Moody's Corp. Q3 2007 Earnings Call Transcript

Question-and-Answer Session

Operator

Thank you. [Operator Instructions]. We'll go to first to Peter Appert at Goldman Sachs.

Peter Appert - Goldman Sachs

Thank you, hey Ray can you give us any additional color on what this restructuring charge might look like in the fourth quarter in terms of sort a range of magnitudes, we could be thinking about? What kind of run rate savings you might be thinking about? And then have you changed your thinking, historically Moody's has been averse to adjusting headcount in the context of cyclical to changes in the market, have you changed your thinking on that?

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

Sure Peter. With respect to the restructuring charge, there is not a whole lot more we can tell you right now. If we had reached a final conclusions on restructuring, it would have been something that would appear in the third quarter rather than the fourth quarter. But we're still working on that, and the two components we're working on obviously are the operational savings that we can realize, and then the appropriate accounting treatment that would be associated with those savings and we will certainly communicate that as we have more information. With respect to headcount we have had what I would characterize as a soft freeze in place, since early in the third quarter. We are still filling essential positions where they need to be filled. But we have dramatically slowed the pace of hiring and the net adds to staff, and I expect that is going to continue.

Peter Appert - Goldman Sachs

Okay. What's the typical annual turnover you're seeing Ray?

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

Year-to-date we have about 15% turnover.

Peter Appert - Goldman Sachs

Okay. And then lastly the longer-term margin expectation, you cite 50% for the next year. You basically are still comfortable with that as a longer-term target that's sustainable.

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

I believe so. And in setting that as a preliminary target for 2008, we do expect that debt market conditions are going to continue to be challenging. But as I mentioned in the prepared remarks, we are still developing our outlook for revenue expectations in 2008. And whether that 50% target proves to be liberal, or conservative is going to depend on the final development of that revenue outlook. We do expect it's going to be a challenging year, particularly in the first half where the comps are difficult.

Peter Appert - Goldman Sachs

All right. And then one actually last thing. Linda can you remind me, what the cost components are on the debt. Or what the average costs for the different pieces?

Linda S. Huber - Chief Financial Officer and Executive Vice President

Sure. First of all Peter, we did want to also point out regarding your margins question. If you look at our investor presentation from August, if everybody looks to page 34 of that. You see that we had said that we thought the third quarter margin would be down from the rest of the year. And in fact it would be the lowest point of the year. So we did caution everybody that we would expect this pattern at this point in the year. So, we'd requested everybody to take a look at that. Peter you were asking about the components of... I am sorry.

Peter Appert - Goldman Sachs

Yes, the components of debt. What average costs are for the different parts?

Linda S. Huber - Chief Financial Officer and Executive Vice President

Sure.Right now we have a $1 billion in debt outstanding right now. And we have a $600 million of private placements and we have the billion dollar commercial paper facility, which gives us a $1.6 billion in capacity, and of that $600 million are still available.

Peter Appert - Goldman Sachs

And what's the rate on it?

Linda S. Huber - Chief Financial Officer and Executive Vice President

We only have the rating on the commercial paper.

Peter Appert - Goldman Sachs

I am sorry, on behalf of the interest rate?

Linda S. Huber - Chief Financial Officer and Executive Vice President

Oh, I am sorry, The blended cost on all that is about 5%, Peter.

Peter Appert - Goldman Sachs

Okay great thank you.

Operator

And we will move next to John Neff at William Blair.

John H. Neff - William Blair & Co.

Hi. Could you give us a little sense of your effective tax rate assumptions for the fourth quarter and may be looking out into 2008?

Linda S. Huber - Chief Financial Officer and Executive Vice President

Sure Peter its.. I am sorry John. We had the third quarter's tax rate. Unfortunately we had a bit of a negative comparison, because we had particularly low tax rate in the third quarter last year. For the rest of the year going forward, we would recommend that everybody models 41%. But we just had a tough comparison in the third quarter this year versus the third quarter last year.

John H. Neff - William Blair & Co.

Okay if we assume that's probably a good rate for '08, as well.

