CREDIT RATING AND INTANGIBLE ASSETS: SOME OBSERVATIONS ON CURRENT PRACTICES

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Abstract

The paper consists of the tentative analysis as to whether and how credit rating agencies consider intangible assets during their rating process and what is the weight of such assets in this process. In particular, the paper explores the methods utilised in this area by the three most important rating agencies operating in the international context: Standard and Poor s, Moody s and Fitch.

The methodology here used is twofold: a detailed content analysis of the rating methods as well as semi-structured interviews to analysts from the above rating agencies.

As a result of a thorough reading of the rating methodologies of the three agencies it emerged that for all of them ratings are mainly based on financial data, and — despite the frequent reference to specific intangibles in their rating manuals — it appears that there is no official algorithm or procedure to track down in a systematic and formalised way the role of intangibles in the evaluation process. Nevertheless, the presence of these assets — and in particular of the human capital — seems often to be related with the granting of high level ratings.

Other significant insights have derived from the personal interviews made to financial analysts of the rating agencies. Firstly, one of the most important intangible assets considered in the rating process is the company reputation/brand, even though it contributes to upgrade the rating only when it is supported by a good financial situation (capacity to produce future cash-flows).

Secondly, the credibility of management — that is, its ability to realize its ambitions and plans — is crucial in the rating process. This is the reason why rating agencies monitor management results at least once a year.

From the interviews carried out it also emerged that intangible assets can have a weight on the final credit rating of up to 20-35% according to different industries (this seems to be particularly true for the banking sector).

Finally, the interviews also confirmed us that there is no a specific formula to evaluate the contribution of intangibles to the rating process. Nevertheless, there appear to exist some informal guidelines, which may vary between analysts, to somehow take into account intangible assets in the evaluation process.

KEY WORDS: Credit rating, Intangible Assets, Rating methodologies.

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1. Introduction

The nature of companies has changed. Stock, fixed assets and debtors have been replaced by goodwill, brand value, intellectual property, intellectual capital and, more in general, off-balance sheet assets and liabilities. As a result, different elements of investment risk have changed, not in their nature, but in their relative importance in the calculation of value. The value of intangible assets is significantly related to the qualitative aspects of company performance and therefore these aspects have gained in importance versus financial criteria. Qualitative (non-financial) criteria arise in three main areas: corporate governance, the environmental impact of company operations and corporate social behaviour.

In this new context, transparency in both financial and non-financial disclosure becomes one of the most important drivers of value, because it allows efficiency in financial markets and benefits for all the stakeholders (government , shareholders, customers, community, suppliers, employees, competitors). The recent Basle II [1] Agreements confirm this change, stating that the more companies will be transparent (in terms of quantity and truthfulness of data available), the more banks will be able to understand correctly their situation and consequently to assign them an accurate rating.

As a consequence of these circumstances it is commonly accepted the fundamental role played by the rating agencies in order to prod transparency and to guarantee the efficient running of financial market thanks to a concise and effective communication device: the rating. The increasing importance of the rating during the last years is basically due to three factors: the market diversification (companies, government, public utilities, and so on), the integration between different markets - which implies the need for more information -, and the IT development, which pushes the necessity to take rapid and effective decisions on the basis of credible information.

Given these premises, it seems important to make clear that the purpose of this paper is not to study the entire rating assignment process, but only to understand whether and how credit rating agencies consider intangible assets and what is the weight of such assets in the above process. In this sense, this analysis is neither addressed to investigate financial aspects of the rating assignment nor the role of the *whole* class of qualitative (non-financial) aspects in the rating practice, yet it is narrowed to a *sub-class* of that aspects: the intangible assets and liabilities.

This study examines the credit rating practices adopted by the three most important rating agencies in the world: Standard and Poor s, Moody s and Fitch. The analysis is deliberately focused on the long-term credit ratings since qualitative aspects, and in particular intangible resources, have a greater influence on long-term ratings than on short-term ones.

The methodology used is twofold: a detailed content analysis of the publicly available rating methods as well as semi-structured interviews to analysts from the above rating agencies. The decision to support the methodologies content analysis with semi-structured interviews is based on the conviction that the former cannot completely allow the researcher to catch all the content and meaning nuances hidden in the analysts choice of their practices.

The basic hypothesis of this paper is that the more intangible assets a company owns, the higher will be its credit rating. The attempt of the study is to verify whether rating agencies have developed

[1] Basle II is a recent agreement between central banks in order to define the minimal mandatory requirement related to financial risk. Within the fixed bounds, companies remain free to choose their own parameters to give ratings.

a formalized procedure or some commonly accepted guidelines in order to facilitate the assessment of intangibles in the credit rating assignment process.

The major result emerging is that for all of the three agencies, credit ratings are mainly based on financial data, and — despite the frequent reference to specific intangibles in their rating manuals — it appears that there is no official algorithm or procedure to track down in a systematic and formalised way the role of intangibles in the evaluation process. Nevertheless, it is commonly recognised the increasing relevance of intangibles - and, more in general, of qualitative aspects - to the rating assignment process.

Furthermore, from both the analysis of the methodologies and the interviews some common informal guidelines, with the aim of attribute a value to intangible assets/liabilities, seem to emerge, even if the evaluation process is still largely based upon the analysts experience.

The paper is structured as follows: the second section provides the reader with some of the main rating definitions and concepts as well as some brief historical notes about the three rating agencies studied. The third section deals with the content analysis of the rating methodologies; for each rating agency the results are presented by category of intangible resource - following the model proposed by Sveiby (the *Intangible Assets Monitor*) - in order to help the practices comparability. Section four shows the results coming from the semi-structured interviews addressed to the analysts. In this section the outcomes are presented by type of questions that, once again, are organized by category of intangible resource, following the *Intangible Asset Monitor* scheme - relational, organizational and human capital. The results are intentionally not presented by type of rating agencies for confidentiality reasons. The main findings and some concluding remarks and critical comments are presented in the final section.

