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January 7, 2009

Leveraged Finance:

More Than A Year Into The Credit Crunch, Lenders Confront Diminished Recovery Prospects

Leveraged Loans & Recovery:
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Table Of Contents

Standard & Poor's Recovery Ratings

Recovery Ratings On Secured Debt Show Little Relationship To Corresponding Credit Ratings

The Outlook For Recoveries Is Lower

Recoveries Remain Issue Specific

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Leveraged Finance:

More Than A Year Into The Credit Crunch, Lenders Confront Diminished Recovery Prospects

Amid a credit market freeze of unprecedented breadth and depth, the leveraged corporate debt market is understandably focusing on defaults.

The increase of speculative-grade borrowers (those rated 'BB+' or lower) suggests that default rates may match or exceed the highest levels seen in recent credit cycles. Standard & Poor's Ratings Services expects defaults to climb well into 2009, and they could rise to nearly 10% in the second half of the year. While the timing and shape of this surge will depend on many variables, the confluence of macroeconomic and financial factors is distinctive in this downturn.

In this environment, we expect recoveries to be lower than historical averages might suggest. This is reflected in our recovery ratings and the factors we expect to determine recoveries in this downturn. Simply put, some of the most important factors for recoveries are new to this credit cycle: changes in the mix of debtholders and the rise of post-default liquidation (rather than reorganization) among defaulted borrowers.

Standard & Poor's Recovery Ratings

Standard & Poor's recovery ratings are our estimates of ultimate recovery of principal and pre-petition interest on specific issues in the event of a potential payment default. We assign recovery ratings on a scale that ranges from '1+', indicating our highest expectation of full recovery for lenders, to '6', indicating our expectation of negligible (0% to 10%) recovery (see table 1). Since introducing the ratings in December 2003, we have assigned estimates of ultimate post-default recovery to more than 5,000 loans and bonds in the U.S., Canada, Europe, Australia, Singapore, and Russia. In the U.S., we have recovery ratings on more than 60% of widely syndicated leveraged loans outstanding (see chart 1).

Table 1

Recovery Rating Scale And Issue Rating Criteria

(For issuers with a speculative-grade corporate credit rating)

Recovery rtg	Recovery description	Recovery expectations*	Issue rtg notches relative to corp credit rtg
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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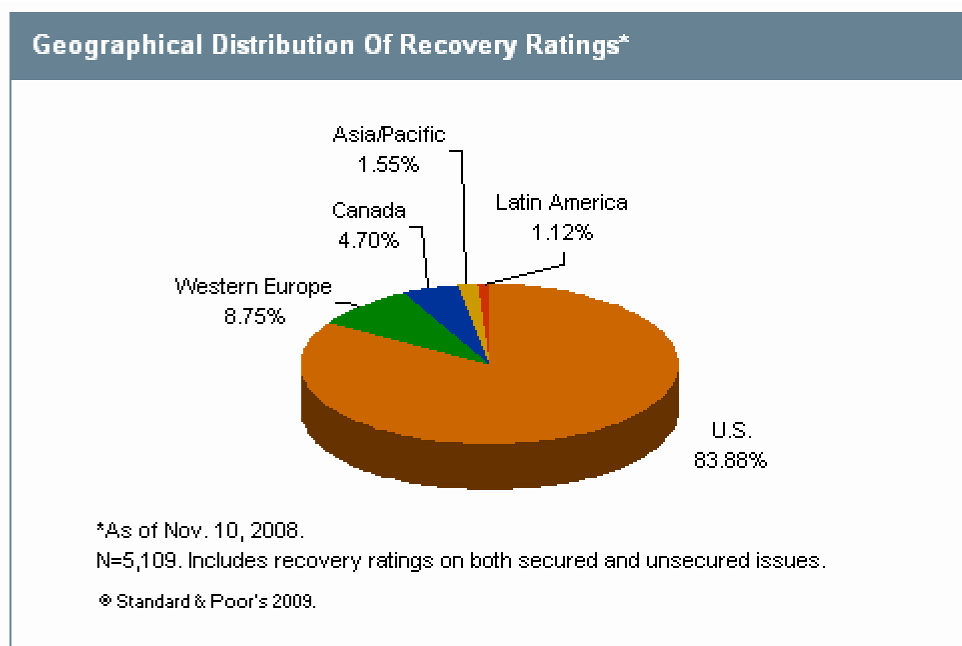
Chart 1



Dispersion among recovery ratings

Since we began assigning recovery ratings, they have been widely dispersed. More than 60% of our rated senior secured issues carry recovery ratings that are higher or lower than the mean recovery rating range of '2' (which indicates the expectation for recovery of 70% to 90%). The distribution is even more dispersed among unsecured issues, 70% of which carry recovery ratings outside the mean rating of '4' (30% to 50% recovery). (See charts 2 and 3.)

