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Criteria | Financial Institutions | Finance Companies:

Recovery Ratings For U.S. Finance Companies

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Table Of Contents

Defining Our Universe

Analytical Considerations

Determining The Most Likely Default Scenario

Estimating What The Company And Collateral Will Be Worth

Determining How To Distribute The Value

Calculating The Recovery Amount

Continuous Monitoring

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Recovery Ratings For U.S. Finance Companies

Standard & Poor's Ratings Services uses a recovery rating methodology for certain speculative-grade finance companies to determine the notching of secured debt obligations relative to the counterparty credit rating. (We will also use the recovery rating methodology in the near future to determine notching for the unsecured obligations of certain speculative-grade finance companies.) The methodology is based on the framework used to assign similar ratings to the debt obligations of speculative-grade industrial issuers, which is outlined in " Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt ," published Jan. 7, 2008, on RatingsDirect.

Defining Our Universe

The recovery methodology is designed to help debt investors by providing an estimate of the likely recovery of principal and prepetition interest in the case of an issuer default. This is a fundamental component of assessing credit risk and it determines our notching of issue ratings for specific debt issues relative to the counterparty credit rating on the issuer. This information is especially pertinent to investors in speculative-grade issues, given the increased probability of the obligor's default.

For our purposes, a finance company is a nondepository financial institution that offers consumer finance, commercial finance, asset management, money services, or other related financial products to clients. This methodology is not applicable to regulated banks, given the prominent role that regulators play in the insolvency process for those institutions (de facto control over insolvent banks and the distribution of their assets). In contrast, finance company bankruptcies are governed by Chapters 11 and 7 of the U.S. Bankruptcy Code, like other corporate entities. Therefore, we use our general recovery methodology to approximate recoveries for these credits.

Of the approximately 250 financial institutions (including banks) that Standard & Poor's Financial Institutions group in North America rates, approximately 40, or 16%, are noninvestment grade. Most speculative-grade credits are finance companies; a few are broker-dealers, exchanges, or bank holding companies. Of those noninvestment-grade finance companies, 12 currently have secured debt outstanding that we have rated publicly using the recovery methodology. Approximately 12 companies have outstanding unsecured obligations that we will rate in the second half of 2008 under the recovery methodology. (Less than five companies overlap into both buckets.)

Table 1

Recovery Ratings For North American Financial Institutions

Issuer	Name/description	Summary rating	Recovery rating
ACE Cash Express Inc.	$155 million, first-lien term B bank loan due 2013	BB-	2
Asset Acceptance Capital Corp.	$150 million first-lien term B bank loan due 2013	BB+	1
Asset Acceptance Capital Corp.	$100 million first-lien revolver bank loan due 2012	BB+	1
BNY ConvergEx Group LLC	$180 million subordinated credit facility bank loan	B-	6
Checksmart Financial Company	$40 million second-lien term bank loan due 2013	CCC+	6
Checksmart Financial Company	$155 million first-lien term B bank loan due 2012	BB-	1
Checksmart Financial Company	$20 million first-lien revolver bank loan due 2012	BB-	1

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Table 1

Recovery Ratings For North American Financial Institutions(cont.)			
DaimlerChrysler Financial Services Americas LLC	$2 billion second-lien term bank loan due 2012	CCC+	6
DaimlerChrysler Financial Services Americas LLC	$2 billion first-lien revolver bank loan due 2012	BB-	1
DaimlerChrysler Financial Services Americas LLC	$4 billion first-lien term B bank loan due 2012	BB-	1
Dollar Financial Group, Inc.	$370 million first-lien term B bank loan due 2012	BB-	3
Dollar Financial Group, Inc.	$100 million first-lien revolver bank loan due 2011	BB-	3
J.G. Wentworth LLC	$325 million first-lien term B bank loan due 2014	B+	1
LNR Property Corp.	$300 million first-lien revolver bank loan due 2009	BB	1
LNR Property Corp.	$300 million term loan A bank loan due 2009	BB	1
LNR Property Corp.	$1.1 billion first-lien term B bank loan due 2011	BB	1
Marsico Parent Company, LLC	$25 million first-lien revolver bank loan due 2013	B+	2
Marsico Parent Company, LLC	$1.2 billion first-lien term B bank loan due 2014	B+	2
NCO Group Inc	$465 million first-lien term B bank loan due 2013	BB-	2
NCO Group Inc	$100 million first-lien revolver bank loan due 2011	BB-	2
Nuveen Investments, Inc.	$2.215 billion first-lien term B bank loan due 2014	BB-	2
Nuveen Investments, Inc.	$250 million first-lien revolver bank loan due 2013	BB-	2
Peach Holdings Inc.	$300 million first-lien term B bank loan due 2013	B	3
Peach Holdings Inc.	$35 million first-lien revolver bank loan due 2012	B	3

