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Moody's 2007 Strategic Plan - Ray McDaniel

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2007 MCO Strategic Plan Overview

Ray McDaniel

July 2007



Moody's Corporation

Agenda

- Financial Summary
- Market Environment
- “Critical few” Strategic Priorities & Supporting Strategies
- Significant Issues in H1 2007
- Linkages Between Current Issues and Longer-Term Strategic Priorities?



Moody's Corporation

07 Financial Performance & Outlook

2007 P&L Summary: H1 and Projected FY

	2006 1H Actual	2007 1H Actual	Growth %	2006 FY Actual	2007 FY Fcst	Growth %
<i>\$ Millions, except per share</i>						
Ratings and Research (a)						
Ratings Revenue	\$762	\$1,003	31.5%	\$1,640	\$1,881	14.7%
Research Revenue	122	153	25.3%	255	316	24.3%
Total Revenue	884	1,156	30.7%	1,894	2,198	16.0%
Expenses (a)	363	498	37.1%	812	990	22.0%
Operating Income	521	658	26.2%	1,082	1,207	11.5%
Operating Margin	58.9%	56.9%		57.1%	54.9%	
Moody's KMV						
Revenue	67	74	9.4%	143	158	10.9%
Operating Income	6	11	71.4%	17	27	64.5%
Operating Margin	9.4%	14.7%		11.6%	17.2%	
Total Moody's						
Revenue	952	1,229	29.2%	2,037	2,356	15.7%
Operating Income	527	668	26.7%	1,099	1,235	12.3%
Operating Margin	55.4%	54.4%		53.9%	52.4%	
Interest Expense, net	4	(17)		1	(37)	
Net Income	316	385	21.9%	658	710	8.0%
Diluted EPS - Pro forma (a)	\$1.07	\$1.37	28.0%	\$2.25	\$2.57	14.2%
Diluted EPS - As Reported (b)	\$1.07	\$1.56	45.8%	\$2.58	\$2.76	7.0%
(a) Excludes gain on sale of HQ in 2006; legacy tax provisions in 2006 and 2007						
(b) Includes gain on sale of HQ in 2006; legacy tax provisions in 2006 and 2007						

Market Environment

Market Environment

Secular growth will continue, but more slowly. Cyclical conditions mixed, but credit cycle has peaked and market sentiment pessimistic...

