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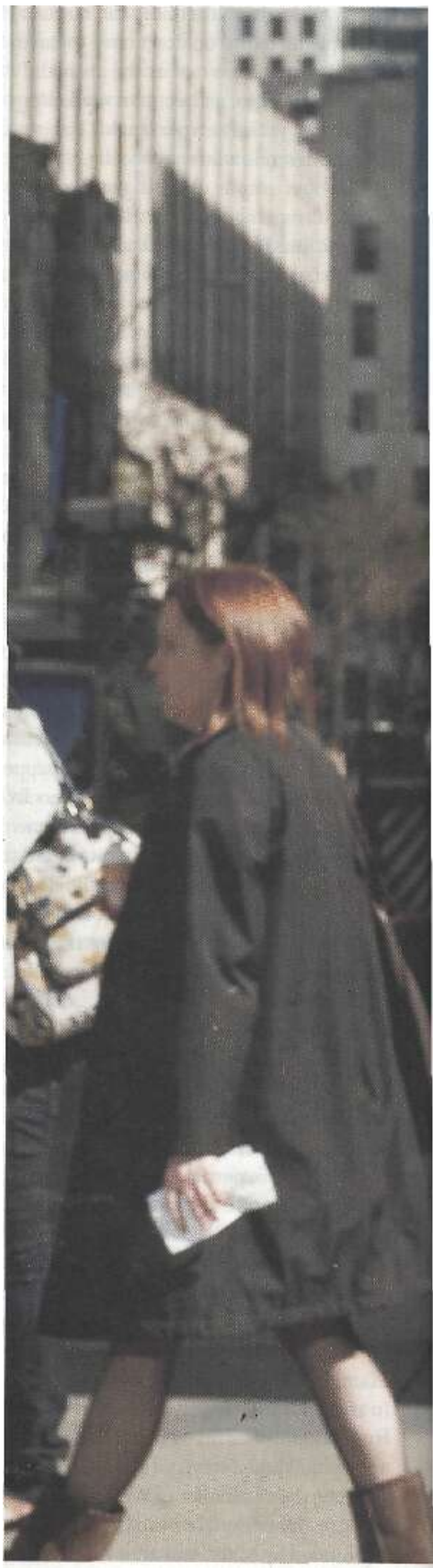
Rating McGraw-Hill

CEO Terry McGraw kept a low profile as he built McGraw-Hill's financial, educational, and media holdings into a moneymaking machine. But that was before its Standard & Poor's subsidiary went from cash cow to a catalyst of the economic meltdown.

BY WILLIAM D. COHAN
PHOTOGRAPHS BY SARAH A. FRIEDMAN



HIS NAME IS ON THE DOOR *Harold "Terry" McGraw III, across the street from Manhattan's McGraw-Hill building*

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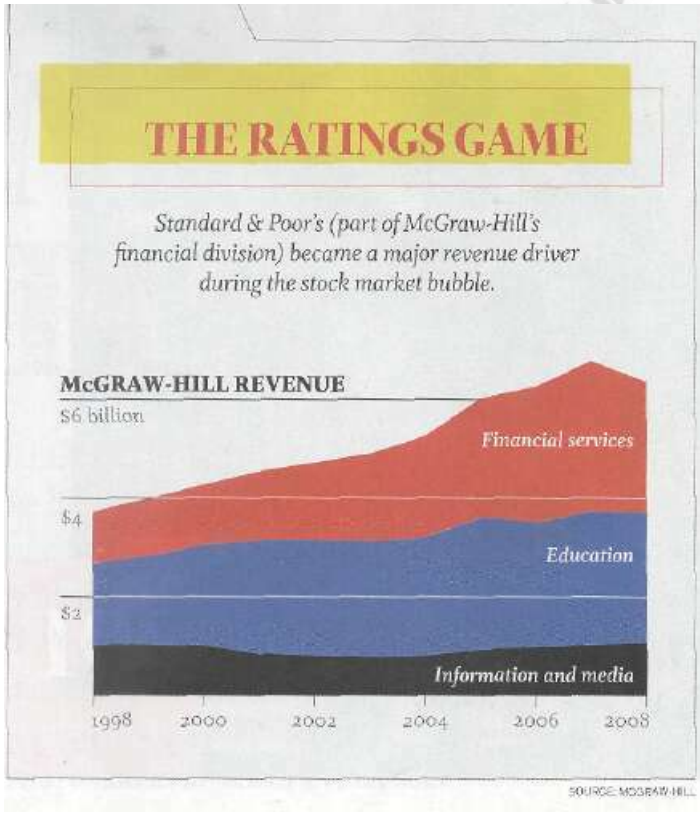
ONE **WARM DAY RECENTLY,** a double-decker tourist bus barreled past Harold "Terry" McGraw III as he walked in front of the Manhattan skyscraper that is the world headquarters of the McGraw-Hill Cos. McGraw, the fourth generation of his family to run the company, heard the tour guide say, "And now we're coming up to the McGraw-Hill building." McGraw thought to himself, "Hey, that's kind of cool Were on the circuit. I didn't know that." Then he heard, "And sadly there are no McGraws alive today." [This unintended slight serves as a metaphor for Terry McGraw's 11 years running the company. Being the CEO of a media dynasty usually guarantees the scion at the helm two things: headlines and headaches. Just ask the Washington Post's Donald Graham or the *New York Times* Arthur Ochs Sulzberger Jr. In contrast, Terry McGraw, 60, has traveled virtually incognito through the greatest scandal in McGraw-Hill's 121-year history. *f The scandal has to do with Standard & Poor's, a McGraw-Hill subsidiary and one of the three major credit ratings agencies blamed in part for causing the current economic crisis.

