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CREDIT DETERIORATION

Companies in Europe Feel the Pinch

There has been a downward rating migration both for publicly rated credits and private estimates

(Editor's note: Since this article was published, we have updated our data to year-end 2008 and our new figures show a similar downward rating migration. At the end of 2008, Triple-C credits comprised 5.2% of our combined publicly rated and credit estimate portfolios, compared to 1.7% at the end of 2007. We will be publishing a 12-month to year-end 2008 default rate shortly as well as an update to our covenant breach data.)

Credit conditions are deteriorating for leveraged companies in Europe. There has been a downward rating migration both for our publicly rated credits and our portfolio of credit estimates (CEs) during 2008. Triple-C credits have grown to 5.2% of our private portfolio in mid-November from 1.6% at the end of 2007. For our publicly rated companies in Europe, Middle East, and Africa (EMEA), credits within 'CCC' categories now comprise 8.8% of our publicly rated speculative-grade industrial ratings in Europe, compared with 3.3% at year-end 2007.

At the end of last year and into the first half of 2008, fundamental operating conditions for highly leveraged companies remained relatively benign, which has been borne out in a low private loan 12-month default rate (1.55%) to June 2008. This is reflected in our study on performance of leveraged buyouts (LBOs), which has shown that on average, companies experienced on-track performance relative to forecast for the end of 2007 and into the first half of 2008. But the second half of 2008 is likely to tell a different story.

Standard & Poor's Ratings Services has already seen defaults accelerating in our private portfolio of credits during the second half of 2008, which will be reflected in our 2008 year-end default rate. We have also seen an increase in covenant breaches. For the 12 months to Oct. 30, 2008, we found there were 38 covenant breaches, waiver requests, or related

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RECOVERY RATINGS

Leveraged Losses Could Reach €20bn

Aggregate losses depend on the number of defaults among companies rated 'B-' or lower

(Editor's note: Since this article was originally published, there have been two further defaults within this portfolio, one of which is that of LyondellBasell Industries AF SCA (SD/--/--), accounting for about €17 billion of rated debt. At the time of the original publication, the issuer was rated 'B-' and the debt was categorised on that basis. Further, there have been a number of other downgrades, including M-Real (CCC+/Neg/--) and Ineos (CCC/Neg), which comprise two of the larger exposures in the portfolio.)

Aggregate losses of up to €20 billion are possible for investors in high-yield companies publicly rated at 'B-' or lower, following a slew of recent rating downgrades. The actual level of losses that crystallizes depends, however, on the number of defaults among the 23 publicly rated companies. Taking into account both the probability of default and the recovery prospects, losses over a two-year period could total €4.2 billion, assuming that, on average, about six of these companies might default. Losses could be substantially higher, however. This could come about if default rates prove to be above average due to the severity of the recession or if defaults are skewed toward the

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EDITORIAL

Defaults, Recoveries Take Center Stage

Leveraged finance market focus has shifted from new deals to defaults and prospective recoveries

"In uncertain times like these, credit benchmarks could help provide needed transparency to restructured transactions."

The global recession and credit crisis has closed the European leveraged finance new issuance market and turned investors' focus to troubled companies and potential defaults. In light of these difficult times, we have prepared a double issue of Leverage Matters, bringing together research not only about indicators of distress in the market but helpful guidance on private ratings and insight into what our recovery ratings may indicate for expected loss during the down cycle.

The current slump is the first time that the leveraged buy-out (LBO) market will be tested after record growth from 2003 to 2007 changed the face of private equity lending in Europe. In "Companies Feel the Pinch," we review the rating migration downward in our portfolio of 703 corporate credit estimates and publish preliminary results of our LBO study, which has tracked performance relative to original forecast for a sample of companies. In the second half of 2008, fundamental difficulties in operating environment have hit companies and resulted in covenant breaches, requests for waivers or defaults, outlined in "Covenant Difficulties Double."

In "Defaults Accelerate in Study," we release another instalment of S&P's European Leveraged Loan Default and Recovery Study. This is the fourth annual consortium report and continues to show strong recoveries following a typically skewed distribution, with more than half recovering more than 90%. Data from this consortium will become increasingly important as it sheds light on actual recoveries for companies defaulting in 2008 and 2009, a real test of debt structuring in Europe.

Market Wakes up to Recovery and Expected Loss

S&P has been stressing the importance of recovery analysis since 2004, and we believe the benefits of this type of analysis will become apparent as defaults rise. We last published a European 12-month default rate in June 2008 of 1.55%. When we publish a default rate for the year ending December 2008, we believe the number of defaults is likely to have at least doubled. The 12-month forecast published in September 2008 for the US speculative default rate is 7.6%.

In light of the expectation of a dramatic increase in defaults, we have given investors an indication of loans and bonds at risk for our publicly-rated portfolio of credits below 'B-' in "Leveraged Losses Could Reach €20bn," equivalent to about 50% of outstanding debt. This approach to evaluating a portfolio of assets highlights the difference in potential losses on subordinated and senior secured debt as well as the difference from company to company. Along the same vein, this issue of Leverage Matters contains the articles "High Recoveries for Telecom Sector" and "Forest Sector Favorable for Unsecured," which highlight the similarities and differences in recoveries between companies within specific sectors. We have also highlighted that recovery prospects are frequently independent of changes in the probability of default for speculative-grade companies in "As Credit Quality Declines, What Happens to Recoveries?" This article shows that eighty percent of all S&P corporate credit rating actions for speculative-grade companies in the past six months did not lead to any recovery rating change.

Frequently Asked Questions

Although the new issue market is stagnant for now, we continue to prepare for a future turnaround and a much changed post-downturn market. As of December 1, 2008, we implemented a new policy on the type of rating support we will be providing for the European market. In "New Private Loan Ratings Clarified," we set out to answer some of the specific questions investors, arrangers and private equity sponsors have had around our new policy.

The overriding objective of this initiative is to improve the quality and depth of ratings support for leveraged loans that are marketed to institutional investors and banks. In uncertain times like these, credit benchmarks could help provide needed transparency to restructured transactions as the European leveraged finance market struggles through its first cyclical downturn.

Taron E. Wade

Taron Wade

IN-DEPTH LOOK

Corporate Ratings Versus Recoveries

As credit quality declines, what happens to recovery prospects?

"Recovery prospects are frequently independent of changes in the probability of default for speculative-grade companies."

Over the past six months Standard & Poor's corporate credit rating actions for speculative-grade companies saw no change in recovery ratings in 80% of cases, highlighting that recovery prospects are frequently independent of changes in the probability of default for speculative-grade companies.

Many of the credit rating actions related to deteriorating business conditions, and in some cases from structural changes. Where restructuring takes place and proves effective, the company's stabilized financial position can lead to an improvement in issuer creditworthiness. However, if it fails, such changes can be detrimental for recovery prospects. Therefore, it is important for lenders to assess the effect of restructurings for both probabilities of default and recovery prospects for specific debt instruments.

Mapping Of Rating Actions

We studied rating actions on about 150 publicly rated speculative-grade industrial companies in EMEA.

About 80% of the issue rating actions are triggered by changes in long-term corporate credit ratings, leading to similar changes in issue ratings, whereas recovery ratings often do not change. About 20% are triggered by recovery rating changes, reflecting a change in recovery prospects for particular debt instruments.

Rating actions in this group came from 37 companies, representing about 25% of the European recovery portfolio. Most of the rating actions were downgrades, representing about 71% and 77% of the changes in long-term corporate and issue ratings, respectively and were +/-1 notch (75%) or +/-2 notches (21%).

Different Types Of Rating Actions

(i) Declining corporate ratings with no changes to recovery ratings

This is the most common situation (80% of actions), where for recovery purposes we focus particularly on the underlying businesses or financial issues triggering the corporate credit rating revision. Often, we don't change our key recovery assumptions materially for operating performance, stressed valuation, and waterfall if our hypothetical path to default still represents the most likely scenario and no material changes have occurred in terms of capital structure, collateral package, and key terms of documentation

However, we may revise our recovery analysis as a result of a material change in key risks and, therefore, the most likely default scenario. Codere S.A. (B+/Watch Neg/--) is a good example, where we revised our path to default following a material change in its key business risks. This change had no effect in terms of recovery range for senior unsecured creditors.