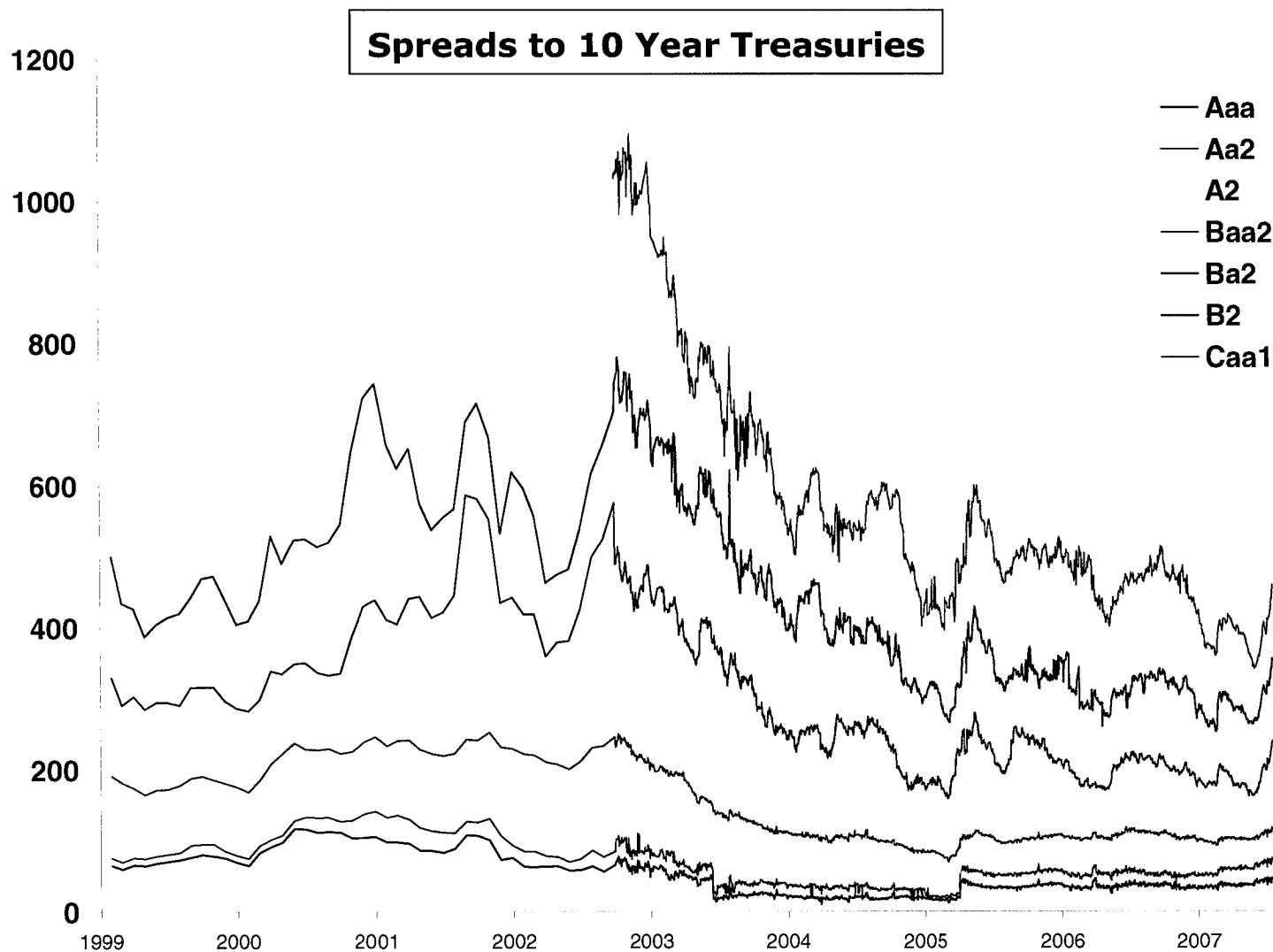
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- **Fed probably won't tolerate an extended "seizing up" of capital markets**
- **Housing market has been slow to undermine broader economic performance**
- **Corp spreads still reasonable by historical measures & default rates at historical lows – 1.4% default rate in June 07**
- **Corporate debt protection compares favorably with 1998 (post-LTCM)**
- **Similar number of upgrades/downgrades of US high-yield companies**
- **De-linking of US & Int'l economic cycles and market performance**

- 'S

- **Ultimate credit (& ratings) performance for RMBS won't be clear for 12-18 months**
- **Contagion risk from sub-prime still uncertain – stabilized credit conditions for housing still 12+ months off**
- **Credit stabilization may not cure aversion to illiquid instruments – esp. for mark-to-market investors**
- **Last major credit crunch followed Enron by >1 yr**
- **Widening of yield spreads – but still below LT mean/median**
- **Overdue rise in creditor risk aversion should reduce the issuance of riskiest corporate debt... knock-on to CLOs?**