Linda S. Huber - Chief Financial Officer and Executive Vice President

I think that's probably fair, but as Ray said, we haven't finished work on '08, yet.

John H. Neff - William Blair & Co.

Okay. And then your weighted diluted share count $267.6 million for EPS purposes. But the balance sheet data shows shares outstanding on September 30th of $258.4. Is that basically diluted and does that... I am assuming that reflects share buyback activity very late in the third quarter.

Linda S. Huber - Chief Financial Officer and Executive Vice President

Yes we have got... the actual is the 258 number. And I believe we also have the diluted number there as well.

John H. Neff - William Blair & Co.

Okay, great. With the expense growth half of that coming from the lease expense, is there any duplicative lease expense at this point or is that just a new run rate given the headquarters move?

Linda S. Huber - Chief Financial Officer and Executive Vice President

Yes we had a duplicative lease expense through the third quarter, and we have completed our move, so that will come off. And the fourth quarter John that runs at about $3 million a quarter. It's about $10 million before this year-to-date, which is a duplicative cost for having both 99 Church Street, and here at 7 World Trade Center, but as I said that ended with the third quarter.

John H. Neff - William Blair & Co.

And you said $3 million of the quarter, was the duplicative?

Linda S. Huber - Chief Financial Officer and Executive Vice President

Yes.

John H. Neff - William Blair & Co.

And then question on the margin. You are targeting 50% for 2008. Why might that not be higher just in terms of the wiggle room you have with incentive comp, which I am assuming is about, If I am correct in my math 13% of total expenses. And can you talk about the revenue component of calculating that incentive comp approval.

Linda S. Huber - Chief Financial Officer and Executive Vice President

I think it's fair to say John that the revenue piece is the tougher thing to forecast here. Let me just step back and go over the margin of assumptions. And then I'll turn it over to Ray, and he'll have some comments on '08. For 2006, the margin number was 53.9%. You'll see we've got it down 220 basis points over 2007. We are looking at approximately 51.7%. We do have room in incentive comp, but of course that depends on revenue, and the operating income that we put out. So a little bit difficult to say going forward, but I would invite Ray to say anything else that you might want to ask.

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

Yes, I mean there are obviously a number of moving parts at this early date in looking at 2008. And I think and I realize this is probably a somewhat frustrating as you try to think about 2008. But the clarity that we have around likely debt market activity is not high right now and particularly for the structured finance business, which has been the high growth business. So we are working on developing what that outlook is going to be. We had never provided a succeeding year outlook in October. And I think given the uncertainty in the markets right now this would probably not be the best time for me to start trying to do that.

John H. Neff - William Blair & Co.

Understandable. Just a quick question, if I could one more, I will get back in the queue. Residential mortgage-backed securities as a percentage of total revenue, my understanding in the past was that, that has been I believe in the realm of about 15%. And can you reconcile what's happening there with a decline in total structured finance revenue? Thank you.

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

Well the residential mortgage-backed revenue, global residential mortgage-backed revenues as a percent of global Moody's Corporation revenue is about 8.5%. That has obviously been declining quarter-on-quarter throughout this year. And as you might expect, we anticipate its going to decline in the fourth quarter as well. And become a very small, at least the U.S. component to that. A very small contributed to global revenue.

Operator

Next we will go to Karl Choi at Merrill Lynch.

Karl Choi - Merrill Lynch

Hi a few questions here. The first one along the lines of the last question. Ray can you tell as the percentage of the total revenues, how much CDO's last in the third quarter. And then also in terms of compensation expense, the percentage of total expenses from compensation in the quarter and also some incentive compensation. Thanks?

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

I'll take the CDO question. And what I have in front of me Karl is the U.S CDO information. The U.S. CDO's in third quarter were about 16% of U.S. revenue. And again that has being a declining percentage quarter-on-quarter throughout the year.

Linda S. Huber - Chief Financial Officer and Executive Vice President

And Karl for incentive comp as a percentage of total comp for Q3. That was 9% of total comp, which is compared to 17% for the third quarter last year, and 19% in the second quarter of this year and 16% for year-to-date. So you can see there the incentive comp as a percentage has come off, almost to the point of half, in fact more than half of the second quarter comparison. And total comp to total expenses is 67%.