Data as of May 31, 2008.

Chart 1

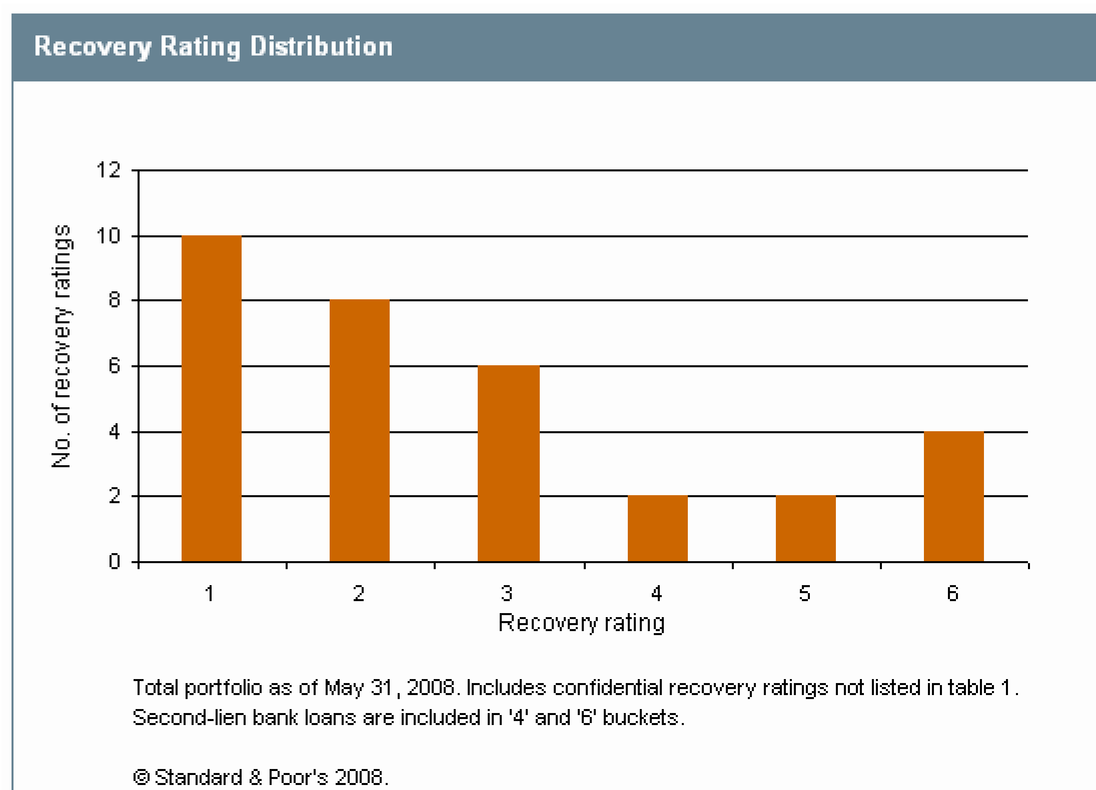

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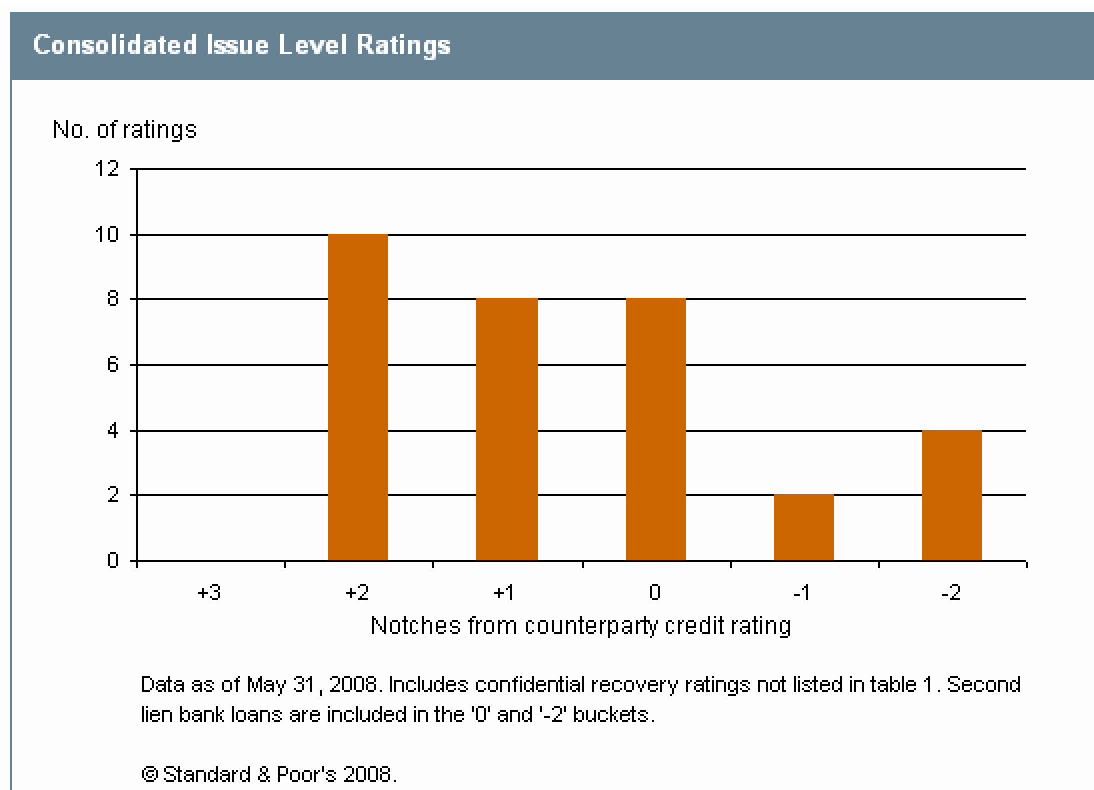
Chart 2



Finance companies that have speculative-grade ratings are often smaller, niche players that operate in a narrowly focused industry segment, or "fallen angels"--larger finance companies that were once investment grade, but have since incurred significant financial stress due to industry or company-specific factors. A number of noninvestment-grade finance companies are money service providers or asset managers. Given these companies' service orientation (as opposed to an orientation toward balance sheet-intensive lending), maintenance of an investment-grade rating is much less important. The corporate-like structure of these service-oriented finance companies has made them particularly attractive leveraged buyout (LBO) targets in recent years. A significant number of our current recovery ratings pertain to the bank loans and term debt used to facilitate these transactions.

Consumer or commercial finance companies that carry a speculative-grade rating traditionally fund their operations in the asset-backed securities markets, where the secondary market for certain financial assets such as auto, mortgage, and commercial real estate loans is reasonably well developed. A modicum of unsecured term funding may also be utilized; however, the lack of investment-grade ratings typically precludes market access at economically attractive rates. Typically such unsecured issuances at speculative-grade traditional finance companies may either be some type of convertible debt or private placement. "Fallen angels" may have outstanding unsecured debt that they issued prior to losing an investment-grade rating; the company likely will find a limited market for additional unsecured issuance at a noninvestment-grade rating level.

We therefore expect our universe of recovery ratings to remain skewed toward secured debt, especially secured bank loans. Secured bank loans have become the primary financing vehicle for high-yield issuers, supplanting high-yield unsecured debt as the vehicle of choice for transactions like LBOs and recapitalizations.

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For secured-debt recovery ratings, the structure of the transaction, most prominently the nature of the collateral package, is crucial to the determination of recovery. A primary benefit of our recovery ratings is to help investors differentiate between loans that are well secured or secured in name only, and those that are somewhere in between. Similarly, when our recovery ratings are rolled out to unsecured finance company debt, our ratings will help indicate what level of recovery, if any, various unsecured debt issues may receive based on a company's overall debt structure and our valuation assumptions.