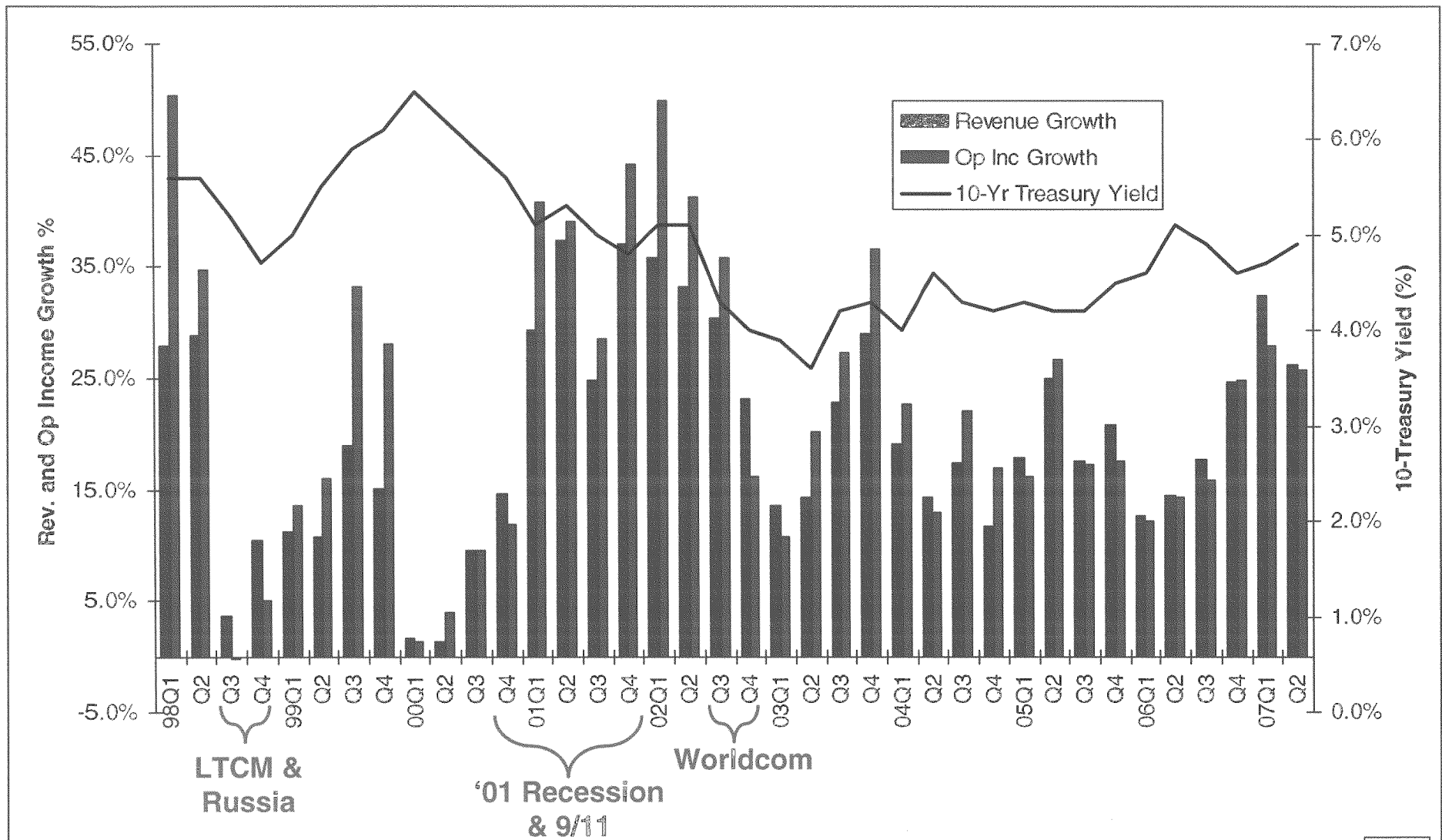
Corporate spreads widening, but still favorable