In fact, the corruptness of S&P's business model—being paid fees by the same Wall Street banks that underwrite the securities S&P rates—is one of the few issues that the left and right agree on.

When the rating agencies' CEOs appeared before the House Oversight and Government Reform Committee last October, Jackie Speier (D-Calif.) called the agencies[1] conduct a "bone-chilling definition of corruption." Similarly, former congressman Christopher Shays (RrConn.) said, "The ratings agencies are useless now. I think they have no brand."



Beyond loss of face, McGraw-Hill is also contending with investigations and litigation—lots of it. Some six states' attorneys general—including New York's Andrew Cuomo, Connecticut's Richard Blumenthal, and Ohio's former attorney general Marc Dann—have investigated S&R (Ohio subsequently dropped the investigation.) "Everybody knows they don't get paid until the transaction gets a triple-A rating," Dann said in September 2007, (S&P has 12 ratings—from the highest, AAA, to the lowest, D—that it bestows on corporate and municipal debt based upon the assessed creditworthiness of the issuer. S&P also rates more exotic forms of debt.)

Then there are the private lawsuits: The Teamsters pension fund, a sizable McGraw-Hill shareholder, and the Boca Raton Firefighters and Police Pension Fund, the lead plaintiff in a large class-action lawsuit, have both sued McGraw-Hill, claiming that the company essentially misled investors through flawed debt ratings, helping to cause the col lapse of the credit markets and drag down McGraw-Hill's stock with it.

In person, Terry McGraw does not come across as the "bone-chilling definition of corruption." He is a mild-mannered Connecticut patrician whose idea of leverage is going double or nothing on a putt at the Wee Burn Country Club in Darien. (He has a nine handicap.) He is married and has two children—a daughter, Megan, and a son, Harold Whittlesey McGraw IV, who works for the privately held agribusiness Cargill. It is not hard to imagine McGraw as the affable local-TV weatherman he briefly was after college. Inside the buttoned-down McGraw-Hill corporate offices, the wags call the natty McGraw "he of the pocket square."

