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# Standard & Poor's Speculative-Grade Sovereign Debt Recovery Ratings

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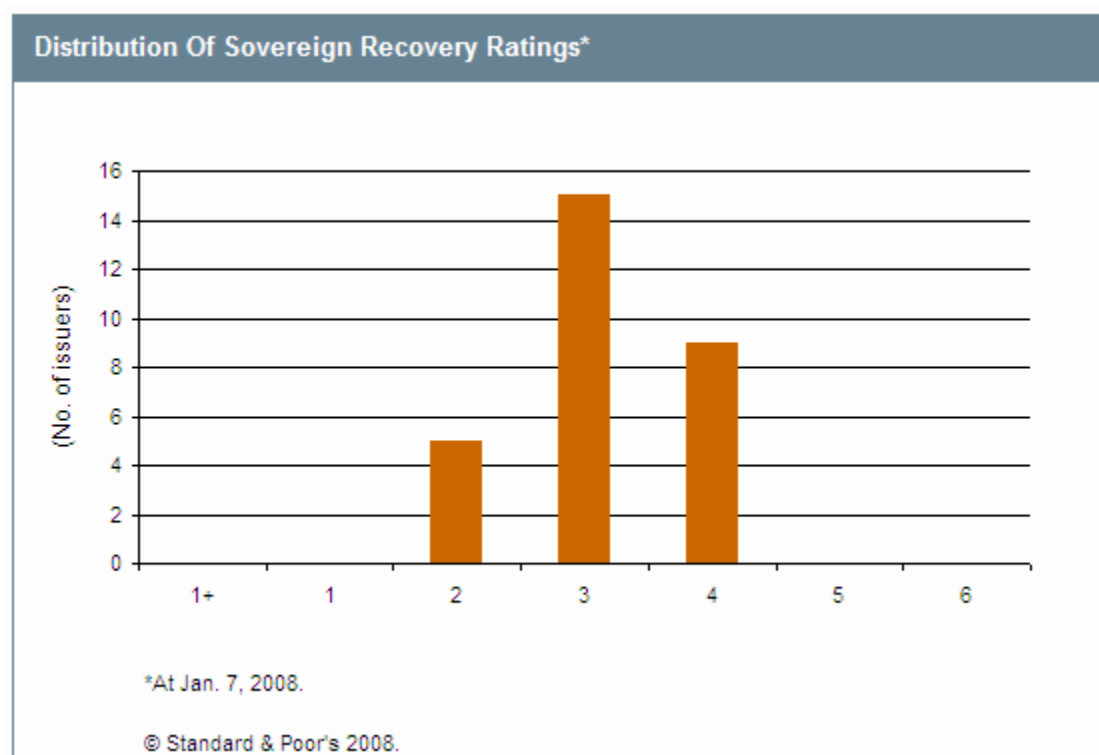
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Standard & Poor's Ratings Services has assigned sovereign foreign currency recovery ratings to the debt of 29 speculative-grade sovereign issuers since June 12, 2007, and expects to assign recovery ratings to the debt of other speculative-grade sovereigns that issue foreign currency debt in global capital markets over the course of 2008. To date, no sovereign recovery rating has been changed since it was first assigned. The sovereign recovery ratings range from '2' to '4', and those with a '2' have issue ratings one notch above their issuer credit ratings. These include the Republic of Colombia, the Republic of Costa Rica, the Republic of Macedonia, the Kingdom of Morocco, and the Oriental Republic of Uruguay. Standard & Poor's also plans to introduce recovery ratings for senior unsecured debt issued by speculative grade local and regional governments.

## Ratings Distribution Mirrors Historical Recovery Levels

The distribution of Standard & Poor's sovereign recovery ratings does not extend to the strongest and the weakest ends of the recovery rating scale (see chart 1). One reason for this is that with no insolvency regime for sovereigns or assets on which to foreclose, the likelihood of very high recovery is low unless the default scenario is a liquidity crisis. On the other end of the scale, the fact that there is no equivalent to corporate liquidation and sovereigns usually continue to exist implies that at least some recovery may be provided. In addition, all the issuers included in our sample are to a considerable extent market-oriented. So we would not normally expect recovery rates at the bottom end of the scale as a result of debt repudiation. Furthermore, the average recovery estimate implied by our recovery ratings coincides with the historical average sovereign recovery rate observed since the mid-1990s.