Moody's Revenue & Op Inc vs. Credit Cycles

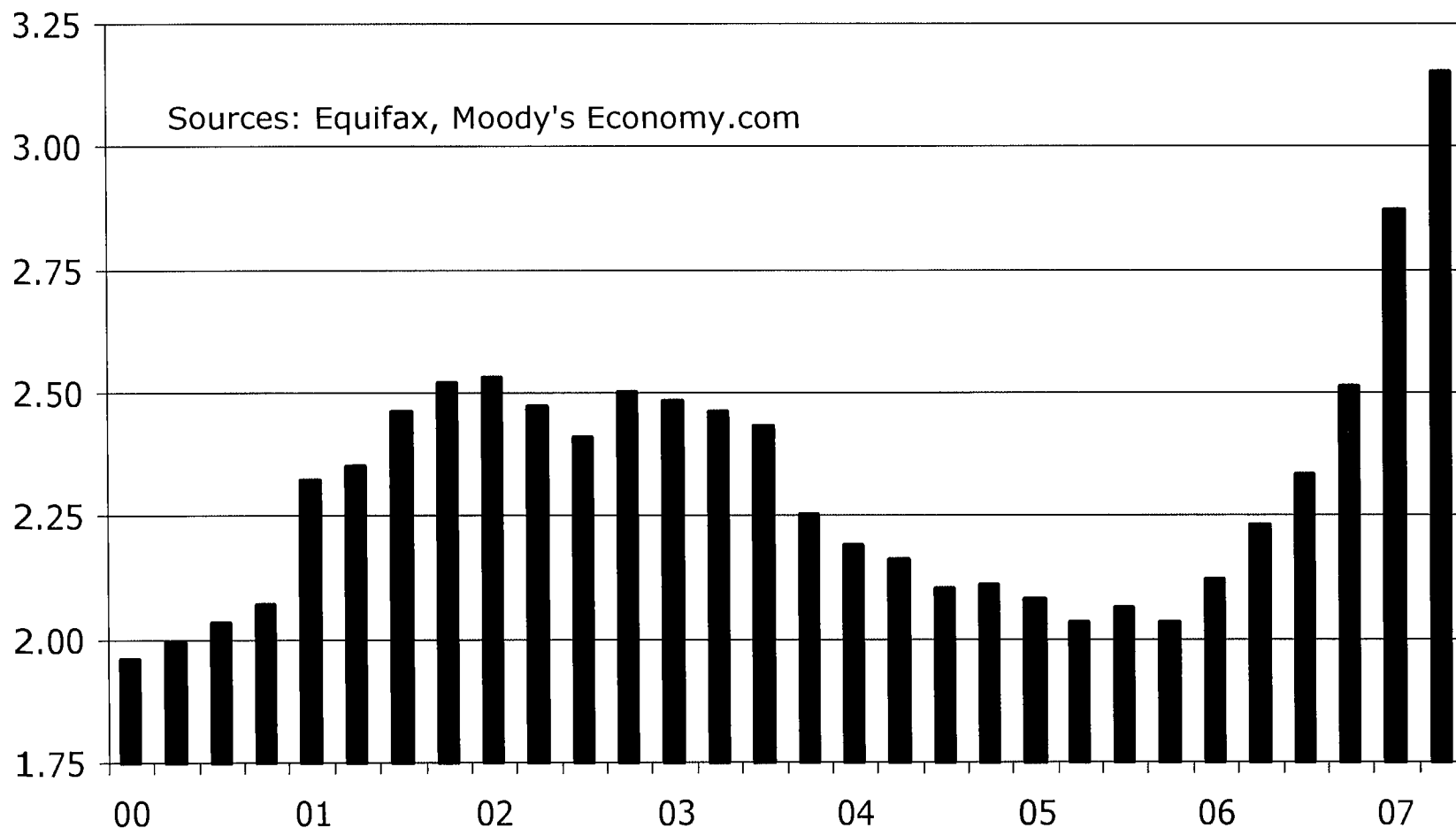
- Moody's quarterly revenue growth has averaged 19.9% since 1998
- Quarterly revenue growth has never been negative during this period
 - The most recent period of low growth was in the first half of 2000 when revenue increased by about 1.5% in Q1 and Q2.
- Quarterly operating income growth has been negative once since 1998, though by only 0.2%
 - In Q3 1998, during the credit problems associated with Russia, Korea and LTCM.
- The last three credit crunches have occurred in 98, 01, and 02
 - Decelerating growth rates occurred during in two of the three crunches; sustained (and higher than average) growth in one of three
 - The two crunch periods of decelerating growth have each been followed by three quarters out of four of accelerating growth

