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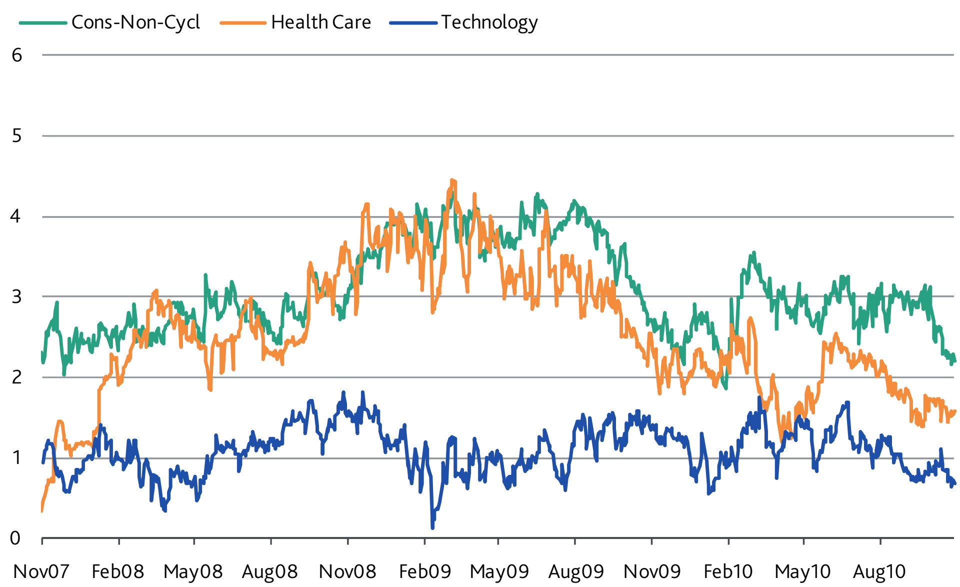
Things Are Not What They Seem: LBO and M&A Speculation, Not Credit Deterioration, Lies Behind Increased Market Risk Signals

Many multi-notch declines in CDS-implied ratings reflect potential creditor-unfriendly actions

Recently, consumer non-cyclical, healthcare, and technology companies such as Clorox, Cardinal Health, Eli Lilly, and Seagate Technology have experienced multiple notch declines in their CDS-implied ratings. These issuers are fundamentally sound from a credit point of view, despite the occasional bumps in the road. As discussed below, ***we believe that in most cases speculation about merger activity and leveraged buy-outs is the main driver of the large drops in companies' CDS market risk signals, rather than the deterioration of their creditworthiness.***

Such developments are not surprising. During the recent recession many firms improved their balance sheets and built up hoards of cash[1]. This, plus the availability of cheap financing and weak organic growth, naturally turn company managers' minds to acquisitions and various forms of buyouts. Also spurring speculation have been high profile deals such as BHP Billiton's hostile bid for Potash of Saskatchewan; Hewlett Packard's bidding war with Dell over 3PAR; Pfizer's acquisition of King Pharmaceuticals; and the private equity takeover of Burger King by an affiliate of 3G Capital.

Figure 1: Average CDS Implied Rating Gaps



Source: Moody's Analytics *All ratings and data as of 11/1/2010*

[1] See Moody's Investors Service, October 26, 2010, *Special Comment*, "U.S. Corporate Cash Hoard Near $1 Trillion, but Unlikely To Be Used for Expansion."

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Falls from high levels place many implied ratings close to their Moody's rating

While LBO and M&A speculation has touched many sectors, consumer non-cyclical, health care, and technology sectors seem to be primary targets. These sectors were less affected by the economic slowdown, and many of the companies have maintained good cash flow and relatively strong balance sheets. Over the past three years CDS spreads in the three sectors have been relatively tight compared to the wider market, as confirmed by the positive sector-average CDS-implied rating gaps (a gap is the difference between the Moody's rating and the market-implied rating, measured in ratings "notches"). Please see Figure 1 for details.

The sector average implied ratings have recently declined from their former very positive levels (recall that a "positive" ratings gap means that an entity's CDS spread is lower than suggested by its Moody's rating). However, despite the declines in many issuers' implied ratings, often by multiple notches, they usually remain above their Moody's ratings. Indeed, half of the companies we list in Figure 2 are in this situation.

Figure 2. Market Implied Ratings, Gaps and Gap Moves

					Market Implied Rating								
			Rating	Moody's	Rating			Gap			Gap move		
Sym	Issuer	Sector	Outlook	Rating	Bond	CDS	Equity	Bond	CDS	Equity	Bond	CDS	Equity
AVP	Avon Products, Inc.	Consumer Non-Cycl	STA	A2	Aa3	A1	A2	2	1	0	1	-2	0
CAH	Cardinal Health, Inc.	Health Care	STA	Baa3	A3	Baa1	Ba2	3	2	-2	0	-5	0
CLX	Clorox Company	Consumer Non-Cycl	STA	Baa1	Aa3	A3	Aaa	4	1	7	-1	-3	-1
CSC	Computer Sciences Corp	Technology	STA	Baa1	Baa2	Baa3	Baa1	-1	-2	0	0	-2	0
CAG	ConAgra Foods, Inc.	Consumer Non-Cycl	STA	Baa2	Baa1	Baa1	A1	1	1	4	-2	-6	-1
DELL	Dell Inc.	Technology	STA	A2	A1	Baa2	Ba3	1	-3	-7	-1	-1	-1
DEO	Diageo PLC	Consumer Non-Cycl	STA	A3	—	A3	Aaa	—	0	6	0	-4	0
LLY	Eli Lilly and Company	Health Care	RUR	A1	Aa2	Aa2	Aa3	2	2	1	0	-2	0
EXPE	Expedia, Inc.	Technology	POS	Ba1	Ba2	Baa3	Ba2	-1	1	-1	0	0	0
FISV	Fiserv, Inc.	Technology	STA	Baa2	Baa1	Ba1	Aa3	1	-2	5	0	-1	0
INTU	Intuit Inc.	Technology	STA	Baa1	A3	Aa1	Aaa	1	6	7	1	5	0
MON	Monsanto Company	Consumer Non-Cycl	STA	A2	A1	A3	Baa1	1	-1	-2	-2	-4	-1
PBI	Pitney Bowes Inc.	Technology	RUR	A1	Baa3	Baa3	Ba3	-5	-5	-8	-4	-1	-2
SLE	Sara Lee Corporation	Consumer Non-Cycl	STA	Baa1	A3	Baa3	A2	1	-2	2	-1	-5	-1
STX	Seagate Technology	Technology	STA	Ba1	Ba3	B2	—	-2	-4	—	-1	-3	0
WU	Western Union Co.	Technology	STA	A3	A3	Baa3	Ba2	0	-3	-5	0	-1	-1

Source: Moody's Analytics *Data are as of November 1, 2010*

Implied rating move may be more visible than CDS spread move

CDS spreads are now quite tight at the top end of the rating scale. Thus, small moves in an entity's spread, if not matched by the broad market, can produce a multiple-notch move in its implied rating. Because many of these companies are investment grade, the corresponding move in their CDS spreads may not stand out within the broader market. But even with this caveat, as noted our view is that press speculation about creditor-unfriendly events such as LBOs is the main driver of the decline in the entities' CDS-implied ratings.

Note: For further detail on 16 companies affected please see our *Market Signals Review* under the same title, "Things Are not What They Seem…", published November 5.

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