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

And Karl since Linda's answer gave me time to calculate, the global CDO revenue was also about 16% of global Moody's Corp revenues.

Karl Choi - Merrill Lynch

Great. Regarding your comment about operating expenses to be down, I think 7% sequentially speaking in the fourth quarter. Can you just give us a little bit more color where the decline is going to come from apart from the lease expenses going away? What are the major components?

Linda S. Huber - Chief Financial Officer and Executive Vice President

Karl. A lot about will that will come from the true-up of incentive compensation if our revenue view hold. Basically we'd see expenses will come up about $20 million in the fourth quarter and that's approximate. A lot of that will come from the room we have because of the true-up in incentive compensation, again if the revenue view that we forecast holds.

Karl Choi - Merrill Lynch

And lastly Linda, can you give me the percentage of our revenues from corporate finance in the quarter that was from high yield in investment grade and the components? Thanks.

Linda S. Huber - Chief Financial Officer and Executive Vice President

Sure, the percentage of revenues from high yield were 8%, that was down net of total global corporate finance, that's down from 13% at the same time last year Karl. On a numerical basis it's a drop of about 31% from $12 million last year to $8.3 million this year.

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

That's the bond, the high-yield bond. If you include loans, it would be... the total would be about 13% I believe of corporate finance revenue.

Karl Choi - Merrill Lynch

What about investment grade?

Linda S. Huber - Chief Financial Officer and Executive Vice President

Investment grade was 22% of total corporate finance set up from 15% for the same period last year and a change of 76.7%.

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

And again we are talking of bond issuance. So that does not include 50... frequent issue pricing fees and commercial paper of medium term note programs. That would be in the other category.

Karl Choi - Merrill Lynch

Right, thank you.

Operator

We will go next to Michael Meltz at Bear Stearns.

Michael Meltz - Bear Stearns
Great, thank you. I think I have three questions. Can you clarify for me your actual... your full year guidance, what it implies for the fourth quarter in terms of revenue and EPS? And then secondly on Karl's question on the cost cut, so you are saying Linda, that you are essentially assuming just a big dropdown in incentive compensation and I assume some discretionary costs, but not headcount reductions?
Linda S. Huber - Chief Financial Officer and Executive Vice President
I think going to that the second question of first Michael, a lot of it will come from the incentive compensation change and I think it's fair to say that we're also looking at headcount across the firm. We're looking at all costs across the firm. We want to be very clear that we understand that we have to bring incentives inline with the revenue picture. So we are looking at everything and we do expect that there will be some selective staff reduction.
Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer
As far as the fourth quarter expectations for revenue, if you back into it from the year-to-date in the full year that we have given, you can see a mid teens to low to mid-20s expected decline in revenue, in fourth quarter.
Michael Meltz - Bear Stearns
Okay and on the EPS side though your... you're using the 224 base on last year? You are saying you're going grow that? Putting all that non-occurring items is that the number you're using.
Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer
I am not sure I heard the question. It was...
Michael Meltz - Bear Stearns
I just want to make sure Ray I understand what EPS you're talking about in terms of this guidance? Are you using... what are you using as a base for over '06 to... in that you're growing that made the mid to high single- digits.
Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer
Okay so I just didn't hear you before. The basis is $ 2.25 for Q4 '06. I am sorry for full year '06.
Michael Meltz - Bear Stearns
Okay and then lastly, I just want to ask about the margin assumption for next year. Is this... I am not sure how you can guide to a margin assumption by not guiding the revenues, since they kind of go...
Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer
Well what I, I am sorry.
Michael Meltz - Bear Stearns
It's because they can't go hand in hand, I just want to understand is your point of saying that just to assure people, do you think Moody's can continue to operate at a 50% type of margin going forward?
Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer
Yes, I would not characterize this as guidance on the margin. As I said, we are targeting a 50% margin. We think that we can continue to maintain a 50% margin even in a much slower revenue growth environment, but there are obviously limits to that. And so what I'm telling you at this point is what I am working on in terms of our goal for our cost management. Once we have taken care of any restructuring that we'll be doing in the fourth quarter and aligning the growth in headcount which is the lion's share of our expense with the revenue outlook that we are developing. So that's the goal and in a range of performance environments for the debt markets, I think we will be able to achieve that but obviously not in all environments and I don't yet know what are our essential case would be for the revenue environment in 2008.
Michael Meltz - Bear Stearns

Okay, Thank you Ray

Operator

Next we'll move to Fred Searby at J.P. Morgan.

