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Recovery:

As Defaults Increase, The Debt Market Spotlight Shifts To Recovery

Loan & Recovery Ratings:
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Recovery:

As Defaults Increase, The Debt Market Spotlight Shifts To Recovery

After months of focus on structured finance and financial institutions' debt, market attention is shifting to leveraged corporate debt as defaults begin to increase. Already this year, global corporate defaults have outnumbered those for all of 2007 (see sidebar at the end of this article), and market participants are understandably sharpening their scrutiny on the bulge of speculative-grade loans and bonds issued during the record expansion from 2005 through mid 2007. As of mid May, corporate borrowers had defaulted on almost $19 billion of debt--more than double last year's total. Standard & Poor's Ratings Services sees the potential for continued growth in defaults through this year and next.

But beyond default risk, the key factor driving credit exposure for many holders of both cash and synthetic leveraged credit is the prospect for recovery. Predicting which issuers will miss payments on which issues can be very difficult when borrowers are rated 'B-' or 'CCC' and nearing the edge of default. But developing an understanding of what lenders can expect in the event of a borrower's default may be more feasible--and this is the focus of Standard & Poor's recovery ratings.

Market pricing on leveraged debt has reflected the increased emphasis on recovery as default risk has risen. Loans in the S&P LSTA index tracked by Standard & Poor's Leveraged Commentary & Data show a widening of average secondary-market credit spreads between loans with disparate recovery prospects: By May, the average spread for loans with a recovery rating of '6' (indicating the expectation for 0% to 10% of recovery in the event of a payment default) had risen more than 700 basis points above the average spread for loans with a recovery rating of '1' (indicating the expectation for 90% to 100% recovery). (See chart 1.)

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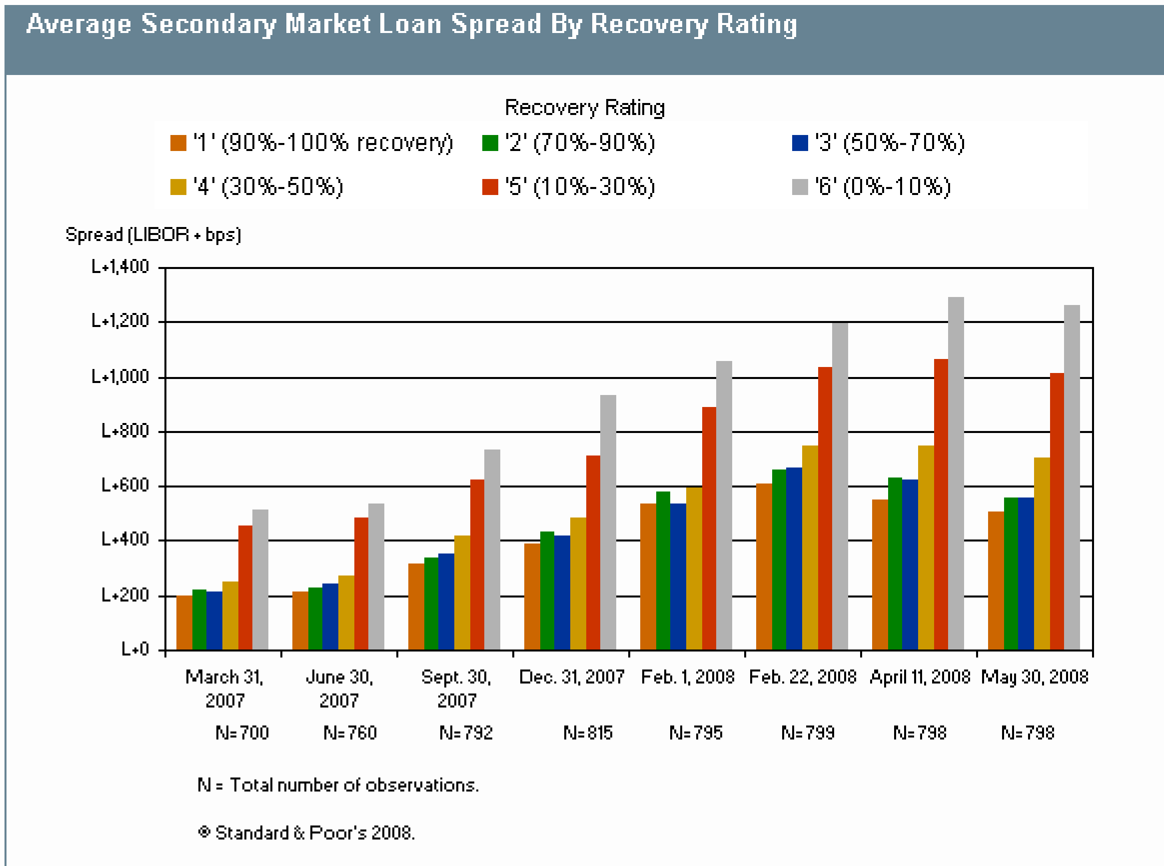
Chart 1



