

August 4, 2009

Credit FAQ:

Corporate Credit Quality: Where Do We Go From Here?

Primary Credit Analyst:

Andrew Watt, CFA, New York (1) 212-438-7868; andrew_watt@standardandpoors.com

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Last year was a challenging one for the credit markets, and these conditions have continued through the first half of 2009. The impact on U.S. corporate ratings has been significant, but not, in our view, totally unexpected. However, the worst part of the deterioration in credit quality is likely behind us. Nevertheless, Standard & Poor's Ratings Services expects credit trends to remain negative over the near future. Here, we answer 10 questions investors frequently ask on the future of corporate credit quality.

Frequently Asked Questions

What does Standard & Poor's expect for corporate credit quality for the rest of 2009?

The overall picture is relatively unfavorable, though not as bad as at the end of 2008 and beginning of 2009. We expect the pace of downgrades to slow considerably in the second half of 2009. In the first half of the year, the accelerated pace of ratings actions was due to the significant decline in operating performance for most U.S. non-financial corporate issuers in combination with the severity of the contraction in the credit markets.

We expect the default rate to rise as the U.S. speculative-grade default rate climbs to near record levels and approaches over 14% by the early part of 2010. (See "Default, Transition, And Recovery: U.S. Corporate Default Rate Expected To Inch Lower To 13.9% By June 2010 After Peaking In First-Quarter 2010, published July 23, 2009.)

We expect the weak economic environment to temper the operating and financial performance of most issuers. Access to the credit markets (loan and bond markets) remains difficult, in our view, particularly for issuers with weaker credit quality.

We continue to expect that investment-grade (rated 'BBB-' or higher) issuers will have access to the credit markets similar to the robust level of U.S. non-financial investment-grade bond issuance in the first half of 2009 (see chart 1). While we expect speculative-grade issuers to have occasional, albeit, costly opportunities to tap the debt capital markets, these opportunities will continue to be subject to the vagaries of the markets (see chart 2). We note that the rise in speculative-grade bond issuance in the second quarter was predominantly in the better-quality 'BB' rating category.