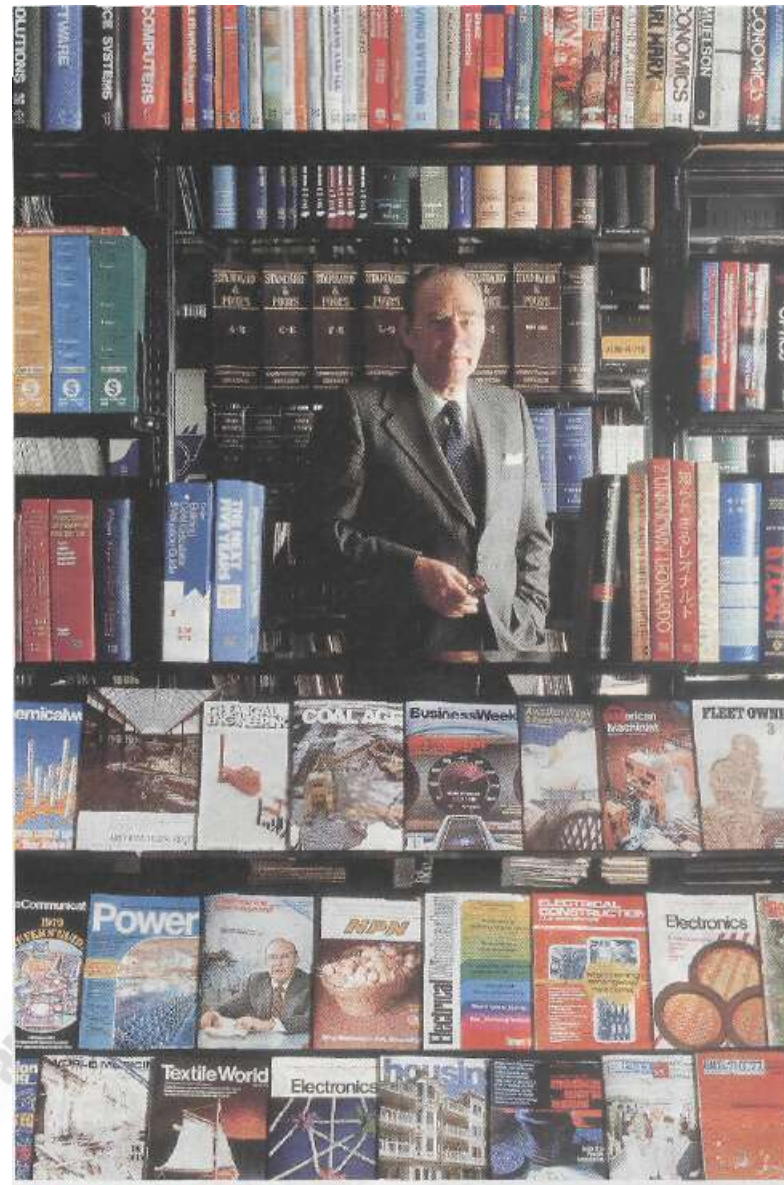
In the wake of the S&P scandal, restoring his family's good name has become the defining test of McGraw's leadership, and his ability to restore McGraw-Hill's credibility with investors will determine his legacy. Despite McGraw's

best efforts to build a bulletproof balance sheet, investors have punished the company because of how highly correlated its revenues are to the financial sector.

Of McGraw-Hill's $6.4 billion in revenues last year, financial services—which includes S&P and Capital IQ (a data service)—accounted for $2.6 billion. Its school textbook business accounted for another $2.6 billion. The balance of the revenues—$i.2billion—come from its media businesses, which include four television stations and Business *Week* (a Fortune competitor).

When it comes to profits, though, it is S&P that really moves the needle: More than $1 billion of the company's 2008 operating profit of $1.5 billion derived from financial services, down from $1.4 billion out of $1.8 billion in 2007. And lately that engine has been sputtering. The issuance of new corporate and government-debt securities fell through the floor in the fourth quarter of 2008, helping to reduce year-over-year revenue by 13% at S&P, where profit margins have historically been as high as 45%.

The downturn has afflicted McGraw-Hill's education and media holdings too. The growing fiscal deficits in 41 states have called into question how much can be spent on the textbooks that McGraw-Hill publishes. Ad spending is down as well. Revenue at the company's four-television stations—augmented by record buys for political ads during 2008—is looking bleak, while ad pages at Business *Week* have fallen 31.8% since 2005. (Fortune's dropped 22% during the same time frame.) Similar woes confront both Platt's, a McGraw-Hill division that publishes trade journals for the energy and metals markets, and J.D. Power & Associates, a provider of data on customer satisfaction.



IT'S A FAMILY AFFAIR *Terry's father, Harold McGraw Jr., photographed for Fortune in 1979 when he was CEO. Harold Jr. retired in 1983. Terry became CEO in 1998.*

Nevertheless, Terry McGraw remains upbeat about McGraw-Hill's prospects. "Once we get through this [credit crunch], then we'll be fine," he said in a rare interview at the company's New York headquarters, in a conference room decorated with landscape paintings by William Elston. He thinks it is only a matter of time before the stock market wakes up to the company's sound fundamentals: Free cash flow is expected to be around $450 million in 2009, and net debt a mere $800 million, none of which matures until 2,012 and one-third of which is due in 2037. (Both Moody's and Fitch rate McGraw-Hill's debt an A.) Nevertheless, the company's stock, which was trading around $45 per share before Lehman Brothers filed for bankruptcy on Sept. 15, 2008, fell by half after that event. It has since come back up and was trading at $24 per share in mid-April. Debt issuance—and the ratings that accompany it—has picked up a bit in the first quarter of 2009 as well.

