



# Moody's Corporation (MCO)

Updated May 28<sup>th</sup>, 2018 Aristofanis Papadatos

## Key Metrics

<b>Current Price:</b> \$174	<b>5 Year CAGR Estimate:</b> 6.0%	<b>Quality Percentile:</b> N/A
<b>Fair Value Price:</b> \$135	<b>5 Year Growth Estimate:</b> 10.0%	<b>Momentum Percentile:</b> N/A
<b>% Fair Value:</b> 129%	<b>5 Year Valuation Multiple Estimate:</b> -5.0%	<b>Total Return Percentile:</b> N/A
<b>Dividend Yield:</b> 1.0%	<b>5 Year Price Target</b> \$216	<b>Valuation Percentile:</b> N/A

## Overview & Current Events

Moody's operates in two segments: Moody's Investors Service provides credit ratings and research covering debt securities while Moody's Analytics offers software and research services for credit and economic analysis. The first segment is the most important, as it generates 65% of the total revenues and 86% of the total operating income.

The most important characteristic of Moody's is the fact that it operates in an oligopoly. The three major credit rating firms, Moody's, Standard & Poor's and Fitch, comprise 95% of the total market share. As a result, they have monopoly-like pricing power. Such a wide moat is rare to find, as competition is heated in almost every sector and regulators do their best to prevent monopolistic conditions. Given this exceptional feature of Moody's, it is not surprising that Buffett has an approximate 13% stake in the company via Berkshire Hathaway.

As global debt, both sovereign and corporate, keeps growing at a fast pace, Moody's greatly benefits. It has thus grown its revenue and its EPS by 9% and 14.8% per year, respectively, in the last five years. Part of this growth resulted from the record-low interest rates that prevailed for years. Those interest rates encouraged most companies to borrow huge amounts to fund investment projects, share repurchases and acquisitions. It is remarkable that the total annual amounts spent on share repurchases and acquisitions currently stand near all-time highs. However, now that interest rates are on the rise, issuance of new debt is likely to somewhat decelerate. Nevertheless, the management of Moody's does not expect a significant effect, partly because about \$4 T of debt will be refinanced in the next four years. In addition, the global speculative-grade default rate has dropped to 3.2% and is expected to fall further to 1.4% next year. This trend will certainly favor Moody's.

The favorable business conditions were evident in Q1, when Moody's exceeded the analysts' EPS estimates by 12% and posted record revenues and earnings. The company benefited, not only from the global economic expansion, but also from its acquisition of Bureau van Dijk, which is a leading aggregator and distributor of business intelligence and data.

## Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
<b>EPS</b>	\$1.86	\$1.69	\$2.15	\$2.49	\$3.05	\$3.60	\$4.21	\$4.60	\$4.81	\$6.07	<b>\$7.77</b>	<b>\$12.50</b>
<b>DPS</b>	\$0.40	\$0.40	\$0.42	\$0.54	\$0.64	\$0.90	\$1.12	\$1.36	\$1.48	\$1.52	<b>\$1.76</b>	<b>\$3.20</b>

Thanks to the strong business momentum, the analysts and the management expect the EPS to grow to \$7.77 this year. Moreover, Moody's has exciting growth prospects ahead. The company has grown its number of Chinese issuers by 24% per year in the last 8 years while it has grown its sales in the emerging markets by 14% per year in the last decade. Overall, it has grown its EPS by 14.8% per year in the last five years, without any signs of fatigue. On the other hand, it is prudent to be somewhat conservative amid rising interest rates and in the absence of a recession for nine consecutive years. Therefore, it is reasonable to expect the company to grow its EPS by 10% per year over the next five years, from \$7.77 this year to \$12.50 in 2023.

## Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
<b>Avg. P/E</b>	17.9	14.5	11.7	13.5	13.5	17.5	20.8	22.3	20.4	20.6	<b>22.4</b>	<b>17.3</b>
<b>Avg. Yld.</b>	1.2%	1.6%	1.7%	1.6%	1.6%	1.4%	1.3%	1.3%	1.5%	0.9%	<b>1.0%</b>	<b>1.5%</b>

Thanks to its accelerated growth lately, Moody's has rallied 50% in the last 12 months. As a result, it is now trading at a P/E of 22.4, which is much higher than its 10-year average P/E of 17.3. Mean reversion to Moody's historical average P/E would cause a 5.0% annualized P/E contraction.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
<b>GP/A</b>	71.2%	63.1%	56.2%	55.5%	48.9%	48.9%	51.5%	49.2%	48.4%	34.7%	<b>37.0%</b>	<b>40.0%</b>
<b>Debt/A</b>	156%	130%	112%	103%	88.2%	90.3%	99.1%	107%	119%	101%	<b>96.0%</b>	<b>90.0%</b>
<b>Int. Cov.</b>	19.4	20.4	14.7	14.6	17.2	13.8	13.6	13.1	5.1	10.6	<b>12.0</b>	<b>15.0</b>
<b>Payout</b>	21.5%	23.7%	19.5%	21.7%	21.0%	25.0%	26.6%	29.6%	30.8%	25.0%	<b>22.7%</b>	<b>25.6%</b>
<b>Std. Dev.</b>	53.1%	60.8%	36.3%	31.6%	23.9%	31.2%	15.5%	15.4%	24.7%	12.5%	<b>13.0%</b>	<b>15.0%</b>

Moody's is a quintessential example of a stock favored by Buffett, as it has one of the widest moats investors can hope for. Companies are obliged to seek its service when they issue bonds; otherwise they will incur a higher interest rate on their bonds. In addition, there are several funds that do not buy bonds that are not rated by Moody's or S&P.

Moreover, Moody's spends very low amounts on capital expenses and hence it generates markedly strong free cash flows. This means that almost all its earnings are available for shareholder distributions.

On the other hand, as Moody's is a financial company, it is vulnerable to recessions. In such periods, companies reduce their leverage and hence they curtail the issuance of new debt. This is an important risk factor to consider amid the rising interest rates, particularly given the rich valuation of the stock and the absence of a recession for nine consecutive years. On the other hand, Moody's is likely to outperform banks in economic downturns, just like it did in the Great Recession. While most banks saw their earnings collapse, Moody's saw its EPS decrease just 32% in the Great Recession.

## Final Thoughts & Recommendation

Moody's enjoys a wide moat and hence it is a great stock to hold for the long term. Nevertheless, the 50% rally of the stock in the last 12 months somewhat limits its expected future returns. Therefore, the stock is likely to offer a 6.0% average annual return over the next five years thanks to 10.0% EPS growth and its 1.0% dividend, which will be partly offset by a 5.0% annualized P/E contraction.

## Total Return Breakdown by Year

