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Market Facts

Size Matters For Credit Ratings

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American businesses allegedly have benefited from greater direct access to capital markets than enjoyed by their more commercial bank-dependent cousins in Japan and Continental Europe.

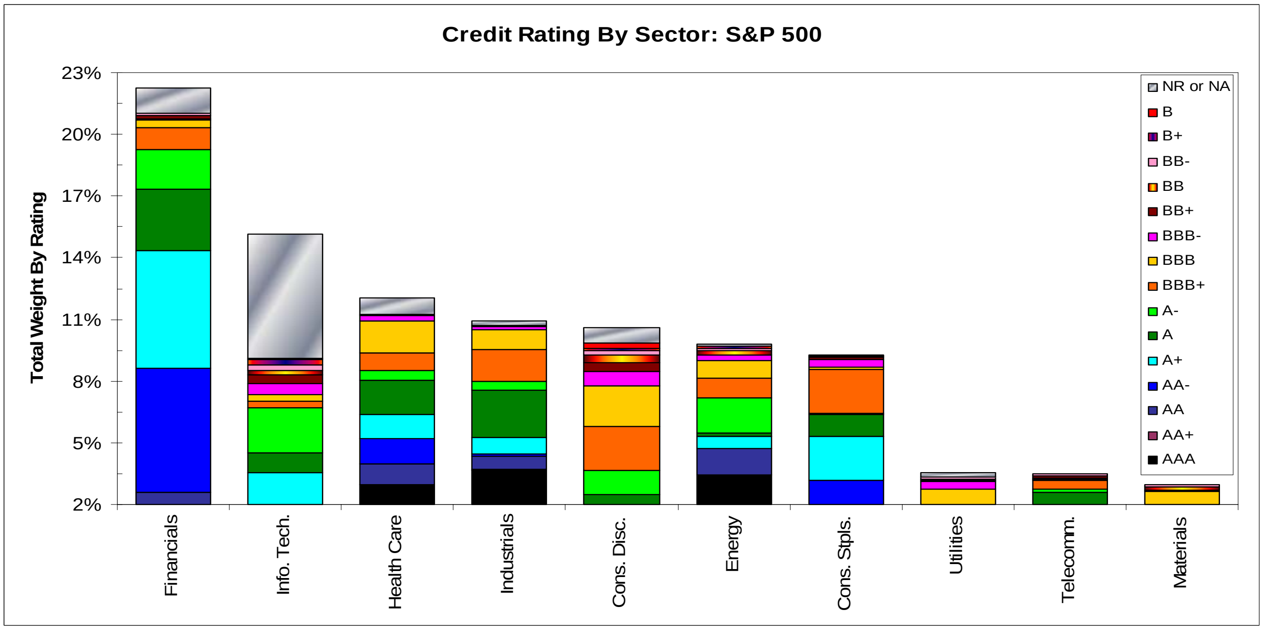
We should not expect, however, equal preference for and access to debt and equity markets across the size spectrum of business. All else held equal, we should expect younger and smaller businesses to prefer debt financing – why surrender equity if your growth prospects are strong? – but we should expect these firms to have either lower or even non-existent long-term credit ratings.

Moreover, in recent years and across important sectors of the economy such as Information Technology, the cost of venture capital, private equity and initial public offerings have been low enough to allow small and fast-growing firms to do without long-term debt on their balance sheets at all.

If significant long-term credit rating differences by market capitalization and economic sector exist, they should be readily apparent. Each stacked column represents one of Standard & Poor's economic sectors, and each band represents the market capitalization subsumed by a different rating. Non-rated or non-existent issues are represented by the silver-shaded band at the top of each column.