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Chart 2

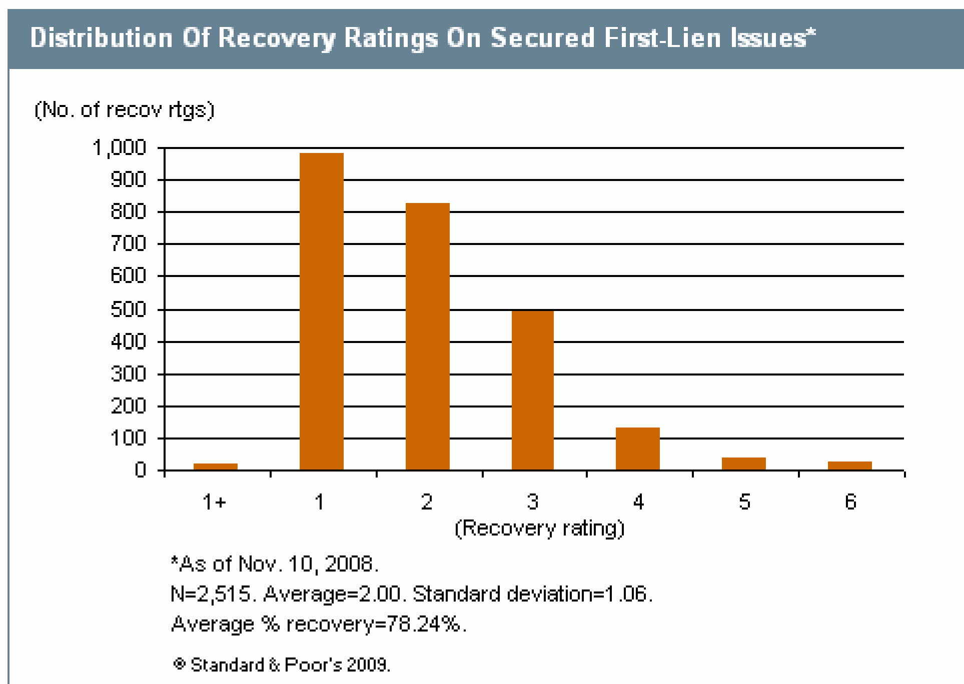
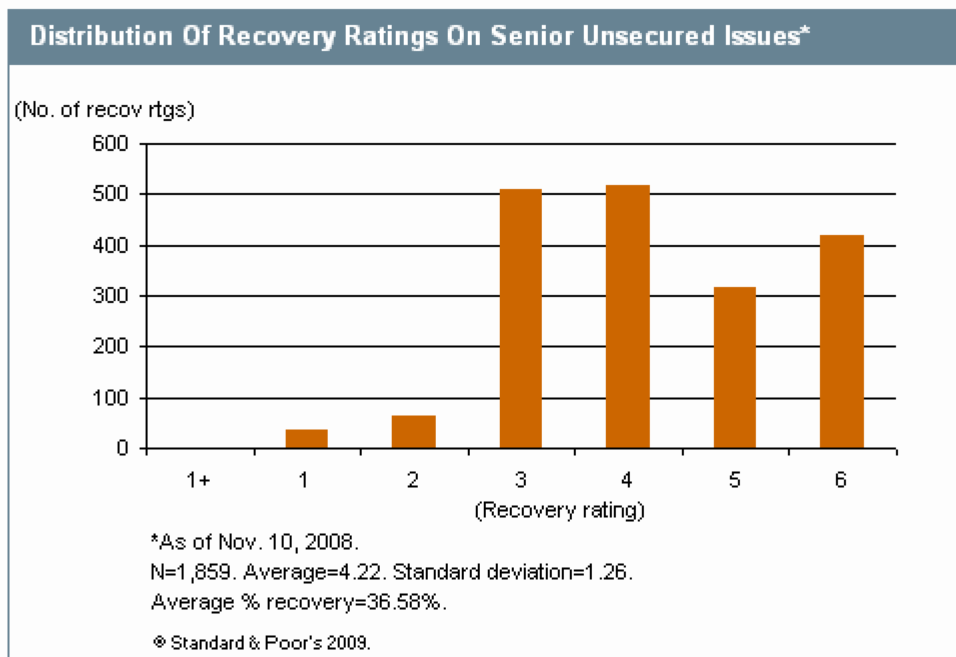


Chart 3



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Recovery Ratings On Secured Debt Show Little Relationship To Corresponding Credit Ratings

As recovery ratings on secured debt have shown since the beginning, they have little relationship to the corresponding default ratings on the issues or the corporate credit ratings on the borrowers. This is because, at any given time, secured debt issues are generally structured to offset default risk, to the extent possible, with strengthened recovery prospects (see chart 4). We note that our recovery ratings estimate that some, but not all, secured loans to issuers at the lower end of the credit rating spectrum will likely provide relatively high recoveries.