Recovery Ratings Profile

Recovery ratings are estimates of ultimate recovery of nominal principal and pre-petition interest if a company were to default on a specific issue. The scale ranges from '1+' (highest expectation for full recovery) to '6' (negligible recovery).

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.

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With the rollout of recovery ratings to 1,800 unsecured loans and bonds in March, we now have recovery ratings on more than 4,000 leveraged loans and bonds, comprising more than 75% of the $1.5 trillion of broadly syndicated speculative-grade debt outstanding in the U.S.

A current review of Standard & Poor's U.S. portfolio of recovery ratings shows that:

Capital structure position alone doesn't determine recovery risk. Even for secured classes of debt, recoveries have become materially spread out.

Recoveries in the current credit cycle may be generally lower than historical data indicate, especially for unsecured bonds and loans.

Recoveries will likely reflect the role of new factors behind insolvencies in the U.S. and, potentially, other markets. Among these are the rise of institutional investors and the decline of banks as holders of leveraged credit, as well as the emergence of liquidations in place of reorganizations in insolvencies (especially in the U.S.) as a result of limited availability of the debtor-in-possession financing needed to complete reorganizations.

Recovery Trends

The rollout of recovery ratings to unsecured debt confirms two key trends: (1) recovery ratings are dispersed among secured and unsecured debt classes, and (2) recovery ratings show little systemic correlation with industry sectors.

Recovery ratings are dispersed among debt classes

Recovery ratings on secured debt are concentrated at the higher end of the overall distribution, with an average rating of '2.23', while recovery ratings on unsecured debt cluster at the lower end of the scale, with an average of '4.59'. Still, both range widely from these central tendencies. (See charts 2 and 3.)