Credit "Crunches" and Moody's Performance



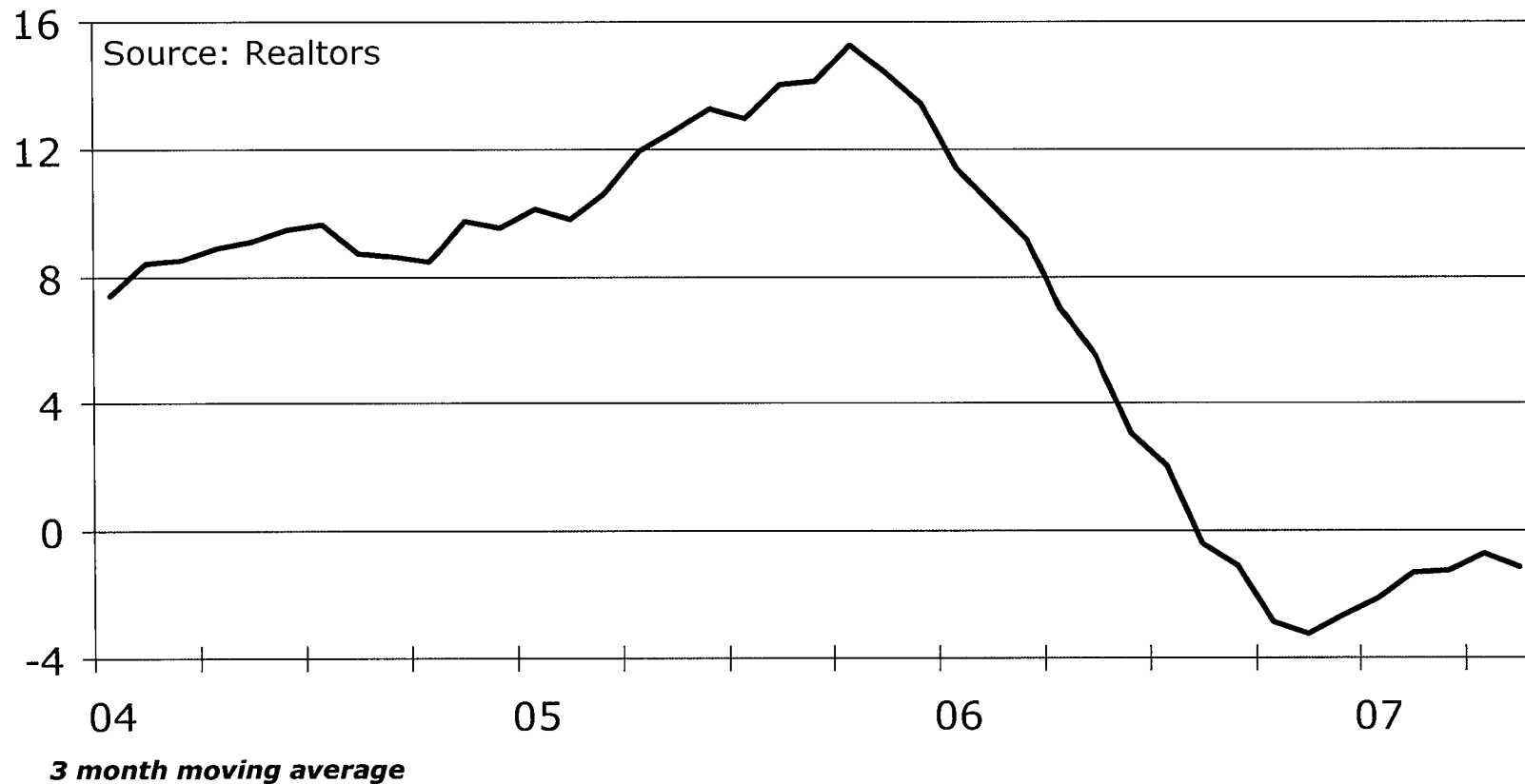
Spotlight on Mortgages: Quality Continues to Erode

Delinquent Residential Mortgage Debt (%)