"Our numbers were all solid," McGraw said. "The balance sheet is solid. Free cash flow is still there. We're profitable and doing well." McGraw also points out that the company has been paying a dividend since 1937 and has been increasing that dividend every year for the last 36. Chatting about the company's figures is easy for Terry. What is a tougher exercise is discussing where he was during S&P's transformation from reliable rating agency to panderer of toxic assets.

GROWING UP, Terry never aspired to be the CEO of the company. As a teenager, he genuinely believed he would be playing linebacker or guard for the Green Bay Packers. During the 19603 the Packers apparently encouraged high schools to send tapes of their outstanding players, on the off chance that there was a rare

talent among them. While at the Salisbury School, McGraw was one of the four players identified on the film the Connecticut boarding school sent to the Packers. "We were really feeling good," he said. "But the Packers rated us as being three years behind the average entering freshman-1 cant tell you how deflating that was."

His first foray into the family business did not go well either. One summer during college, before he headed off to be a camp counselor, he decided he wanted to see what it would be like to be a salesman at McGraw-Hill. He spent three weeks working for the top salesman at the company and came up with the idea of asking travel agents to sell a foreign-language translation product that McGraw-Hill produced. The veteran McGraw-Hill salesman told McGraw the product would not sell well in the travel agencies, but McGraw insisted anyway. "I went, 'Charlie, you're the best. I think it'll work,'" McGraw remembers.

A Teamsters' pension fund alleges that the McGraws sold "the company's integrity for a steady and increasing stream of fees."

"He said, "Fine, okay. Let's put together a list of all the travel agencies in New York City on this one. We'll put together this kit, and good luck.' About 2 1/2 weeks later, guess what? Doesn't work. So I'm back to being camp counselor."

After graduating from Tufts and getting an MBA at Wharton, McGraw went to work at GTE (a telephone company that is now part of Verizon), revamping its pension plans. His career path changed when. American Express, led by James D. Robinson III. launched a $34-a-share, $830 million hostile takeover of McGraw-Hill The year was 1979, and Terry took a three-month leave of absence to help his father, Harold McGraw Jr. (then CEO), fend off the takeover.

American Express's offer represented a 30% premium to McGraw-Hill's prevailing stock price at the time. American Express raised its offer to $40 per share a few weeks later. But from the start, the McGraws by and large viewed the American Express offer as an unwelcome act of corporate aggression, especially since Roger H. Morley, the president of American Express, was on McGraw-Hill's board of directors. Charges of corporate espionage, betrayal, and immorality were flung far and wide as McGraw-Hill hunkered down to fight American Express. "This was a violation of the worst order," Terry McGraw says of the way that a McGraw-Hill director encouraged his boss at American Express to launch the hostile bid.

McGraw-Hill repeatedly rejected the American Express offers, and it won. This style of takeover defense came to be known as Scorched Earth, and the McGraws were one of the early adopters of the tactic at a time when the rules on the M&A battlefield were changing rapidly. The term of art, Scorched Earth, describes the willingness of shareholders and management to do whatever it takes to fend off a hostile takeover. It meant accusing American Express of being an inappropriate steward of the First Amendment issues supposedly so near and dear to McGraw-Hill.

"The conclusion obviously was." McGraw explained, as if back in the moment, speaking directly to James Robinson, "If McGraw-Hill were to sell itself, you wouldn't be the one we would sell to. We don't care for your approach,

BIPARTISAN BASH *Clockwise from top left: Republican Christopher Shays said the ratings agencies had lost their way; Rep. Jackie Speier (D-Calif.) called them corrupt; Andrew Cuomo investigated them.*

and we'll fight you." The defense worked, and American Express slunk away empty-handed. A year later McGraw left GTE for good and came to McGraw-Hill. His father retired as president and CEO in 1983 and was replaced by longtime McGraw-Hill executive Joseph Dionne—a neighbor of the elder McGraw's in New Canaan—who ran the company for the next 15 years. In 1998 the board selected Terry McGraw as CEO. His younger brother Robert left the company not long after that. (Robert is now the chief executive officer of Averdale International, an investment and consulting company.)

CLEANUP MAN
Deven Sharma took over S&P last summer.

Despite a McGraw often being at the helm of the company, Terry is quick to point out that the company is not a family business. There is no Class A and B stock like the New York Times Co.'s. Rather, Terry sees McGraw-Hill as a publicly traded corporation professionally managed for the benefit of shareholders. He reports to an independent board of directors. That said, McGraw himself owns some 7.9 million shares out of the 314,412,208 primary shares outstanding. They are worth a little less than $200 million. (His father owns 6.4 million shares, worth a little more than $155 million.)