(ii) Recovery rating changes, with changes in corporate credit rating affecting valuations

This scenario represents 5% of rating actions. Here, the recovery approach to potential corporate rating changes is based on changes in business and financial issues, along with potential implications for collateral assessment, stressed valuation, and revised waterfall assumptions in terms of the expected outstanding amount at default and the priority ranking of the company's liabilities.

For example, the corporate credit rating on NXP B.V. (CCC/Negative) was lowered due to concerns over the group's cash flow generation capability and announcement of a massive restructuring program. At the same time, the recovery rating on the senior secured notes was lowered following the assumed increased leakage in the security package and a lower valuation of the group and collateral package at our hypothetical default.

(iii) Change in recovery ratings due to capital structure, security, or documentation changes

The third scenario represents 15% of rating actions. During surveillance, we review our recovery assumptions according to potential changes in corporate ratings and outlooks, but also as a result of additional credit or structural changes that potentially affect key recovery aspects such as lenders' control, liquidity, or capital structure.

As seen with Virgin Media Inc. (B+/Positive/--), most of the structural changes can lead to bifurcated implications for corporate credit and recovery ratings, as positive rating drivers in terms of issuer creditworthiness might negatively affect recovery assumptions. In a recent amendment to the senior facility, the group obtained agreement to roll the 2009-2011 bank amortization payments to June 2012 and loosen covenants in return for a 20% repayment of the outstanding term loan A

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This is an abridged version of "As Credit Quality Declines, What Happens To Recovery Prospects," published on Jan. 21, 2009, available on Ratings Direct, www.ratingsdirect.com, Standard & Poor's web-based credit ratings and research information service.

CREDIT FAQ

New Private Loan Ratings Clarified

Practical application of our new procedures for leveraged finance ratings in Europe

"The methodology and analytical process employed in determining a private loan rating is identical to that supporting a public rating."

In July 2008, Standard & Poor's Ratings Services announced new procedures relating to the provision of ratings in the European leveraged finance market. As of Dec. 1, 2008, this framework is now in place for newly underwritten transactions where total debt (funded and unfunded) is greater than €500 million.

To recap, the main changes in our approach to ratings for this market are that:

- Only public ratings will be offered for those transactions with total debt facilities of more than €1 billion;
- For transactions where total debt facilities are less than €1 billion, at the request of the company we will provide public or private ratings, including loan and recovery ratings, on any associated debt instruments; and
- Credit estimates will be restricted to new transactions where total debt facilities are less than €500 million.

What is a private loan rating?

The analysis and output of private ratings is the same as that of public ratings. The crucial difference is that private ratings will not be disclosed publicly or on RatingsDirect. These ratings will only be provided to the private lender group.

As with a public rating, we would be engaged by the borrower to undertake private loan ratings. In terms of scope, we will provide a corporate credit rating, as well as loan and recovery ratings on the supporting debt instruments. The methodology and analytical process employed in determining a private loan rating is identical to that supporting a public rating. We meet with management prior to holding a committee to assign the relevant ratings. Research reports will be produced in the same way as for public ratings, the only difference being that there should be less sensitivity to the private information disclosed in those reports. Surveillance will be ongoing.

Why is Standard & Poor's offering to provide private ratings?

The overriding objective of this initiative is to improve the quality and depth of ratings support for leveraged loans that are marketed to institutional investors. Our initial proposal centered on the provision of public loan and recovery ratings. However, following extensive market consultation last year, it became clear that the option of private ratings for mid-market transactions would address certain key concerns. These concerns included the potential impact of public disclosure of the ratings on the private equity business model, as well as the more widely shared concern that the provision of public ratings could lead to a reduction in the quantity and quality of information provided to the lender group.

What is the difference between a confidential rating and a private rating?

A confidential rating is a full interactive, issuer-specific rating. When a company engages Standard & Poor's to assign a corporate credit rating, it is at its discretion if it decides to maintain it confidentially. Under such circumstances, the rating is not disclosed to the market until the company decides to publish it, usually to support a capital or debt market funding exercise. At that point, public issue and recovery ratings (if appropriate) are also assigned.

Private loan ratings, by contrast, support syndication of purely loan-funded transactions in the European leveraged loan market and are issuer-, issue-, and recovery-specific.

How will Standard & Poor's approach situations where existing unrated transactions are refinanced or upsized?

We intend to assess each transaction individually, recognizing that it will be difficult to envisage all potential situations.

Where a transaction is refinanced and/or upsized above €500 million, and the ownership structure has not changed and a credit estimate has been provided in the past, we will continue to provide a credit estimate if a rating is not requested to support the refinancing. (Acquisitions could be accommodated under this arrangement as long as the additional debt was not more than €500 million.) This would reflect the probability that most of the lender group would recommit or upsize their existing commitments.

When refinancing occurs as a result of a change of ownership, we will treat it as a new transaction.

Are there circumstances in which Standard & Poor's would not be able to provide a private loan rating opinion or, for deals under €500 million total debt, a credit estimate?

In addition to newly underwritten transactions where the total debt exceeds €1 billion, we will not offer private loan ratings where the borrower is issuing in public markets.

Specifically, this refers to transactions where an issuer seeks to distribute loan tranches to institutional investors in the U.S. or where there is a speculative-grade bond component in the capital structure.

Where the quantum of debt is less than €500 million, there may be certain situations where we will not provide a credit estimate. One of these situations arises when a public or private rating is withdrawn.

Restrictions are also invoked when a credit estimate request is made for an unrated entity that is part of a rated group. On such occasions, we will require authorisation from our rated client, without which we will not proceed.

Finally, in situations where a credit estimate is requested to support synthetic transactions and the analysis can only be undertaken based on private information, then sufficient private information will need to be provided both upfront and on an ongoing basis.

How will private ratings and associated research be distributed to the lender group?

By contractual agreement with the borrower, ratings letters and associated research reports will be channeled through the facility agent or, where appropriate, published directly through a private third-party document exchange such as IntraLinks. Publication needs to be on a timely basis and provided simultaneously to all lenders, subject to compliance with our standard procedures. This includes providing notice to the borrower in the same way as would occur for public ratings.

Why has Standard & Poor's selected a threshold of €1 billion of total debt (funded and unfunded), above which only public ratings will be offered?

There is general agreement in the European leveraged finance market that even in more normal market conditions than exist in the current climate, transactions above €1 billion have to be syndicated very broadly; participants require liquidity in the secondary market and the ability to hedge in any instruments that may be available (including loan credit default swaps). We believe that the number of deals of this size will be limited and that these transactions are essentially public in nature.

What information will Standard & Poor's require, both upfront and ongoing, in relation to the initial private ratings and ongoing surveillance?

A key guiding principle is that there should be a level playing field with respect to the provision of information. Consequently, our expectation is that Standard & Poor's will have access to the same information, at the same time, as that provided to participant banks and institutional investors as part of our credit assessment and that this will include full details of the security package and loan and intercreditor agreements.

However, while certain information may only be available initially in draft form, or may become available at a later stage in syndication, we do not anticipate that precluding us from providing preliminary ratings on a timely basis.

Will Standard & Poor's require all debt instruments in the capital structure to be rated?

As announced in July 2008, for new clients from Dec. 1, 2008, we will be assigning loan and recovery ratings to all debt instruments issued by the rated entity. The benefit of providing post-default recovery prospects for the various instruments in the capital structure eliminates the need to second guess or infer what the unpublished recovery ratings might be.

How early can Standard & Poor's be engaged in a transaction in order to achieve a viable early-stage rating opinion?

Where there is a ratings requirement for an early-stage rating opinion, for instance in a takeover situation, then it is important to engage with us as soon as is practicable. This is something we encourage and there are various types of ratings assessment that can be undertaken to ease the process, depending on the quality of the information provided and the degree of ratings certainty required.