2. Main rating definitions and concepts and brief notes about S&P, Moody s and Fitch

What is a debt or credit rating

A credit rating is an opinion by an external and independent organism (the rating agency) of an issuer/obligor s capacity to fulfil its bond obligations[2] with respect to principal and interest payments and to further eventual financial obligations. This opinion finds expression in a synthetic judgement, generally represented by an alphanumerical character, which is sometimes accompanied by + and - modifiers within the same category. This value allows stakeholders to compare the risks associated to different bonds offered on the market (from both a geographical and an industry point of view) ; therefore it is possible to choose the best investment alternative given a specific purpose (investment or speculation) of the investor.

The judgement is based both on public and on confidential data and information and it is carried out in order to assess the issuer capacity to generate and keep cash flows (which repay the debt). Some of the most relevant elements of the company taken into account are the present and future economic-financial condition, as the characteristics of the industry and environment in which it acts.

The credit rating is not a suggestion to buy, maintain or sell a bond[3]. Nor does it comment on the suitability of an investment for a particular investor. In facts this issues depend on some patrimonial characteristics of the bond, on its price volatility and on the investor risk propensity. Nevertheless,

[2] This study focuses on the long-term bond obligations.

[3] Actually many analysts state that there is a correlation between the rating and the suggestion to buy/maintain/sell the bond, likewise the security prices, even if the causal link between these variables is still unclear.

given its capacity to provide stakeholders with the bond default probability[4], the credit rating is often improperly read as a suggestion for investment[5].

Ratings can be classified on the basis of the two following variables:

1) the subject requiring the rating;
    a. rating required by the issuer itself;
    b. rating required by external institutions (e.g. institutional investors);
    c. rating autonomously provided by a rating agency.

In case b. and c., if the company doesn t know about the rating, it is called *shadow*.

2) the confidentiality of the rating
    - public rating
    - confidential rating (also called *indicative*)

Phases of the rating evaluation process

The rating evaluation process follows in general four phases:

a) a preliminary meeting;
b) the credit rating assessment;
c) the rating assignment and publication (only if the rating is public);
d) monitoring.

The preliminary meeting between the analysts team and the company managers is required in order to collect the set of information needed for the rating assessment (second phase). Obviously, when the rating is required by an external institution, it is based on public external information like scientific report, press and so on.

After having examined all the information collected (it takes normally about two months) the analysts confer a synthetic score accompanied by the relative justification. The issuer is free to accept the rating or to ask the analysts its revision on the basis of further information. The following table represents the rating scales employed by Standard and Poor s, Moody s and Fitch for mid-long term bonds.

Table 1: ***Rating scales for mid-long term bonds (due beyond 12 months)***

Capacity to meet financial obligations	*Standard and Poor s*	*Moody s*	*Fitch*
	Investment-Grade		
Absolute	AAA	Aaa	AAA
Very high	AA*	Aa 1,2,3**	AA
High	A*	A 1,2,3**	A
Likely	BBB*	Baa 1,2,3**	BBB
Adequate		Ba 1,2,3**	BB
	Speculative-Grade		
Adequate	BB*		
In the short term	B*	B 1,2,3**	B
Immediate	CCC*	Caa 1,2,3**	CCC
Unlikely	CC	Ca	CC
Almost null	C	C	C
Insolvent	D		DDD,DD,D

* These ratings can be modified by the addiction of a plus or minus sign to show relative standing within the major rating categories.
** The numerical modifier 1 indicate that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end.

[4] According to Fitch Ratings definition a company has defaulted if it fails to make a timely payment of principal and/or interest. Defaults includes any bankruptcy filings or distressed exchanges, in which bond investors were offered securities with diminished structural or economic terms compared with existing bonds .

[5] A research leaded by Moody s showed the negative correlation between the rating and the default probability (Cantino, p.77).

The publication phase does not occur when the rating is asked uniquely for internal purpose (confidential rating).

The fourth phase implies a periodical activity of monitoring through balance-sheet data, information received from the company and meetings between management and analysts.

Brief historical notes about Standard and Poor s, Moody s and Fitch

Standard and Poor s, Moody s and Fitch IBCA are the three most important rating agencies in the world.

Standard and Poor s Rating Services was founded in the USA in 1916 and is now a business unit of the editorial group McGraw-Hill . It was the first rating agency that made public its rating criteria and procedures. It was also the first rating agency to offer an on line information service and to publish a weekly rating review.

Moody s investor service was set up in New York in 1900 by John Moody. In 1909 Moody introduced the scale of standard symbols (letters) for the evaluation of the credit capacity. In 1924, almost the whole American bond market was assessed by Moody s. Today Moody s is included in the group Dunn & Badstreet.

Fitch grew in importance and size through a mergers and acquisitions policy. In 1997 Fitch investor service - American group leader in financial industry - merged with the European group IBCA - group leader in banking and companies. In June 2000 Fitch acquired Duff and Phelfs Credit Rating Co (DCR). Fitch Rating is a wholly owned subsidiary of European-based Fimalac. Fitch is the only European-owned rating agency. Recently Fimalac launched CoreRatings, a global rating agency providing only qualitative risk analysis.

3. Content analysis of the methodologies

The rating evaluation process judges both quantitative and qualitative company s aspects.