Chart 1

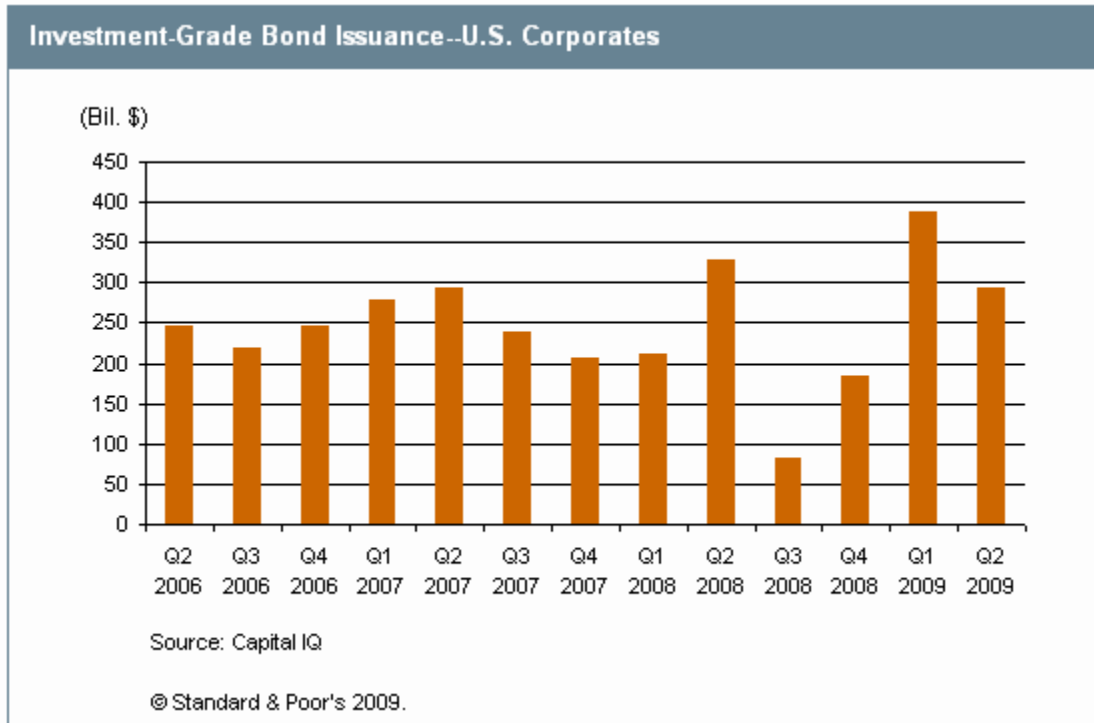
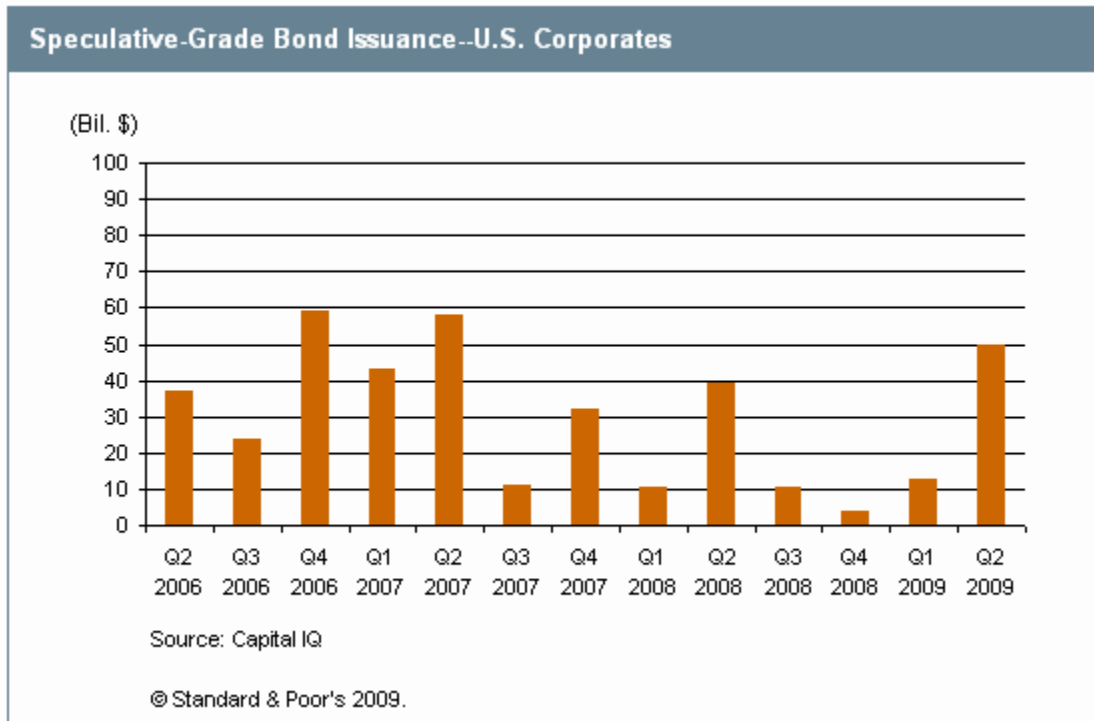


Chart 2



Are corporations actually reducing debt leverage?

Credit metrics don't yet provide a clear picture of reduced debt leverage. However, those metrics are historical measures. Recent developments indicate that financial leverage is falling.

Lenders are providing less credit under more onerous terms, thereby forcing deleveraging. Mergers and acquisitions are now funded in a more balanced manner and not as reliant on a large portion of debt financings. We expect more prudent financial strategies to be implemented over the near to intermediate term.

Financial restructurings have surged as have debt repurchases. Standard & Poor's assigned 36 selective default ratings in the first half of 2009 compared with just 12 in 2008. (See "Global Credit Comment: Bondholders Get Buzzed (Premium)," published May 1, 2009.)

What are the risks to a recovery in credit quality?

It is too early to state that a recovery is underway. However, the worst is likely behind us. Rating trends will remain negative but not overwhelmingly negative, as they were in the first half of 2009. The fragile state of capital markets and the economy leads us to believe that any risks are on the downside in terms of credit trends. Standard & Poor's economists expect a tepid GDP growth rate of just 1.2% in 2010.