Chart 1



## Recovery Ratings Reflect Analysis Of Simulated Default Scenario

Standard & Poor's starts its recovery analysis by identifying the likely default scenarios, including distressed exchanges, which we include in our definition of default. These scenarios set the relevant parameters for the subsequent recovery analysis, as they envisage the economic, fiscal, and political conditions surrounding the default. The default scenarios underlying the recovery analysis are typically derived from the key rating constraints that affect the sovereign issuer credit rating. It is important to point out that the recovery analysis is performed under a hypothetical assumption that the default scenarios have occurred. (The sovereign issuer credit rating, which is not affected by the recovery analysis, addresses the likelihood of default.) The recovery analysis is fundamentally based on the issuer's payment ability and recovery incentives following a default, and takes into account the impact of official creditors, including potential assistance (see table 1).

Table 1

Factors Involved In Sovereign Recovery Analysis*		
Ability to make payments after default	Incentives to make payments after default	Influence of official creditors
Comparison of stressed debt levels with debt capacities	Default and restructuring history	Proportion of official bilateral lending
Impact of default crisis on financial system and economic activity in general	Recent recovery precedents of other sovereign defaulters	Proportion of existing IMF debt
Potential for currency depreciation	Importance of access to global goods and capital markets	Extraordinary assistance
Fiscal and external flexibility	Exposure of domestic financial sector to sovereign debt	

**Table 1**

Factors Involved In Sovereign Recovery Analysis*(cont.)	
Nature of financial inflows	Proportion of resident to nonresident debtholders
Potential for additional debt to be added to that of the sovereign	Expected postdefault political situation
	Bargaining power

\*After the identification of the specific sovereign default scenario.

## Weak Correlation Between Issuer Credit And Recovery Ratings

A number of factors that we have identified for our sovereign recovery rating analysis are similar to those considered when we assess the probability of sovereign default. Of particular importance in both cases are:

- The ability to bear prevailing debt levels;
- The need to consider reputational cost;
- The effects of a prolonged loss of access to capital markets or of economic sanctions; and
- The desire to increase residents' confidence and their propensity to hold savings at home.

Nevertheless, crisis dynamics and knock-on effects following the default scenario (including currency depreciation, economic contraction, and political instability) may lead to conclusions on debt service payment ability and recovery incentives in the event of default that are distinct from those in a pre-default situation. In general, these distinctions will grow as the sovereign issuer credit rating approaches investment grade. Our empirical research, for example, shows that historical sovereign recovery rates have been more closely correlated to the debt burden that built up during the crisis than to debt levels just prior to the crisis.

In fact the correlation between Standard & Poor's issuer credit ratings and recovery ratings is fairly weak (see chart 2). Although a trend line would have some positive slope, the dispersion of data points around the trend line indicates a very weak correlation. In fact, if issuer credit ratings and recovery ratings were presented on a linear scale (which is a very simplified approach as the default probabilities implied by issuer credit ratings are not linear),  $R^2$  would currently be at a very weak 0.23.



Table 2

Speculative-Grade Sovereign Recovery Review*						
Recovery analysis						
Issuer	Foreign Currency Issuer Credit Rating (LT/Outlook/ST)	Recovery Rating¶	Foreign Currency Issue Rating¶	Default Scenario	Recovery Factors	Analyst
Argentina (Republic of)	B+/Stable/B	4	B+	The recovery analysis assumes that Argentina would default following a failure to take timely and effective policy steps during a global downturn. This would result in sharply lower economic growth and possibly high inflation, and a market perception that exchange controls would be imposed.	The rating on Argentina's debt is somewhat supported by a diversified economy with foreign currency earnings that would be resilient to the crisis. It is also supported by our expectation that, contrary to the country's last default episode, there is no foreign exchange regime in place that may abet the build-up of large external imbalances. Constraining factors weigh more heavily, however, and include the expectation of strong capital outflows and a significant debt burden as simulated under our default scenario. Furthermore, Argentina's last default episode involved an aggressive restructuring approach.	Joydeep Mukherji
Belize	B/Stable/B	3	B	The recovery analysis assumes that Belize would default on its commercial foreign currency obligations in an effort to reduce debt stocks, potentially triggered by an extreme adverse external event such as a hurricane.	Under this scenario, the recovery rating is supported by Belize's "best efforts" approach to restructuring taken in late 2006, a stance we believe would be employed again. This is balanced, however, by constraining factors, which include relatively high levels of both public sector debt (domestic and external) and external debt (public and private sector) under the default scenario. The recovery rating is also constrained by Belize's low fiscal and external flexibility.	Olga Kalinina
Brazil (Federative Republic of)	BB+/Positive/B	3	BB+	The recovery analysis assumes a change in market sentiment toward Brazil. This would be characterized by investors' increased aversion to risk following a global external shock, or a sustained period of low economic growth that weakened the government's fiscal commitment.	Under this scenario, the recovery rating is supported by moderate external debt even under our simulated stress scenario. It is also supported by our expectation of strong recovery incentives owing to the country's integration into the world economy, and by the low likelihood of a dramatic political change. These supporting factors are balanced by Brazil's high public sector debt relative to GDP under our default stress scenario. In addition, the large absolute size of debt may reinforce the sovereign's bargaining power in a restructuring process.	Lisa Schineller