This section is dedicated to the analysis of the rating methodologies used by Standard and Poor s, Moody s and Fitch in assessing intangible assets. For each rating agency the methodologies description has been structured by category of intangible resource in order to help the comparison between the three agencies. The categories employed are the same suggested in the model proposed by Sveiby - the *Intangible Asset Monitor* - which divides the intellectual capital (the whole set of intangibles) in three categories: relational capital, organisational capital and human capital. In addition to these categories we have examined a fourth one: the company s strategy. It is studied separately because, but it is mentioned by all the three rating agencies as a key issues for the rating process, but it it is not mentioned in the Sveiby scheme s categories.

Standard and Poor s

In assigning its credit ratings Standard and Poor s considers two broad categories of risks:

- the Business Risk: industry characteristics, competitive position, management, business strategy; and
- the Financial Risk: financial policy, profitability, capital structure, cash-flow protection, financial flexibility.

Clearly, intangible resources affects the business risk, therefore we will concentrate the analysis only on the first category of risk.

Another key rating factors are the overall strategy, that is the management objectives, the leverage tolerance level and goals, and shareholders value considerations.

Relational Capital

As already pointed out, the firm s competitiveness within the industry is one of the relevant features to assign the credit rating. It includes investigations about marketing, technology, quality/price of products/services, distribution capabilities, customer service, and so on. For any particular company, one or more factors can hold special significance, even if that factors is not common to the industry.

Market share analysis often provide important insights. However large shares are not always synonymous with competitive advantage or industry dominance[6].

The competitive position depends also upon the product diversification. When a company participates in more than one business, each segment is separately analysed weighting each element according to its importance to the overall organisation. S&P analysts bear in mind that a firm is not diversified since its success was still determined substantially by one line of business. Limited credit will be given if the various lines of business react similarly to economic cycles. For example, diversification from nickel into copper cannot be expected to stabilize performance because similar risk factors are associated with both metals. Most critical is a company s ability to mange diverse operations. The ever-changing character of the company s assets typically is viewed as a negative. On the other hand, there is often an off-setting advantage: greater flexibility in raising funds if each line of business is a discrete unit that can be sold off.

Analysts also take into account the way the company is seen by the community that is:

- its reputation which is also part of the competitive position; and
- its standing within its home financial community (access to bank financing).

Both these factors can influence the company s capacity to repay its obligations.

Organisational Capital

One of the organizational aspects examined by S&P is the company size. S&P has no minimum size criterion for any given rating level. However size usually provide a measure of diversification and often affects competitive issues. Obviously the need to have an broad line or national marketing structure is a factor in many businesses and would be a rating consideration. In this sense, sheer mass is not important; demonstrable market advantage is. Small companies also can posses the competitive benefits of dominant market positions, although that is not common. Still, small companies are, almost by definition, more concentrated in terms of product, number of customers, or geography. In effect they lack some element of diversification that can benefit large firms. In addition, lack of financial flexibility is usually an important negative factor in any case of very small firms.

Other important issues are related to the company s ownership structure. Without a guarantee or other form of formal support arrangements, a state-owned corporate issuer does not intrinsically carry the same level of credit risk as its sovereign owner. Nevertheless, state ownership can bolster a company s credit profile through implicit support. The analysis of an issuer on a stand-alone basis allows the rating to reflect both the likelihood of the issuer needing to seek external state support and the likelihood ton receiving such support.

There are both positive and negative implications of group affiliation. In many cases, a company may benefit from operating relationships or greater access to financing. Conversely, a company s group affiliation could bring responsibility for providing support to weaker group companies. S&P assesses whether constraints on group influence, such as an external minority interest position, justify rating an issuer on a stand-alone basis. If not, the analysis attempts to incorporate the

[6] For instance, if a industry has a number of large but comparable-size participants, none may have a particular advantage or disadvantage. Conversely, if an industry is highly fragmented, even the large firms may lack pricing leadership potential. The textile industry is an example.

economic and financial trends in the issuer s affiliate group as well. Affiliation between a stronger a weaker entity will almost always affect the credit quality of both, unless the relative size of one is insignificant. A weak subsidiary owned by a strong parent will usually, although not always, enjoy a stronger rating than it would on a stand-alone basis. A strong subsidiary owned by a weak parent generally is rated no higher than the parent. The reason for this are:

- the ability of and incentive for a weak parent to take assets from the subsidiary or burden it with liabilities during financial stress; and
- the likelihood that a parent s bankruptcy would cause the subsidiary s bankruptcy, regardless of its stand-alone strength.

Both factors argue that, in most cases, a strong subsidiary is no further from bankruptcy than its parent, and thus cannot have a higher rating.

Formal support, such as guarantee, by one parent or sponsor ensures that the debt will be rated at the level of the support provider. When the default risk is considered the same for the parent and its principal subsidiaries, they are assigned the same corporate credit rating. Obviously the opinion may reflect the creditworthiness of guarantors, insurers or other forms of credit enhancement on the obligation.

S&P evaluation is sensitive to potential organizational problems as well. These include situations where: the relationship between organizational structure and management strategy is unclear, shareholders impose constraints on management prerogatives.

<u>Human Capital</u>

Management is assessed for it role in determining operational success (financial performance goals) and also for its risk tolerance. The first aspect is incorporated in the competitive position analysis; the second is weighted as a financial policy factor. Opinions formed during the meetings with senior management are as important as management track record. While a track record may seem to offer a more objective basis for evaluation, it often is difficult to determine how results should be attributed to management skills. In fact, the analyst must decide to what extent they are the result of good management, or achieved despite management.

Plans and financial policies have to be judged for their feasibility. The way they are implemented determine the view of management consistency and credibility. This can become a critical issue when the company is faced with stress or restructuring and the analyst must decide whether to rely on management to carry out plans for restoring creditworthiness.