For finance companies, the collateral package may be comprised of the tangible and intangible assets of the borrower, and increasingly, the capital stock of operating units, which provides secured lenders an indirect claim to the value represented by the subsidiaries. Many finance companies (especially those with a service orientation) have few tangible assets. Others may have financial assets on their balance sheet; however, these are typically pledged as collateral for secured borrowing vehicles such as warehouse lines that generally are not rated. Rarely are there any nonfinancial tangible assets of any consequence. This contrasts with industrial companies, where the collateral backing senior secured obligations may be comprised of assets such as accounts receivable, inventory, property, facilities, and equipment.

Analytical Considerations

Our approach is largely based on the framework we use to assign recovery ratings to industrial companies' obligations, with certain analytical adjustments to account for finance companies' unique characteristics.

The recovery rating methodology builds on our traditional approach to issue ratings. Specifically, issue ratings are a combined indicator of the probability of default and recovery prospects, with a built-in bias toward the former. However, in this case, the recovery rating dictates whether the issue rating is notched lower, higher, or the same as the counterparty credit rating. In the past this notching was based on a prescribed regime that reflected the issue's relative position in insolvency. The new recovery methodology is based on the specific issue's recovery expectations relative to the long-term average recovery rate of unsecured debt. We will rate issues with recovery rates we estimate to be significantly higher than 50% (i.e., an expected recovery of 70% or more) higher than the counterparty credit rating, and those significantly below 50% (i.e., an expected recovery of 30% or below) lower than the counterparty credit rating.

Our notching regime for recovery ratings is described in detail in "Recovery Analytics Update: Enhanced Recovery Scale and Issue Ratings Framework," published May 30, 2007, on RatingsDirect.

Table 2

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

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Table 2

Recovery Rating Scale And Issue Rating Criteria(cont.)			
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.

The following steps are used to calculate the recovery value, which in turn determines the appropriate notching regime relative to the counterparty credit rating. The steps include:

- Determining the most likely default scenario;
- Estimating what the company and collateral will be worth;
- Determining how the value is likely to be distributed;
- Calculating the recovery amount; and
- Monitoring on an ongoing basis.

An explanation of how each step is applied to U.S. finance companies is outlined below.

Determining The Most Likely Default Scenario

As a starting point, we determine the most likely path to default. We identify the primary economic, industry, and firm-specific factors that contribute to a payment default. This generally includes only a few key operating factors, with a focus on higher-probability scenarios. For finance companies, typical economic and industry factors include the state of the economy, position within the credit cycle, level of market interest rates, degree of liquidity available in the credit markets, and borrower demand. Key company-specific operating factors may include asset quality, liquidity/funding, market risk exposure, and other operational issues. Cash-flow projections may be used to understand the sensitivity of the finance company to these variables. Lastly, we project the company's financial condition at the time of default. This may include projections of default-level EBITDA and major balance-sheet line items at the time of default.

Estimating What The Company And Collateral Will Be Worth

The valuation process focuses on the value that investors would receive at the end of an insolvency process as the company emerges from bankruptcy or is liquidated. We use two methods for finance companies: discrete asset analysis or enterprise valuation. The choice of method generally depends on the nature of the company's business, the path to default, and the type of assets and collateral.

We use discrete asset valuation most often when our simulated default scenario indicates that the borrower's liquidation is the most likely outcome of insolvency, or when we believe that recovery depends on the value of specific assets rather than on a borrower's enterprise value. Therefore, we typically use discrete asset valuation when the company's default is due to a fatal decline in its business model (i.e., there is no sustainable business model to reorganize) or when the collateral consists of readily defined financial assets (such as mortgages, auto loans, or credit card receivables). We usually ignore assets such as accounts receivable, inventory, or property, plant, and equipment--which are insignificant for a finance company--in our liquidation analysis. We may also use discrete asset valuation when, due to the nature of the company, there is significant uncertainty regarding the value of quantitative inputs used to calculate an enterprise valuation. For example, although the analyst may have a

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reasonable idea what a finance company's path to default may look like, the form that reorganization would take and the implications for the company's valuation may be more challenging to fathom. Thus, as a simplifying assumption, we may posit that the company liquidates and use a discrete asset valuation approach.

