



## We Were Right All Along

by Glenn E. Atkins, CFA

Almost three years ago (4Q01) we introduced in our newsletter the concept of “Ratings Drift” in the bond market. Ratings drift is the concept that as the underlying fundamentals of the companies change, the actual ratings may not. The main reason that the underlying rating does not change is that the rating agencies like to “rate through the cycle”, meaning that they like to keep their ratings stable throughout a full economic cycle. This reduces the whip-sawing of rating changes and it serves to stabilize the bond market to a degree.

As we noted then, the risk in this kind of environment is not credit risk per se, but what we termed “headline risk.” For example, even though the company is fundamentally weak due to the then-current economic conditions, the company may not ever actually be downgraded – that is until it makes the front page of the Wall Street Journal or is mentioned on CNBC. Then suddenly the agencies are playing a game of catch-up and the actual rating falls off a cliff. Selecting individual bonds during periods of rating drift can be quite frustrating. Ratings drift is indicated in the table at the top of page three which shows the average financial ratios for each rating category from Standard & Pools.

The gold shading indicates the “better” ratio for each category if it occurred during 2000 as opposed to 2003 and for the average line, gold shading indicates that all averages were better in 2003. As can be seen, almost every ratio improved for every rating category with the major exception being the EBITDA coverage ratio. Could there be some arcane tax arbitrage surrounding the recent removal of goodwill amortization deductibility that is causing the weakness in this ratio? I am not sure.

The takeaway from this table is that operating margins are stable, companies are paying down debt with internally generated cash, and they are becoming more efficient and productive as we noted in our previous articles.

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In fact, almost two years ago (1Q03) we noted in our article “Credit Stability”, that “we have seen a firming of credit metrics and even an improvement when compared to the credit metrics of four years ago.” We went on to say:

*“First, this improvement suggests to me that credit quality across the board may be beginning to improve, because the companies on our list (approved list) represent a large cross section of industrial America. Second, it suggests that certain companies have absorbed the recent economic weakness quite well and that those that can have used this opportunity to strengthen their balance sheets and improve their competitive position relative to those companies who are incapable of improving their financial positions. Third, it appears to me that much of this improvement has come through the maintenance of margins, operating cost reductions, and debt reduction through largely internally generated cash flow.”*

Beginning in 1998 the average numerical score of bonds on our approved list was 6.1 (lower numbers indicate stronger company fundamentals) and was indicative of a single-A rating. This number bottomed at 6.72 (single-A minus, or A-) in FY2001 at the exact same time as we began talking

	PreTax Interest Coverage (1)		EBIT DA Coverage (2)		FFO As % of Debt (3)		FOpCF As % of Debt (4)		PreTax Return on Capital		Oper. Inc. As % of Sales		LTD As % of Capital		Total Debt As % of Capital	
	2000	2003	2000	2003	2000	2003	2000	2003	2000	2003	2000	2003	2000	2003	2000	2003
AAA	21.40	23.40	26.50	25.30	128.80	214.20	84.20	156.60	34.90	35.00	27.00	23.40	13.30	(1.10)	22.90	5.00
AA	10.10	13.30	12.90	16.90	55.40	65.70	25.20	33.60	21.70	26.60	22.10	24.00	28.20	21.10	37.70	35.90
A	6.10	6.30	9.10	8.50	43.20	42.20	15.00	22.30	19.40	18.10	18.60	18.10	33.90	33.80	42.50	42.60
BBB	3.70	3.90	5.80	5.40	30.80	30.60	8.50	12.80	13.60	13.10	15.40	15.50	42.50	40.30	48.20	47.00
BB	2.10	2.20	3.40	3.20	18.80	19.70	2.60	7.30	11.60	11.50	15.90	15.40	57.20	53.60	62.60	57.70
B	0.80	1.00	1.80	1.70	7.80	10.40	(3.20)	1.50	6.60	8.00	11.90	14.70	69.70	72.60	74.80	75.10
Average	7.37	8.35	9.92	10.17	47.47	63.80	22.05	39.02	17.97	18.72	18.48	18.52	40.80	36.72	48.12	43.88

Source: Standard & Poor

(1) Earnings before interest and taxes divided by interest expense.

(2) Earnings before interest, taxes, depreciation and amortization, divided by interest expenses.

(3) Operating cash flow as a percentage of total debt.

(4) Free operating cash flow (operating cash flow minus capital expenditures) as a percent of total debt.

about ratings drift. When we made the improving credit quality call in the 1Q of 2003 we were essentially using FY2002 numbers. The average score for 2002 improved to 5.72 (single A) and was choppy into 2003, ending the year at 5.9 (also single A). From the lows of 6.72 (single A minus) in 2001, the average score on our approved list has improved to 5.3 (single A plus) as of the year ended 6/30/04. The table below shows the recent average scores for each of the companies currently on our approved list for 2001, 2003 and the 12 month period ending 6/30/04. The names have been omitted to protect the guilty!

Average Garner Rating Score			
	FY2001	FY2003	YE2Q04
	6.75	3.25	3.25
	9.25	9.00	7.13
	7.13	7.13	7.13
	9.50	6.88	6.50
	5.00	3.75	3.75
	7.50	6.00	5.75
	6.13	6.63	8.50
	7.13	4.38	4.00
	5.25	3.50	2.50
	6.38	5.00	4.63
	7.88	5.50	5.75
	6.63	5.38	5.25
	7.38	4.75	3.88
	7.13	6.50	6.50
	4.00	3.88	3.75
	5.13	4.63	3.75
	7.13	8.88	6.38
	2.75	2.00	2.00
	8.38	5.00	6.00
	6.00	9.63	6.13
	4.88	5.13	4.50
	10.63	11.63	8.00
	6.38	5.88	5.50
	7.00	7.38	6.75
Average	6.72	5.90	5.30
Rating	A-	A	A+

As can be seen from the table, only two companies have failed to show improvement since the fundamentals bottomed in 2001. In both cases, easily identifiable operational issues have been the culprit and we remain comfortable with the names.

Since the credit fundamentals bottomed during the FY2001 period, we have more than doubled the names on our corporate bond approved list. Granted, we have not purchased them all yet because many of them are not available at all or are not available at a price/yield that we are willing to pay.

Focusing on such minute changes in underlying credit fundamentals can seem rather nit-picky. Keep in mind though that our focus has been primarily on the bonds on our approved list. Since we try to make a habit of picking good companies my sense would be that overall industrial fundamentals are much more volatile than our approved universe. That's the way it should be. The upside for us is that we miss a lot of bad credits when they are on the way down. The downside is that we probably also miss a few of the good credits when they are improving. I'll take that side of the trade any day and clip my coupons all the way to the bank. So should you. ■

MAINNA GEMINI COMPANY  
 GARNER RATING SYSTEM