by rating agency

Appeals process

Source: Standard & Poor's

The broad acceptance by fixed income investors of the opinions and judgments made by credit rating agencies has made it very difficult for potential borrowers to tap the debt markets without a credit rating. Before any sale or registration of a debt issue, an issuer will approach a rating agency to provide them with an indication of what rating they can expect. The detailed independent and objective qualitative and quantitative assessment of an issuer done by a rating agency is what provides the credibility of the agency's judgment.

Outlined below is the process a Corporate Issuer would go through with a Credit Rating Agency to receive a rating:

- Corporation would approach one or more rating agencies to request a credit rating. (It is common practice that an issue be rated by at least two agencies to provide maximum investor confidence.)
- Once approached, the rating agency will assign an analytical team to conduct the basic research. Rating agencies will assign an analyst with the greatest relevant industry expertise to the evaluation. This industry specialization of the analyst provides an understanding of the business and of the financial and economic conditions that specifically relate to companies within an industry sector. The industry analyst will handle the relationship with the issuer and will lead the analytical team.
- With the analytical team in place, the rating agency will arrange to meet with the issuer. The rating agency will request the participation of the Chief Executive Officer, Chief Financial Officer, and the key operating executives of the corporation. In advance of the meeting the issuer will be requested to provide: 5 years of audited financial statements, narrative descriptions of operations and products, last interim financial statements, and a draft of the proposed debt offering, if available. The analytical team will review this information to prepare for the company meeting. During the meeting with the issuer the rating agency will address: industry environment and prospects, overview of major business segments, operating statistics, competition, financial policies and goals, accounting practices, management's financial and market projections, capital spending plans, and financial alternatives and contingency plans. Rating agencies, because they are privy to detailed budgets and forecasts required to perform a full credit evaluation, are considered "insiders."
- Once the meeting has been completed and the rating agency is satisfied that they have all the relevant data required to apply a rating, the information is presented to a rating committee. The industry analyst makes the presentation of all the relevant data and provides a rating recommendation. The rating committee will then come to an agreement on the rating. Once the rating has been made, the company is informed of the rating agency's credit rating decision.
- The company, after being informed of their rating, is allowed to appeal the agency's decision before publication of the rating. A company may feel that not all of the pertinent information was available or considered in reaching the credit rating. If an appeal is made, the rating committee will reconvene to consider the new information. When this is completed the rating agency will inform the company of their rating decision and will then proceed to disseminate the information to the media and public (via a press release or a more detailed rating report).
- The job of the rating agency does not end once a rating has been determined. The rating agency will then begin ongoing surveillance of the issuer and the industry, advising investors of positive or negative implications that may affect the rating. The common practice among rating agencies is to review the issuer once a year or more if required.

From the amount of due diligence and guidelines provided by Credit Agencies, the credit rating of a fixed income issuer is considered "an investors' valuable ally."