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Recovery:

Recovery Ratings Extended To Australia's Unsecured Speculative-Grade Corporate Issues; Elsewhere In Asia-Pacific To Follow

Primary Credit Analyst:

Anthony Flintoff, Melbourne (61) 3-9631-2038; anthony_flintoff@standardandpoors.com

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Recovery Ratings Extended To Australia's Unsecured Speculative-Grade Corporate Issues; Elsewhere In Asia-Pacific To Follow

Mirroring global trends, recovery expectations are becoming increasingly important for investors in Australian debt markets. For many investors, recovery has historically been a secondary consideration in corporate credit. Several factors, however, are converging to encourage a more comprehensive analysis of recovery prospects: the requirements of Basel II and other risk-based capital-adequacy management regimes, as well as the prevalence of collateralized debt obligations (CDO) and credit default swaps (CDS). More than ever, these factors are forcing investors to decompose credit into its key components—default and recovery.

Accordingly, Standard & Poor's Ratings Services has started assigning recovery ratings to unsecured loan and bond issues of Australian speculative-grade-rated corporate issuers. This follows the launch of unsecured recovery ratings in North America and Europe in March this year. Recovery ratings are indicators of estimated recovery prospects for creditors in the event of a debt issuer's payment default (see "Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt," published on Jan. 7, 2008), and serve as inputs to Standard & Poor's traditional issue-level ratings.

Recovery ratings assess a debt instrument's ultimate prospects for recovery of estimated principal given a simulated payment default. Our recovery methodology focuses on estimating the percentage of recovery that debt investors would receive at the end of a formal bankruptcy proceeding or an informal out-of-court restructuring. Lender recoveries could be in the form of cash, debt or equity securities of a reorganized entity, or some combination thereof.

We view the development of recovery expertise and the dissemination of recovery information as key to the Australian market's development, not least to keep pace with global developments. In the global market, Standard & Poor's is increasingly being asked to provide information and analysis on Australian recovery levels: for example, banks want empirical data on actual loss given default (LGD) levels in Australia, CDO investors and arrangers want loan-specific recovery ratings for corporate loans, and U.S. private-placement investors want our views on the relative ranking of creditors in the wake of court decisions, such as in the *Sons of Gwalia* case.

Given the Australian corporate-rated universe is predominantly investment grade, only a handful of speculative-grade recovery ratings have been assigned so far. However, we expect more speculative-grade corporates to be publicly rated in the future, as reduced lending capacity in the banking sector drives bond market volumes. It is, therefore, timely to have an enhanced focus on recovery, because as we head down the credit curve to where the default probability is significantly higher, recovery becomes a more important part of the investment equation. Recovery ratings will be important for these companies, as they will be a key determinant of the rating assigned to the debt issues.

Unsecured recovery ratings are an extension of our existing recovery rating framework, which—until now—in Australia has been limited to secured bonds and loans. Likewise in Asia-Pacific, existing recovery ratings have been assigned to secured loans in Singapore and Hong Kong. We will begin assigning recovery ratings to unsecured debt

in other Asia-Pacific countries following the completion of a review of the insolvency practices and securities laws as they relate to bankruptcies and voluntary workouts. In 2008, we expect to roll out unsecured recovery ratings in Singapore, Hong Kong, and Japan, and thereafter in other jurisdictions such as Korea, Malaysia, and Taiwan.

To illustrate unsecured recovery ratings in Australia, the new recovery ratings assigned to the unsecured debt of Griffin Coal Mining Company Pty Ltd. and PMP Ltd. are outlined at the end of this report.

Importance Of Recovery In The Current Leveraged Debt Markets

The expansion of recovery ratings to unsecured debt follows the release of our revised issue rating framework and recovery rating scale for speculative-grade secured debt issues in June 2007. Outside of Australia, both the leveraged loan market and speculative-grade-rated bond market have grown dramatically in the past few years. Standard & Poor's has observed nascent growth in these markets in Asia-Pacific and expect faster growth in the coming years. With unsecured recovery ratings, we are well placed to provide additional differentiation among speculative-grade instruments.

Table 1

Recovery Rating Scale And Issue Rating Criteria			
For issuers with a speculative-grade corporate credit rating			
Recovery rating	Recovery description	Recovery expectations*	Issue rating notches relative to corporate credit rating
1+	Highest expectation, full recovery	100%¶	+3 notches
1	Very high recovery	90%-100%	+2 notches
2	Substantial recovery	70%-90%	+1 notch
3	Meaningful recovery	50%-70%	0 notches
4	Average recovery	30%-50%	0 notches
5	Modest recovery	10%-30%	-1 notch
6	Negligible recovery	0%-10%	-2 notches

*Recovery of principal plus accrued but unpaid interest at the time of default. ¶Very high confidence of full recovery resulting from significant overcollateralization or strong structural features.