McGraw believes he has earned every promotion on merit alone. He says he never for a minute thought, "I've been here 25 years. I'm senior. It's my turn. It's my time. It's my thing." Instead he said to himself, "Wait a minute—no, no, no, no. Be careful now. That's an entitlement feeling, and entitlement isn't part of the vocabulary … Everything has to be about performance."

IN THE SUMMER OF 2007, McGraw first expressed publicly the idea that S&P, a division he ran for around four years, needed fixing. The signs of impending trouble were clear to S&P's rank and file long before that. In the fall of 2006, S&P's own structured-finance specialists were concerned by the uptick in defaults on both subprime and so-called Alt-A mortgages—the very same mortgages that were the underlying assets for many of the securities that S&P had rated AAA. According to the Boca Raton Firefighters and Police Pension Fund lawsuit, E. Christopher Meyer, an associate director in S&P's Global CDO Group, wrote in an e-mail to a colleague on the evening of Dec. 15,2006, "Ratings agencies continue to create [an] even bigger monster—the CDO market. Let's hope we are ail wealthy and retired by the time this house of cards falters." He then used an ernoticon signifying a wink and a smile.

One lawsuit alleges that in the first months of 2008, S&P employees "were shredding things like every five seconds."

By April 2007 gallows humor had become the order of the day, according to the Boca lawsuit and a congressional hearing into the ratings agency. Notable is one text-message exchange between two analysts, Rahul Dilip Shah and Shannon Mooney. "Btw, that deal is ridiculous," Shah wrote Mooney in a text.

"I know, right … model definitely] does not capture half the risk," she replied.

"We should not be rating it," Shah answered.

"We rate every deal," Mooney replied. "It could be structured by cows and we would rate it."

S&P went from McGraw-Hill's cash cow to a major problem in June 2007, with the announcement that two Bear Stearns hedge funds, which had invested heavily in mortgage-backed securities, were performing poorly. In response S&P announced the first in a series of ratings downgrades on July 10—in this case on 498 residential mortgage-backed securities totaling $5 billion. The downgrades would continue off and on for the next eight months, and they became known as "express-train downgrades" for how rapidly they occurred.

Inside S&P, tempers were flaring. State attorneys general, including Ohio's Marc Dann, were portraying the once-venerable ratings agencies as aiding and abetting fraud. Matters came to a head on Aug. 31, when McGraw abruptly fired Kathleen Corbet, S&P's president, and dressed up the announcement with the usual corporate jargon, saying she had left "to pursue other opportunities." Deven Sharma replaced her.

"She has two young teenage boys, and she decided she was going to transition and take care of the boys" is the way Sharma described Corbet's decision in a recent interview with Fortune. Reached at her home, Corbet declined to comment,

As Sharma, a former Booz Allen management consultant, initiated a five-month study to reform S&P, New York State attorney general Andrew Cuomo subpoenaed documents from S&P as part of a broader investigation into the mortgage market. From Sharma's study came the announcement, on Feb. 7, 2008, that S&P had voluntarily agreed to implement a series of 27 measures designed "to further strengthen our ratings operations and better serve capital markets around the world."

Left out of Sharrna's press release was any mention of allegations, later made.in the Boca Raton complaint, that in the first months of 2008, S&P employees "were shredding things like every five seconds," and that an outside shredding vendor had been hired to help process the huge volume of paper that executives in the residential mortgage-backed securities ratings department wanted destroyed.

A spokesman for McGraw-Hill responds, "The lawsuit is without

legal or factual merit, and our motion to dismiss is pending with the court."

Cuomo initially dismissed Sharma's initiatives as "window-dressing." Finally, on June 5, 2008, Cuomo reached a settlement with McGraw-Hill and S&P, which included what he called "landmark reforms." They required that, among other things, the ratings agencies be paid whether or not the ratings they assigned to a debt security were acceptable to the underwriter—i.e., no more negotiating for desired ratings—and that all information about a potential securitization be disclosed publicly. Although McGraw-Hill said it was "pleased" to work with Cuomo on the reforms, the company was not out of the woods.

On July 30, Connecticut attorney general Richard Blunienthal took his best shot—suing S&P, Moody s, and Fitch for giving better credit ratings to corporations than to municipalities and other public entities. The lower ratings forced issuers to either buy bond insurance to get a higher rating or pay a higher interest rate to investors to compensate them for the supposedly higher risk. Either way, the lower ratings cost Connecticut taxpayers.