We use enterprise valuation when the analyst expects the business to survive default, reorganize, and emerge as a viable ongoing venture. The goal of reorganization is to maximize overall value and increase the chances of repayment for unsecured and other less-protected creditors. This valuation method is most amenable for use with finance companies that have similar financial characteristics as corporate entities. The financial variables used in an enterprise valuation--including EBITDA, free cash flow, and cash flow multiples--are reasonably estimable and meaningful for these service-oriented finance companies. In contrast, we generally do not use enterprise valuation as the primary valuation method for traditional consumer and commercial finance companies, because these companies are typically liquidated after a major tailspin event that leads to bankruptcy. Also, enterprise valuation inputs tend to be less meaningful for traditional finance companies.

We may use a combination of valuation techniques (both discrete asset and enterprise valuation) when it is unclear which method would produce the most accurate result, or as a check on the valuation results generated by one of the valuation methods. In any event, we endeavor to provide sufficient transparency to the market regarding our valuation approach and key assumptions. This is in recognition that our opinions are more valuable to market participants when they can draw value from the analysis (rather than just the conclusions), and reach their own conclusions as they see fit.

Note on discrete asset valuation

Under discrete asset valuation, we model the finance company's significant balance-sheet items as of the default year. We usually ignore insignificant balance-sheet items, generally nonfinancial assets, in the analysis. This forecast is based on pro-forma projections developed internally, with input from the company and third-party sources. Unlike industrial organizations that have a fairly static pool of assets, it is important to reflect the natural portfolio churn (which will be higher for shorter-term financial assets) in estimating the value of financial assets as of the default year.

We then apply a haircut to the estimated value of these financial assets. This haircut reflects both the intrinsic value of the asset in the market and the "forced" nature of its sale. Haircuts may be derived from a number of internal and external sources. For example, haircuts may be extrapolated from the credit enhancement levels required to rate structured securities to a certain rating level under our structured finance criteria. We have experience with collateral pools for a broad spectrum of assets classes and we can draw on this knowledge in determining the appropriate haircuts. Haircuts may also be based on advance rates that are available on the same or similar financial assets, as determined through discussions with the finance company and/or independent third parties. The haircuts used for each asset category are outlined in the recovery section of the analysis.

Note on enterprise valuation

To calculate a finance company's enterprise value upon emergence from bankruptcy, we use multiples and/or a discounted cash flow (DCF) analysis.

To apply multiples analysis, we calculate enterprise value by taking a multiple of projected EBITDA at the time of default. The "default EBITDA proxy" is our estimate of the EBITDA at the point the company's profitability and available funds are insufficient to pay the firm's fixed charges in the default year. Fixed charges include scheduled debt amortization, required cash interest payments, and "bare bones" maintenance capital expenditures. (Bullet

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maturities of debt are not considered fixed charges; we assume such amounts would be automatically refinanced, thus requiring additional deterioration to actually trigger a default.)

Ideally, in selecting the appropriate multiple, we would choose an "emergence" multiple that reflects the price at which a similar firm was reorganized and purchased out of bankruptcy. While theoretically this is the most satisfying answer, most such transactions are private and as such, little public information is available. Most often, we use transaction multiples derived from mergers and acquisition transactions conducted by the same or similar companies, which are more widely available, especially for small to midsize niche finance companies. We apply a haircut to the transaction multiple to reflect the company's distressed condition as it emerges from bankruptcy. Another option might be to use trading multiples for similar firms; however, this is not preferred because these companies are typically larger and more financially sound, and the multiples wouldn't reflect an emergence scenario, but current market conditions. Regardless of the choice of comparable companies, analytical judgment is required to adjust the results for market conditions, such as deteriorating industry fundamentals, if necessary.

We occasionally use a three-stage DCF model, usually as an adjunct to multiples analysis. The path to default, period during insolvency, and long-term terminal value of the reorganized firm are modeled separately and summed to determine the enterprise value. The limited use of DCF reflects the fact that most traditional consumer and commercial finance companies are liquidated after bankruptcy. In addition, we believe DCF is not the optimal method to calculate recovery for companies whose value is derived more from the assets on their balance sheets than from GAAP earnings and associated cash-flow measures, which can be obscured by accounting conventions. DCF is more likely to be used to value finance companies with corporate characteristics, especially when we assume the company is reorganized and there are insufficient comparable transactions.