Fred Searby - J.P. Morgan

Thank you. Couple of questions. One, I wondered if you could help me Ray and Linda think about do you saw growth still in structured finance in Europe. Given the issues that seem to be manifesting themselves in a housing market, how much of an impact do you think that's going to be on structured finance in Europe and then I wondered if you could give us some sense as to what you baked in a structured finance implied 4Q or projection in terms of CDO issuance, and then if you have any thoughts on this rescue front and what it... that's a wild card, but what could it all mean? Thank you.

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

Sure Fred, I'm going to invite Brian Clarkson to comment on most of this, but let me just give you the expectation for the fourth quarter on the CDO side. In the U.S, CDO market were expecting a decline of 40% to 50% and that includes both CLOs and asset back CDOs. We expect a decline in the asset back CDOs to be greater than 40% to 50% and the decline in the CLO markets to be somewhat less. Globally, we would expect a decline for CDOs to be between 30% and 40% and I'll ask Brian to add any comments that he can on the European structured finance side and on the rescue front.

Brian M. Clarkson - President and Chief Operating Officer of Moody's Investor Services

Sure this is Brian Clarkson, on the European structure finance side particularly CDOs, what we don't see is the same type of decline or the same sort of containment that we see in the U.S. with respect to the housing market. And the big reason for that is you don't really see ABS, CDOs that include housing securities. And either if you did in Europe what we haven't seen is the same downturn housing market, and so we're still seeing some growth in the overall structured finance market in Europe, but also in CDOs because of that and also CLOs.

With respect to the rescue front, we're certainly involved, we've been talking to people, with respect to... we haven't assigned a rating and we're listening to the proposal. The outcome is really uncertain at this point although I will say that if they are successful selling this up that it will actually... it should provide some equities to the market.

And also help this SIVs that are trying to sell good assets to the extent that they can sell them in fair prices that will actually provide liquidity to the market. If those SIVs that may either attempt to well, may wind down... it can wind down in an orderly fashion. What it overall does, if it is successful, it will enable them to for those who want to restructure they can restructure themselves in a different type of vehicle, and those who actually want to wind down they can do in 6-month or a 12-month period.

Fred Searby - J.P. Morgan

Thank you and just one follow up. In terms of some of your emerging areas of growth that you've highlighted hedge fund ratings the insurance category. Is there any breakout story there that you see materializing? Thank you.

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

As far as the two areas you've just mentioned. I would say no. there is not a break out story there. We're continuing to assign ratings, we're continuing to get growth out of those areas but it is steady growth off a small based rather than break out opportunity, at least as yet. Where we are expecting good growth in the fourth quarter is on the investor services side of the business, and as we move to integrate investor services, our global sales of research with our other non-ratings businesses. I expect, we're going to see good growth out of what will be the Moody's Analytics business in 2008. So I do feel confident that we're going to have a good story there in 2008.

Fred Searby - J.P. Morgan

Thank you guys.

Operator

[Operator Instructions]. We will go next to Greg Huber at Lehman Brothers.

Craig Huber - Lehman Brothers

Yes. Hi thank you. A couple of questions; historically I think you had roughly a 60:40 revenue split between... revenues based on new issued volume and on the other side the recurring monthly revenue support. Can you tell us how do that revenues break out this quarter?

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

Sure. It hasn't changed dramatically. The transaction related revenue in the third quarter was about 70% of ratings revenue with the relationship revenue being 30% and then, if you keep in mind that about 20% of our business is outside of the ratings area, Moody's KMV and our research business what you've got is transaction revenue that is about 70% or 80% or in the mid 50% range. So I mean its still is about 55%, 45% split between transaction and relational revenue.