It is also considered the significant reliance on an individual, especially one who may be close to retirement.

<u>Strategy</u>

As enlighten above, the strategy assessment is part of the management evaluation process. Nevertheless, in order to stress the crucial role of this topic in obtaining the final rating, it is worth to mention at this point that in 1998, S&P formalized its rating advisory role under the name Rating Evaluation Service (RES). S&P analyses the potential credit impact of alternative strategic initiatives, establish a definitive rating outcome for each, and share these with management.

Moody s

What characterize Moody s methodologies is the explicit focus on transparency and disclosure quality (extent and reliability - quality is more important than quantity), because in this rating agency experience a lack of transparency is often used to obscure problems and on management quality.

Relational Capital

One of the most fundamental aspects of Moody s credit analysis is the franchise strength [7], that is the company ability to generate, based on its competitive advantage, a reasonable risk-adjusted return on capital in the foreseeable future. It is considered both the company s overall market and its position in the market (a strong market share for example may give the company pricing power).

The key components of franchise strength are the following:

- product/service offering: level of innovation, expected long-term trends for volume growth;
- market presence: Moody s does not judge a strong presence in the emerging economies as an absolute positive, and, conversely, a strong presence in developed markets as an absolute negative. Other factors can have a critical influence (size, products/services quality).

A trait that may provide franchise strength is diversification, because it can reduce the volatility of a firm s asset quality, earnings and cash flows. Once the company s strength is established, it is analysed whether its competitive advantage is defensible and sustainable in the long-term.

The distribution strategy is also important because it may provide flexibility in terms of costs and business volume management: brick network (number of branches and locations, whether they are within department stores or shops and the number of independents); telephone, internet, mailing, geographic presence. Distribution is particularly important for banks and insurances; they analyse the type of markets a company serves, the cost structure of its distribution network, and the retention and productivity of distribution as well as a company s ability to control its own distribution and, by extension, its ultimate customers. The exclusive or non-exclusive nature of various distribution relationships may also pose opportunities or risks for individual company.

The market presence is also affected by the brand value, that is one of the most important and most elusive of the qualitative factors to analyse. Brand equity describes the degree of attachment or loyalty of consumer s to the company s products. If this attachment is strong, consumers have higher propensity to pay higher price for the products and a lower propensity to consider competitive products. Brand equity is built trough advertising and promotional expenditures: Moody s found that, by and large, the higher the spending over the medium-term, the higher a company s margins are over the medium-term. In gauging a company s brand equity, Moody s asks three questions: How high and how sustained is brand equity spending? , How committed is management to sustained brand building? , How much of the spending is truly brand building? .

The value of a firm s intellectual property is another component of relational capital which is inextricably tied to the value of the company. Intellectual property can consist of various items including trade names, trademarks, contract rights, and so on. Moody s typically does no isolate the specific component of IP, but rather value the group as a composite based on an overall enterprise valuation. But, there are certain cases in which it make sense to value certain components separately. For example, the film library of a movie company could be separately valued because it would have an intrinsic and separate worth. The ability to protect IP for extended period (e.g. pharmaceutical) provides a substantial barrier to entry and supports the sustainability of high gross margins, once a new product has been brought to the market.

Organisational Capital

Moody s mentions the size in relation to banks. It utters that a bank has not to be big in order to be strong, the important thing is whether a bank is able to exploit its size, as set market prices, have innovative products. In emerging markets, many big banks are often inefficient and lethargic

[7] Sometimes it is also called franchise value .

Moody s also refers to ownership structure aspects. Emphasis is put on partnership as a key driver of expansion.

Strong and committed shareholders can have a positive influence on the financial strength and consequently on the debt ratings. Much depends on whether a small group of committed shareholders exercises effective control over the company, or whether ownership is dispersed among a large number of shareholders none of whom act in concert.

Succession issues are also considered in family-owned companies.

The privatisation of banks in Europe generally leads to higher credit ratings because private shareholders tend to demand higher rates of return than governments, and this forces management to focus on profitability and efficiency.

Private and public companies may be subject to conflicting pressures from shareholders. With private companies, they take into account whether the company is a pure independent, a captive finance company that finance its owner s products, or a strictly financial subsidiary of a larger entity.

Moody s analysts also examine the many different forms of parental supports provided by financially stronger entities to subsidiaries, affiliates or other related entities with lower intrinsic credit quality than issue debt. Such support mechanisms are an important rating factor for the debt issued by the supported entity. In many, but not all case, the debt issued by the supported entity is rated as the same level as that of the supporting entity. Some of the elements considered by Moody s to evaluate the support mechanisms are the credit quality and the guarantees provided (structures and terms)[8] by the supporting entity, the intrinsic credit quality of the supported entity on a standalone basis, and the incentive of the supporting entity to provide support[9] (the last one in case of maintenance agreements).

Governance is also an important consideration in the process of assessing insurance financial strength; in particular, the often conflicting interests of shareholders and policyholders are taken into account.

Furthermore, Moody s looks at the investment in and use of technology, as key drivers of creditworthiness.

Human Capital

Moody s attempts to form an opinion of management s quality and motivation. This is recognized as a critical and necessarily subjective assessment of the ability of the management group to respond to challenges. It is included:

- an assessment of the management experience and competency;
- an assessment of the management credibility and reliability also examining whether its goals and ambitions are adequate to the context of the firm s economic, competitive and regulatory environment.
- an assessment of the management appetite for risk (financial culture[10], propensity towards share buybacks and dividends[11], appetite for acquisitions[12]).

