COMMUNICATIONS FOLLOWING A RATINGS DOWNGRADE: ONE SIZE DOES NOT FIT ALL

Ratings agencies continue to deliver a sharp message to companies: shoot first, ask questions later.

Ratings agencies are dealing with a hail of criticism levelled at them in the past two years regarding ratings of many structured finance securities. While they can't retract their investment-grade blessings of various structured products or securitized instruments that later proved to be wildly off the mark, ratings agencies are currently downgrading issues with near-record frequency – much of it either recession-related or reflecting concerns about accessing capital. Ratings downgrades of corporate issues by Standard & Poor's outnumbered upgrades by nearly 10 to 1 in the last quarter of 2008 and first quarter of 2009 – a trend that's likely to continue.

Despite a propensity to downgrade issuers showing any signs of financial distress or liquidity concerns amid this recession, recent evidence suggests ratings changes lag market-based indicators with respect to the timely identification of changes in credit risk. For example, both Moody's and S&P downgraded General Electric, long a hallmark of the vaunted 'AAA' credit rating, in March while the Company's bond spreads relative to Treasuries implied that credit markets had "downgraded" GE several months prior to that. Moody's and S&P's now notorious 'A' rating of Lehman Brothers a month before it collapsed also raised questions about the accuracy of the ratings system and the timeliness of ratings changes.

Despite past missteps, arguable conflicts of interest and some prominent outcries for an overhaul of the entire ratings system, credit ratings continue to be the most visible and widely followed summary measure of corporate creditworthiness within the business and investment communities.

A public rating or private rating estimate remains a sine qua non for most large new debt issues. Moreover, issue or issuer ratings downgrades can entail a wide range of business consequences depending upon the severity of the downgrade and the narrative that accompanies it, specific contractual provisions attached to the downgrade, and stakeholders' reactions to the downgrade.

These diverse stakeholder perspectives and the host of possible economic consequences from a ratings downgrade necessitate a strategic communications plan that allows senior management and the Board of Directors to effectively manage reactions of investors, employees, customers and the media, often in very short order. Rather than viewing a downgrade as a standalone event, companies must rethink what their ratings mean holistically for the entire business enterprise. This perspective will guide the proper communications strategy.

Anticipating Potential Downgrade Impact

Because the impact of a ratings downgrade can vary so significantly among issuers, the first and most critical step in developing a communications strategy is to assess the likely impact on your business in terms of economic cost, market reaction and reputational challenges. In other words, how will the downgrade directly affect your company and how will it be understood by your key stakeholders? While there may be little opportunity to avoid the negative effects of a downgrade that are contractually in place, effectively managing key stakeholder reactions to the downgrade can help avoid a feedback loop.

With respect to impact, a ratings downgrade typically falls into one of four categories, as outlined below. Most companies undergo some combination of the following effects when the downgrade is officially disclosed:

1. Existential Threat

   This most extreme scenario exists when the viability of the enterprise is put at immediate risk because the downgrade will trigger events that could precipitate the bankruptcy of the company. The bankruptcy may result from debt covenants that allow banks to immediately call loans or suspend access to vital credit lines, counterparty obligations that result in crippling levels of collateral calls or cross default provisions in credit agreements or trust indentures that permit other creditors to accelerate demand for payment.

2. Business Model Disruption

   Here, the viability of the business and the soundness of its strategy are called into question, as the downgrade reflects agency concerns that particular lines of business or the enterprise itself is on a path that is not financially sustainable in the long term. Often, the ratings agency maintains a negative outlook for the issuer even after the downgrade and suggests that future downgrades are possible without remedial action by the issuer. The difference between this situation and an existential threat is that, while there may be liquidity pressures that ensue, they are not necessarily immediate or crippling.

3. Erosion of Stakeholder Confidence

   In this scenario, the survival of the enterprise is not in question; however, its credit profile has weakened to the point that key stakeholders may start to re-evaluate the terms of their business relationship with the company. This may be especially true for “crossover credits” that move down to speculative-grade status from investment grade, or speculative-grade credits that get downgraded into “deep junk” territory—generally considered B- or worse. The downgrade can potentially threaten supplier or customer relationships or change the business terms of those relationships.