Determining How To Distribute The Value

Thus far, we have discussed how we use discrete asset and enterprise valuation techniques to determine the recoverable value that will be available to pay off creditors. This section discusses considerations that affect the distribution of that value, and therefore, the ultimate recovery.

Lender recoveries can be in the form of cash, debt or equity securities of a reorganized entity, or some combination thereof. The distribution of value to claimants is based on the relative seniority of claims.

We generally assume that value is distributed by using a waterfall approach that considers the relative seniority of claimants. In order of seniority, that waterfall is:

- Debtor-in-possession financing;
- Administrative expenses;
- Federal and state taxes;
- Senior secured debt, including any associated revolving debt;
- Junior secured;
- Senior unsecured;
- Subordinated debt;
- Preferred stock;
- Common equity.

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The goal of our recovery methodology is to estimate the recovery lenders will recoup on the secured and unsecured obligations of speculative-grade companies. However, we note that the beneficial position of secured creditors is only valid to the extent they are fully collateralized. In this light, whereas the category of a debt instrument gives some indication of relative seniority, the legal structure and associated terms and conditions associated with each transaction are the ultimate arbiter of seniority. We also acknowledge that strict adherence to this priority list does not always hold in a Chapter 11 proceeding because senior creditors may elect to provide some level of accommodation to junior creditors to speed a resolution. That said, predicting whether accommodations will occur or be material enough to affect recoveries is challenging and is generally beyond the scope of our analysis.

Priority claims and other considerations

Priority claims are claims that must be satisfied prior to each relevant class of creditors. Priority claims must be considered before determining what the ultimate recovery will be. Examples of potential priority claims include administrative claims (professional fees or post-petition financing), asset-based loans that have priority liens on particular assets (including asset-based revolvers, warehouse facilities, and other on-balance-sheet secured vehicles--including on-balance-sheet securitization liabilities), and debtor-in-possession financing. The presence of obligations with higher priority liens on certain assets means that the recovery value available to other creditors must be reduced, in some cases, to account for the distribution of value to satisfy these creditors.

Debtor-in-possession (DIP) financing

DIP facilities are usually super-priority claims that enjoy repayment precedence over unsecured debt and, in certain circumstances, secured debt. However as a practical matter, DIP financing is rarely provided to an insolvent company unless the DIP lenders are highly confident of a full recovery--hence its prominent placement in our waterfall. Even so, it is very difficult to quantify the size or likelihood of DIP financing. Further DIP financing may fully or partially repay prepetition debt and may help overall recovery prospects by allowing a company to restructure and preserve the value of its business. As a result of these uncertainties, our analysis does not account for the potential impact of DIP facilities, even though we recognize that DIP facilities may materially affect recovery prospects in certain cases.

Administrative claims

Administrative expenses relate to fees incurred in the bankruptcy process for lawyers and other professionals. Although these costs are not explicitly priority claims, they must be paid as part of the bankruptcy process, and thus, are effectively senior to those of other creditors. Our estimate for these expenses ranges from 3% to 7% of our anticipated enterprise valuation, depending on the complexity of the firm's capital structure. For a discrete valuation, we generally assume that these costs are implicitly covered in our liquidation value estimates.

Unpaid state and local taxes

Various U.S. government authorities successfully assert tax claims as administrative, priority, or secured claims. However, it is very difficult to project the level and status of such claims at origination. Although such claims will normally be paid before senior secured claims, their overall amount is seldom material enough to affect lender recoveries. Therefore, we acknowledge that tax claims may indeed be priority claims, but we generally do not, at origination, reduce our expectation for lenders' recovery by estimating the amount of potential tax claims.

