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Leveraged Finance:

Leveraged Market Losses Could Reach €20 Billion For Investors In Companies Rated 'B-' Or Below In Europe

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Aggregate losses of up to €20 billion are possible for investors in high-yield companies publicly rated at 'B-' or lower, following a slew of recent rating downgrades. The actual level of losses that crystallizes depends, however, on the number of defaults among 23 companies at these rating levels. Taking into account both the probability of default and the recovery prospects, losses over a two-year period could total €4.2 billion, assuming that, on average, about six of these companies might default. Losses could be substantially higher, however. This could come about if default rates prove to be above average due to the severity of the recession or if defaults are skewed toward the five largest companies in this sample, where there is an aggregate risk of losses of up to €16.8 billion. Ratings of 'B-' and lower indicate a relatively high probability of default. Three of the companies in this sample have already defaulted under Standard & Poor's Ratings Services' definition.

Although the average aggregate loss potential across this portfolio of names is about 50% of the face value of the debt issued, substantial differences in recovery are evident, with prospective losses on subordinated debt being substantially greater than the prospective losses on senior secured debt. Nonetheless, even for these companies at the greatest risk of default, there are substantial differences in recovery prospects from company to company, particularly among the senior secured debt tranches.

Focusing On Recoveries Is Key To Weathering Downturn

We are still in the early stages of what is likely to be a recession. The most recent data revisions from European statistical offices confirm that GDP growth was negative in the Eurozone in the second quarter of 2008, and there are signs that this retrenchment has spilled over to the third quarter (see "European Economic Forecast: Europe Tips Into Recession As Corporates Scale Back Their Investment," published on Oct. 22, 2008). When times are good and companies are leveraging their balance sheets in a bull market, it is easy for lenders to pay less attention to recovery prospects, as deal timetables can be rushed. But as we enter a recession in Europe, it is clear why it is important to focus on both aggregate and expected recoveries.

Credit deterioration is already apparent in the current environment. Credits rated 'CCC+' or lower now make up 8.8% of our publicly rated speculative-grade ratings in Europe, compared with June 2008, when they comprised only 4.3% of our rated high-yield credits. A year earlier, in June 2007, 'CCC' rated companies comprised 2.8% of this group. 'B-' rated companies currently make up 10.2%. This figure is stable since the end of 2007, when 'B-' rated credits comprised 10.3% of publicly rated high-yield credits in Europe.

At Nov. 30, we had recovery ratings on 23 companies in these rating categories, with almost €41 billion in debt. This can be broken down further into nearly €33 billion of debt issued by 12 'B-' rated issuers, and €8 billion of debt by 10 'CCC+' or lower-rated issuers. We have determined prospective losses on this group of names by using our recovery ratings for rated tranches of debt.

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.

For this research, we assumed midpoint recoveries within each of our recovery rating levels for each tranche of debt. For example, our recovery rating category of '1' indicates 90%-100% recovery (see table 1). Where a recovery rating of '1' was assigned to a tranche of debt, we have assumed 95% recovery. We have not included recovery ratings for companies in Russia and other CIS countries. We did not include companies rated 'B-' or lower for which we don't have recovery ratings outstanding. In total, a further 16 companies rated at this level at Nov. 30 are not included in this sample. These comprise mainly issuers from Russia or Central and Eastern Europe. It is worth noting that since we publicly rate about 20% of the leveraged finance market in Europe, potential losses for investors in the speculative-grade market may be substantially higher when taking unrated companies into account.

Aggregate Loss Versus Expected Loss

Although corporate credit ratings of 'B-' or lower indicate a high probability of default, it is unlikely that every company will default. Using our cumulative default statistics, we would therefore expect that within two years, on average, only six of this particular group of 23 companies might default, but since our default data reflects average default rates over a 27-year period, default rates during a recession could be meaningfully higher than the average.