4. Higher Cost of Capital

   Virtually all downgraded companies experience a higher cost of capital in some form—directly, such as loan pricing grids tied to credit ratings, or those imposed by credit markets when it’s time to borrow again. This would be considered the lowest level of impact that a downgraded company can expect. Although this does not directly impact the business model, it often causes companies to seek out alternative sources of capital or to forgo marginally attractive business investments that can no longer be justified.

Strategic Communications Considerations

Irrespective of the severity of the anticipated business impact, the following communications issues should be factored into the strategic communications plan for any downgrade:

- Which stakeholders are most affected (investors, customers, employees, business partners)? How well do they understand the impact?

  Understanding the relative impact on various stakeholders will help the company to prioritize communications with each group and develop the appropriate materials. Accurately assessing stakeholders' understanding of the situation will allow the company to effectively communicate the agency's rationale, potential remedies for their concerns and the timeframe in which key milestones will be accomplished, without raising unwarranted red flags.

- Is the rating still investment-grade? Does the downgrade trigger any debt covenants or counterparty obligations?

  A multiple-notch downgrade is generally more severe than a single notch change because it may signal that issues are developing quickly. The impact is greater still if the downgrade places the company's credit rating below investment-grade status. In this scenario, the company must help investors understand the immediate implications for existing debt or credit agreements and the status of conversations with banks.

- What are the reasons for the downgrade? Are they primarily company-specific or are they due to industry or macroeconomic factors? Have your peers been downgraded?

  Company-specific downgrades may result in broad criticism from stakeholders who assume the business has been mismanaged. To some extent such criticisms are mitigated when the downgrade is linked to industry or macroeconomic trends. However, such industry-wide downgrades might also suggest that the issuer is subject to forces beyond its control and unable to "fix itself."

- What action is the company taking as a result of the downgrade?

  While companies may not be prepared to explain remedial actions at the time of the first announcement, they should express a strong commitment to restoring their prior ratings and provide as much guidance as possible about how this will be achieved. For example, if the downgrade cited capitalization concerns, the company should outline its plan or intention to raise additional capital or refinance existing debt, or explain why it believes such action is not necessary at the moment.

- Are downgrades by other agencies likely to follow?

  There is often a temptation to delay announcements of the first ratings agency downgrade if additional actions seem likely. Companies may think they can bundle announcements to limit the news cycle, but in reality, they are putting themselves at a significant risk by not communicating their strategies for restoring prior ratings. In contrast, proactive communications reinforce the company's transparency amid difficult circumstances and provide a solid foundation for related communications in the future.

Downgrade Communications Approaches

Communications that respond to a ratings downgrade can take many forms, ranging from a formal press release or media statement to internal communications directed primarily at employees and customers. Such communications should focus on remedial actions and reinforce the company's continued operations. Additional, scenario-specific considerations are as follows:

1. Existential Threat

   This scenario demands some form of public comment, particularly since bankruptcy speculation may ensue. The communication must address the immediate steps the company is taking to mitigate the impact of the action and maintain the viability and purpose of the enterprise. This strategy should include direct communications to all stakeholders including investors, customers, business partners and employees.

2. Business Model Disruption

   Investors, customers and business partners will look to the company to provide clarity about how the action may affect day-to-day operations. If a public statement is not made proactively, the company should be prepared to respond to inquiries from its key stakeholders.

3. Erosion of Stakeholder Confidence

   In this scenario, the greatest risk is a loss of confidence among key customers, suppliers or business partners. Accordingly, a proactive communication targeted directly to these stakeholders is often the most effective approach. A reference to peer downgrades (if applicable) may demonstrate that adversity is besetting the entire industry and not entirely the result of the company's strategies or business decisions.

4. Higher Cost of Capital

   Because this scenario does not directly impact the business model, communications should primarily target lenders and select investors. More proactive communications may be necessary in some instances but may also inadvertently draw undue attention to the downgrade.

Downgrades will likely continue to dominate ratings actions long after credit markets and the economy begin the process of healing. Management and Boards must be prepared to respond appropriately based on a careful assessment of what the rating means to the company and the impact of a downgrade on operations and stakeholders.

For more information, please contact:

Kal Goldberg
Managing Director
T +1 (212) 850-5731
kal.goldberg@fd.com

Ellen Barry
Managing Director
T +1 (214) 397 1632
ellen.barry@fd.com