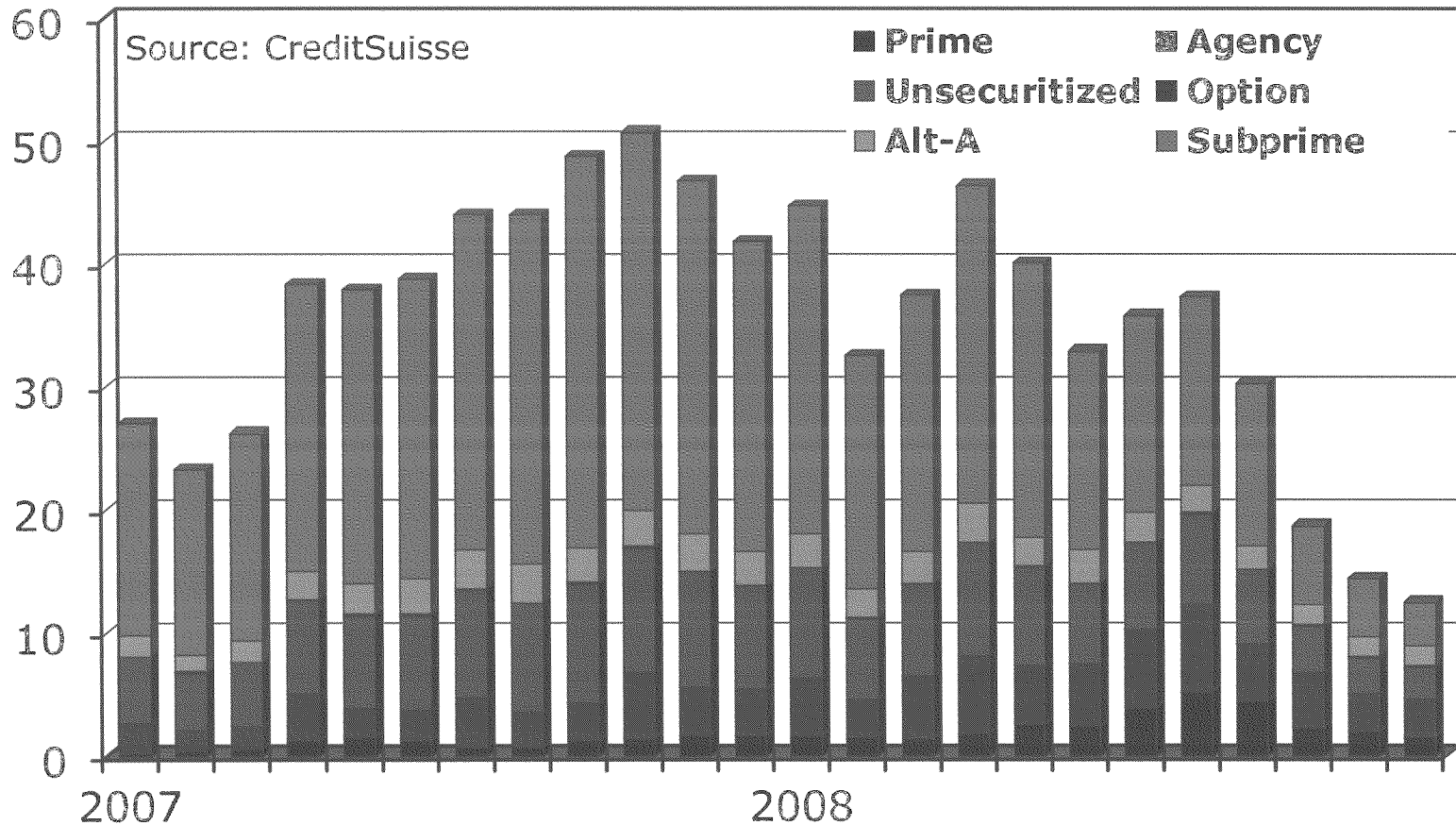
House Prices Are Falling...