Will Standard & Poor's grandfather existing transactions where credit estimates are provided?

We are not changing the framework that will apply to unrated obligors that currently benefit from the provision of credit estimates. These estimates will continue to be updated on a periodic basis. However, that is not to say that certain existing issuers may not benefit from requesting public or private ratings, to obtain a clear view of recovery prospects for their senior and mezzanine debt, for instance; or to provide lenders with greater clarity on the key drivers of rating changes.

Why will loan and recovery ratings be required for new transactions if the collateralized loan obligation (CLO) market remains quiet?

Our view is that loan and recovery ratings can support the re-establishment of market activity by providing credit benchmarks when structuring and pricing new leveraged loan transactions. They can also help to attract new investors into the asset class by tracking the performance of these credits over time, much needed in the absence of more traditional leveraged loan market participants.

How will private loan ratings be treated in CLOs?

No differently to public ratings. CLO managers have the option to use asset-specific recovery ratings assigned to both public and private loan ratings.

Paul Watters, Paul Drake

INDUSTRY FOCUS

High Recoveries for Telecom Sector

The telecom sector is in a better position than during the previous cyclical downturn

"In our view, this sector will continue to suffer defaults caused by financial and operational problems; however, long-term demand for the companies' services will remain solid thus enhancing post-default valuations and recovery prospects."

During the previous downturn in early 2000, the telecom sector represented a clear example of inflated asset valuations, mainly as a result of overambitious growth expectations. The subsequent collapse in share prices and market valuations followed a period of aggressive acquisitions and led to very low market and restructuring multiples.

The sector today is substantially different; there are fewer network operators, particularly in cable, following a period of consolidation and restructuring. Although cash flow generation is generally adequate to strong, debt leverage is still quite significant, if lower than it was at its peak in early 2000. The improved financial profiles and cyclically defensive nature of the business place the telecom sector in a relatively better credit-risk position than at the start of the previous cyclical downturn, although attractive fixed-line operators are still vulnerable.

If a borrower defaults, secured lenders at EMEA telecom operators are likely to recover more than lenders can expect on average (and slightly more than the average recoveries historically reported). In our view, this sector will continue to suffer defaults caused by financial and operational problems; however, long-term demand for the companies' services will remain solid thus enhancing post-default valuations and recovery prospects.

Another reason is that the publicly rated issuers mainly represent leading operators in the target markets, which should improve their ability to retain value at default, for example, in terms of valuable asset networks, customer bases, and licenses. When we look at the subsector distribution, it becomes evident how lower-scale operators such as alternative networks, which represent only a small proportion of the publicly rated issuers, drag down overall numbers in terms of hypothetical valuations at default and recoveries.

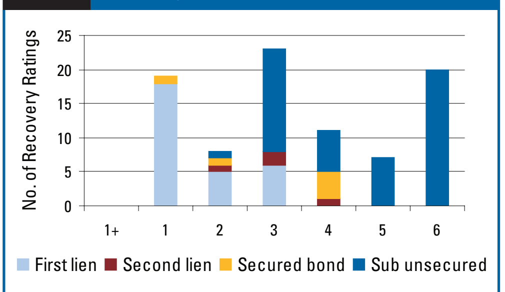
We also believe that the ongoing consolidation process within the sector has an important role in increasing retained value at default. Consolidation has ensured that fewer players remain, and they operate at a larger scale.

Finally, capital structures reveal another very important general consideration in assessing recoveries. Most rated issuance was structured before the highly aggressive borrower-friendly loan structures seen in the European leveraged finance market in 2006-2007, at the peak of the credit cycle. Some of the biggest publicly rated telecom names have strict covenant packages and ongoing deleveraging requirements due to significant debt amortizations. This is likely to support valuations (in terms of lower operating stress and better retained value at default) and recoveries at default.

Higher recovery expectations for senior secured lenders also benefit junior lien and unsecured noteholders. Second-lien lenders, in particular, benefit from a relatively small proportion of these debt tranches in the capital structure compared to the overall valuation, which is likely to support recoveries.

In Europe, Standard & Poor's rates an aggregate of €60.4 billion of secured and unsecured debt instruments issued by 23 telecom operators. The average recovery for first-lien facilities for these operators is about 75%, reflecting our expectation of substantial recovery in the event of a payment default. This is slightly higher than the average 64% recovery across our full portfolio of rated debt instruments from about 150 rated European companies. Recovery prospects for second-lien debt instruments in the telecom sector are about 50% (the average recoveries for second-lien instruments in our entire portfolio is 22%). We estimate an average recovery (that is, about 47%) for secured noteholders, and an average expected recovery for third-lien/unsecured debtholders of about 18% in the telecom sector. Unsecured ratings are highly sensitive to the proportion of priority debt in a borrower's capital structure and valuations assumptions. We see a clustering in the lowest recovery bucket of '5' and '6', indicative of a high proportion of priority liabilities ranking ahead.

Chart 1 Distribution of Recovery Ratings in the Telecom Sector



This is an abridged version of "Standard & Poor's Expects Recoveries For European Telecom Companies to Be Higher Than Average," published on Dec. 10, 2008, available on Ratings Direct, www.ratingsdirect.com, Standard & Poor's web-based credit ratings and research information service.

Carlo Castelli

LEVERAGED LOAN STUDY

Defaults Accelerate in Study

Historical recoveries may be higher than those in the future

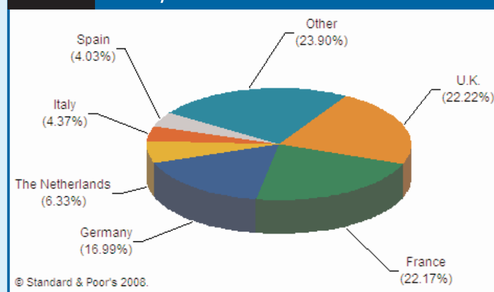
"Recoveries of defaults in the aggregate portfolio were very strong and follow a skewed distribution typical of recoveries, with more than half recovering more than 90%."

Standard & Poor's Ratings Services has completed its latest "European Leveraged Loan Default And Recovery Study." This is the fourth annual study, with analysis up to the end of 2007. With an increase in the number of data providers, the size of the portfolio of transactions is contributing to an increasingly robust report. However, with the backdrop of the liquidity crunch and in particular the banking crisis, we emphasize that the analysis in the report is historical in nature and reflects defaults and recoveries from a much more benign credit environment. Future recoveries may be lower.

Highlights of the report's findings include the following:

- The annual default rate in 2007 shows some acceleration to nearly 2.0% from 1.3% in 2006.
- The seven-year cumulative default rate for transactions in the aggregate leveraged loan portfolio was approximately 15%, which is slightly below the seven-year cumulative default rate for publicly rated 'BB-' corporate debt.
- Recoveries of defaults in the aggregate portfolio were very strong and follow a skewed distribution typical of recoveries, with more than half recovering more than 90%.
- Up until 2004 there was little, if any, empirical default and recovery data for European leveraged loans or data distinguishing between the recoveries of differently structured loan transactions. Since then, we have worked with 17 leading banks and investors active in leveraged finance in Europe to pool default and recovery data from their loan portfolios. Pooling data from individual lenders into an aggregate portfolio provides participating institutions with a much wider data set than they would otherwise have had based on their own individual loan portfolios. Our aim is to provide an independent, objective analysis of the historical risk performance of European leveraged loans and to quantify potential future performance.

Chart 1 Breakdown Of Total Transactions In Portfolio By Country



The consortium whose data we pool and analyze comprises Alcentra Ltd., Alliance & Leicester Commercial Bank PLC, Babson Capital, Bank of Scotland PLC, BayernLB, Calyon, DZ Bank AG, Fortis Bank (Nederland) N.V., GE Commercial Finance, Harbourmaster Capital Management Ltd., HSH Nordbank, KBC Bank NV, M&G Investment Management Ltd., Natixis, Royal Bank of Scotland, Société Générale, and WestLB AG.