This number already includes two companies that had already defaulted before Nov. 30 (IT Holding SpA (CC/Negative/--) after being raised from 'SD' on Nov. 21, and Belvedere S.A. (D/--/--) and one company that has defaulted since that date (Waterford Wedgwood PLC (SD/--/--).

We calculated the aggregate loss on the portfolio of names according to the recovery ratings assigned to each tranche of debt. For example, a €100 million tranche of debt with a recovery rating of '3' (50%-70% recovery) translates into a loss potential of €40 million (60% midpoint recovery on €100 million). (See table 1.)

The expected loss on the portfolio of €4.2 billion also takes into account the corporate credit rating, which is an indicator of probability of default. We calculated this using the formula in chart 1. We have used a simple calculation of expected loss that does not assume any correlations between the component risks of probability of default and loss given default. However, it is important to not dismiss the actual value at risk of €20 billion, because if even one of the largest issuers of debt does default, investors' total losses could be much higher than the expected loss. For example, if both LyondellBasell Industries AF S.C.A. (B-/Negative/--) and NXP B.V. (CCC/Negative/--)

defaulted, investors could lose up to €9.8 billion--double the expected loss for all the credits at these rating levels, assuming our recovery ratings broadly correlate with eventual recovery.

Chart 1
Calculating Expected Loss

Expected Loss (EL) = Probability of Default (PD) X Loss-Given Default (LGD or 1 - Recovery)

Worked example for M-Real Corp (B-/Negative/B)

€1,690 million senior unsecured debt with a recovery rating of '4' (30%-50% recovery at default)

LGD = €1,690 million X 60% (midpoint loss) = €1,014 million

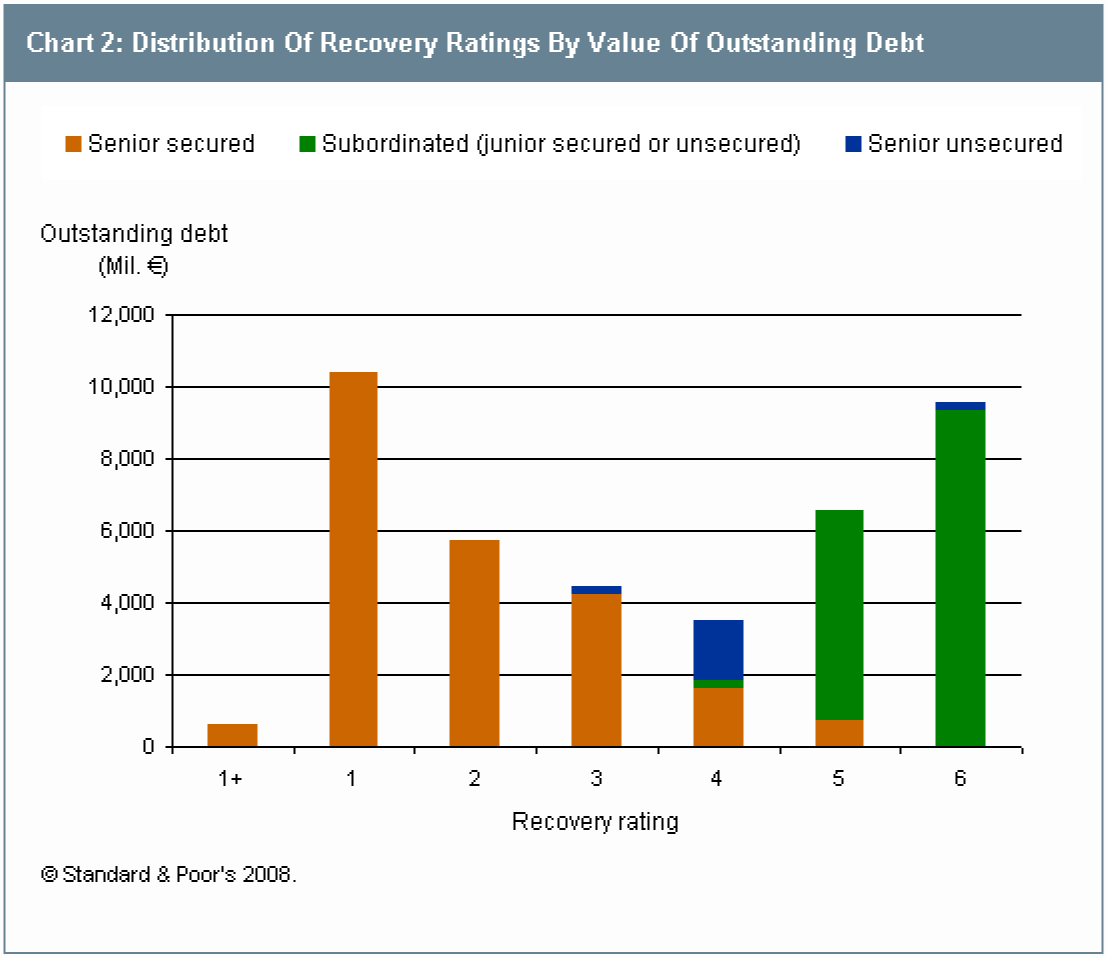
EL = 16.94% (two-year cumulative default rate for 'B-' rated issuers) X €1,014 million

