**The Rating agencies**

Rating agencies have clearly gained in importance in Europe in the last 20 years, as shown by the 35% annual increase in the number of companies carrying a Moody’s rating.

This is obviously due mostly to the transition of continental Europe from an economy based mostly on banking intermediaries to one where the ﬁnancial markets are becoming predominant.

CFOs can no longer shield themselves from this additional consideration. Ratings are even becoming one of their main concerns. Financial decisions are taken based partly on their rating impact; or, more precisely, decisions that have a negative rating impact will be adjusted accordingly.

Some companies even set rating targets (e.g. Vivendi Universal, PepsiCo). This can seem paradoxical in two ways:

• Although all ﬁnancial communication is based on creating shareholder value, companies are much less likely to set share price targets than rating targets. • In setting rating targets, companies have a new objective: that of preserving value for bondholders! This is praiseworthy and, in a ﬁnancial market context, understandable, but has never been part of the bargain with bondholders.

We see several possible explanations for this paradox: • A downgrade is clearly a major event for a company that goes well beyond bondholder information.A downgrade is traumatic and messy and almost always leads to a fall in the share price. Thus, by preserving a ﬁnancial rating, it is also shareholder value that management is protecting, at least in the short term.

• A downgrade can also have an immediate cost if the company has issued a bond with a step-up in the coupon, i.e. a clause stating that the coupon will be increased in the event of a rating downgrade. Step-ups are meant to protect lenders against a downgrade and obviously make managers pay more attention to their debt rating. • A good debt rating guarantees some ﬁnancial ﬂexibility. The higher the rating, the easier it is to tap the bond markets, as transactions are less dependent on market ﬂuctuations. An investment grade company, for example, can almost always issue bonds, whereas market windows close regularly for companies that are below investment grade. The seizing up of the high-yield market over the last few months is quite instructive here, as many issues have had to be postponed. The high-yield market is similar in this respect to the equities market. Under the new Basel II banking solvency standards the highest rated companies will probably have even greater ﬂexibility, as loans to them will require lower reserve requirements and banks will more readily lend to them. • Some banks sell the concept of lower cost of capital (and, thus, enhanced value) as a function of rating – for example, obtaining the lowest possible cost of capital for a BBB rating. This is based on the tax savings brought about by ﬁnancing costs but, beginning with a certain level of debt, the savings are cancelled out by the discounted value of the cost of bankruptcy. Readers who know us well know that we are not great fans of this argument. For it seems difﬁcult to maintain that companies rated BBB can be valued signiﬁcantly higher than others. The average company rating is closer to A, after all, and major groups such as Nestl´e and AstraZeneca, which have stable cash ﬂows, do not try to play leverage, preferring to hold onto their very strong rating. Similarly, setting out to obtain the best rating possible is getting things backwards! This minimizes the cost of debt, but so what? If it also requires an exorbitant level of equity, the cost of capital has not necessarily been reduced.

There is a phenomenon that is even more perverse than setting a target rating: refusing to be rated or asking for a conﬁdential ‘shadow rating’.

Being rated can be scary, and CFOs balance out the lack of ﬂexibility created by the lack of rating (e.g. certain investors can no longer be tapped and the bond market is mostly closed off) with the potential lack of ﬂexibility created by a poor rating.

In extreme cases, we have even seen companies that, in their initial rating process, tried to obtain the worst possible rating for their particular ﬁnancial proﬁle. They have done this in order to gain some ﬂexibility, i.e. some room for their situation to get marginally worse without undermining their rating. In this particular case, caution has a clear impact on value, as a lower rating means higher debt costs. But this is like an insurance premium that always looks too high until an accident strikes.

All in all, the desire of many companies to set a rating target reminds us that ﬁnancial structure is above all the choice of the level of risk that shareholders choose to run and that the European debt market is becoming a real market with varied, segmented products, offered to investors who need some criteria in making their choices.