Portfolio Analysis Parameters and Future Reporting

Scope of the study

The 2007 portfolio comprises European leveraged loan data originated or acquired in the 10-year period from Jan. 1, 1998 to Dec. 31, 2007. We observed defaults in the period from 2000-2007 and used the Basel II definition of default to determine defaulted transactions. Notably, this definition includes restructured leveraged loans and distressed sales of the loans.

The 2007 aggregate portfolio doubled in size to approximately 2,084 transactions (involving more than 13,573 related leveraged loan tranches). Of these, 82 transactions defaulted and reached resolution. While adding a significant number of new observations, the vast majority of conclusions and trends remain consistent with the ones we have reported previously.

In terms of jurisdiction, the U.K., Germany, and France account for more than 60% of the portfolio and most of the defaulted transactions (see chart 1). Nevertheless, there is an observable increase in transactions originated in the smaller European markets.

The sectors we analyzed included media and telecommunications, chemicals, manufacturing, services and leasing, food and beverage, and conglomerates. An analysis of default rates by sector shows volatility across all of them.

The report lists recovery by type of resolution, broken down into liquidation, restructuring, and instrument sale. Finally, we performed a correlation analysis between the credit environment, as measured by the default rate, and leveraged loan recoveries. Results from such an analysis help to quantify differences between recoveries in downturn periods and those in more benign credit periods.

The next report for the bank group is scheduled to be published in mid-2009 and will include leveraged loan portfolio data up to Dec. 31, 2008.

Audrey Whitfill

This is an abridged version of "New Results From European Leveraged Loan Study Show Slight Acceleration In Default Rate," published on Oct. 30, 2008, available on Ratings Direct, www.ratingsdirect.com, Standard & Poor's web-based credit ratings and research information service.

FINANCING PROBLEMS

Covenant Difficulties Double

As recession fears grow, companies are having a harder time complying with covenants

"Weaker operating performance has been the common theme for companies with covenant difficulties."

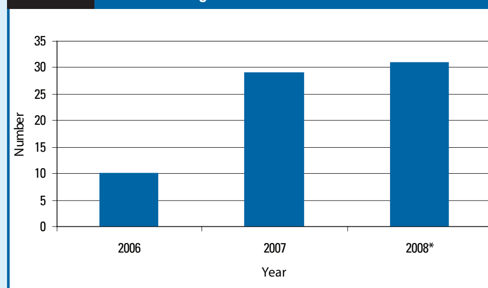
Covenant breaches, requests for waivers, and related restructurings of loans to highly-leveraged companies in Europe have accelerated over the past year, reflecting slowing economic growth and weaker operating performance. Standard & Poor's Ratings Services expects the financing difficulties being experienced by speculative-grade companies (that is, those rated 'BB+' or lower) to intensify as much of Europe enters into recession and private equity companies are no longer able to justify supporting portfolio companies with new equity.

Covenant breaches can be early warning signs that companies are experiencing difficulties. Financial covenants are included in loan documentation and provide minimum levels of cash flow coverage and interest coverage or maximum levels of leverage and capital expenditure. Failing to meet these conditions over a defined period can constitute a default, giving lenders the opportunity to reset lending terms, or in a worse-case scenario ask for their money back.

Standard & Poor's examined over 800 speculative-grade industrial companies in Europe, using publicly-available sources and information obtained through our public ratings process and our private credit estimate portfolio. Sponsor-related activity makes up about 90% of leveraged loan issuance on average, and therefore approximately 90% of companies examined. For the 12 months to Oct. 30, 2008, we found there were 38 covenant breaches, waiver requests, or related restructurings, compared with 18 in the previous 12 months--an increase of over 100% (see chart 1). In addition, the time from financing to experiencing problems with covenant tests has decreased dramatically in 2007 and 2008, compared with 2006 (see chart 2). The number of companies experiencing covenant difficulties within three years of their last financing has increased to 29 in 2007 and 23 in 2008 year-to-date, from four in 2006.

In total, there were 64 companies that we found experienced covenant problems during 2006, 2007, and so far in 2008. Of these, 48% were covenant breaches, 34% were waivers or covenant resets prior to an actual breach, 3% were equity cures to avoid breaches, and 14% were financial restructurings related to any of the previous.

Chart 1 Covenant Breaches, Waivers or Resets, and Related Restructurings 2006-2008



Weaker Operating Performance Driving Covenant Breaches

Weaker operating performance has been the common theme for companies with covenant difficulties. When private equity purchased portfolio companies during the boom years many predicted aggressive and steady EBITDA growth rates, which helped to justify high purchase multiples. But we understand that the turbulence in the economic environment since the liquidity crunch began in mid-2007 has made meeting these projections very difficult for many companies, particularly those operating in sectors dependent on consumer demand or in highly cyclical or seasonal businesses.

Rising raw material prices - such as oil, grain, or steel - affected many companies included in our study during 2007 and most of 2008. In a large number of cases, rising costs damaged liquidity positions as the need for working capital increased. Vulnerable companies, if un-hedged, may now be aided by the fact that raw material prices are declining again. However, in our view, a drop in demand due to the worsening economic environment may cancel out any cost savings.

Separately, we have observed problems in the gaming and leisure sector (9% of our sample). These problems have developed from specific regulatory risks for this industry, independent from the cyclical downturn. Most of the companies in this category were hit by a drop in demand due to the smoking ban in the U.K., which affected their earnings growth.

Many Sectors Affected, Particularly Cyclical Businesses

The companies with covenant problems identified in our survey operate in a variety of sectors--26 industries in all. Some of the sectors typically considered to be cyclical were present as expected, such as retail (9%), construction (5%), autos (9%), chemicals (8%), containers or packaging (6%), food industries (9%), and

This is an abridged version of "Loan Breaches By Highly Leveraged European Companies Double As Recession Fears Grow," published on Nov 12, 2008 available on Ratings Direct, www.ratingsdirect.com, Standard & Poor's web-based credit ratings and research information service.

home furnishings (5%). Other cyclical sectors--some represented by only one company--include industrial equipment, insurance, metals and mining, and oil and gas.

These concentrations are generally higher than the sectors' respective share of total issuance in the European market as a whole, indicating that covenant problems are not necessarily correlated to high debt issuance levels. For example, in the 12 months to June 2007, retail comprised only 6.7% of the new-issue market while chemicals made up 4.1%, according to Standard & Poor's Leveraged Commentary and Data (LCD).

Surprisingly, telecommunications, which typically is considered a defensive sector, represented 5% of the companies experiencing trouble, indicating the range of industries with difficulties. Other sectors usually considered to be stable, such as electrics, consumer non-durables, cable, and beverage and tobacco were also present in the group of companies with covenant problems.

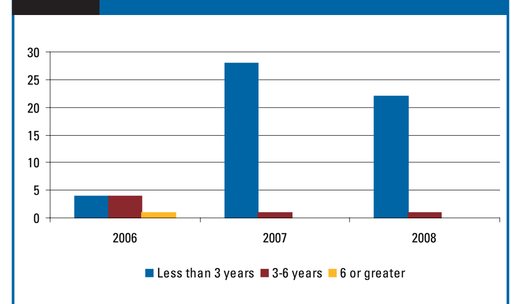
Increase in Private Equity Cash Injections In 2008

Cash injections by private equity appear to be rising. During 2008, the number of transactions where private equity owners injected new equity in response to a breach, covenant waiver, or reset increased to 11 out of 24 deals, or 46%. This was up from 33% of deals where financial sponsors made a new equity contribution in 2007, and 20% in 2006.

Financial sponsors may be injecting new equity in order to buy time while raising funds. In some cases, they might still see value in a particular business, or they may be waiting to see how difficult market conditions might get. Also, in the past we understand that banks were likely to have been more lenient and agreed to waivers or resets without asking for equity. In the future, if sponsors have already taken equity out of a company through a dividend recapitalization and have made a return on their original equity, they may be less likely to put new funds to work, particularly if they see no potential for future returns.