EL = €172 million versus prospective loss if M-Real defaulted = LGD = €1,014 million

Recoveries For Rated Companies Below 'B-' Are Lower Than Average

The average senior secured recovery rating on the credits rated below 'B-' is '3' (50%-70% recovery), which is lower than the average '2' (70%-90% recovery) across Standard & Poor's senior secured recovery rating universe in Europe. By number, and not volume, there are a relatively high proportion of senior secured deals with relatively low recovery ratings (largely '4' and '5'), which pulls down the average (see chart 2).

Chart 2

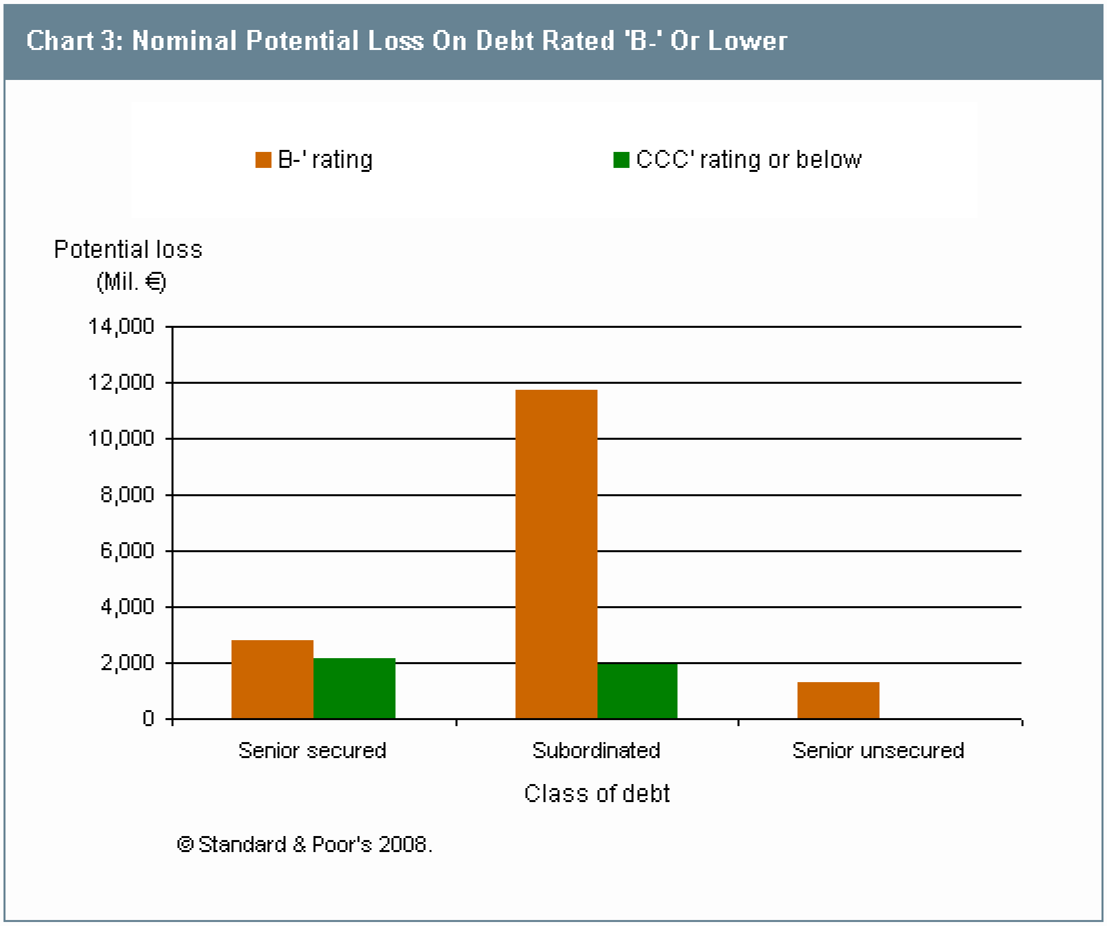


Investors Holding Subordinated Debt Most At Risk

The composition of our €20 billion aggregate prospective loss comprises nearly €5 billion of senior secured debt, €13.5 billion of subordinated debt, and €1.2 billion of senior unsecured debt (debt with very little secured debt ranking ahead). In percentage terms, this means that whilst senior secured lenders could see an average recovery of 79%, subordinated lenders would see an average 11% recovery and unsecured lenders potentially could recover 39% of the nominal value of their investments.

The high prospective loss exposure (see chart 3) for subordinated debt can be accounted for by the average subordinated recovery rating of 5.8, which implies close to 10% average recoveries. This is in line with our usual expectation of recovery prospects for subordinated debt. Unsecured debt instruments have an average recovery rating of 4.3, which is also broadly in line with our rated universe. However, these credits make up a small portion of debt within the 'B-' or lower categories.

Chart 3



Handful Of Credits Comprise 83% Of Potential Losses