It is also examined whether the bank is run by a dominant CEO or by a board and cohesive team. Dominant CEO can be useful in pushing through overdue change and in making decisive strategic initiatives, but a dominant CEO all too often become a domineering CEO, with the results that

[8] If the credit substitution is unconditional, irrevocable, enforceable and on time the rating will be in the range of A.
[9] For instance, analysts try to understand whether there is a common interest between the supporting and the supported entity.
[10] For instance a strategy of higher return on equity implies high leverage, this means higher risk for bondholders.
[11] The focus is on the impact that buybacks can have on the level of debt relative to cash flow, and on their timing.
[12] Acquisitions are not inherently negative. Moody s focuses on factors like coherence with the company strategy, price and mode of financing acquisitions, and possible risks associated with integration.

expertise and opinions of others senior mangers are ignored. There is also the problem that a bank can lose direction if a dominant CEO suddenly leaves the bank.

Rapid turnover is usually indicative of dysfunctions in corporate governance.

There is also a review of the second tiers mangers, who implement strategies formulated by the board and the senior management.

From 1999, Moody s provides institutional investors with Management Quality Ratings (MQs). These are appraisal of asset management companies (investment management of institutional and/or retail asset), custodian banks (process and safekeeping of securities), and administrative service providers (pricing and accounting of securities, fund and other pooled investments). MQ ratings are different from traditional debt ratings in that they do not apply to a management company s ability to repay a fixed financial obligation its own or satisfy contractual financial obligations which it may have been entered into through an actively managed portfolio[13]. In fact, they assess an entity s organisational structure, risk management capabilities and operational controls, and provide the market with an opinion on the overall quality of the organisation including management characteristics and operational practices. Ratings are expressed in the form of a scale ranging from MQ1 (excellent) to MQ5 (unsatisfactory) [14].

Following, we present a list of some of the fundamentals examined by Moody s when assessing an MQ rating.

- Organisational structure: ownership structure and relationship to parent or related entity; size of firm; market share; number of employees; number and type of product offered, and so on. It is important in determining the firms overall ability to exercise timely, accurate and properly authorized control over the many diverse activities involved in its obligations.

  The assessment is based on discussion with senior management and key employees, on the examination of internal documents (e.g. procedure manuals), and on the review of past practices. It is important to note that Moody s does not only evaluate the structure by itself, but also whether it is appropriate to the size of the firm, and whether the firm utilizes its resources effectively.
- Management quality, strategy and the investment decision making process. The loss of key personnel, particularly members of senior management and leading portfolio managers are also controlled because they could have an adverse effect on investment performance. In addition there is a review of the contingency plans and systems for sharing information (IT).
- Risk management: practices and procedures the company uses to manage business risk[15].
- Client servicing: general quality of servicing.

<u>Strategy</u>

A review of the strategy includes the firm s long-term vision, risk-return appetite, attitudes towards financial and operating leverage, strategies for raising capital and view of shareholder value creation. The growth strategy - acquisitions, joint-ventures or strategic alliances - can alter a company risk profile too.

[13] Nevertheless, it seems worth at this point to mention this new service to show that rating agencies focus more and more on qualitative aspects, and in particular on human capital characteristics.

[14] The scale used for Management Quality Ratings is the following:
- MQ1: excellent management;
- MQ2: very good;
- MQ3: good;
- MQ4: average;
- MQ5: adequate;
- MQ6: unsatisfactory.

[15] Some examples of risk are the technology risk (associated to inadequacy or malfunction of computer systems); strategies risk (associated to bad decision policies); reputation risk (associated to bad publicity); product risk (associated to a specific product/service), and so on.

Fitch

The three basic areas of interest examined by Fitch in order to confer the credit rating are the company risk, the financial risk, and the financial flexibility[16]. Some of the most important intangibles like market position, organisational structure and management are included in the first of these areas (company risk). The company risk is often also called economic or qualitative risk and it is in contrast with financial risk because it focuses more on qualitative than on financial aspects of the company activity. These qualitative aspects differ from financial ones also because they have a longer-term effect. What seems interesting is that the weight of qualitative characteristics compared to financial, on the final credit rating is not always the same, but greatly depends on the specific industry and company[17].

Furthermore, Fitch examines the intangible assets/liabilities both from an historical than from a prospective point of view.

Relational Capital

Fitch divides the investigation of the relational capital in aspects linked to the relationship with the market and aspects linked to the relationship with the Government and the economic environment in general.

To assess the relationships with the market the strengths and weaknesses of the competitive position are explored. Here is a list of some features examined:

- Market share;
- Capacity to influence prices;
- Distribution channels control;
- Marketing expenses;
- R&D expenses;
- New products;
- Leadership degree of the main products/services;
- Reputation;
- Degree of dependency on suppliers and customers (relevance - types of contracts - and concentration of clients - number -, substitutability, and so on);
- Diversification of products/services;
- Geographical diversification of revenues.

The analysis of these factors is fulfilled to verify to what extent external events affect the company activity.

It is also assessed the role of the company in relation to the Government and, in general, to the economic environment (e.g. Unions, banking system, and so on). A protective or hostile legislation could in fact represent a threat to the company development.

Organisational Capital

The organisational structure is examined from the first meeting (due diligence).

The size is an important feature because it has a great effect on the ability to react to external turbulence as well as on the company financial flexibility. In this sense a little company is perceived as more fragile than a big one.

Another crucial element to assess the company financial solidity is the ownership structure. When the company is owned by a family, it finds more problems to gather financing funds. This

[16] The financial flexibility is defined as the issuer capacity to meet debt obligations against economic scenarios reasonably adverse to its specific circumstances.

[17] For instance, Fitch assumes that banks are more likely to fail than other non-bank corporates because they are inherently risky institutions.

type of company can also be penalised by the fact that depends much on a person. Nevertheless, an excessively complex property structure (with many shareholdings in other companies) is perceived as negative too, because it hinders the information transparency.