Surprisingly, of the companies examined by Standard & Poor's that experienced difficulties over the last three years, only two had been through a recapitalization (3%). This could be because those companies that were able to recapitalize their debt structures were typically stronger financially, and so were at less risk of a breach. However, since a recapitalization usually results in a much more highly leveraged structure, these newly recapitalized companies may now be more likely to experience covenant breaches than before the recapitalization. Furthermore, there has been no lack in overall recapitalizations in the past few years. In 2006 and 2007, these transactions made up 21% and

Chart 2 Time Elapsed to Covenant Problems 2006-2008



17% of newly syndicated transactions, respectively, according to LCD.

Many in the private equity industry argue that reputational risk will encourage financial sponsors to continue to support portfolio companies, otherwise it may be difficult for them to raise funds in the future. On the other hand, firms also tend to protect their limited partners and ensure equity upside when investing and consider the opportunity cost of supporting an impaired business. From the data available we have identified no clear trends to explain specific transactions where sponsors have supported transactions in breach of covenants versus those where new money has not been forthcoming. There are a few observations that can be made, however. Of those five sponsors that appeared more than once in the dataset (the maximum time any one firm appeared was twice), only one consistently contributed equity when their portfolio companies were struggling. The other four supported one company with equity and not the other, which could reflect that funding with new equity is highly company-specific. Also, the types of financial sponsors that made equity contributions versus those that did not were mixed, meaning high profile, large firms appeared in both categories.

Conditions May Get Worse Before They Get Better

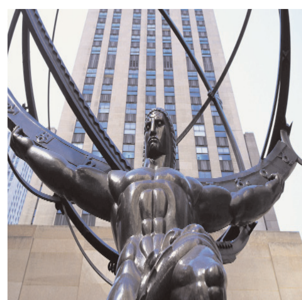
The most recent data revisions from European statistical offices confirm that the Eurozone experienced negative GDP growth in the second quarter of 2008, with France, Germany, and Italy all reporting a decline in output. This retrenchment appears to have spilled over to the third quarter. In our view, the downturn in the spring was mainly caused by weak consumer demand, as higher inflation and a deceleration in employment growth put a squeeze on household purchasing power. Now slack demand and a tightening in corporate liquidity are further undermining business confidence. (For more details, see article titled "European Economic Forecast: Europe Tips Into Recession As Corporates Scale Back Their Investment," published Oct. 22, 2008, on RatingsDirect, the real-time Web-based source for Standard &

Continued on page 16

STANDARD & POOR'S LEVERAGED COMMENTARY & DATA (LCD)

Signs of Stress Come into Sharp Focus

Small cracks in investors' portfolios have now turned into large crevasses



"To keep leverage low, brand-new investments required a much larger commitment from the private equity firms."

The first full year of the current credit crunch comes to an end on a sombre note. 2008 has shown a sharp rise in defaults and restructurings in Europe versus prior years. At the same time, the ratings profile of the current pool of outstanding credit has deteriorated, as the share of issuers rated in the CCC/CC range in the S&P European Leveraged Loan Index (ELLI) more than quintupled, from 0.22% to 1.25%. As the average bid of ELLI slid from 95.03 to 59.11 over the course of the year, investors' portfolios have lost a total of 30.0%.

Volume at Five-Year Low

Against this grim backdrop, it comes as no surprise that European leveraged loan new-issue volume plummeted in 2008 to a five-year low of €53.6 billion, a 68% drop from the record high €165.5 billion seen in 2007. In fact, this is only the second time since LCD started tracking the European leveraged loan market in 1998 that new issuance has declined year-on-year. The first time was in 2002, when volume dropped by 44% to €41.2 billion, from €74 billion in 2001. Unlike the current lack of issuance, the 2002 drop resulted from the disappearance of the telecom capital expenditure financings, which dominated syndicated lending in Europe up to that point.

The LBO market saw a similar drastic decline in 2008, as volume stood at €48.6 billion, 65% lower than the €140 billion all-time high seen last year. The current LBO loan volume is the lowest reading in four years, behind €44.4 billion in 2004. In addition, it represents the first time on record that sponsored new issuance has declined year-on-year. Even the post-telecom bubble did not lead to a decline in LBO activity, as the telecom expansion deals of late 1990's and early 2000's did not fall under the LBO umbrella. As a result, their disappearance did not cause LBO loan volume to shrink in 2002. Instead, it rose by 15% to €28.4 billion, from €24.7 billion in 2001.

Institutional Investors Retreat; Spreads Reach All-Time High

The absence of institutional appetite, combined with the overall resistance to aggressively leveraged deals contributed to the market's movement away from large deals. During 2008, only 25% of primary allocations went to institutional investors, down from 56% in 2007, an all-time high. Institutional investors' share grew steadily from 20% in 2003 to 40% in 2005, before reaching the record-setting level in 2007.

TLB and TLC facilities that did launch in 2008 carried much higher spreads in order to have any chance at syndicating amid the rocky market conditions. The average weighted average institutional spread (WAIS) reached a record high of E+337 during the year, a 72 bps increase on the 2007 level of E+265. The average pro rata spread also rose, to E+252, surpassing E+208 seen in 2007 by 44 bps.

LBO loans followed the same trend, with the average WAIS increasing to E+335 in 2008, 73 bps higher than the 2007 level. At the same time, the average pro rata spread reached the same level as that of the overall leveraged loan market, also 44 bps higher than the 2007 reading.

Milder Leverage and Bigger Buyout Contributions

On the risk side of the risk/reward spectrum, the average total debt/EBITDA ratio of leveraged loans launched in 2008 decreased to a four-year low of 5.1x, down from a record-setting 5.9x in 2007 (based upon pro forma financials).

To keep leverage low, brand-new investments required a much larger commitment from the private equity firms. Although purchase price multiples remained at 9.7x in 2008, the same as in 2007, the equity contribution increased to an all-time high of 44.7%, up from 33.6% last year. In addition, the 2008 level is significantly higher than the previous record of 38.6%, set in 2002.

In addition to new equity investments, some of sponsors' portfolio companies have been underperforming under the burden of heavy debt and the global recession, skirting very close to financial covenants. As a result, some sponsors had to make additional investments into the businesses to either cure a covenant breach or pre-empt future trading difficulties. Moreover, most issuers that asked for covenant relief in 2008 also received an equity injection from the private equity owners. Based on LCD news reports, 14 out of the 22 companies that requested a covenant waiver in 2008 received an equity injection.

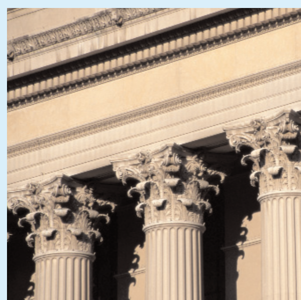
Today's super-cautious lenders expect to see a lot more cash from the private equity sponsors. In fact, 31% of buyouts tracked by LCD in 2008 had an equity contribution of 50% or greater.

Marina Lukatsky

RECOVERY RATINGS

Forest Sector Favorable for Unsecured

European forest product sector's debt structures support above average recovery for unsecured



"Sub-investment grade issuers in the forest products sector operate in jurisdictions that are relatively favorable for creditors."

Recovery prospects for debt issued by non-investment grade companies in the European forest products sector are in the middle of the recovery scale range reflecting the fact that most issuers with recovery ratings have unsecured capital structures. However, compared with our entire portfolio of companies with recovery ratings in Europe, these companies have better-than-average recovery ratings on unsecured debt.

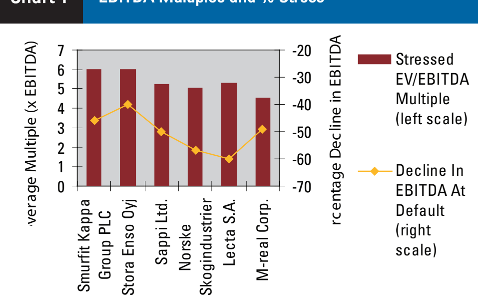
Forest Products Includes Fallen Angels

Of the nine companies in the European forest products sector that we rate, six are subinvestment grade and have recovery ratings. Of these, three have been downgraded to subinvestment grade in the past three years. Four of the six with recovery ratings are rated in the 'BB' category, at the high end of the subinvestment grade rating range.