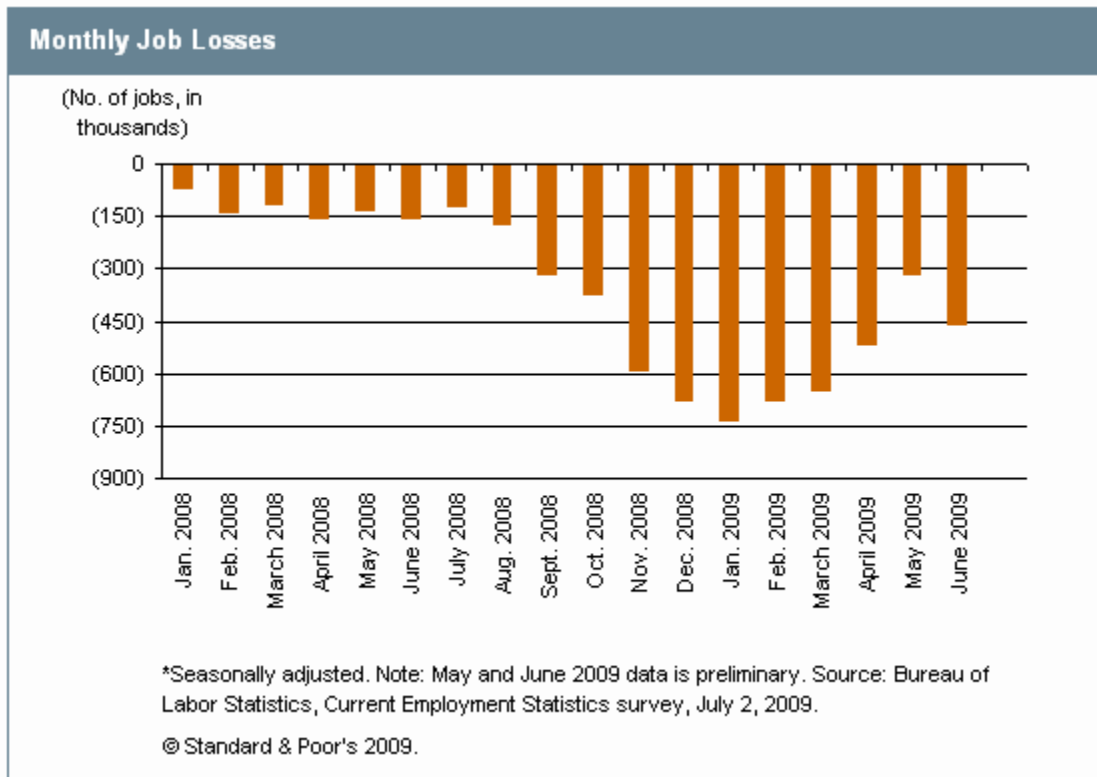
The economic picture remains bleak. Our economists expect the unemployment rate to rise into the first half of 2010 (see chart 3). A major determinant of corporate performance will be the economic conditions that companies face. Still, there will be material variations across industries, with many late-stage industries, such as capital goods, continuing to struggle with weaker operating performance.

Other notable concerns include:

- Refinancing issues, given rising maturities in upcoming years;
- The impact of the unemployment rate (which tends to lag economic recovery) on consumer confidence; and
- Business investment remaining weak, which would undermine the sustainability of a recovery.

(See "Economic Research: U.S. Risks To The Forecast: Spraying Round-Up On The Green Shoots," published Aug. 5, 2009.)