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Chart 2

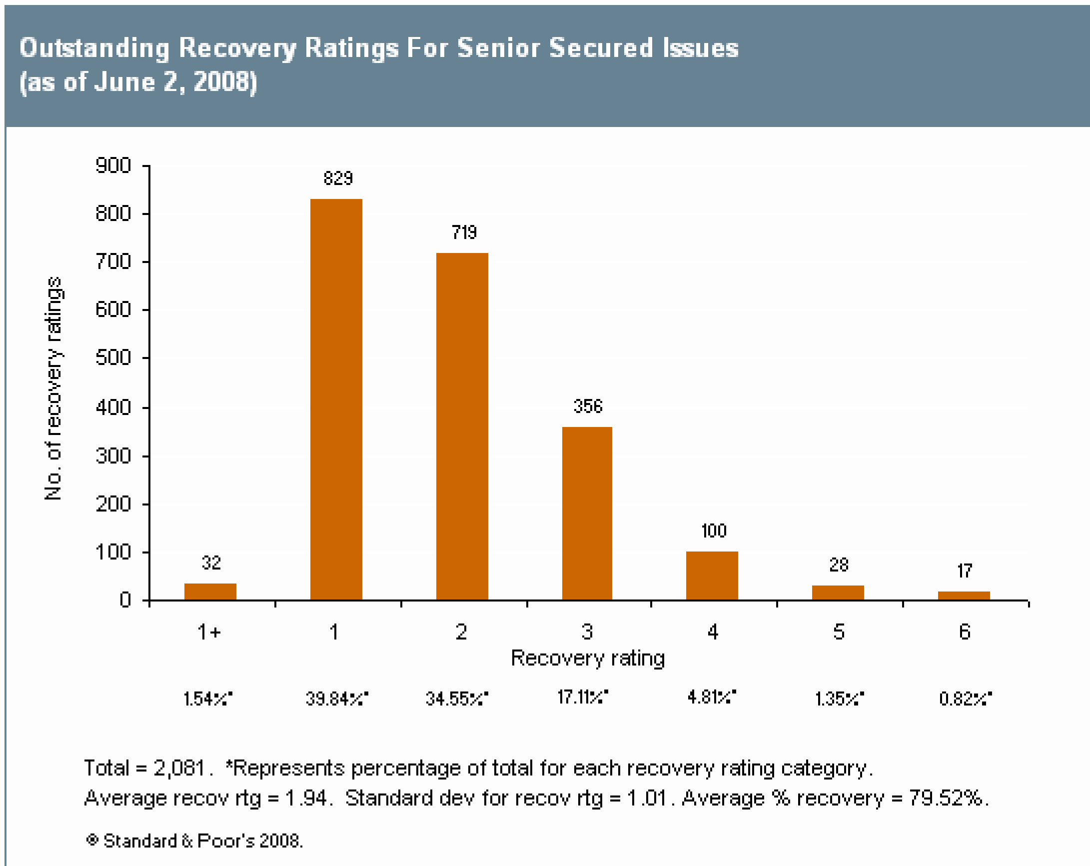

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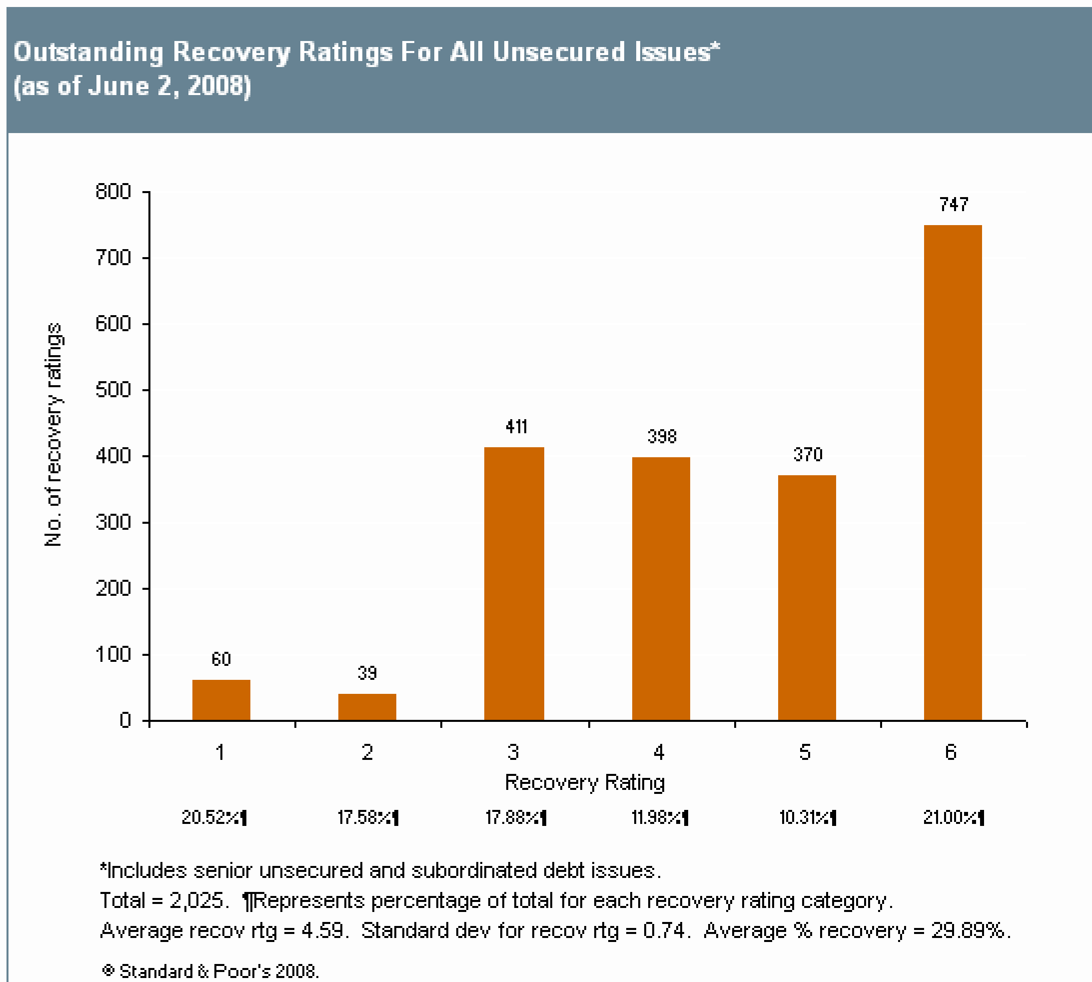
Chart 3