Four of the six companies with recovery ratings, namely Stora Enso Oyj (BB+/Stable/B), Sappi Ltd. (BB/Negative/B), Norske Skogindustrier ASA (BB-/Negative/B), and M-real Corp. (B-/Negative/B), issued all or part of their debt when they were rated at investment-grade level. The capital structures of these issuers are dominated by unsecured debt, which, in an event of default, would get enough value flowing through to support an average recovery rating of '3.25'. This reflects our estimate of average (30%-50%) recovery prospects for unsecured debtholders. This estimated recovery level is relatively high for unsecured debtholders, and compares with an average recovery rating of '4.2' (or modest 10%-30% recovery) for unsecured debt across the European recovery rating portfolio. This is because these companies have limited secured or other senior debt ranking ahead of rated unsecured issues, unlike unsecured debt in a typical leveraged buyout structure, in which recovery prospects are impaired by a high proportion of secured debt in the issuer's capital structure.

In the forest product sector, the "average" recovery prospects estimated for the unsecured debt of issuers with mostly unsecured structures are dramatically better than the estimated "negligible" recovery (0%-10%; average recovery rating '6') for unsecured lenders to issuers with capital structures weighted more heavily toward secured debt.

Chart 1 EBITDA Multiples and % Stress



Documentation Relatively Loose

Because most issuers in the sector have "corporate"-type capital structures dominated by unsecured debt, the documentation is relatively loose compared with the typical documentation drafted for highly leveraged buyout transactions. This is typical for bonds, which traditionally have no maintenance financial covenants. A typical suite of nonfinancial covenants includes limitations on liens, asset sales, and mergers, but lacks restrictions on dividends and other payments to shareholders. The bond documentation of Smurfit Kappa Group PLC (BB/Stable/--) and Lecta S.A. (B+/Stable/B) features much tighter documentation, including financial covenants on incurring additional debt and more detailed suites of nonfinancial limitations.

Insolvency Regimes Favorable for Investors

Subinvestment grade issuers in the forest products sector operate in jurisdictions that are relatively favorable for creditors. Most of their centers of main interests (COMIs) are located in the group of countries that we classify as "Group A1" countries. Lecta is the only exception, with its COMI in Spain and operations spread between Spain, Italy, and France, all of which we consider relatively creditor-unfriendly and classify as "Group B" countries. Due to the geographic diversity of the issuers that we rate, we see the possibility of multijurisdictional proceedings in the event of insolvency and a related negative impact on recoveries, whether from higher costs or extended timing.

Going Concern Valuations Dominate Sector

All companies in the sector are rated on a going concern basis, with the stressed value of the businesses, however, underpinned by the value

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This is an abridged version of "European Forest Product Sector's Debt Structures Support Above Average Recovery For Unsecured Lenders," published on Dec 16, 2008 available on Ratings Direct, www.ratingsdirect.com, Standard & Poor's web-based credit ratings and research information service.

Continued from page 1

COMPANIES IN EUROPE FEEL THE PINCH

"Surrounding economic conditions are beginning to affect operating performance for highly leveraged companies, resulting in a downward migration of credit."

This is an abridged version of "Credit Conditions Deteriorate for Private Equity-Owned And Leveraged Companies In Europe," published on Dec 10, 2008 available on Ratings Direct, www.ratingsdirect.com, Standard & Poor's web-based credit ratings and research information service.

restructurings, compared with 18 in the previous 12 months--an increase of over 100%. In addition, the time from financing to experiencing problems with covenant tests has decreased dramatically in 2007 and 2008, compared with 2006 (for more details, see "Loan Breaches By Highly Leveraged European Companies Double As Recession Fears Grow," published on Nov. 12, 2008, on RatingsDirect) When we update our LBO performance study to include third-quarter and year-end data early next year, we expect to see a deterioration in performance versus previous forecasts.

Economic Conditions Affect Highly Leveraged Companies

In Europe, we are in the early stages of what is likely to be a severe recession. These surrounding economic conditions are beginning to affect operating performance for highly leveraged companies, resulting in a downward migration of credit. The percentage of companies with CEs in the 'ccc' category (5.2%) has not been this high since 2004, when 'ccc' CEs made up 7.9% of the portfolio. Companies with 'b-' CEs have also increased relative to our existing portfolio, at 17.6%, compared with 11.7% in June 2007 (see chart 1). Since the end of 2003, the percentage of 'b-' companies had not risen above 12.9% until December 2007, when it began to creep higher to 14.8%.

Likewise, in our public-rated portfolio--predominantly comprising high-yield issuers in EMEA--the number of companies in the 'CCC' rating categories has increased substantially since June 2008, doubling to 8.8% from 4.3%. When viewed in the context of the lowest rating categories ('BB-' to 'CCC' or lower), the other large shift comes from a shrinking of the percentage of ratings at the 'BB-' level. The percentage of 'B+', 'B', and 'B-' ratings has stayed relatively stable, as some credits are lowered into these categories and credits already in these categories have been lowered into the 'CCC' categories.

Downgrades have accelerated in both groups of credit estimates and public ratings. For example, for the private CEs, since June 2008, downgrades occurred for 7.5% of the portfolio, but upgrades were 2.2%. In the previous six months, downgrades comprised 7% of the total, and upgrades were about 5%. For publicly rated

Chart 1 Percentage of Outstanding 'ccc' and 'b-' Credit Estimates

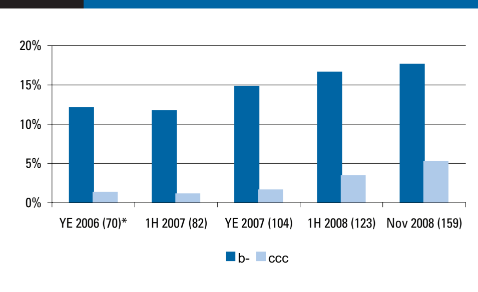
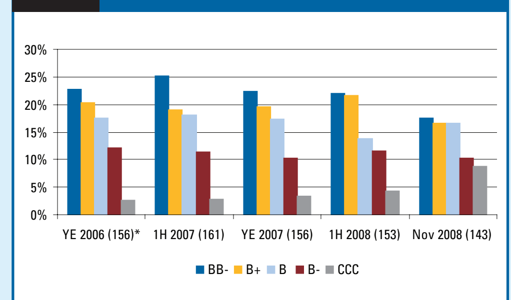


Chart 2 Percentage of Outstanding European Public Ratings



credits in Europe, since June 2008, downgrades comprised 16% and upgrades were 5%. However, the previous six months included 7% each of upgrades and downgrades.

This shows two things: first, that private CEs and public ratings share a similar rate of downgrades to upgrades; and second, that for the months between June and November 2008, downgrades for both groups occurred at a much higher rate than in the previous year. During those five months, for both companies with private CEs and those with public ratings, there were three times more downgrades than upgrades. The previous year, the ratio of downgrades to upgrades was about 1.6 times higher for companies with credit estimates and about equal for publicly rated companies.

LBO Performance Shows Relative Stability Until June 2008

At the end of 2007 and in the first two quarters of 2008, performance relative to forecast projections for private equity-owned companies has remained relatively stable, although there are some signs of weakening performance. This view reflects our ongoing LBO performance study, which is an extension of our work from earlier in the year when we collected data on 34 companies from four sectors (for more details, see "European Private Equity Deals Display Wide Disparity In Performance; More Than Half Lag EBITDA Forecasts," published on Feb. 12, 2008, on RatingsDirect). We have expanded this survey and for the results published here we have used data from 88 different companies with private credit estimates within 14 sectors.