The shareholders structure and composition are studied too with the purpose of understanding the specific corporate governance model (benefits and weaknesses).

Other organizational aspects reviewed are the equilibrium of responsibility, the adequacy of delegation mechanism, the middle management involvement in the decision making process, the excessive personnel turnover, the incoherence between strategy and organisational structure.

The internal image and the technology access are two more aspects explored.

Human Capital

The objective of the management evaluation is to appraise its capacity to carry out its plans. This is why it is assessed not only on the basis of its competence (based on experience), but also and especially on the basis of the results achieved in both strategic and financial terms (credibility), also in comparison with the peers. The analysis of the past performance is supposed to provide objectivity to the management evaluation process, which maybe more than others run the risk to be subjective.

It has to be said at this point that long- term objectives are supposed to be better then short-term ones; furthermore, the management characteristics (aggressive or prudent) are scrutinized according to the industry examined. It is also studied the management s attitude to possible negative scenarios.

If the company is owned by a family it is also considered the succession issue, given that the dependency from key-men could endanger the company state.

In addition to the ordinary management assessment for the final credit rating, Fitch offers also a new service[18], the Asset Management Rating , in order to examine:

- the *level of security* that an asset management organization can provide to an institutional investor that delegates the management of all or part of its assets; and
- the *added value* that an asset manager provides to an institutional investor on the management of a given asset class.

The first issue implies the asset management organisation analysis (trough questionnaires) as well as the exploration of structure, means and control processes. The result of this investigation is an intrinsic rating [19] on the capacity to master the risks linked to asset management. The second issue - the value added - implies the analysis (through questionnaires) of the management of a given asset class and in particular its capacity to generate high level of performance through a solid investment process. As a result a performance rating [20] is assigned. The intrinsic rating is a prerequisite to the performance rating .

[18] This service could also have been included in the Organisational Capital section because it is strictly related to organisational issues. For further information see www.fitchratings.com.

[19] The scale used for the intrinsic rating, is the following:

- aaa superior;
- aa+, aa, aa- excellent;
- a+, a, a- good;
- bbb acceptable;
- bb+,bb, bb- weak;
- b+, b, b- insufficient.

[20] The scale used for the performance rating is:

- 7 superior;
- 6 excellent;
- 5 satisfactory;

The asset management ratings often become a decision tool in the process of selecting asset managers, through asset manager searches and through direct purchases of open mutual funds.

Strategy

The strategy of the company - especially about acquisitions - is investigated from the beginning during the due diligence meeting. The information related to the strategy adopted remain most of times confidential.

4. Semi-structured interviews addressed to financial analysts

This section shows the results coming from the semi-structured interviews addressed to the analysts. The outcomes are presented by type of questions which, once again, are organized by category of intangible resource, following the *Intangible Asset Monitor* scheme (relational, organizational and human capital). We also added a subsection called other information dealing with information collected during the interviews and not specifically related to a type intangible resources but that we believe to be interesting in order to understand better credit ratings practice.

The answers are intentionally not presented by type of rating agencies to respect the analysts will. Thus, per each question the relative answer will be the aggregate of the three answers of the rating agencies examined.

The questions are devoted to investigate aspects that were missing or not sufficiently explored by the publicly available rating methodologies.

The questions are intentionally presented in a generic form. This choice is aimed to not to push the analysts answers in a specific direction; in other words, the aim is to let the analysts as much freedom as possible in their answers.

Relational Capital

- How is the *external image* (reputation) evaluated and what is its impact on the credit rating?

The external image is examined on the basis of public information from medias. For instance, when a company withdraws a product, the analysts simulate the cash-flows decrease, according to the product relevance. In particular they take into account the negative effect of a brand s worsening on the capacity to produce cash-flows.

- When is a *brand* considered strong? How do the analysts say whether the brand is popular?

The brand value is very important and very vulnerable; in spite of this there is no a scientific method to evaluate it.

The significance of brand value is different by industries: it is very important in the retail industry (brand awareness: 80/90%) as well as in the banking and insurance, while, generally speaking, it is less relevant in the industrial.

Brand value is evaluated looking at the premium price for the company s products/services, and looking at the capacity to maintain the market share. Furthermore, the analysts examine the historical series of the statistics generated by the brand, but they also ask the managers their forecasts about their future trend. Analysts also order to external institutions market surveys to establish the brand awareness level per each industry.

One of the elements having a great influence on the company reputation is the customer satisfaction. This is assessed on the basis of public information (e.g. trend of customers number). Similarly to the brand, it is weighted mainly a heavy reduction of the customer satisfaction

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- 4 acceptable;
- 3 weak;
- 2,1 insufficient.

➢ Do the *marketing expenses* have an impact on the rating?

They have an impact on the credit rating because they represent a way to built the brand. Nevertheless, their impact is different according to the industry observed: in the retail it is about 5/8% of the total sells, while in the industrial is not so relevant like the R&D expenses impact .

➢ How do the analysts point out the *dependence on* a particular *supplier or customer*?

To assess this dependency degree, rating agencies carry on peers analysis.
In addition, when the company is not new, analysts look at its past performance in facing crisis related to suppliers or customers dependency.
It is also considered the product/service substitutability for the customer, strictly related to the complexity of the product/service itself.

<u>Organizational Capital</u>

➢ Do rating agencies assess the *internal image*?

The internal image is not as much considered as the external. It is only examined when strikes occur in the organisation.

➢ Why is *innovation* often ignored as a feature affecting the rating process?

The innovation opportunities are not necessarily perceived as positive to factor because they are risky.

➢ In what way *R&D expenses* influence the credit rating?