Craig Huber - Lehman Brothers

In that 70% number you talk about specifically in the ratings business. How does that differ across the different asset class, particularly the structured versus high yield versus the investment grade of loans?

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

Yes as we commented before the structured finance and public finance businesses are much more transactionally based. The corporate financial and financial institutions businesses having more rating for its relationship, with the financial institution business being most heavily weighted to relationship fees.

Craig Huber - Lehman Brothers

Okay. And then just switching back to the variable cost for second aside from the incentives, compensation are there any other material variable cost you can point to here that you can to start to dial it down if top line doesn't perform?

Linda S. Huber - Chief Financial Officer and Executive Vice President

No I think credits start to say we have some flexibility but it's not limitless we have some choices we can make for example on technology project spending and things like that we can dial down if we see revenues often a split again 70% of our expenses are actually 67% for this quarter, all compensation-related. So that's why we have to take such a hard look to top line.

Craig Huber - Lehman Brothers

Is that remaining because you are talking about roughly in the 5% to 8% range?

Linda S. Huber - Chief Financial Officer and Executive Vice President

I am sorry, could you repeat that question?

Craig Huber - Lehman Brothers

Is that IT tax roughly in the 5% to 8% range your cost?

Linda S. Huber - Chief Financial Officer and Executive Vice President

That's fairish, yes.

Craig Huber - Lehman Brothers

Yes okay and then lastly if I could can you just comment a little bit about what you seeing in the month of October that might be better or worse across asset classes virtually you saw in September? Thank you.

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

We don't obviously have a full month of October in but I would say the story in October is not dramatically different than what we've seen in September there continues to be significant stress in some important sectors of the debt market including important sectors the structured finance and most of the activity that we are seeing on the corporate finance side continues to be investment grade activity. But not a dramatic change in the profile from what we are seeing at the end of the third quarter.

Craig Huber - Lehman Brothers

Okay. Thank you.

Operator

[Operator Instructions] We will go to Catrina Ure [ph] at Citi.

Unidentified Analyst

Hi it's Catrina Ure from Citi. I just wanted to follow-up on Craig's question about the monthly seasonality. In the past credit crunches that we've seen and I think you have talked about this in previous presentations. You've talked about how long the credit crunches have lasted and how long the decelerating growth rates occur before we start to see a turn around back towards growth again how would you compare this credit crunch to what you have seen maybe with the WorldCom or with the 2001 recession and 9/11?

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

Sure Catrina. While there is a little bit difficult to see long distance in the middle of the storm, I would say that right now I would expect, the recovery from this credit tightening to be more protracted than what we saw with either the recoveries from the LTCM period in 1998 or in the post WorldCom period, I sort of put the 2001 period to the side because we have very strong performance through that period and so I don't think its good to compare it for. The reason I think we'll probably have a more protracted recovery period is that the credit issues that have come up in the structured finance area I think are probably going to drive some more basic rethinking about certain asset categories or classes of structured finance.

Obviously the areas that have been most hard hit are the sub prime residential mortgages, the short-term markets particularly that part of the market represented by the structured investment vehicles and the knock on effect to the credit derivatives market. I think its not unreasonable to expect, that we will probably see more standardization coming out of this, this market going forward with some of the more complex securities being more difficult to place for a longer period of time so the combination of the market having to digest the ongoing problems with the housing market in the U.S. and to think about the adjustments that will be made to securities and potentially creating more standardized securities classes in structured to accommodate more liquidity, more transparency.

I think its going to take some time and that's why we're being cautious about the pace of recovery coming out of this trench.

Unidentified Analyst

Okay. Thank you very much.

Operator

And at this time we have no further questions. Mr. McDaniel, I will turn the conference back over to you.

Raymond W. McDaniel, Jr. - Chairman and Chief Executive Officer

Okay. I want to thank everyone who joined us this morning and we look forward to speaking with you after we get our year-end results. Thank you.

Operator

And that does conclude today's conference. So again thank you for participation.