To comprise our dataset, first we selected a variety of industries to provide a mix of cyclical and noncyclical sectors. Then we selected companies within those sectors for the study that we believed would best provide a representative mix of transaction sizes, countries, and CE categories. As a method for tracking performance, we compared original forecasts for sales, EBITDA, and debt made at the time of the company's most recent financing to actual figures for the end of 2007. For first- and second-quarter 2008 results, we compared actual figures against companies' budgets because forecasts from the original buyout base case models are not always available on a quarterly basis. For that reason, quarterly

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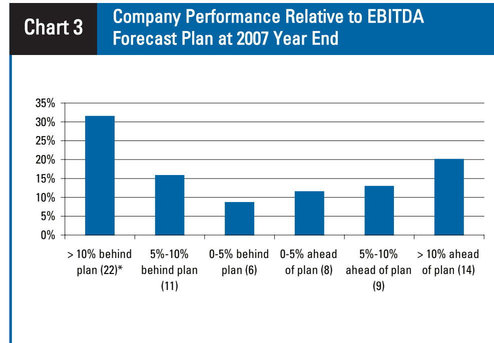
COMPANIES IN EUROPE FEEL THE PINCH

Chart 3 Company Performance Relative to EBITDA Forecast Plan at 2007 Year End



performance data is not directly comparable to year-end 2007.

At the end of 2007, approximately half of companies were ahead of plan and half behind, although there was some differentiation. More specifically, 56% of companies in our sample were behind forecast on EBITDA projections, compared with 44% that were ahead or on target. Likewise, 58% of companies had higher debt than originally projected and 42% had debt lower than projections or exactly on target. Actual sales figures versus forecast levels, however, look slightly more optimistic. At the end of 2007, 57% were ahead of forecast, versus 43% behind.

We tracked the percentage higher or lower than forecast at the original time of the buyout and the median figures show a similar pattern. Median actual sales were almost on target to forecast (0.9% ahead), EBITDA was slightly behind forecast (-4.6%), and debt was slightly more than originally forecast (3%).

Drilling down further into those figures, it is possible to see the variation in performance relative to forecast EBITDA at origination. Over 30% of companies were more than 10% behind plan on EBITDA targets and 20% were more than 10% ahead of plan (see chart 3). Slightly more than 50% of the companies were behind plan and 15% of the total were behind plan by more than 20%. However, to balance this out, just over 10% of the companies were ahead of EBITDA plan by more than 20%.

Incidentally, two-thirds of the companies that we had identified as having breached covenants or asked for a waiver from their senior lenders, come from the group of companies underperforming targets by more than 10%. The sector most common in this group of companies was health care (22%). For all the companies behind plan, health care represented 15% of companies, automotive comprised 15%, food products were 10%, industrial equipment was 10%, and retail was 8%.

Companies ahead of plan were a more diverse group. For those performing more than 10% ahead of plan, no sectors stood out. For all companies ahead of plan, the largest concentration was in food services companies (13%). Cable and satellite companies represented 9% of these companies, industrial equipment comprised 9%, and publishing was 9%. However, if telecom, cable, and satellite are grouped together, they represent 16% of the companies ahead of target at the end of 2007. It should be noted that the industrial equipment companies that were in this group had better liquidity positions than those in the underperforming group.

Taron Wade

Continued from page 3

CORPORATE RATINGS VERSUS RECOVERIES

tranches. The lack of significant amortization requirements in the short term would be positive for liquidity and probability of default risks, but could be negative overall for recoveries.

As the amendment depends on conditions such as the 20% paydown of the term loan A, we have not yet revised the recovery ratings, with our current hypothetical default scenario reflecting the pre-amendment structure and assuming the company's inability to cope with its debt amortization payments in 2010. Yet the deferral of the remaining amortization payments and the final maturity date of the term loan A tranches and revolving facility, would lead to a possible extension of our hypothetical default date. This, along with loosened control by the lenders, means that operating performance may have deteriorated further before reaching payment default. Projected EBITDA would be about 10% lower than the existing scenario. This could lead to lower overall enterprise value (EV) at default. However, if implemented as proposed, this negative impact would be more than offset by a different mix of outstanding liabilities.

Looking Forward

In the current challenging environment, with performance issues arising and refinancing no longer an option, to avoid covenant breaches and payment defaults, borrowers would likely rely on implementing "softer" tools, such as debt rescheduling and amending covenants. If problems persist, then more radical procedures become necessary, often involving fresh equity to strengthen the balance sheet, and operational restructuring measures aiming to ensure longer-term viability of the business. All these measures can affect recovery.

As we expect significant restructuring for the next 12-24 months, we foresee many rating actions. Recovery rating changes will likely continue to be independent to corporate credit rating changes, but with increased potential for action. In this context, it will be important to properly assess the impact of these changes and restructurings in terms of both probabilities of default and recovery prospects for each debt instrument in the capital structure at default.

Carlo Castelli

Continued from page 1

LEVERAGED LOSSES COULD REACH €20BN

"Substantial differences in recovery are evident, with prospective losses on subordinated debt being substantially greater than the prospective losses on senior secured debt."

five largest companies in this sample, where there is an aggregate risk of losses of up to €16.8 billion. Ratings of 'B-' and lower indicate a relatively high probability of default. Three of the companies in this sample have already defaulted under Standard & Poor's Ratings Services' definition.

Although the average aggregate loss potential across this portfolio of names is about 50% of the face value of the debt issued, substantial differences in recovery are evident, with prospective losses on subordinated debt being substantially greater than the prospective losses on senior secured debt. Nonetheless, even for these companies at the greatest risk of default, there are substantial differences in recovery prospects from company to company, particularly among the senior secured debt tranches.

Focusing on Recoveries is Key To Weathering Downturn

We are still in the early stages of what is likely to be a severe recession. The most recent data revisions from European statistical offices confirm that GDP growth was negative in the Eurozone in the second quarter of 2008, and there are signs that this retrenchment has spilled over to the third quarter (see "European Economic Forecast: Europe Tips Into Recession As Corporates Scale Back Their Investment," published on Oct. 22, 2008). When times are good and companies are leveraging their balance sheets in a bull market, it is easy for lenders to pay less attention to recovery prospects, as deal timetables can be rushed. But as we enter a recession in Europe, it is clear why it is important to focus on both aggregate and expected recoveries.

Credit deterioration is already apparent in the current environment. Credits rated 'CCC+' or lower now make up 8.8% of our publicly rated speculative-grade ratings in Europe, compared with June 2008, when they comprised only 4.3% of our rated high-yield credits. A year earlier, in June 2007, 'CCC' rated companies comprised 2.8% of this group. 'B-' rated companies currently make up 10.2%. This figure is stable since the end of 2007, when 'B-' rated credits comprised 10.3% of publicly rated high-yield credits in Europe.

At Nov. 30, we had recovery ratings on 23 companies in these rating categories, with almost €41 billion in debt. This can be broken down further into nearly €33 billion of debt issued by 12 'B-' rated issuers, and €8 billion of debt by 10 'CCC+' or lower-rated issuers. We have determined prospective losses on this group of names by using our recovery ratings for rated tranches of debt.

For this research, we assumed midpoint recoveries within each of our recovery rating levels for each tranche of debt. For example, our recovery rating category of '1' indicates 90%-100% recovery. Where a recovery rating of '1' was assigned to a tranche of debt, we have assumed 95% recovery. We have not included recovery ratings for companies in Russia and other CIS countries. We did not include companies rated 'B-' or lower for which we don't have recovery ratings outstanding. In total, a further 16 companies rated at this level at Nov. 30 are not included in this sample. These comprise mainly issuers from Russia or Central and Eastern Europe. It is worth noting that since we publicly rate about 20% of the leveraged finance market in Europe, potential losses for investors in the speculative-grade market may be substantially higher when taking unrated companies into account.