Recovery Ratings For Unsecured Issues Of 'BB' Rated Companies

For issuers rated in the 'BB' category, Standard & Poor's generally caps its recovery ratings at '3' (expected recovery of 50%–70%) to reflect a limit on recovery prospects because of the potential for additional debt on parity with, and prior to, the rated unsecured obligations. Using a fundamental approach to assess the recovery prospects of a company with a corporate credit rating in the 'BB' category is significantly more problematic than using this approach on 'B' and 'CCC' rated credits since the latter are inherently closer to default and the visibility of a path to default is much clearer.

Issuers rated 'BB' often have very limited, if any, secured debt, and the terms of their existing debt issues generally leave ample room for additional debt issuance. While our methodology assumes that all committed debt is fully funded prior to default, it does not make any assumptions regarding the addition of any new debt prior to default, although as a company's credit profile heads toward default, the capital structure will, in reality, look very different.

In recognition that default and valuation modelling is much more difficult for these high-speculative-grade

companies and that unsecured creditors are more likely to be negatively affected by capital structure changes, Standard & Poor's typically caps its recovery ratings on the unsecured debt of companies with corporate credit ratings in the 'BB' category (subject to certain exceptions). The recovery rating cap of '3' effectively caps our issue-level rating on such debt at the level of the corporate credit rating on the issuer.

Selected Australian Unsecured Debt Recovery Ratings

The Griffin Coal Mining Company Pty Ltd.

Standard & Poor's assigned a recovery rating of '3' to The Griffin Coal Mining Company Pty Ltd.'s (BB-/Stable/--) US\$475 million senior unsecured notes, indicating the expectation of meaningful (50%-70%) recovery in the event of default. The issue rating of 'BB-' was unchanged.

The privately owned Griffin is one of two coal-mining companies located in the Collie region of Western Australia.

Simulated default scenario

For the purposes of estimating recoveries, Standard & Poor's simulates a hypothetical default scenario. We believe the most likely path to default would involve significant delays to the mine expansion and the commissioning of the char plant. For the simulated default, the severity of the delays is assumed to result in zero revenue growth during 2009 and 2010, leading to a hypothetical default in 2011. We assume that lenders would expect to achieve greater value by a reorganization that would allow the mine to resolve the expansion and commissioning delays rather than through a liquidation of assets. Other assumptions include full utilization of all cash balances, continuation of the U.S. dollar/Australian dollar cross-currency swap, and a fully drawn US\$475 million bond and cash-advance facility.

Valuation

Under our simulated scenario, we have used a combination of discounted cash flow and enterprise value approaches to determine the enterprise value of Griffin at the point of emergence from the hypothetical default. For senior unsecured debtholders, Standard & Poor's anticipates recovery in the range of 50%-70% range, indicating meaningful recovery, resulting in a recovery rating of '3'. As a result, there is no notching in the issue rating for the U.S. dollar notes.

PMP Ltd.

Standard & Poor's assigned a recovery rating of '3' to PMP Ltd.'s (BB+/Stable/--) A\$330 million multi-currency senior syndicated loan, indicating the expectation of meaningful (50%-70%) recovery in the event of default. The issue rating of 'BB+' was unchanged.

The senior unsecured syndicated bank loan includes a standard package of financial and nonfinancial covenants. Under the terms of the syndicated bank facility, PMP is subject to a negative pledge, material-adverse-change provisions, change-of-control limits, and financial covenants. The syndicated loan does not have rating triggers, but it has restrictions on dividend payments and share buybacks.

Simulated default scenario

In our hypothetical default scenario, we think that the most likely path to default would be a precipitated by a significant deterioration in print demand. In addition, the company's operating margins would fall, as price competition generally intensifies during cyclical lows when market participants compete aggressively and sometimes irrationally to maintain volumes and capacity utilization. Other assumptions include full utilization of all cash balances, and a fully drawn committed bank facility.

For the purposes of undertaking a recovery analysis, the hypothetical scenario is assumed to occur in 2009, when the scheduled debt amortization is A\$90 million. We presume that lenders will expect to achieve greater value by a debt reorganization than through a liquidation of the company's assets.

Valuation

Under our simulated scenario we have valued PMP using a combination of discounted cash flow and enterprise value approaches. For senior unsecured debtholders, Standard & Poor's anticipates recovery in the range of 50%-70% range, indicating meaningful recovery, resulting in a recovery rating of '3'. As a result, there is no notching in the issue rating for the syndicated loan.

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