Westinghouse Solution

1 If the CBS acquisition had been financed with all equity, then the rating of the existing Westinghouse debt will actually go up as all the ratios will become better. But Westinghouse financed the acquisition entirely with debt. Since all the debt have the same seniority, the risk of the existing debt will increase. So in July 1995, on the date of the acquisition of CBS, the ratings of the debt should decrease. But actually, S & P just placed the Westinghouse debt on credit watch.

2 Almost all the cash flow and interest coverage ratios used to predict bond ratings are likely to worsen as the interest payments will increase. Only if CBS has extraordinary cash flow and income can the ratios become better. All the balance sheet based ratios will worsen as the acquired assets (mostly goodwill) will equal the new debt. Only size a positive factor for ratings will increase and help the bond rating.

3 Westinghouse return on Nov., 29 1995

0.375	/	(	17.125	-	0.375	)
0.375	/		16.75	=	2.24%	

Market return	S & P 500	Composite	0.20%
	S & P 500	Industrials	0.17%

Westinghouse seems to have experienced abnormal returns

4 On Nov. 29, 1995, the only significant event of importance to Westinghouse that happened was the downgrading of its bond ratings. Note that nothing of fundamental importance relating to the operations of Westinghouse happened on that day. No new information about Westinghouse was released by Westinghouse on that day unless you count the new "skilled analysis" of Westinghouse by S & P released on that day. But "many" bond investors and traders price Westinghouse debt based on the ratings. This means that the bond prices will go down on that day.

5 On Nov. 29, 1995

Bond prices go down.
Stock prices go up.

Westinghouse fundamentals have not changed. So cash flow from operations will not change. Westinghouse can buy back (retire) debt more cheaply as bond prices are lower. So stockholders will benefit. Note that the total value of the firm will nor change on that day unless, S & P uncovered new facts on that day. So if bond prices went down, stock prices have to go up.