Aggregate Loss Versus Expected Loss

Although corporate credit ratings of 'B-' or lower indicate a high probability of default, it is unlikely that every company will default. Using our cumulative default statistics, we would therefore expect that within two years, on average, only six of this particular group of 23 companies might default, but since our default data reflects average default rates over a 27-year period, default rates during a recession could be meaningfully higher than the average.

This number already includes two companies that had already defaulted before Nov. 30 (IT Holding SpA (CC/Negative/--) after being raised from 'SD' on Nov. 21, and Belvedere S.A. (D/--/--) and one company that has defaulted since that date (Waterford Wedgwood PLC (SD/--/--).

We calculated the aggregate loss on the portfolio of names according to the recovery ratings assigned to each tranche of debt. For example, a €100 million tranche of debt with a recovery rating of '3' (50%-70% recovery) translates into a loss potential of €40 million (60% midpoint recovery on €100 million).

Chart 1 Calculating Expected Loss

Expected Loss (EL) = Probability of Default (PD) X Loss-Given Default (LGD or 1 – Recovery)

Worked example for M-Real Corp (B-/Negative/B)

€1,690 million senior unsecured debt with a recovery rating of '4' (30-50% recovery at default)

LGD = €1,690m X 60% (mid-point loss) = €1,014m

EL = 16.94 % (two-year cumulative default rate for B- issuers) X €1,014 million

EL = €172 million versus prospective loss if M-Real defaulted = LGD = €1,014 million

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LEVERAGED LOSSES COULD REACH €20BN

Chart 2 Distribution of Recovery Ratings By Value of Outstanding Debt

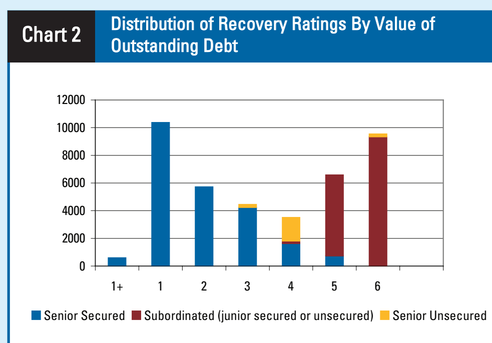
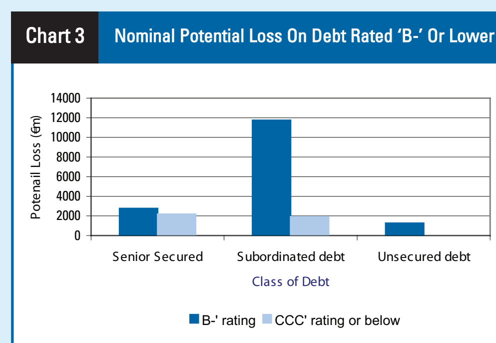


Chart 3 Nominal Potential Loss On Debt Rated 'B-' Or Lower



The expected loss on the portfolio of €4.2 billion also takes into account the corporate credit rating, which is an indicator of probability of default. We calculated this using the formula in chart 1. We have used a simple calculation of expected loss that does not assume any correlations between the component risks of probability of default and loss given default. However, it is important to not dismiss the actual value at risk of €20 billion, because if even one of the largest issuers of debt does default, investors' total losses could be much higher than the expected loss. For example, if both LyondellBasell Industries AF S.C.A. (B-/Negative/--) and NXP B.V. (CCC/Negative/--) defaulted, investors could lose up to €9.8 billion--double the expected loss for all the credits at these rating levels, assuming our recovery ratings broadly correlate with eventual recovery.

Recoveries for Rated Companies Below 'B-' Are Lower Than Average

The average senior secured recovery rating on the credits rated below 'B-' is '3' (50%-70% recovery), which is lower than the average '2' (70%-90% recovery) across Standard & Poor's senior secured recovery rating universe in Europe. By number, and not volume, there are a relatively high proportion of senior secured deals with relatively low recovery ratings (largely '4' and '5'), which pulls down the average (see chart 2).

Marc Lewis, Taron Wade

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FOREST SECTOR FAVORABLE FOR UNSECURED

of their assets. We estimate stressed value at default on the basis of a combination of discounted cash flow and market multiple approaches, taking into account historical valuation in the sector and ranking the issuers against one another. The average blended enterprise value/EBITDA multiple in the sector is 5.3x, with average EBITDA stress of almost 51% from the latest reported full-year level.

This level of operating stress is relatively strong, especially for issuers rated at the lower end of the corporate credit rating scale. This results from our assumption that even in cases when the simulated payment default is triggered by debt amortization or debt maturity, such refinancing risk would only materialize in the event of a deterioration in operating performance. This implies a combination of material deterioration of generated cash flows and a depressed economic environment unfavorable for asset sales. The level of operating stress is worsened by the absence of maintenance covenants resulting from the prevalence of unsecured capital structures in the sector. This lack of covenants deprives lenders of the possibility to negotiate additional fees or higher interest, as is the case when they have a right to intervene, thereby resulting in lower stressed EBITDA.

Accordingly, valuations at the point of default are negatively affected by both low EBITDA levels (in the case of a market multiple approach) and weaker cash flow generation post-default (in the case of a discounted cash flow approach). We consider the sector to be asset intensive with relatively high levels of capital expenditure and hence low cash conversion rates, which limits the stressed valuation multiples we apply to a range of 4.5x-6x EBITDA at default.

In addition, the upward potential of unsecured recovery ratings in the sector is very limited. Even if the numerical estimate of recovery on an unsecured issue is higher than the rating threshold, we cap the recovery rating at '3' for debt issued by companies rated in the 'BB' category. This is due to the possibility of capital structure changes on the path to default inherent to issuers rated in the 'BB' category, and the relatively low level of protection provided to unsecured creditors by the documentation.

Abigail Klimovich

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COVENANT DIFFICULTIES DOUBLE

Poor's credit ratings, research, and risk analysis.)

The impact of this is apparent in the acceleration of covenant breaches, waivers or resets, equity cures, and restructurings. In addition to the companies we examined that are already in breach of covenants, there are many companies which we understand are near to breaching their covenants and may be in breach over the next few quarters.

In our view, this does not bode well for default rates. Standard & Poor's has already estimated that by mid-2009, defaults for leveraged loans in Europe easily could increase to 5.8%. (For more details, see article titled "European First-Half Loan Default Rate Stable So Far, But A Sharp Jump Is Plausible," published Sept. 3, 2008, on RatingsDirect.) We would expect this to translate into approximately 38 defaults when applied to our credit estimates of 648 institutional leveraged loans. Of the 64 companies that had difficulties with covenants in our study, only 11 have gone on to default and only one company with a breach in 2008 has defaulted so far. However, of the 10 companies with covenant problems in 2006, six went on to default. Assuming the same pattern, this would mean that of the transactions with difficulties in 2007 and 2008, 31 defaults may likely occur. Six have already happened; meaning we would expect that approximately 25 could default in the near future.

This is 13 shy of our 12-month estimate, but when economic conditions worsen some companies will likely default before a breach even happens, and we anticipate that there will be breaches occurring in the coming months that will eventually result in defaults. And in cases where resets are requested, we anticipate that lenders will not be so lenient, asking for much higher margins. That extra interest cost could put the company into default sooner than they would have been otherwise. Despite relatively loose covenants in recent years, the aggressiveness with which companies were expected to deleverage or raise EBITDA means that breaching covenants will likely be unavoidable for some. An additional roadblock that could push companies into default is where unanimous amendment or waiver approval is needed from the lender group.

Private equity commitment to portfolio companies is another key to anticipating how rapidly breaches turn into defaults. If financial sponsors inject new equity to give companies more breathing room, lenders will generally benefit. But if the number of recapitalized companies that experience covenant problems increases, private equity may be less interested in contributing new funds. We expect that they will be less likely to support an investment if they have already made a good return on equity and see no upside.

The acceleration in companies breaching covenants or needing resets is indicative of the very difficult economic conditions that highly leveraged companies are facing. In our view, the next two to three years will be very difficult for investors in this asset class as not only breaches, but defaults, accelerate as well.

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Leverage Matters

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