Overall, our recovery ratings suggest that actual recoveries will be below the historical levels shown in Standard & Poor's LossStats® data for both secured and unsecured debt. The data suggest that senior secured recoveries will be below the historical average of above 80%, with a mean recovery rating equivalent to 79.5%. Unsecured recoveries may be below the historical average of about 40%, with a mean recovery rating equivalent to 30% for all unsecured debt issues and 35% for senior unsecured debt (see charts 3 and 4).

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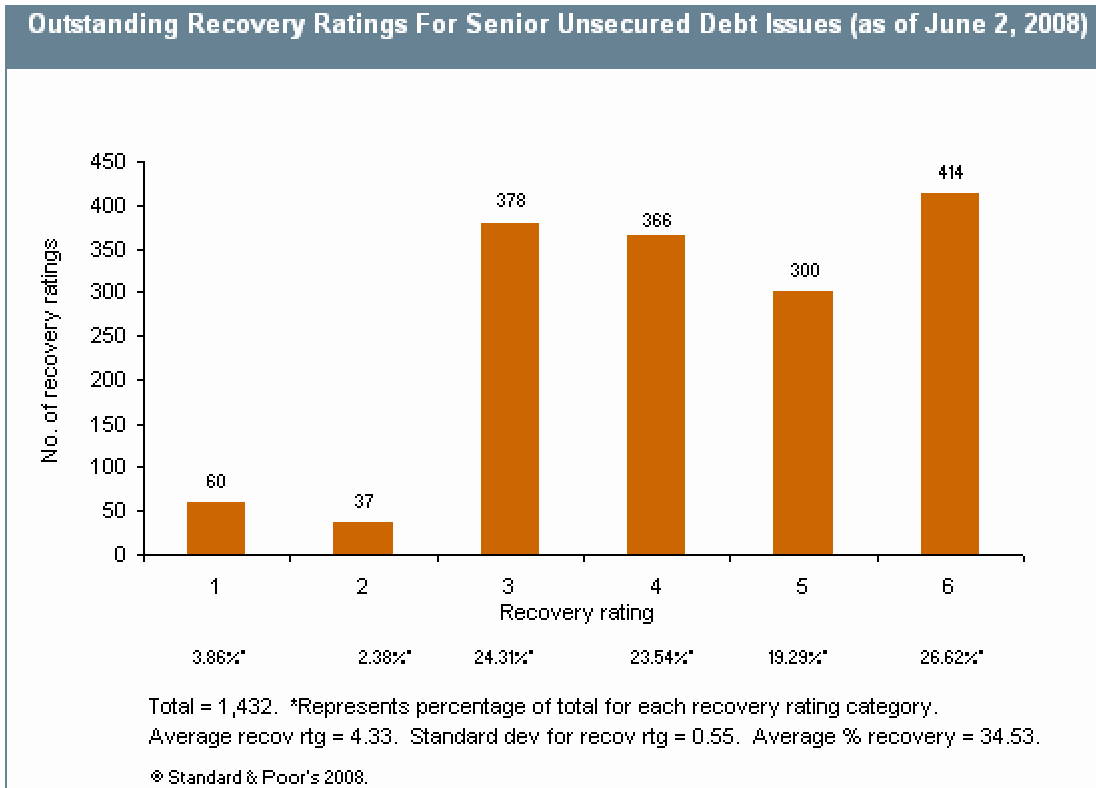
Chart 4