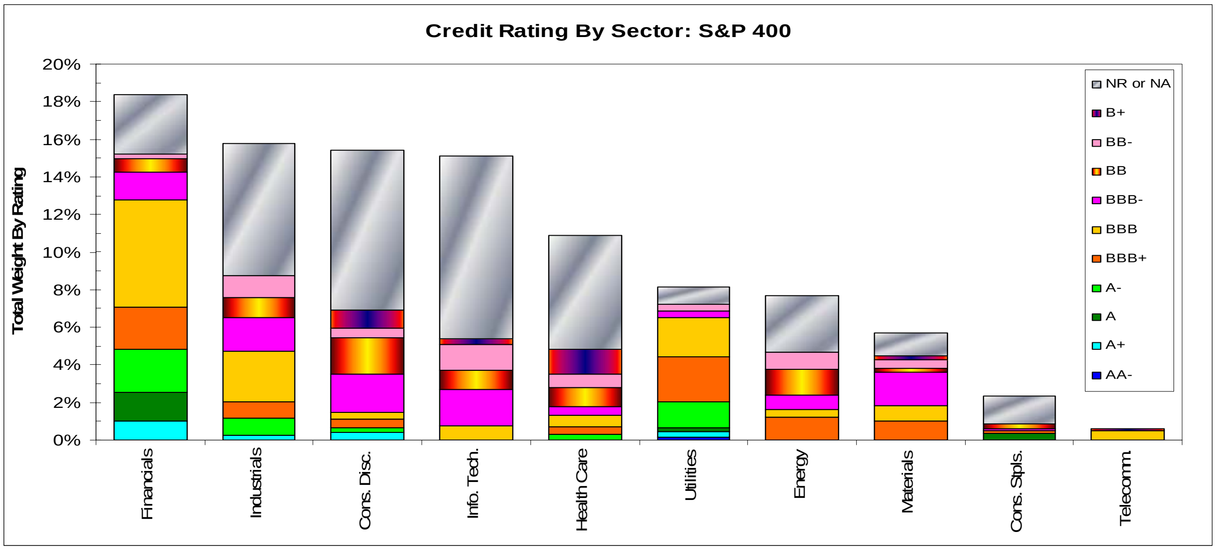
Within the S&P 500, Financials have both the largest total capitalization and the largest representation of A- or higher credits. As OTC trading costs are related closely to credit rating, we should not be surprised how firms strive to protect them. As an aside, we should note how improvements in risk management have satisfied perennial regulatory concerns over derivative chains; at the risk of tempting the fates, note how well capital markets handled the fallout in 2006 from Amaranth Advisors' failure compared to the 1998 demise of Long Term Capital Management. While nothing is foolproof in finance, we do seem to be getting better at quarantining failure.

As expected given comments above, the only sector with a significant representation of non-rated issues is Information Technology.



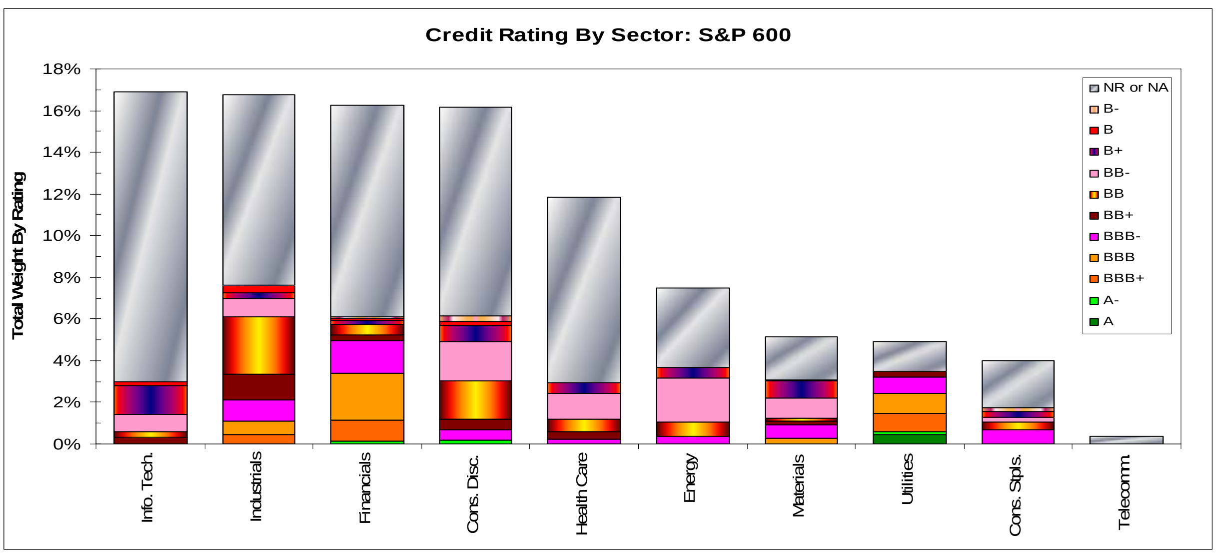
Middle-Capitalization Firms

Once we move down the size scale to the S&P 400, differences become marked. Only one firm, Washington, D.C., natural gas utility WGL Holdings, has a long-term credit rating as high as AA-. The Consumer Discretionary, Information Technology and Health Care sectors all have significant numbers of below investment-grade issues. These sectors along with the Industrials sector have significant non-rated or non-existent weights.



Small Capitalization Firms

The posited link between size and credit rating continues with the S&P 600. Here the credit landscape is dominated by non-rated or non-existent ratings and by below investment-grade issues.



Conclusion

An old joke about bankers is they only lend money to those who prove they do not need it. The size dependency of long-term credit ratings is of a similar vein; cheaper long-term debt is available mostly to larger firms.

However, as nothing suggests smaller public companies are starved for capital at present, we have to conclude these firms are financing themselves by other means, including short-term credit and equity. Size may be a gatekeeper to American corporate bond markets, but it is not an insurmountable barrier.

We have commented in other contexts how the social benefits of financial engineering derive from providing funds, albeit at a price, to those otherwise unable to obtain them. This comment holds with respect to the impact of long-term credit ratings on American corporate finance.

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