Table 2

Speculative-Grade Sovereign Recovery Review* (cont.)						
Colombia (Republic of)	BB+/Stable/B	2	BBB-	The recovery analysis assumes a default scenario driven by a political crisis, combined with deterioration in the current account balance.	Under this scenario, the recovery rating is supported by Colombia's moderate debt burden—even under the default stress scenario. It is further supported by continuously strong institutions that would offer protection against the political crisis. We also expect that Colombia would continue to pursue market-friendly policies under a default scenario, and that its debt payment culture would remain strong. The recovery rating is somewhat constrained by weak external flexibility under the default scenario, in conjunction with portfolio outflows. The recovery rating is also limited by a high proportion of debt owed to multilateral institutions, which we would expect to benefit from preferential treatment by the government.	Richard Francis
Costa Rica (Republic of)	BB/Stable/B	2	BB+	The recovery analysis assumes a banking or balance of payments crisis in Costa Rica, ultimately leading to sovereign default.	Under this scenario, the recovery rating is strongly supported by a moderate debt burden—even under our simulated stress scenario—and in particular by the expectation of political stability and continuously strong institutions under default. The recovery rating is somewhat constrained by the high level of dollarization of deposits and loans in the banking sector, which suggests a significant impact on private sector balance sheets under default.	Joydeep Mukherji
Dominican Republic	B+/Stable/B	3	B+	The recovery analysis assumes a balance of payments and ensuing currency crisis, arising from a terms of trade shock or capital account vulnerabilities, as the Dominican Republic suffers from weak external liquidity.	Under this scenario, the recovery rating is supported by a significant stream of remittances into the country that we view as countercyclical, and low debt levels even under our default stress simulations. Recovery incentives would be boosted by the Dominican Republic's small open economy and reliance on global debt markets. Under the last default episode (albeit different from the scenario assumed for the recovery rating), the Dominican Republic offered an exceptionally high recovery. These supporting factors are offset by weak institutions and poor policy implementation, which we would expect to be prominent factors in the default scenario.	Richard Francis

Table 2

Speculative-Grade Sovereign Recovery Review* (cont.)						
Ecuador (Republic of)	B-/Stable/C	4	B-	The recovery analysis includes two scenarios that cover a fall in oil prices and/or a proactive stance by the government promoting default. These events call for a restructuring of Ecuador's debt and the subordination of timely debt service to other political priorities, possibly at a time of weakening oil prices. Crucial aspects of the recovery analysis are similar under both default scenarios.	Although Ecuador's debt burden would be only moderately high under our default stress simulation, the recovery rating is constrained by Ecuador's weak payment culture and the possibility that the government would insist on significant debt relief as part of a restructuring.	Lisa Schineller
Egypt (Arab Republic of)	BB+/Stable/B	3	BB+	The recovery analysis on Egypt primarily assumes a fiscal shock resulting from a banking sector crisis. Our recovery rating also reflects the possibility of alternative default scenarios related to political instability.	The recovery rating is supported by Egypt's low external debt--even under our default stress scenario--and by Egypt's history of cooperation with external creditors. On the other hand, government debt would be fairly high and possibly boosted by fiscal costs relating to stress in the banking system, to the detriment of government creditors.	Ben Faulks
El Salvador (Republic of)	BB+/Stable/B	3	BB+	The recovery analysis assumes an increase in El Salvador's fiscal deficit, which could be due to a combination of events such as a large natural disaster, or public finance mismanagement that would result in a debt increase. This could also be accompanied by more market-hostile policies.	Under the default scenario, the recovery rating is supported by the high level of remittances, which we would expect to remain at least stable under default. The recovery rating is also supported by El Salvador's traditionally cooperative approach with the outside world, and the fact that the country regularly receives external financial assistance following natural disasters. The risk that the default scenario may imply a political change balances these supporting factors.	Roberto Sifon Arevalo
Gabonese Republic	BB-Stable/B	4	BB-	The recovery analysis is based on a default scenario in which a terms of trade shock, materialized by a drop in oil prices and accompanied by a worsening fiscal situation, would undermine the viability of the current economic and political model.	The recovery rating takes into consideration Gabon's default history, which has lowered the sovereign's debtor reputation cost in case of determining recovery in a hypothetical future default, and its low reliance on capital markets. On the other hand, we expect that Gabon would continue to pursue market-friendly policies, mainly due to the economy's relatively high level of integration with the global trade system. Moreover, the envisioned buyback of the vast majority of Gabon's Paris Club debt will greatly dilute the current dominance of official creditors to the government, therefore lowering the risk of effective subordination of commercial creditors.	Sarah N'Sondé