These lower recovery prospects reflect a series of general factors that Standard & Poor's has identified since the inception of recovery ratings in 2003: rising leverage, levered dividend cash-outs, the growth of asset-light deals and covenant-lite structures, and the advent of payment-in-kind debt in leveraged credits. In addition, the lower recovery expectations for unsecured debt reflect the growth of secured debt ahead of unsecured issues in the recent expansion of the leveraged debt market.

Sector distributions mirror overall dispersion

Recovery ratings show little systemic correlation with industry sectors. The distribution of recovery ratings within most sectors shows little material departure from the overall distribution, with a few exceptions: U.S. investor-owned electric utilities, and U.S. health care, consumer products, and high-tech borrowers. (See chart 5.)

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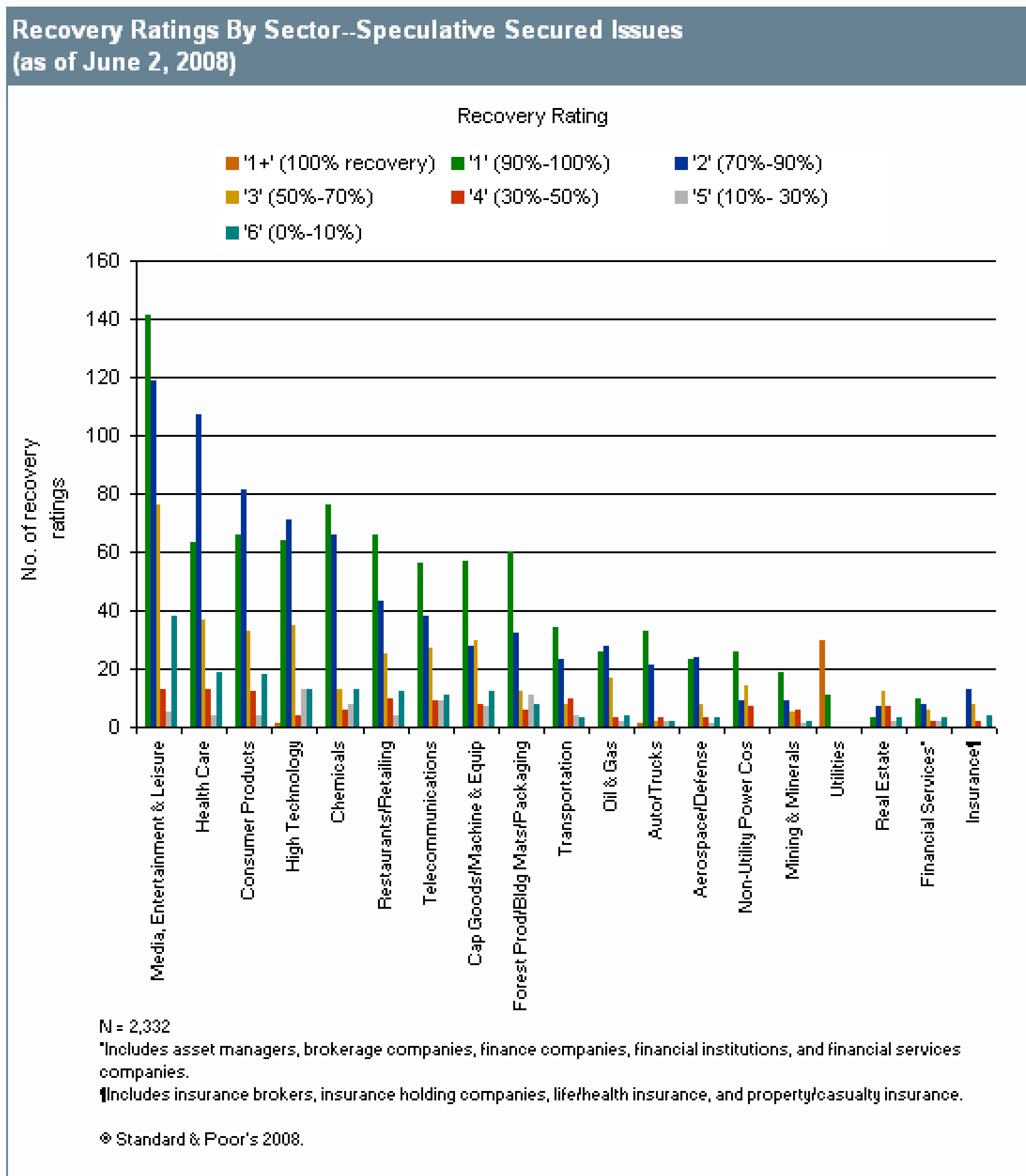
Chart 5



