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Leveraged Finance:

Case Study: Countrywide PLC's Borrower-Friendly Capital Structure Wards Off Default Risk, But Weakens Secured Debt Recovery Prospects

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Table Of Contents

Corporate Credit Rating History

Recovery Rating Rationale

Borrower-Friendly Features

Severe Operating Performance Stress Diminishes Recovery Prospects

Related Research

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Case Study: Countrywide PLC's Borrower-Friendly Capital Structure Wards Off Default Risk, But Weakens Secured Debt Recovery Prospects

The boom years of 2006 and 2007 allowed for highly aggressive borrower-friendly loan structures in the European leveraged finance market. Many companies under private-equity ownership took advantage of this favorable environment, using it as an opportunity to strengthen their balance sheets in late 2006 and early 2007. This refinancing activity may have deferred defaults because any fundamental problems resulting in cash flow difficulties could be buffered by ample liquidity and a lack of effective loan covenants. But the consequent deterioration in lending standards harms ultimate recovery for investors.

The leveraged buy-out of Countrywide PLC, the largest integrated real-estate services provider in the U.K., completed in May 2007 by private-equity firm Apollo Management, was financed at the peak of the credit cycle, backed by instruments containing a number of prominent issuer-friendly features. This, together with the company's relatively flexible cost base, cushions the negative impact of weakening housing market conditions in the U.K. On the other hand, Countrywide's capital structure underpins the relatively strong operating stress simulated as part of the hypothetical path to default, thereby depressing the stressed valuation and suppressing recovery prospects for the largest class of senior secured creditors--the holders of the senior secured floating-rate notes (FRNs) and payment-in-kind-election FRNs (toggle notes). The senior secured noteholders accounted for more than 60% of total debt drawn at June 30, 2008.

The senior secured notes have a recovery rating of '4', indicating Standard & Poor's Ratings Services' expectation of average (30%-50%) recovery in the event of a payment default. We consider this level weak for first-priority debtholders given that the average recovery rating on secured first-lien debt in Europe is '2.3', with a median of '2', which covers the 70%-90% recovery band.

The issuer-friendly features in Countrywide's capital structure include an absence of maintenance covenants on the bank debt, an option available for the issuer to pay interest on the £100 million toggle notes in kind, and availability of a revolving credit facility (RCF) that is oversized compared with working capital needs. These features provide additional liquidity for the company.

Corporate Credit Rating History

On April 23, 2007, Standard & Poor's assigned its 'B' long-term corporate credit rating and stable outlook to Castle HoldCo 4, the holding company of Countrywide, and assigned issue ratings to the group's secured and unsecured debt (see "Recovery rating rationale" below). Castle HoldCo used the proceeds of the debt issues to finance Apollo Management's acquisition of Countrywide.

On Nov. 15, 2007, we revised the outlook to negative, reflecting that conditions in the U.K. residential property market are likely to adversely affect the group's future trading performance and may weaken its leveraged credit

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profile.

Falling house transaction volumes and the weakening of other leading indicators in the first quarter of 2008 then led us to expect a sharp deterioration in group trading performance during the year. There have been no further rating actions, however, as we take comfort in Countrywide's liquidity position, particularly its available cash, which we expect to support the group in 2008.

The rating continues to reflect the group's heavy reliance on the cyclical real estate sector, its geographical concentration risk in the U.K., and its highly leveraged capital structure. These factors are partially offset by Countrywide's leading market position, relatively profitable and cash-generative operations, and experienced management team.

Recovery Rating Rationale

The group's £100 million RCF is rated 'BB-', two notches higher than the corporate credit rating. The recovery rating is '1', indicating our expectation of very high (90%-100%) recovery in the event of a payment default. The £370 million senior secured FRNs and £100 million toggle notes are rated 'B', at the same level as the corporate credit rating. The recovery rating on the senior secured notes is '4' and indicates our expectation of average (30%-50%) recovery in the event of a payment default, with cover at the low end of the range. The £170 million senior unsecured notes are rated 'CCC+', two notches lower than the corporate credit rating, with a recovery rating of '6', indicating our expectation of negligible (0%-10%) recovery in the event of a payment default.

The issue and recovery ratings on Castle HoldCo's secured and unsecured debt reflect the group's multilayered capital structure, with clearly defined priorities of different debt tranches; full security package provided to the RCF and to the senior secured noteholders; the absence of maintenance covenants in the RCF documentation; the possibility for noteholders that the £100 million toggle notes will switch to a payment-in-kind (PIK) coupon; and the favorable jurisdiction in which Countrywide operates.

Our simulated default scenario incorporates the negative dynamics seen in the U.K. housing market in the second half of 2007 and the first half of 2008. Revenues at the hypothetical year of default are assumed to drop about 45% from the 2007 level, reflecting Countrywide's business sensitivity to the transaction volume of house sales. This sensitivity was demonstrated by a 29% year-on-year revenue drop in June 2008, following the market stress indicated by Nationwide Building Society's reported mortgage approvals, which in June 2008 declined by two–thirds from the same time last year, to 36,000. We assume that negative top-line dynamics will be accompanied by a deterioration in gross margins, an increase in fixed costs due to the time lag in adjusting the cost base for revenue stress, and rising interest rates on variable-rate debt. Under our simulated scenario, a default is unlikely to occur before late 2009. We believe that the business would be more likely to be reorganized than liquidated at default and we have therefore valued the group on a going-concern basis.