Median Existing House Price – % Change vs Prior Year



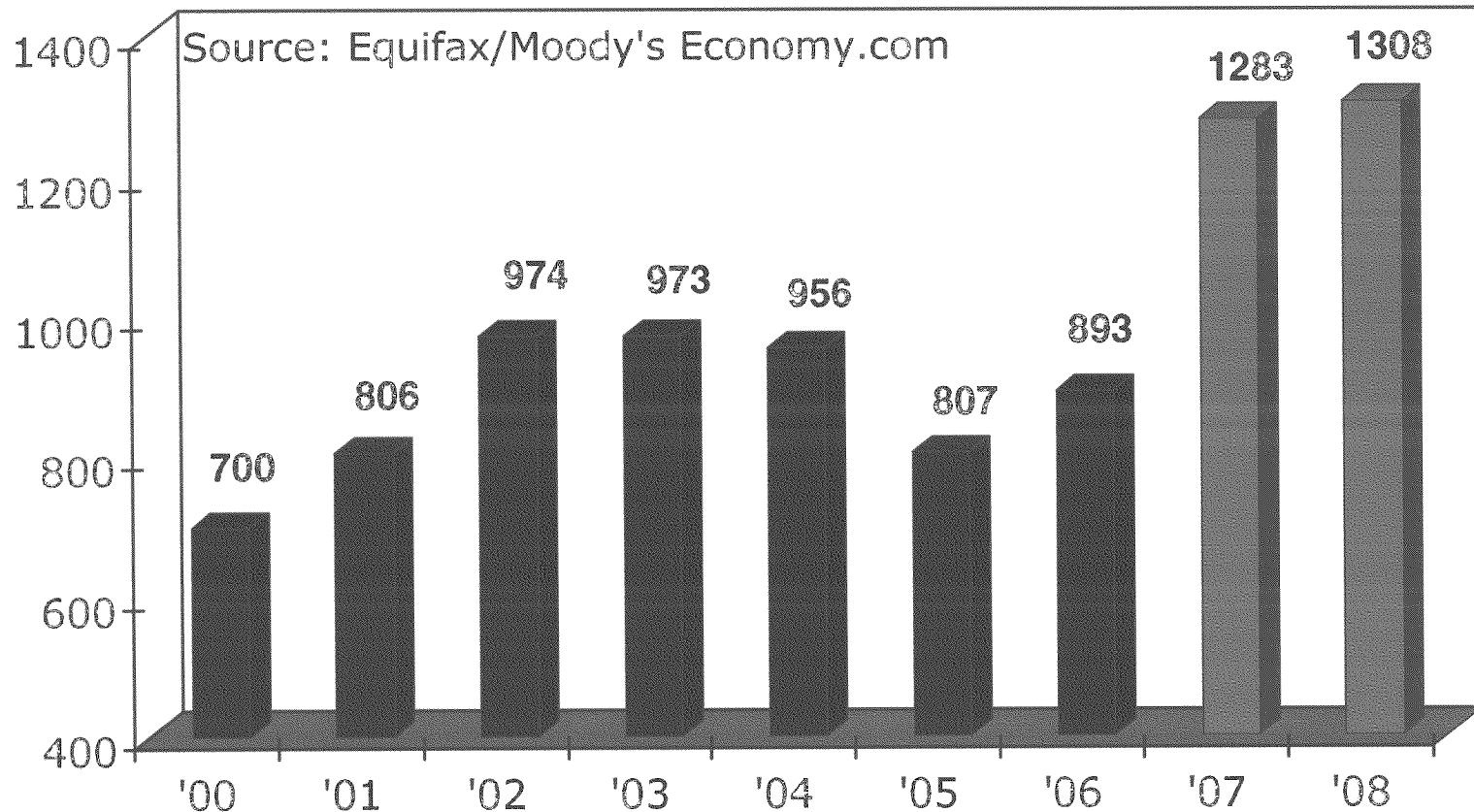
Mortgage Payment Resets are Mounting

Mortgage Debt Facing First Payment Reset (\$ Billion)



1.3 MM Mortgage Defaults Forecast 2007-08

First Mortgage Loan Defaults (000s)



On the Horizon...?

- Credit crunch
- More hedge fund failures
- Sub-prime problems spread to Alt-A & Prime
- LBOs
 - 9 postponed so far, 32 in the pipeline
 - Banks holding significantly more risk than planned – how long?
- CLOs
 - Markets appear to be closing – how long?
- CMBS
- States Attorneys' General investigations

2007 Strategic Priorities

Critical Few Priorities

Strategic Priorities

- Market Relevance
- Product Development (esp. around proprietary data/analytics)
- International Expansion
- Corporate Development (acquisitions)
- Synergies (revenue & expense)

Supporting Strategies

- Execution
 - Corporate Positioning (brand & identity, communications, etc.)
 - Organizational design
 - Information Strategy
 - Human Resources Management
- Financial Strategy
- Legal & Regulatory Strategy