Table 2

Speculative-Grade Sovereign Recovery Review* (cont.)						
Ghana (Republic of)	B+/Stable/B	3	B+	The recovery analysis assumes a default scenario in which a terms of trade shock leads to a sustained deterioration in the balance of payments and budgetary performance. The default scenario also assumes a concomitant deterioration in donor relations.	Under the default scenario, we expect that Ghana would continue to pursue market-friendly policies, mainly due to the economy's dependence on trade with industrialized countries. Nevertheless, it would have limited capacity to repay debt in full. Moreover, we expect that debt owed to multilateral and official lenders would continue to be a relatively large proportion of the total external debt stock, raising the risk of effective subordination of commercial creditors.	Farouk Soussa
Grenada	B-/Stable/C	3	B-	The recovery analysis assumes fiscal stress in Grenada resulting from lower-than-expected economic growth or insufficient fiscal discipline. We also take into account a scenario in which a natural disaster could trigger default.	Under the default scenario for Grenada, the recovery rating is supported by the country's membership in the Eastern Caribbean Currency Union (ECCU), which makes a currency crisis and related knock-on effects less likely. The recovery rating is also supported by the last default episode, in which Grenada made significant efforts to restructure its debt quickly. The main constraint on the recovery rating, which balances the above supporting factors, is Grenada's very high public sector debt, which would further increase under our default stress simulation.	Olga Kalinina
Guatemala (Republic of)	BB/Positive/B	3	BB	The recovery analysis assumes a financial sector crisis in Guatemala accompanied by a political crisis and social unrest. This could not only produce a run on deposits, but also a significant depreciation of the currency.	Under the default scenario, the recovery rating is supported by debt that would remain moderate--even under our default stress scenario--and by a continued strong inflow of remittances. The recovery rating is also supported by Guatemala's openness to international capital and goods markets. A constraint on the recovery rating is the expectation that the government might be inclined to support the domestic banking sector to the detriment of government creditors. The recovery rating is also limited by a high proportion of debt owed to multilateral institutions, which we expect would benefit from preferential treatment by the government, to the detriment of commercial creditors.	Roberto Sifon Arevalo

Table 2

Speculative-Grade Sovereign Recovery Review* (cont.)						
Indonesia (Republic of)	BB-/Stable/B	3	BB-	The recovery analysis for Indonesia assumes a political crisis or policy errors, and social unrest. These would engender a sustained high interest rate environment, coupled with a falling currency and reserves that would put pressure on domestic and foreign debt, respectively.	Under the default scenario, the recovery rating is supported by simulated debt levels which, while high under default, remain well below Indonesia's past crisis levels. Government policies are not expected to radicalize under the default scenario. But the recovery rating is constrained by Indonesia's Paris Club-induced rescheduling of commercial loans in the recent past and the expectation that official loans would remain significant in a default scenario. The scenario assumes that, in this case, both official and commercial creditors, including bondholders, would face a moderate haircut of principal.	Sani Hamid
Jamaica	B/Stable/B	4	B	The recovery analysis assumes that Jamaica would default on its commercial foreign currency debt as a result of a natural disaster that causes significant damage to the country's tourist infrastructure.	Under this scenario, the recovery rating is somewhat supported by strong institutions and a relatively strong debt payment culture. Nevertheless, the recovery rating is substantially constrained by very high levels of fiscal and external debt under our default stress simulations, and by the potential for a contemporaneous banking crisis.	Olga Kalinina
Lebanon (Republic of)	B-/Watch Neg/C	4	B-	The recovery analysis assumes that Lebanon would default on its commercial foreign currency debt as a result of refinancing difficulties. These difficulties would arise from a political crisis that causes domestic banks and the Lebanese diaspora to lose confidence in the government.	Under this scenario, the recovery rating is somewhat supported by the country's debt payment culture. Constraining factors outweigh this, however, and include very high levels of fiscal and external debt under our default stress simulations, and the financial stress that could result if a default led to the loss of the exchange-rate peg.	Ben Faulks
Macedonia (Republic of)	BB+/Stable/B	2	BBB-	The recovery analysis assumes that Macedonia would default on its commercial foreign currency debt following political instability (potentially due to inter-ethnic tensions) and the loss of momentum for reform.	Under this scenario, the recovery rating is strongly supported by Macedonia's EU candidacy, which creates high incentives for the government to offer favorable terms to creditors, and our expectation that inflows of remittances would remain relatively robust in the crisis. The recovery rating for commercial debt is somewhat limited by a high proportion of debt owed to multilateral institutions, which we expect would benefit from preferential treatment, to the detriment of commercial creditors.	Sladana Tepic

