

July 10, 2007

HEARD ON THE STREET

Shares Could Come Under Fire as Ratings Are Questioned Anew By KAREN RICHARDSON and SERENA NG
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Short sellers love to target companies heading into financial turmoil.

Now, some of those investors who bet on a stock's decline are targeting a company that is paid to spot financial problems before they occur: Moody's Corp.

Rating Game

A look at Moody's share price and its recent rankings of debt

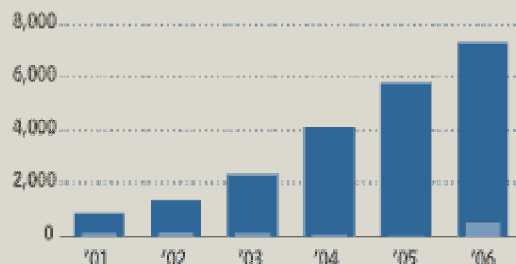
Share price

Yesterday's close: \$61.50
Change since end of 2004: up 42%



Total number of subprime bonds rated compared with number that have been downgraded

Downgrades and downgrade reviews** — Total number of subprime bonds rated



Sources: Moody's; WSJ Market Data Group *Includes multiple downgrades on same bond Note: As of July 2, 2007

But unlike some of the blowups in the recent past that the New York-based credit-ratings firm and its main rivals caught too late, such as WorldCom Inc. and Enron Corp., its profitability and cash flows remain strong. That makes it a tough stock to bet against.

Still, Moody's and other credit-rating firms are again taking heat for the meltdown in the subprime-mortgage market.

"I think they did a bad job, but they've weathered reputational storms before," says Glenn Tongue, managing partner at T2

Partners LLC, a hedge fund in New York that manages about \$170 million. "There might be a black eye on the franchise associated with subprime-mortgage securitizations, but the business flow, and probably the liability, will be contained."

Bearish investors are betting that Moody's shares will tumble as the company's lucrative business in providing ratings for structured debt products, such as collateralized debt obligations, or CDOs, could dry up due to fears spreading from rising defaults in those mortgages extended to borrowers with poor credit histories.

Together with some analysts and academics who believe the rating agencies played a key role in the subprime crisis by giving high ratings to thousands of bonds that fell quickly in value, some short sellers also are wagering that legislators, regulators and disgruntled investors will shake up the existing oligopoly structure and put an end to its fat margins and profits.

"It's a great business model as long as you can get people to pay for it," says James Chanos, president of Kynikos Associates, a New York hedge fund with about \$3 billion in assets that specializes in short selling. Mr. Chanos, among the most vocal of Moody's critics, is known for having bet early against Enron. "If they have no predictive power over that which they're rating, then why bother?"

'Shoddy Goods'

Many of Moody's ratings for subprime debt represent "shoddy goods," according to Joseph Mason, a professor of finance at Drexel University. "If the quality of the good isn't going to be maintained by the producer, then it has to be maintained by a regulatory authority," he adds.

In a paper co-written with Joshua Rosner, an independent research analyst, Prof. Mason argues that the ratings agencies -- including Standard & Poor's Corp. and Fitch Ratings, as well as Moody's -- are deeply

involved with investment-bank underwriters in structuring pools of assets, which places them in a more active role than simply publishing opinions on the creditworthiness of the underlying assets. The ratings companies have stated that they don't advise on the structures, but do provide guidelines on how pools of assets can be set up to achieve good ratings.

In past lawsuits that involved corporate debt ratings, judges have ruled that such rankings are opinions, like newspaper editorials, and are protected under the First Amendment. But, if lawyers can convince a judge that Moody's debt ratings shouldn't be treated as opinions, the company could be hurt by lawsuits.

The argument against ratings agencies appears to be gaining traction, at least in Ohio. The state's attorney general, Marc Dann, is investigating the role of the credit-ratings firms, including Moody's, to determine whether they have any culpability in the subprime-mortgage breakdown.

Moody's says it can't be held responsible for drops in market value of certain assets. "Our ratings predict the probability of default. We do not offer views on market pricing and valuation," says Linda Huber, chief financial officer of Moody's. "People enter the market and trade these securities at their own risk."

Bullet Proof

Indeed, Moody's hold on the market, along with S&P, has proved bullet proof despite criticism during the Russian and Asian debt crises and after accounting scandals turned investment-grade telecommunications bonds into "junk" overnight. It has taken Fitch about 15 years to compete as a distant third in the market behind Moody's and S&P, so it will likely take a while for competition to erode Moody's big margins and profits.

To date, Moody's hasn't been sued in federal court for any of its subprime credit ratings, which constituted around 6% of its revenue last year. And while structured finance ratings made up 43% of its total revenue last year, another 40% came from non-U.S. revenue, where there also is strong growth.

"Subprime debt clearly hasn't been the only driver of the business," says Neil Godsey, an analyst at Friedman Billings Ramsey, which has a "buy" recommendation on the stock.

For most of the past decade, even when Moody's was under fire for the WorldCom and Enron debacles, its operating margins have held steady at about 53%, which is higher than Google Inc.'s margin. It generates a lot of cash, with a healthy cash-flow yield of about 4.6%. This is one reason that Berkshire Hathaway Inc., led by Warren Buffett, is Moody's largest investor.

Stock-Price Hit

Yet as the only public "pure play" credit-ratings firm, Moody's stock has taken a big hit recently. It is off 19% from its 52-week high and about flat against its share price at the end of 2005. In 4 p.m. trading yesterday on the New York Stock Exchange, Moody's fell 79 cents, or 1.3%, to \$61.50, bringing its market value to about \$17 billion. The stock is trading about 23 times estimated 2007 per-share earnings, which is lower than its average price/earnings ratio from 2001 to 2002, when Moody's was last heavily criticized for its ratings.

Ms. Huber says the recent weakness in Moody's share price has provided an opportunity for the company to repurchase its shares more aggressively. During the first quarter, Moody's bought back about \$443 million of its stock and has continued to repurchase shares in recent weeks.

In early June, Moody's also raised its outlook for the current financial year. Moody's is expecting to chalk up revenue growth of roughly 15% to 20% and earnings-per-share growth of 10% to 15% in 2007.

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