A few weeks later the Teamsters piled on after their pension fund, which owns more than 10,000 shares of McGraw-Hill, became concerned that McGraw was peddling ratings for increased profits. In a letter dated Aug. 18, 2008, Maya Saxena, a Florida lawyer representing the Teamsters Allied Benefit Funds, claimed that the officers and directors "encouraged employees to issue false ratings on securities in order to satisfy Wall Street expectations." She further claimed that the board members "breached their fiduciary duties" by failing to supervise and monitor the "adequacy" of internal controls and allowing "misleading statements and filings" to be disseminated. Saxena demanded that the board investigate and "bring forward all appropriate legal action" against anyone "found to have committed or participated in the wrongdoing."

Asked whether it is fair to criticize S&P for its role in the credit crisis, McGraw says, "It's a yes and no on that one."

Six weeks later Floyd Abrams, the noted First Amendment attorney and a longtime partner at Cahill Gordon, responded to Saxena, informing her that the McGraw-Hill board had "undertaken a review" of the matters described in her letter. Following that review, Abrams wrote, the board determined not to pursue any legal action against any of the company's officers or directors and found that Saxena's letter "provides no basis … to accede to your demands."

The Teamsters disagreed with Abrams, and on. fan. 8 the pension fund sued as individuals Terry McGraw and his father, former CEO Harold McGraw Jr., plus the McGraw-Hill board of directors, in U.S. District Court in New York City. The suit alleged that the McGraws and the rest of the board had "sold the Company's integrity for a steady and increasing stream of fees on these transactions." (Harold McGraw Jr. was subsequently dropped as a defendant in the lawsuit because of his advanced age of 91.)

The complaint also quoted Richard Gugliada, another former S&P managing director, as saying that S&P was involved in a "market share war where criteria were relaxed" but that McGraw-Hill management "mandated" that S&P executives "find a way to issue positive" ratings.

"I knew it was wrong at the time," the complaint quotes Gugliada as saying. "It was either that or skip the business. That wasn't my mandate. My mandate was to find a way. Find the way." (Reached at his home on Staten Island, Gugliada declined to be interviewed.)

The case is still pending. During the company's Jan. 27 earnings call, Terry McGraw labeled the Teamsters' suit as "totally without merit"; he told *Fortune* that his lawyers have told him "the risk is very low" and "nobody likes to get sued;' but "we'll get through it." Cahill Gordon filed a motion to dismiss the case on March 27.

WARRENBUFFETT ONCE OBSERVED, "It takes 2o years to build a reputation and five minutes to lose it. If you think about that, you will do things differently." The challenge now for Terry McGraw is rebuilding his company's reputation. Although McGraw-Hill declined to make its new S&P ombudsman, Roy Groves, available for an interview, Steven Weiss, a spokesman for the company, emphasized repeatedly that the voluntary reforms that S&P has implementedjncluding the appointment of Groves, are all part of a concerted effort to begin to ensure the highest standards, quality, and transparency at S&P.

Asked whether it is fair to criticize McGraw-Hill for its role in the credit crisis, McGraw says, "It's a yes and no on that one." He believes it is fair to criticize the methodology S&P used when rating CDOs, but he believes it a stretch to say, "Well, your assumptions didn't work, so you're cornplicit or you're incompetent... That's a little over the top."

Despite McGraw's best efforts to appear to be responding to McGraw-Hill's role in the financial crisis, the hits just keep on coming. In an April 6 letter to Fed chairman Ben Bernanke, Connecticut's Richard Blumenthal urged Bernanke to "reassess and revamp" a policy that would reward S&P for rating securities issued in the future under the umbrella of the Fed's Term Asset-Backed Securities Loan Facility, known as TALF. "The policy handsomely rewards failure," Blumenthal wrote. "Indeed, it enables [S&P, Moody's, and Fitch] to profit from their own self-enriching malfeasance."

Clearly the time has come for Terry McGraw and the other CEOs who had a hand in causing this financial crisis to restore credibility to the capital markets. And that may require a little more of an overhaul than changing a few business practices and appointing an ombudsman. It may require no longer negotiating ratings with the underwriters who have traditionally paid S&P's fees. D

FEEDBACK *forlunemail_letters@fortunemail.com*

COHAN, William D. Rating McGraw-Hill. **Fortune**, Amsterdan, n. 9, p. 66-72, May 18. 2009.