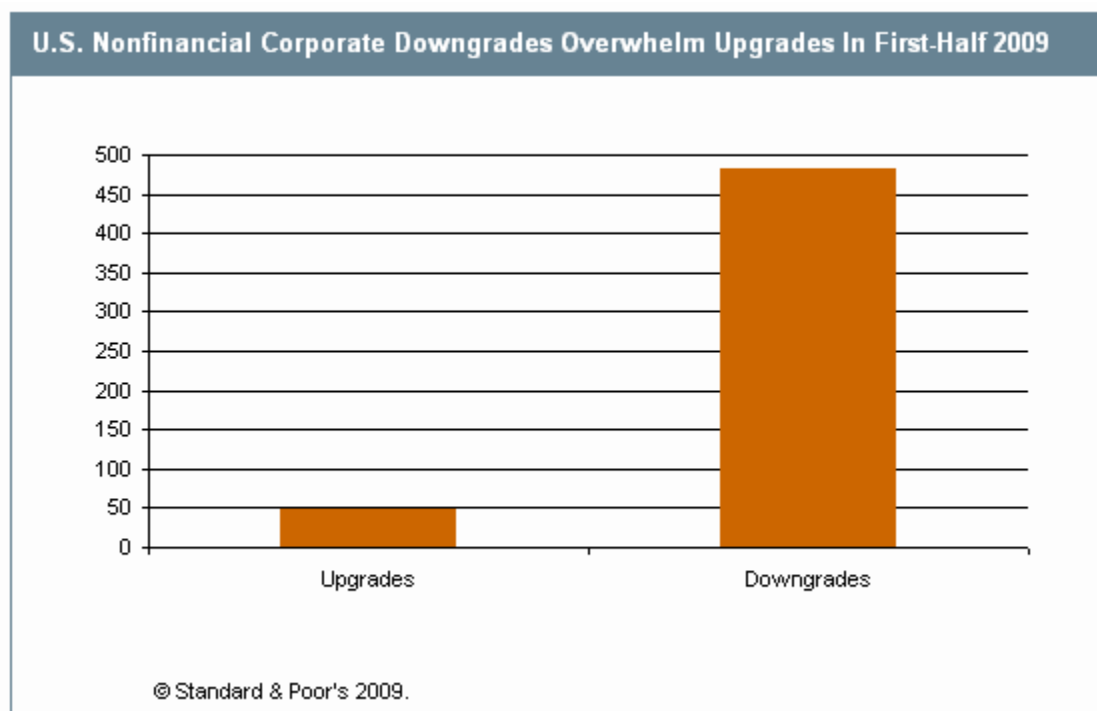
Chart 3



What is the trend in defaults and downgrade ratios?

The number of defaults is fairly high and will probably level off within the next 12 months, though the annual default rate will likely keep rising. The downgrade to upgrade ratio has moderated to 10:1 in the first half of 2009 after being nearly 14:1 in the first quarter (see chart 4). We expect the downgrade to upgrade ratio to moderate significantly through the rest of 2009. The trend will likely still be negative, with 34% of outlooks currently negative, compared with just 6% positive, for U.S. nonfinancial corporate issuers. About 58% of outlooks are stable. The rest either carry developing rating outlooks or are listed on CreditWatch.

Chart 4



What caused Standard & Poor's to take so many downgrades in the first half of 2009?

Deteriorating operating performance was the principal factor in more than half of the downgrades. That combined with the contraction in credit and the tenuous credit profile of many issuers caused the substantial downgrade activity in U.S. corporate ratings. For example, we downgraded Alcoa Inc. (BBB-/Negative/A-3) because of weak cash flow and earnings and eventually because of deteriorating credit measures that precipitated the two-notch downgrade. The company suffered from fluctuating demand and a drop in aluminum prices.

In the chemicals sector, Tronox Inc. (not rated) suffered from weak end market conditions in the housing market, cost pressures, and strained liquidity leading to its downgrade.

The overwhelming amount of the downgrade activity was in the speculative-grade area, and much of that was in the 'B' or 'CCC' category. In certain sectors, such as chemicals, natural resources, and real estate, almost 60% of the ratings actions were on companies in the 'CCC' category or below. So, distressed and vulnerable issuers had the most downgrades.

What sectors had fewer downgrades in the first half of 2009? Do you expect those sectors to continue to fare better than most?

The sectors that have held up the best in the first half of the year are health care and utilities. Our expectation is that those two sectors will continue to perform better than most.

In the health care sector, our view since last year that the industry is relatively stable has been borne out. In the first half of 2009, sustained demand for essential medical products and services, relative pricing visibility, and strengthening credit measures bolstered health care ratings. Through mid-2009, we upgraded about twice as many health care companies as we downgraded. One-half of the upgrades in health care involved the movement of issuers

higher up within the investment-grade category. These companies shared the common prospect that sustained cash flows in excess of ongoing needs increasingly protects them against potential industry uncertainties and prepares them for attractive acquisition opportunities. On the other hand, all of the downgrades in health care in the first half of the year were on the bottom rungs of the speculative-grade ladder, where issuers have more challenging liquidity issues. Still, we are closely watching the formidable financial needs, persistent recessionary influences, and uncertain political developments taking us into mid-2010. There are about twice as many negative outlooks and CreditWatch listings as those listed as positive for the health care sector.