The largest five companies rated 'B-' or lower account for nearly 85% of the total prospective loss in those rating categories: LyondellBasell Industries AF S.C.A., Ineos Group Holdings PLC (B-/Watch Neg/--), NXP B.V. , M-Real Corp. (B-/Negative/B), and WIND Hellas Telecommunications S.A. (B-/Negative/--).

LyondellBasell and Ineos are both cyclical businesses with high leverage at a point when the economy and chemicals cycles are turning downward. This combination of factors has led to recent downgrades. WIND Hellas is a telecoms business recently downgraded due to weakening liquidity. NXP's rating was also lowered on the back of prospectively weakening liquidity in a rapidly deteriorating operating environment. M-Real is facing similar liquidity and business environment issues in the forest products sector.

These companies comprise almost 90% of the total issued debt within the rating categories of 'B-' or below. LyondellBasell and Ineos alone account for 64% (€26 billion) of the €41 billion debt outstanding, but some of the debt has very good recovery prospects: €15 billion of these two companies' debt has recovery ratings of '1' (90%+ recovery) and '2' (70%-90% recovery). With the exception of M-Real, all the companies have a mixture of senior secured and subordinated debt of some form. In most cases, we expect the losses on subordinated debt to far exceed the potential losses on the senior secured debt.

Issue- And Issuer-Specific Analysis Remains Key

This research highlights the continuing importance that investors scrutinize not only the probability of default risk, but also recovery prospects. We have been issuing recovery ratings since 2004 in an attempt to help investors with this analysis. As we enter a recession in Europe, investors should be focused on expected recovery, particularly when valuing these loans and bonds in the secondary market.

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