Analysts evaluate R&D expenses on the basis of the industry benchmark parameters. The absence of R&D expenses is weighted negatively because it may affect the amount of future sells. R&D expenses are not considered in any case of financial difficulties.
In the banking industry R&D expenses are not so relevant, however it is crucial the bank capacity to develop new products, in addition to the traditional ones.

➢ How do rating agencies evaluate the organisation s *technological capability*?

It is investigated only on the basis of information collected both from the company itself and from the media. There is no a technical inspection of the technological capability by analysts, because they are not experts in this field. However, in some cases of little size companies, analysts could ask the company to show them the factories to weigh up the facilities state of the art.
In the banking industry the technological capability assessment implies the evaluation of the control systems adequacy, measured by the analysts on the quality of information received by the banks themselves.

➢ Do you examine the *corporate culture*?

Analysts do not consider the corporate culture *per se* (e.g. spirit, approaches like knowledge-sharing) because it is not believed to have an influence the company s ability to generate cash flows. The culture issue is usually examined as a management issue.

- What type of impact does the *performance-based culture* stimulated by managers have on credit rating?

Good compensation mechanisms are able to diminish the management turnover, thus they improve the company stability and the credit rating. This circumstance is supposed to have positive effects on the company s ability to meet its financial obligations. An example of performance-based culture is given by the stock options plans (in particular in the banking industry), that represent an indicator to simulate the performance and to hold the management.

- How the structure of the *ownership* influence the final credit rating?

The more the structure is transparent (e.g. flat structure), the easier to understand will be the type of activity carried on by the controlled and connected companies. Under this circumstance the company will be able to resort to multiple financial markets.

Human Capital

- How do you assess the management in terms of credibility and motivation?

Top managers credibility is measured on the basis of the track record (past performance), thus it is examined especially their capacity to carry on successfully their plans and goals. This practice implies for instance that banks are observed for many years.
The management risk propensity is perceived as negative, if the industry is mature, and positive if the industry is dynamic.

- What about the skill and competences of the other employees?

The analysts confirm that most of times they don t consider the lower level employees. They only dialogue with CEOs and CFOs, even if sometimes they involve lower lever personnel to present innovative projects. These moments are useful to investigate the relationships between different management levels. One of the reason why they do not consider lower level employees is because it is difficult to measure their competencies. Additionally, a good manager is supposed to take with him good skills.
The training is usually not weighted up. An exception is the case of the banking industry, when the bank had some troubles due to the lack of lower level employees competencies. In this circumstance the employees training is seen as a positive factor.

Other information

- How do the analysts summarize the information collected?

Sometimes there is an internal methodology, which is neither a score model, nor a fixed matrix. It is a set of non formalized guidelines, coming from the analysts experience, in order to think in a more structured way. By structured way analysts mean that they look for a common trace to decide *what* are the qualitative elements to take into account in the rating assignment. This does not necessarily mean that they have a structured methodology stating *how* to evaluate these aspects. Often, the structure development consist of a challenge process , involving a committee of analysts discussing about the best elements to consider in the rating process.

- How much do the intangible assets/liabilities weigh on the final credit rating?

A crucial part of the rating assignment process in order to understand the significance of intangibles in the rating is the dialogue with the company. Some of the questions the analysts try to answer are Are intangibles relevant for the industry examined? , Are they relevant in the balance sheet? , and so on.
In the banking industry they are supposed to affect the 20/35% of the final credit rating. This very high percentage may be due to the fact that in this industry the most important value drivers - such as the brand, the strategy, the ownership structure, the management capacity, the technology[21] used, the franchise value, and so on - are, by definition, intangible.
In the consumer industry the weight of intangibles on final credit rating is less significant because it is a more standardized industry.

- How do financial analysts limit the high degree of subjectivity related to their judgements in relation to qualitative aspects?

Judgements subjectivity is limited through the involvement of international rating committees as well as through the analysis of the company past performance, considered an objective evidence of the its strength. Another way to frontier the subjectivity is to look at the industries benchmarking parameters. In facts, it is often stressed that the industry is the critical variable. For each industry analysts use some sort of grids or pondering mechanisms to evaluate the impact of a particular feature on the company s creditworthiness. Nevertheless, the peers analysis is not necessarily a numerical comparison; context variables are examined.

5. Main findings and some concluding remarks and critical comments

The main results from the analysis of the methodologies are the following:

1) For all the three rating agencies the most important features affecting the assessment of the relational capital are the company s competitive position, with particular attention to diversification of products/services, distribution channels and reputation aspects. Fitch seem to offer the most superficial description - even if it mentions more features than the other two agencies-, because it just presents a list of the elements considered, without explaining the way its analysts lead the analysis.

2) The study of organisational aspects shows that it is commonly recognized the relevance of size and ownership structure, on the contrary very little - or nothing - is said about the way to assess the company internal image (by employees) and the technological capabilities of organisations. This is quite surprising because these are factors may seriously affect, even though indirectly, the company financial solidity.

   An emerging paradox in the rating assignment practices involving organizational aspects is that R&D expenses are considered almost only in the pharmaceutical industry, while they are crucial in many other industries. Innovation is another factor often missing through the methodologies and, even if it examined, it is perceived as a risk factor; thus it leads to lower credit ratings. This practice discourage investment in innovative activities that obviously are riskier than the non-innovative ones, but that potentially may confer a better competitive position (which is typically the basis for a good rating), or reconstruct the financial position.

   Another weakness emerging from the analysis of the methodologies is that none of the rating agencies mention the employees satisfaction - sometimes defined *internal image* - as a relevant organisational intangible aspects. The internal image in fact may have an effect

[21] It has to be pointed out that in this meaning, technology is the capacity to develop new products.

on the company s outputs (by improving - if positive - or threat - if negative - organisational processes) and, worse, it could affect its reputation (*external image*).