Table 2

Speculative-Grade Sovereign Recovery Review* (cont.)						
Morocco (Kingdom of)	BB+/Positive/B	2	BBB-	The recovery analysis is based on a default scenario in which a terms of trade shock and/or a deteriorating internal security situation lead to a sustained deterioration in Morocco's balance of payments and budgetary performance.	Even under a restructuring scenario, we believe that Morocco's debt burden would remain at a relatively moderate level, and that foreign remittance inflows would remain stable. Furthermore, we expect that Morocco would continue to pursue market-friendly policies, in part because of its strong political and commercial ties to the EU and the U.S. Also, we expect that debt owed to multilateral and official lenders would continue to be a relatively small proportion of the total external debt stock, reducing the risk of effective subordination of commercial creditors.	Veronique Paillat-Chayrigues
Pakistan (Islamic Republic of)	B+/Negative/B	3	B+	The recovery analysis assumes that Pakistan would default on its commercial foreign currency debt following a political crisis that precipitates capital flight and endangers the financing of a large current account deficit.	Under this scenario, the recovery rating is supported by the relatively limited impact of a default on the wider economy and a stable flow of remittances. External assistance may also be provided owing to Pakistan's geopolitical importance. On the other hand, the recovery rating is constrained by a relatively high level of debt under our default stress simulations. It is also constrained by a high proportion of debt owed to multilateral institutions, which we expect would benefit from preferential treatment by the government, to the detriment of commercial creditors.	Agost Benard
Panama (Republic of)	BB/Positive/B	3	BB	The recovery analysis assumes that Panama would default on its commercial foreign currency debt following a prolonged slowdown in global trade flows that in turn impairs the sovereign's fiscal dynamics. Equally, there could be fiscal deterioration triggered by problems at the Panama Canal (such as a reduction in traffic, cost overruns with the extension, or terrorist attacks).	Under this scenario, the recovery rating is supported by Panama's strong integration into global trade and capital markets, which should encourage the government to offer favorable terms. On the other hand, the recovery rating is constrained by very high levels of fiscal debt under our default stress simulations and the adverse effects of the default scenario on fiscal flexibility.	Lisa Schineller