The U.S. electric utility industry has continued to perform relatively well despite economic turbulence. Standard & Poor's expects the ratings trend for the sector to remain generally stable for the next 18 months because of responsive rate orders and cost-recovery mechanisms, in conjunction with actions by management that support credit quality. More than three-quarters of rated entities have stable outlooks with the average rating at 'BBB'. There were eight upgrades and just 11 downgrades in the first half of 2009.

Nonetheless, the recession may create a drag on the credit quality of the utility industry, especially if regulatory support wanes as financial demands increase. In addition to the economic downturn, the industry will continue to confront a variety of business, operational, and financial pressures that may impair the sustainability of overall financial performance. These challenges include maintaining sufficient liquidity and access to the capital markets, directing heavy construction programs, managing rate needs, regulatory issues, and complying with environmental mandates.

What sectors had the most downgrades this year and what are your expectations for those areas for the remainder of 2009?

Media and publishing, autos and autos suppliers, and real estate are the most troubled.

We expect 2009 to be the year of the lowest auto sales in decades. In our view, lower sales and production this year has so far contributed significantly to two automaker bankruptcies (General Motors and Chrysler LLC) and multiple auto supplier defaults, and has pushed a number of other auto suppliers close to default. In our view, significant structural changes are underway.

The credit outlook appears grim for rated U.S. media and entertainment companies, thanks to the recession that we see continuing into 2010. After getting a boost from 2008's record spending on election advertising, U.S. ad spending has now dropped by an unprecedented magnitude. The decline has both cyclical and secular causes that raise uncertainty about the timing and magnitude of a recovery in the industry. We also expect that adverse secular trends will continue to buffet many of the industry's consumer-dependent subsectors. Even online advertising has decelerated to single-digit growth rates. The recession is multiplying the industry's difficulties, and relative to the business plans on which debt financing was predicated, companies are, in our view, significantly underperforming. Speculative-grade rated companies that have recently gained access to public debt markets have incurred higher costs of debt.

Commercial real estate operating fundamentals continue to weaken, and the sector faces significant debt maturities in a financing environment that remains difficult and more expensive for even the most creditworthy real estate borrowers. We acknowledge that recent robust equity issuance and dividend cuts support these companies' deleveraging efforts. However, we view this activity essentially as a down payment on the additional capital they will need to comfortably meet their debt maturities and capital investment requirements over the next few years.

Which sectors are likely to be at or approaching an inflection point in credit quality?

The pace of downgrades in the gaming and homebuilders sectors has slowed noticeably, though these industries still face difficult operating conditions.

Ratings in the gaming sector are gradually stabilizing because we believe that the future operating assumptions underlying our gaming company ratings are sufficiently conservative to limit significant further downside pressure on ratings. This is not to say there will not be any additional downgrades. We are monitoring many company-specific issues, including potential covenant violations and near-term refinancing risk.

For homebuilders, we believe the credit quality of several of the nation's largest homebuilders may begin to stabilize later in the year. We are seeing signs that the U.S. homebuilding industry may be nearing the end of its three-plus-year dive, but we caution that the climb back up may be slow and gradual. Better-capitalized companies may be able to purchase attractively priced land parcels, increase their market share, and eventually return to profitability. Conversely, overleveraged builders will likely be at a significant disadvantage relative to their stronger peers. These companies may continue to shrink their platforms to stem losses, and the most vulnerable may elect to restructure their balance sheets, either through bankruptcy or by executing distressed debt exchanges.