Asset-based loans

Asset-based loans are collateralized by assets that are currently part of a borrower's enterprise value, necessitating the inclusion of the associated debt in our analysis. We address the debt and related assets differently under each

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valuation method. In an enterprise valuation, we generally assume that the asset-based facility is fully drawn and the value available in recovery to creditors is reduced by this amount. Under the discrete asset valuation methodology, the requirement that borrowers maintain a certain level of overcollateralization influences the amount of residual assets that are available to satisfy the claims of secured and unsecured borrowers. In limited cases, we may assume static advance rates and collateral values for analytical purposes. (This would typically occur when the collateral consisted of lower-volatility financial assets.) However, if the default scenario envisions rapidly declining collateral values, assumptions will be made as to the amount of currently unencumbered collateral that needs to be reserved to back the secured obligation, and therefore won't be available in recovery for other secured and unsecured debt holders. For most traditional consumer and commercial finance companies, the default scenario will likely incorporate extreme liquidity stress. In these cases, we will assume that all eligible assets are encumbered, leaving nominal assets for recovery.

Claims related to swap transactions and other financial contracts

The U.S. Bankruptcy Code accords special treatment for counterparties to certain financial contracts (such as swaps, repurchase agreements, securities contracts, and forward contracts) to ensure continuity in the financial markets and to avoid systemic risk. In addition to not being subject to the automatic stay that generally precludes creditors from exercising their remedies against the debtor, these financial contract counterparties have the right to liquidate, terminate, or accelerate the contract in a bankruptcy. Most currency and interest rate swaps related to secured debt are secured on a pari passu basis with the respective loans. Other swaps are likely to be unsecured. Although we acknowledge the potential for such claims, quantifying such claims will usually be impractical and beyond the scope of our analysis.

Securitization

In a securitization transaction (which generally involves the sale of assets to a bankruptcy-remote entity), the financial assets sold are not legally part of an entity's estate, even though they may be recorded on the balance sheet. Under the discrete asset valuation method, we treat securitized debt as a secured claim with priority on the value of the associated assets. Therefore, only the residual values from these transactions may be considered an unencumbered asset for valuation purposes. Due to the volatility often associated with residual assets, analysts will decide on a case-by-case basis whether these assets will retain value in a default scenario and what haircuts, if any, should be employed.

The recovery ratings on the speculative-grade obligations of finance companies that regularly access the asset-backed securities market are for the most part assigned using the discrete asset valuation approach. In the rare cases where an enterprise valuation is used, the associated securitization debt is excluded from the analysis and does not reduce the value left for secured and unsecured claimants in recovery. Because the investors that rely on the assets for repayment generally have no recourse against the company, we don't consider them claimants under the enterprise valuation method.

Leases

Leases are not a major analytical factor for most finance companies. Where leases consist mainly of headquarters and operational facilities, we make a simplifying assumption that effectively excludes them from the recovery analysis. We assume that in a bankruptcy, leases will be brought current and the lessor has no claims on the recovery value of the bankrupt entity. Further, the lessee continues to use the leased facility and the cash flow/resulting value from its use is available to support other creditors. Exceptions to this simplifying assumption may be made for entities whose business operates through retail store networks, including money services businesses

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such as check cashers/payday lenders. When the maintenance of current lease payments is viewed as unlikely given the assumed default scenario, these assumptions may be altered. If the analyst determines that a number of the operating leases will be rejected in bankruptcy, he may estimate the value of the resulting claim and add this to the claims of other unsecured creditors, including unsecured debt holders, in determining the total unsecured claim against any value available after settling the priority and secured claims.

Calculating The Recovery Amount

To determine the recovery ratings, we distribute the nominal value (which has been determined by the enterprise or discrete asset valuation methods) to the various secured and unsecured creditors, based on their relative priority. There are several nuances to the calculation:

- Although the estimated value that investors will receive is sometime in the future, we do not calculate recovery in terms of present value. Because market participants use a variety of discount rates, we assume they can best apply their preferred discount rate to our nominal recovery.
- Six months of past-due prepetition interest is added to the outstanding debt, in order of priority. Interest is considered a formal prepetition claim and as such, it affects ultimate recovery.
- In terms of exposure at default, we generally assume all secured and unsecured revolving facilities are drawn.

Continuous Monitoring

The analyst will complete periodic and event-specific surveillance designed to monitor developing risk exposures that might affect recovery. At a minimum, a committee will review the recovery rating formally once per year.

Click on this link to see other articles in "Special Report: The Debt Market Spotlight Shifts To Recovery."

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