Table 2

Speculative-Grade Sovereign Recovery Review* (cont.)						
Peru (Republic of)	BB+/Positive/B	3	BB+	The recovery analysis assumes Peru would default on its commercial foreign currency debt following a combination of increasing social tension that polarizes the political debate in the country and a terms of trade shock such as a rapid decline in mineral prices.	Under this scenario, the recovery rating is supported by relatively low fiscal and external debt levels--even following our default stress simulations. Nevertheless, these supporting factors are balanced by the detrimental effect of the default scenario on Peru's balance of payments and on its fiscal revenues. The recovery rating is also somewhat constrained by the large proportion of debt owed to multilateral institutions, which we expect would benefit from preferential treatment by the government, to the detriment of commercial creditors.	Sebastian Briozzo
Philippines (Republic of)	BB-/Stable/B	3	BB-	The recovery analysis assumes that the Philippines would default on its commercial foreign currency debt as a result of a loss of investor confidence and ensuing exchange rate pressures. The latter could be triggered by the weakening of fiscal austerity measures, a terms of trade shock, or political turmoil.	Under this scenario, the recovery rating is supported by the Philippines' inflows of remittances, which we expect would remain relatively stable in the crisis. The country's still relatively high reliance on external creditors also indicates high incentives to offer favorable restructuring terms following default. External assistance may be provided owing to the geopolitical and counter-terrorism importance of the Philippines. Nevertheless, these supporting factors are balanced by constraints that include vulnerability to the confidence-sensitive peso and limited fiscal flexibility.	Agost Benard
Serbia (Republic of)	BB-/Stable/B	4	BB-	The recovery analysis assumes that Serbia would default on its commercial foreign currency debt as a result of greater influence of nationalist or populist attitudes on government policies and the willingness to service foreign currency debt.	Under this scenario, the recovery rating is somewhat supported by inflows of remittances, which we would expect to remain relatively stable during the crisis. The recovery rating is substantially constrained by high external debt indicators under our stress simulations, and the expectation that external creditors' claims would receive a relatively low priority following default.	Sladana Tepic
Sri Lanka (Democratic Socialist Republic of)	B+/Stable/B	4	B+	The recovery analysis assumes that Sri Lanka would default on its commercial debt obligations as a result of separatist conflict where disabling attacks on key economic targets would cause a sharp and sudden impairment of foreign exchange inflows, or if the conflict results in the break-up of Sri Lanka into separate entities.	Under this scenario, the recovery rating would be supported by the inflow of remittances, and the likely forbearance extended by creditors sympathetic to Sri Lanka's predicament. The recovery rating is constrained by the continued high reliance on concessional multilateral external debt and the expectation that such creditors would enjoy priority over commercial creditors under a default scenario.	Agost Benard

**Table 2**

Speculative-Grade Sovereign Recovery Review* (cont.)						
Turkey (Republic of)	BB-/Stable/B	3	BB-	The recovery analysis assumes that Turkey would default on its commercial foreign currency debt following a balance of payments crisis that pushes the sovereign's short-term financing requirement to an unsustainable level.	Under this scenario, the recovery rating is supported by the country's good debt payment record, its EU aspirations, and its economic dependence on inflows of capital. These factors give the government high incentives to offer the best possible restructuring terms following default. External assistance may also be provided owing to Turkey's geopolitical importance. Even so, the recovery rating is constrained by relatively high levels of fiscal and external debt under our default stress simulations.	Farouk Soussa
Ukraine	BB-/Negative/B	4	BB-	The recovery analysis assumes that Ukraine would default on its commercial foreign currency debt following a combination of a political crisis and economic stresses, such as pressure on the currency from a terms of trade shock.	Under this scenario, the recovery rating is somewhat supported by low levels of fiscal debt, even under our default stress simulations. The recovery rating is substantially constrained, however, by low external flexibility under the default scenario and a political environment in which the claims of external creditors post-default may not be a high priority.	Moritz Kraemer
Uruguay (Oriental Republic of)	B+/Positive/B	2	BB-	The recovery analysis assumes that Uruguay would default on its commercial foreign currency debt following a reduction in economic growth that increases refinancing pressures beyond a sustainable level.	Under this scenario, the recovery rating is supported by Uruguay's small, open economy that is reliant on global capital markets. The high level of post-default recovery in the most recent restructuring is also a positive factor, as is a strong local credit culture. That said, the recovery rating is somewhat constrained by high external debt levels under our default stress simulations.	Sebastian Briozzo
Venezuela (Bolivarian Republic of)	BB-/Stable/B	4	BB-	The recovery analysis assumes that Venezuela would default on its commercial foreign currency debt as a result of a sharp fall in oil prices that leads to a political decision to default rather than cut back on social expenditure programs.	Under this scenario, the recovery rating is somewhat supported by still-moderate levels of fiscal and external debt under our default stress scenario. The recovery rating is substantially constrained by the country's weak institutions and our expectation that concerns of international creditors would not be a high political priority following default.	Richard Francis

**Table 2**

Speculative-Grade Sovereign Recovery Review* (cont.)						
Vietnam (Socialist Republic of)	BB/Stable/B	3	BB	The recovery analysis assumes that Vietnam would default on its commercial foreign currency debt following a drop in capital inflows (possibly triggered by policy missteps along the transition path to a market economy) that increases fiscal and balance of payments pressures.	Under this scenario, the recovery rating is supported by an economy (and the export sector in particular), that is relatively resilient after default. On the other hand, the recovery rating is constrained by reduced foreign direct investment inflows and, under an alternate (and less likely) scenario, the fiscal costs associated with a possible financial sector crisis.	KimEng Tan

\*All ratings and data as of Jan. 7, 2008. ¶For rated foreign currency senior unsecured debt.

**Table 3**

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