We have revised our simulated default scenario twice to reflect the accelerating rate of the housing market weakening in the U.K. and its expected impact on Countrywide's growth prospects and profitability. Consequently, after reported first-quarter 2008 results, the simulated EBITDA at default declined to negative from nil in the original analysis. After reported second-quarter results, the simulated EBITDA at default declined to negative over a period of more than one year. Our stressed valuation is now £275 million, down from £320 million after first-quarter results and £370 million in our original analysis. The hypothetical default year has been brought

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forward to 2009 from 2010 and could have been brought further forward if it weren't for the liquidity enhancements exercised by the company. These include drawing on the RCF, switching to PIK interest on the £100 million toggle notes, and the ability to maintain the interest rates on the issued debt due to the absence of maintenance covenants.

Borrower-Friendly Features

Countrywide's acquisition financing was structured in the late days of the credit boom and as such is characterized by a number of the borrower-friendly features that ceased to exist in the primary market in the second half of 2007. The most prominent include:

Absence of maintenance covenants

None of the debt in the company's capital structure (including the RCF) contains maintenance covenants that would require leverage and/or coverage test(s) on a regular basis, for example quarterly. This impairs recoveries, both delaying the timing of the hypothetical default and necessitating a more severe operating stress in the simulated default scenario, which further depresses the stressed valuation. (This contrasts with structures where such covenants are present and require the issuer to pay higher fees and interest costs to buy ongoing lender support as covenants are repeatedly breached.)

PIK option on interest payments

The £100 million toggle notes feature an option for the group to switch between cash payment and issuing additional securities when paying the coupon (available until 2011, from which point cash interest will be required). In general we view PIK toggle options as likely to be exercised at times of increased risk of default in order to weather the negative impact on liquidity from the stress on earnings. We see them as a means to delay default leading to a deterioration of recovery prospects for all creditors by depressing stressed value. Countrywide has opted to pay the full amount of the coupon on its toggle notes in kind for the interest period commencing May 15, 2008, and this option will remain in force until a further election is made.

Large revolver

The group raised its £100 million RCF despite minimal working-capital needs. At June 30, 2008, £90 million had been drawn down under the facility. Our standard assumption underlying the recovery ratings is that the revolver would be fully drawn at default. This, together with the facility's superpriority status, further suppresses the recovery prospects of senior secured creditors ranking behind the RCF on enforcement.

Other financial and nonfinancial covenants in the senior secured notes documentation are relatively standard for a high-yield issue of this kind.

Severe Operating Performance Stress Diminishes Recovery Prospects

Due to the absence of triggers giving lenders the opportunity to have their say in Countrywide's strategy at the early stages of operating performance deterioration, the business may be significantly weakened by the time of a payment default. The impact of such deterioration is twofold. First, the level of EBITDA stress in the simulated payment default is higher than average for 'B' rated companies. Owing to Countrywide's asset-light business and low operating leverage driven by the variable nature of labor costs, which comprise the bulk of the cost base, our simulated default scenario envisages negative EBITDA for a period of more than one year. This compares with an

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average 35% EBITDA stress applied to 'B' rated issuers in Europe. Second, valuation at the hypothetical point of default is lower due to the stronger efforts needed for the group to overcome an operating trough and reach pre-stress performance rates.

Countrywide's valuation at the point of default is negatively affected by both simulated historical underperformance (negative EBITDA at default) and weakened postdefault growth prospects (cash flow forecast and terminal EBITDA). Our valuation at default is a combination of a discounted cash flow (DCF) and market multiple approach, with the latter based on terminal EBITDA. As a result of the extremely unfavorable market dynamics and gloomy prospects for the U.K. housing market for the near future, the DCF part of the valuation has gone down, reflecting lower long-term growth prospects and the greater time needed for the business to return to the pre-crisis level. Consequently, the blended enterprise value-to-EBITDA multiple decreased after second-quarter results to 5x terminal EBITDA, from 6x when the recovery ratings were first assigned.

Taking into consideration priority liabilities comprised of enforcement costs and the superpriority RCF, together with PIK accrual of interest on the £100 million toggle notes, coverage of the senior secured notes is in the range of 30%-50%. We consider this level weak for the first-priority debtholders.

Related Research

- "Recovery Report: Castle Holdco 4's Recovery Rating Profile," published Aug. 1, 2008
- "When It Comes To The Crunch, Recovery Matters For European Debt Investors," published May 22, 2008
- "Covenant-Lite Structures Fall By The Wayside As European Leveraged Loan Market Sees Return To Fundamentals," published Aug. 9, 2007
- "U.S. Credit Comment: PIK-Tock, PIK-Tock, Delaying The Inevitable," published June 13, 2008
- "Analysis: Castle HoldCo 4," published May 30, 2008
- "European Economic Forecast: Major Corrections On the Cards as Housing Markets Turn Down," published April 1, 2008
- "European Economic Forecast: Boom Turns to Bust in Exposed Housing Markets," published July 30, 2008

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