For U.S. electric utilities, secured recovery ratings are substantially higher than in other sectors, concentrating in the highest categories of '1+' and '1'. Actual recoveries on the limited number of utility defaults that have occurred in the U.S. underpin these superior recovery prospects. U.S. utilities' recovery prospects benefit largely from borrowers' limited leverage and the favorable regulatory treatment that holders of secured and unsecured utility debt have received in the insolvencies of private U.S. utilities.

In the U.S. health care, consumer products, and high-tech sectors, high leverage combined with asset-light deals that lasted until mid 2007 to limit recoveries, making the most frequent recovery rating on secured debt in these sectors '2', rather than '1' (as in the overall distribution of secured debt recovery ratings).

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New Factors In Recovery

It is too early to gauge the specific profile of recoveries in the current credit cycle. But it is clear that some new forces have the potential to play a role in this round of defaults and recoveries: the change in holders of leveraged loans and the rise of liquidation as an alternative to restructuring, especially in the U.S.

Change in holders

In past market contractions (including the two most recent, in 2000-2002 and 1990-1992), most loans were originated and held by banks, which generally booked loans at par and often held them to maturity. If a loan defaulted, banks had strong interest in achieving par or near-par recovery on the secured debt, in order to avoid the recognition of losses.

Since 2002, nonbank institutional investors have substantially replaced banks as the holders of broadly syndicated loans, with nonbank institutions now holding more than 60% of widely syndicated loans--up from less than 20% in 2002. These institutional holders may not have the same incentives as banks in pursuing debt recoveries during restructuring. They may have shorter holding periods, less interest in par recoveries, and, in some cases, may focus on strategies with only secondary interest in debt recovery (such as so-called loan-to-own).

Rise of liquidations

In addition, U.S. insolvencies in recent credit cycles have generally involved restructuring rather than liquidation, with the former outnumbering the latter by a wide margin in the U.S. But restructurings require some form of liquidity to support the borrower during the reorganization process. In the current market, contraction in overall bank liquidity has, for some borrowers, limited the availability of traditional sources for lending to support restructurings (such as debtor-in-possession financing in the U.S.). As a result, Standard & Poor's expects that there will be more liquidations in place of restructurings during this credit cycle than in recent credit reversals (at least in the U.S.), and that this trend may contribute to lower recoveries.