Selected 2006-07 Accomplishments

Market Relevance

- Created Investor Advisory Councils
 - Strategic Calling Officers
 - Customer Service Steering Committee
 - Brand Strategy Project
-

New Products

- SFG New Products Group
 - MKMV RiskFrontier
 - Corporate Financial Metrics
 - M3 Sub-prime Mortgage Model
-

International Expansion

- Joint venture in China
 - Acquisition of CRA Ratings in the Czech Republic, CA Ratings in South Africa, and Kasnic Ratings in Indonesia
 - Moody's office in Dubai
-

Corporate Development

- Adopted investment criteria & scoring
 - LOBs taking more active role in deal identification
 - WSA acquisition; international expansion (see above)
 - Actively pursuing deals: e.g. Fermat, KIS Ratings, Strat
 - Analytics
-

Synergies

- Project Athena
- Established Global Project Finance Group
- SFG New Products Group

Significant H1 '07 Issues

Major First Half Challenges

- Joint Default Analysis for Banks
- Challenges with foreign regulators – China; European scrutiny of structured finance
- SEC Rule-making Process
 - The notching debate
- U.S. Sub-prime
 - Spawning private litigation & state AG investigations
 - Creating significant scrutiny of our role & performance; misinformation & disinformation

Exceptional financial performance with challenging regulatory and credit environments is similar to 2002-03 (post-Enron)

Relationship of Current Challenges to Long-term Strategic Priorities

Common Themes to 1st Half Challenges

- Understanding of ratings lags sensitivity to rating actions
 - Performance assessed by anecdote, not data
- Significant & irreconcilable conflicts between user groups for ratings
 - “Standards” users vs. “alpha” seekers; longs vs. shorts
 - Ratings being adopted for uses beyond credit
- Rating agencies assessed as a collective, not individually
 - But MCO is only public company in industry – the example
- Behaviors/actions intensely scrutinized both for independence & competence

Observations & Implications

Is the current environment any different than what we've had to confront historically?

- **Rating agencies today have a more prominent role in the capital markets** than 5 years ago – and much more than 10 years ago...Why?
 - Hard-coded into global financial system infrastructure (Basel II, Reform Act, IOSCO)
 - Embraced by emerging market authorities/companies as a “stamp of arrival” (accelerating use ahead of need)
 - Proliferation of structured finance driving more demand for independent, credible opinion & guidance to cope with financial complexity
 - Global disintermediation

Observations & Implications

- Capital markets are more accessible to more people, becoming directly linked to the “real world” – **rating agencies are increasingly relevant to real people**, e.g.:
 - Ratings with more obvious social, political & geo-political implications (securitization of housing and consumer finance, China, “national champions”, etc.)
 - Expansion into general economic commentary with MEDC
- As a U.S. public company, MCO is the symbol of an industry perceived to be very profitable, powerful and – possibly – conflicted
 - External actions to-date have not broken our position
 - Good results = bad publicity?

Observations & Implications

Confronting and managing multiple “big” issues at once is an aberration historically, but prospectively?

- We are perceived as having “system lock-in”, in an industry that has system lock-in, in a system that matters more to more people
- We’ve always taken unpopular positions, but complaints about us have a wider and more willing audience in the media, among bankers, in Washington, Brussels...
 - Our environment breeds intense scrutiny of everything we do
 - Many parties resent us for the position that we have & for lack of control over us

We need to better deal with the Real World’s opinions about – and interference in – our business, and its desire to define our role and to influence our activities to suit various purposes.

Observations & Implications

More interest and involvement from the real world requires us to:

- Understand our customers *and our customers' customers* more deeply
- Anticipate reactions to our actions on an interdisciplinary basis
- Develop and communicate messages rigorously & *simply*
 - Our role and function in the capital markets
 - How we manage the rating system
 - How we compete
 - Where we invest
- Stay on message and drive key messages down and out
- Operate in a world of zero tolerance for ambiguity and error – ***being right without being persuasive is failure***

Critical Few Priorities

We must transmit implications into actions consistent with the major ideas we are discussing with the board:

