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On The Cover/Top Stories

The Risk List

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Is the recession over? Is Corporate America out of the woods? Some indicators on Wall Street seem to say yes. Yields on junk bonds are way down. A lot of companies that were on the brink a year ago have refinanced, pushing maturities of debt out to 2014 or later. And if last March you had bought an assortment of shares in the shakiest borrowers you probably would have made a huge profit. Auto parts maker ArvinMeritor was trading at 32 cents at its low on Mar. 11. It has since climbed 3,503% to \$11.53.

But financial risk is not out of the system. Last year saw 207 bankruptcies of publicly traded companies. If there's a double-dip recession, this year's count could easily be as high. Leverage is still a big feature of American business.

We asked Audit Integrity, a research boutique in Los Angeles, to rank 2,700 companies for financial risk. The group consists of all public nonfinancial companies with market values of at least \$100 million and \$150 million in assets. Focusing on the 100 firms at the top in risk, it calculates an average 8% probability of going bust over the next 12 months.

ArvinMeritor is among the high-risk companies. More likely than not, it will sail through 2010 without any financial trouble. But the risk is higher here than at 99% of public companies, in AI's opinion.

AI's risk model incorporates the usual factors that go into credit ratings, like balance sheet strength and earnings. But it also figures in a measure of "accounting and governance" quality. The idea is that historical data can uncover push-the-envelope accounting and help predict which firms are likely to undergo financial restatements, regulatory troubles, class actions or severe financial distress.

James A. Kaplan, chairman of AI, set up the firm eight years ago after building and selling two other financial data crunchers: Capital Management Sciences, a bond analysis outfit, and the online financial portal MarketWatch. His inspiration for the latest venture came in 2002 as Enron was falling apart. Was there something that might have flagged this firm as a likely target of a Securities & Exchange Commission enforcement action? While studying SEC cases he deciphered common patterns involving such things as doing lots of acquisitions, divestitures, restructurings and share repurchases, or relying heavily on stock price gains in determining the boss' pay. From that he created his firm's Accounting & Governance Rankings.

AGRs are now used by big investors, director and officer liability insurers and others to gauge the chances that a public company will restate financials, face SEC action or get hit with shareholder litigation. Forbes.com publishes AGRs on its company tear sheets. "Companies rated 'Very Aggressive' or 'Aggressive' have proved much more likely to face class action litigation and financial restatements and to suffer severe equity loss," Kaplan says.

Recently Audit Integrity began assessing bankruptcy risk as well, using not only accounting indicators like liquidity and leverage but also the AGR metrics and market measures like stock volatility. "We find governance and transparency correlate with bankruptcy," says Kaplan. Under AI's model 81% of the public companies that went bankrupt last year would have been classified among the riskiest 10%.

Not surprisingly, many of the companies now dubbed risky find fault with AI's methodology. One criticism is that the model doesn't capture some recent balance sheet or earnings improvements. Another is that the

calculations don't give companies enough credit for making debt nonrecourse or for extending maturities. ArvinMeritor notes that its bonds are trading above par and its stock has soared.

All valid arguments. Yet at a time when markets are giddy and the riskiest assets the hottest, investors would do well to recall that bad things can happen--even to companies with credible arguments about why the naysayers are wrong.

High Risk, High Return

The apparent end of the recession has turned shares of financially weak companies into hot properties. Click on company name to see comments.

COMPANY/INDUSTRY	RECENT PRICE	% CHANGE FROM 52-WEEK LOW	ACCOUNTING & GOVERNANCE RANKING*	FINANCIAL RISK PERCENTILE**	SEC FILINGS LINK
ArvinMeritor /Auto & truck parts	\$11.53	3,503%	Very Aggressive	1	SEC
Eastman Kodak /Photography	5.07	152	Very Aggressive	1	SEC
Bon-Ton Stores /Retail	9.63	903	Average	2	SEC
Sunrise Senior Living /Health care facilities	3.46	1,136	Very Aggressive	2	SEC
Federal-Mogul /Auto & truck parts	18.52	761	Very Aggressive	2	SEC
US Airways Group /Airline	5.59	198	Average	2	SEC
Westwood One /Broadcasting	4.25	32	Aggressive	2	SEC
Acco Brands /Office equipment	8.12	1,112	Aggressive	3	SEC
BlueLinx Holdings /Construction	3.06	155	Average	3	SEC
DineEquity /Restaurants	23.70	352	Aggressive	3	SEC

Prices as of Jan. 14. Report was prepared on Dec. 30, 2009. Criteria: U.S.-listed nonfinancial corporations with market value greater than \$100 million and total assets greater than \$150 million. *Accounting & Governance Ranking: A measure of the transparency and statistical reliability of a corporation's financial reporting and governance practices. Companies rated Very Aggressive or Aggressive have proved to be much more likely to face class action litigation and financial restatements, and to suffer severe equity loss. **Financial Risk: A percentile score of 1% to 100%. Companies with the lowest scores face the highest risk of bankruptcy or severe financial distress. Sources: *Audit Integrity; Interactive Data via FactSet Research Systems; Thomson Reuters.*