With defaults creeping higher and a rising focus on recovery prospects, we believe it is especially important to look at instrument-specific analysis rather than average recoveries based merely on historical data. Against this background, recovery ratings for both secured and unsecured debt show the importance of estimating individual recoveries and recognizing that past patterns for recovery may change with the rise of new forces in the leveraged debt markets.

Research assistance for this report was provided by Alfred Bonfantini and Annabelle Garces.

Sidebar: Defaults Creep Higher

Amid increasingly dour economic forecasts and continuing tight credit market conditions, defaults on Standard & Poor's rated corporate credits have begun to creep up from the historical lows of recent years. While still well below recent totals, global corporate defaults this year have already outpaced those for all of last year on both an absolute and monetary basis, according to Standard & Poor's Global Fixed Income Research. Through May 13, 2008, a total of 28 defaults were recorded--more than the 22 defaults in all of last year. And the dollar amount affected tells an even starker story. So far this year, $18.9 billion has been affected--more than double the $8.1 billion for all of last year, and approaching three times the $7.13 billion (on 30 defaults) in 2006.

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All but one of this year's defaults (as of May 13) have been in the U.S. (the other was in Canada), with some concentration in certain sectors, especially those that are most affected by discretionary consumer spending. The U.S. leisure/media and consumer service sectors, for example, each suffered three defaults in April alone. While secured lenders to these sectors can expect substantial to meaningful recoveries--as reflected in our recovery ratings on borrowers in the sector--unsecured lenders may see only modest to average recoveries of principal and pre-petition interest in the event of a default.

Standard & Poor's default projection

While the 12-month trailing global corporate speculative-grade bond default rate has been below the long-term (1981-2007) average of 4.35% for more than four years, it jumped to a 12-month high of 1.29% in April, from 1.14% in March. By region, the rate was 1.64% in the U.S., 0.50% in Europe, and 0.17% in emerging markets. And we expect defaults to continue to rise, especially in the U.S.

Standard & Poor's mean baseline forecast is for the U.S. speculative-grade default rate to escalate to 4.7% in the next 12 months, from a 25-year low of 0.97% at the end of 2007. This surge in defaults reflects unfolding recessionary conditions, weaker earnings prospects, and continued financial pressures that will increase lending constraints.

Meanwhile, some speculative-grade borrowers are paying interest rates that suggest investors are anticipating corporate default rates even higher than our mean projection. We agree that a material risk remains that defaults could be significantly more pronounced and severe, especially if a U.S. economic recession were deeper and longer than currently expected.

In any event, we simulate the impact on default rates using two alternative economic scenarios--one worse and one better than the baseline--both of which have an estimated 20% chance of occurring. The pessimistic scenario yields a mean 12-month default rate of 8.5%, while the optimistic scenario yields an average rate of 3.7%. It should be noted that 136 defaults would be required to reach the pessimistic forecast, with 59 needed to reach the optimistic projection.

The weakest links

With the U.S. leading the way in the increase in defaults, it should be noted that the country also has the highest number of "weakest links" (issuers rated 'B-' or lower, with either a negative outlook or listed on CreditWatch with negative implications)--with a total of 107.

Globally, as of May 13, the count of weakest links was the highest in five years, with 130 entities vulnerable to default (on rated debt of $127.4 billion). Media and entertainment, consumer products, and retail/restaurants continue to be the most vulnerable sectors, with the highest concentration of weakest links for the eleventh consecutive month. Of the 28 defaults so far this year, half were from these three sectors.

Global Fixed Income Premium Research

This sidebar is based on Global Fixed Income Research content. The premium version contains expanded analysis of the article's most significant points, typically broken out by sector and region. Also in the premium version are in-depth charts and tables, the underlying data of which are available for download. Click here for more information.

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