3) All the rating agencies studied develop the investigation of human capital on the basis of the management quality assessment. Management is evaluated both for its experience and competence, and for its past performance. The latter feature is supposed to provide objectivity to this assessment process, which is commonly perceived by the rating agencies as the most subjective between the qualitative ones. An emerging weakness of the human capital resources review is that any of the rating agencies studied mention the relevance for the company of the other employee s skills and competencies.

4) Another outcome from the content analysis of the methodology is that sometimes the goodwill treatment is taken into account as a feature of the financial risk, likewise off-balance sheet intangibles and goodwill and underestimated activities. The goodwill is defined as the excess of cost over net assets of companies acquired by purchase. For S&P the treatment of goodwill offers an example of balance-sheet distortion. In some countries, companies write off goodwill at the outset of an acquisition, whereas companies in other part of the world do not. U.K. companies tended to write off goodwill, that is, until recent changes in their accounting procedures. The result is that U.K. companies tend to have capital structures that look weaker and earnings that look better than those of competitors from countries that capitalize goodwill and amortize it over time. To adjust, the analyst may add back goodwill to shareholders funds and make a qualitative or quantitative adjustment for goodwill amortization in analysing a U.K. company.

5) It has also to be pointed out that from the analysis of the methodologies it emerged that the most comprehensive methodologies (both in details and explanation s richness and in number of examples and exceptions from different industries) are provided by Moody s. Nevertheless, most of times, while rating agencies clearly explain *what* are the intangibles they take into account, they are often deficient in the explanations of the *way* in which they weigh these factors. It is not clear in fact how they do asses features like the company strategy, its image and brand, and, most of all, it is not clear the weight of intangible assets on the final credit rating. Perhaps, this is due to the fact that the rating assignment still remains almost completely based on the analysts experience than on formalized procedures. This is the main reason why this study is also based on the interviews addressed to the analysts.

The main results from the semi-structured interviews are the following:

1) A first issue emerging clearly speaking with the analysts than reading the methodologies is that the basic philosophy to assign a credit rating is to minimize the risk for the investor. All the analysts interviewed in fact emphasise the fact that the rating assignment is based upon a prudential and conservative viewpoint.
The best way for the company to minimize the risk is to guarantee the capacity to generate cash-flows. Therefore each features is weighted on the basis of its effect on the company s capacity to create cash-flows.

2) Looking at the relational capital, a crucial factor for the rating assignment is the brand, especially when its weakening affects negatively the company s capacity to generate cash-flows. In this sense, the brand recognition is high only when it is accompanied by a very strong financial position. The logic behind this practice is that the negative effect of a brand worsening on the capacity to generate cash-flows is greater than the positive effect

of a brand improvement. But in fact, many examples point out the strength of consolidated brands in order to guarantee creditworthiness (e.g. Coca Cola).

3) Moving to the organisational aspects, analysts completely ignore a key feature: the company s culture. As a result, they do not investigate aspects such as the presence of a knowledge sharing culture or the knowledge monopoly by the top managers. Analysts also take no notice of the internal image (except in case of strikes).
Furthermore, likewise for brand and customer satisfaction, high R&D expenses and strong innovation capabilities are not considered as positive aspects in case of financial difficulties. This practice assumes erroneously that a particular financial position is independent from the mentioned organisational aspects.
The technological capability and the internal image are other examples of organisational aspects mistreated. This seems to be a quite myopic and contradictory view of the organisation.

4) From a human capital point of view analysts totally overlook the role of the lower level employees, stating that a good manager implies good skills. This could not be always true; furthermore, it is not necessarily rightful the contrary (that a bad manager implies bad lower level employees skills)!

5) A further remarkable finding is that the 20/35% of the final credit rating of a bank is related to intangible aspects. The above percentage decreases when observing other industries (e.g. retail).

It has to be pointed out that this is a work in progress and that we are analysing the possibility to use combinations of many different methodology in order to study the credit rating assignment phenomenon. An interesting possibility could be to compare the rating of big, listed companies preparing Intellectual Capital Reports (e.g. Skandia), with ratings of companies without IC Reports in order to understand whether this new form of disclosure helps the company to gain value in tem of credit rating.

Another possibility is to use laboratory experiments. For example, we could study two separate groups of analysts assigning the rating to the same company. The two groups should have the same set of information, except for the IC Report. This is another way to observe whether and in what direction information about intangible assets drives credit rating.

Concluding, from the study it emerged that the rating assignment is not an exact science and that because it involves a look into the future, credit rating is by nature subjective. Moreover, because long term credit judgements involve so many factors unique to particular industries, issuers, and countries, any attempt to look for a formulaic methodology seems useless. Our study shows that the approach adopted by rating agencies to risk analysis aims to bring at first an understanding of all the relevant risk factors and viewpoints to every rating analysis, then they rely on the judgement of the analysts in light of a variety of plausible scenarios for the issuer.

The credit rating is the result of a combination of both quantitative financial analysis (historic) and qualitative assessment (future-oriented). From this study it comes out a clear predominance of the former, nevertheless the latter seems to affect more than in the past the final credit rating. Our review actually is based only upon a subclass of qualitative aspects, the intangible assets, excluding other significant qualitative features for the rating assignment like the industry analysis, the stage of life cycle, the role of regulation and legislation, the country risk (local/economical political risk factors), the importance of transparency, and so on.

Given the crucial role of credit rating in the financial markets and given that qualitative information - intangibles in particular -, affect heavily the final credit rating, from this study it also emerges the necessity to have more transparency and objectivity about the rating assignment practices.