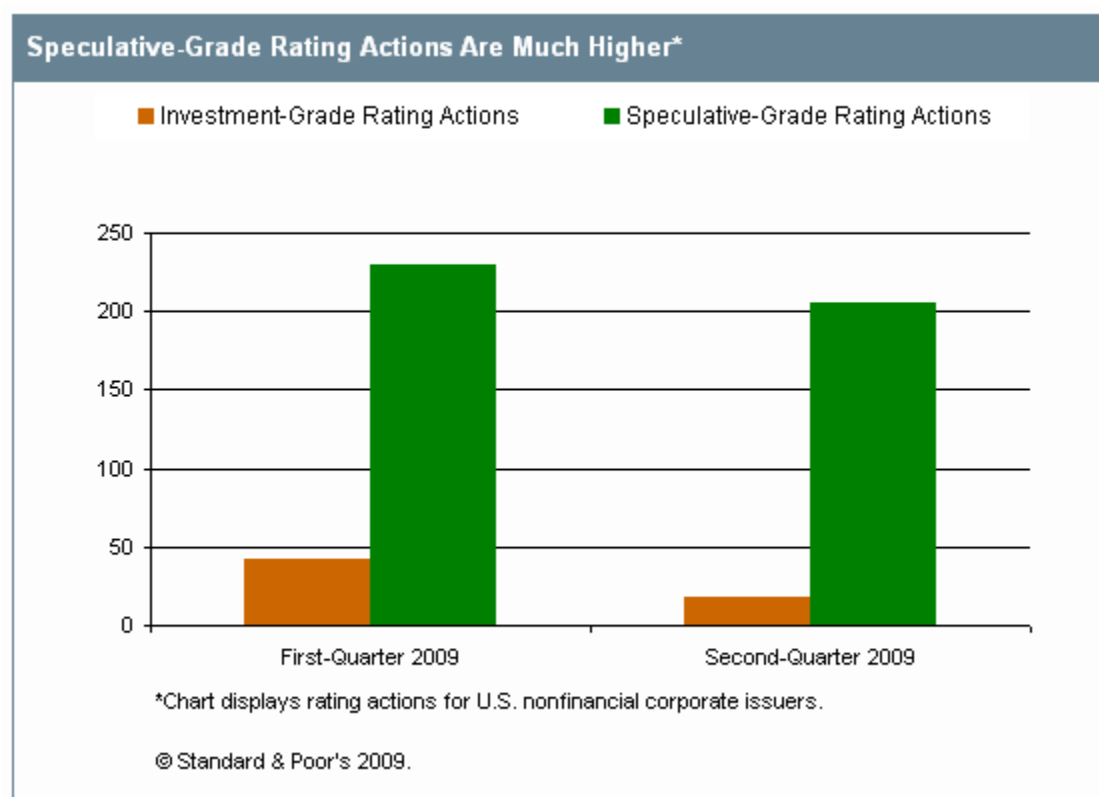
How are speculative-grade borrowers coping with covenant breaches?

Many speculative-grade borrowers struggle to remain in compliance with covenants and we expect these problems to intensify over the coming quarters. This is especially true of issuers who face step-down provisions. Indeed, the number of companies seeking covenant relief surged in 2009. According to Standard & Poor's Loan Commentary and Data (LCD) group, a record 206 loan issuers have sought looser covenants through June 30, 2009, up from 60 during the first six months of 2008 and more than 2008's full-year count of 148. Bank loan amendments have become the bulk of lenders' activity in 2009 as opposed to new loans. (See "Many U.S. Speculative-Grade Corporate Borrowers May Breach Loan Covenants This Year," published Aug. 3.)

In what ways are the effects of the recession and credit squeeze amplified for speculative-grade issuers?

There are about 200 nonfinancial corporate issuers with corporate credit ratings in the 'CCC' category or below. These are the most susceptible to further deterioration in credit quality over the near term. We expect these issuers to dominate ratings trends in the speculative-grade arena in the near term. Speculative-grade companies are more vulnerable and susceptible to credit deterioration in an economic downturn. The concentration of negative rating actions among speculative-grade companies underscores the strain at the lower rating levels as business conditions remain weak, and capital markets access is costly and still somewhat constrained (see chart 5).

Chart 5



In certain industries, the concentration and velocity of downgrades at the lower end of the speculative-grade category is stark. For example, in the building materials sector, 26, or two-thirds, of the downgrades were to the 'CCC' category or below.

Related Research

"Quarterly Default Update And Rating Transitions (Premium)," Aug. 5, 2009

"Global Corporate Default Update (July 31 – Aug. 6, 2009) (Premium)," Aug. 7, 2009

"Default, Transition, And Recovery: Global Bond Markets Weakest Links And Monthly Default Rates (Premium)," July 27, 2009

"U.S. Corporate Default Rate Expected To Inch Lower To 13.9% By June 2010 After Peaking In First-Quarter 2010," July 23, 2009

"2008 Annual Default Study And Rating Transitions," April 2, 2009

"U.S. High-Yield Prospects: Market Rally Could Take A Summer Vacation (Premium)," July 4, 2009

"Downgrade Potential Across Credit Grades And Sectors (Premium)," Aug. 7, 2009

"U.S. Credit Overview (July 30 – Aug. 5, 2009) (Premium)," Aug. 6, 2009

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