WSJ.com THE WALL STREET JOURNAL. ONLINE

February 9, 2008

Tiny Firm Gives Ratings Giants Another Worry

Mr. Egan's Ranks Gain Favor as S&P, Fitch, Moody's Draw Scrutiny

By AARON LUCCHETTI
February 9, 2008; Page B1

For the past 12 years, Sean Egan has slogged away in offices near Philadelphia, trying to establish his tiny credit-rating firm as an alternative to the industry's three giants.

His time has finally arrived.

Tough Guys

Egan-Jones Rating Co. often gives lower ratings to bonds than larger rivals such as Standard & Poor's Ratings Services

	Rating	
Company	Egan-Jones	S&P
Ambac Financial*	BB-	AA
Walt Disney	A	A
Wells Fargo	AA-	AA+
United Parcel Srv.	AA-	AA-
General Electric	AA	AAA
General Motors	CCC	B
Amazon.com	A-	BB

*S&P has a AAA rating on the financial strength of Ambac's insurance unit

Sources: Egan-Jones; S&P

Moody's Corp.'s Moody's Investors Service, the Standard & Poor's Ratings Services unit of **McGraw-Hill** Cos. and **Fimalac** SA's Fitch Ratings are reeling from criticism over the top-notch ratings those firms gave to mortgage bonds that looked safe until the housing market swooned last year. Regulators are probing whether the three companies were too cozy with investment banks. A slew of self-imposed overhauls have been denounced by New York state's attorney general, Andrew Cuomo, as "too little, too late."

Despite the crisis of confidence in the roughly $5 billion-a-year credit-rating industry, business is booming at Egan-Jones Rating Co., where the 50-year-old Mr. Egan is president.

Revenue at the closely held firm surged 30% in 2007, according to Mr. Egan. Egan-Jones landed 100 new client accounts last year, giving it a total of about 500. Even more important: The Securities and Exchange Commission recently gave the firm official recognition that should help it gather clients and corporate information.

Unlike the big rating companies, where revenue comes mostly from the companies issuing bonds to raise capital, Egan-Jones makes its money by charging investors $20,000 to $100,000 a year for ratings and related research.

Thomas Atteberry, portfolio manager at First Pacific Advisors LLC, an asset-management firm in Los Angeles, recently signed up to buy Egan-Jones research after passing on similar product offerings from Moody's and S&P. "I like that I'm paying for it and that he's not beholden to the companies he's analyzing," Mr. Atteberry says.

Mr. Egan's maverick style could be tested now that he is gaining a bigger following. Investors and rival ratings firms will be scrutinizing his research more aggressively than ever. But if the growth lasts, it could be a sign that many investors are determined to force a fundamental change in how ratings firms operate in the wake of subprime-mortgage blowups.

Wall Street stock research was transformed by regulatory upheaval after the dot-com bubble burst, creating opportunity for independents. But big Wall Street firms with deep management contacts and access to deals still dominate.

Mr. Egan has never been shy about what he thinks is wrong with the big bond-rating companies. Since the 1970s, Moody's, S&P and Fitch have collected most of their fees from securities issuers. The tradition has its roots in rapid market growth and high-profile bankruptcies that caused ratings to become more important and more expensive.


Sean Egan

As a result, "the interests of issuers and investors are diametrically opposed," Mr. Egan complains. "The market is in dire need of alternatives."

S&P, Moody's and Fitch say they aren't influenced by the conflicts of interest that come from being paid by issuers. Under their system, ratings also are distributed for free, making it easier for companies to raise capital.

The big firms claim Mr. Egan's compensation formula isn't perfect, either, because customers who pay for ratings have biases that can influence the process, such as wanting bonds they hold to be rated highly. Mr. Egan says he doesn't know his clients' positions in particular bonds.

Mr. Egan had been a banker at Chemical Bank, now part of J.P. Morgan Chase & Co., then worked with banks as a consultant at accounting firm KPMG before starting research firm Red Flag Research in 1992.

"As a banker, I did well financially, and I wanted to start something," he says. Soon, Mr. Egan hired former Moody's analyst Bruce Jones, now managing director at the firm. The company was renamed Egan-Jones and issued its first rating in December 1995. It now is based in Haverford, Pa.

Like other credit-rating firms, Egan-Jones basically assigns shorthand grades on the likelihood that a bond will default and leave investors in the lurch. But Mr. Egan has only 15 analysts in his company, compared with about 1,000 apiece at S&P and Moody's.

Mr. Egan says he relies on the analysts but doesn't disclose their names, partly because of security concerns. He says he has been threatened with lawsuits and bodily harm by people who disagreed with his research conclusions. "We're big boys, but I have to do what I can to minimize it," he says.

Over the years, Mr. Egan's targets have included auto makers and highfliers such as WorldCom Inc. and Enron Corp., which he downgraded before larger rating firms lowered their ratings and the companies collapsed. His critics counter that the batting average is higher because Mr. Egan is quicker to change his ratings. He, too, rated Enron highly at one point. S&P and Moody's attempt to have ratings hold up through good and bad economic cycles.

Mr. Egan also has given high ratings to takeover targets such as Nextel Communications Inc. and technology companies such as Amazon.com Inc. that he liked because they had low ratios of debt to market value. Lately, though, he has been drawing attention for his negative views on bond insurers such as MBIA Inc., which he rates at B -- 14 notches below its triple-A financial-strength ratings from S&P and Moody's.

"Triple-A means they'll pay come hell or high water," Mr. Egan says. S&P, which is reviewing MBIA for a possible downgrade, says it will take action when it thinks it is warranted. Moody's says it is proceeding with plans to finish its review of the triple-A-rated bond insurers this month.

For nearly a decade, Mr. Egan lobbied to get his firm recognized by the SEC as a "nationally recognized statistical rating organization" -- essentially a federal seal of approval. Many institutional investors have rules requiring them to buy bonds that carry a minimum rating by an SEC-approved ratings firm.

S&P, Moody's and Fitch had such a lock on the "NR-SRO" designation that Mr. Egan frequently took his case to Congress. Around the office, Messrs. Egan and Jones joked that the acronym really stood for "No Room-Standing Room Only."

On the Friday before Christmas, Mr. Egan was reviewing some financial statements about mortgage lender Countrywide Financial Corp. when a lawyer interrupted with news that the SEC had approved the Egan-Jones application.

Mr. Egan plans to hire 10 new analysts -- increasing the firm's research staff by two-thirds -- and to start rating more complex mortgage and structured-finance bonds.

Write to Aaron Lucchetti at aaron.lucchetti@wsj.com[1]

URL for this article:
http://online.wsj.com/article/SB120251672233155415.html

Hyperlinks in this Article:
(1) mailto:aaron.lucchetti@wsj.com