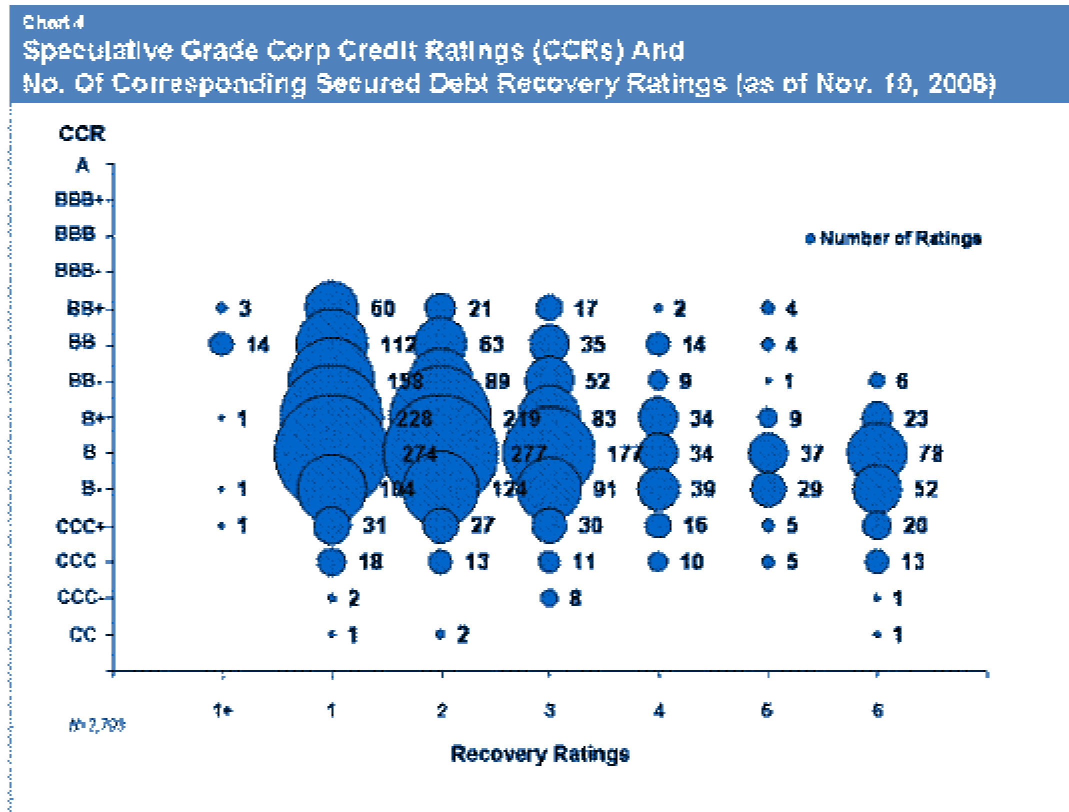

Chart 4
Speculative Grade Corp Credit Ratings (CCRs) And No. Of Corresponding Secured Debt Recovery Ratings (as of Nov. 10, 2008)

The Outlook For Recoveries Is Lower

Our recovery ratings indicate that the next round of recoveries will be lower than historical averages might otherwise suggest. This is true for each chief debt class, with the mean estimated recovery materially below the recent average for actual recoveries, and below the historical averages tracked by Standard & Poor's LossStats database (see table 2).

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Table 2

Current Market: Trends In Recovery

Recovery & recovery ratings in current downturn: Beginning decline from record high historical avg recoveries

	LossStats Avg Annual Nominal Recovery (%)			S&P Estimated Recoveries* (%)	
	2006	**2007**	**2008**	Senior secured bank loan	78
Senior secured bank loan	84	92	99	Senior unsecured	36
Senior unsecured	71	83	69	Subordinated bonds	12
Subordinated bonds	30	47	46		
		Mean nominal recovery 1988-2008 (%)			
Senior secured bank loan		82			
Senior unsecured		45			
Subordinated bonds		17			

*Based on recovery ratings as of Nov. 3, 2008

We expect that recoveries will be lower because of several factors, some of which are new and particular to the current downward credit cycles.

The relationship between default rates and recoveries

In this, as in most cycles, recovery rates will likely drop as default rates rise, especially if default rates jump sharply, as we expect them to do. Rising default rates increase the supply of defaulted debt relative to the funds available to invest in defaulted paper, thus reducing available recovery values. In the current cycle--with the potential for default rates to rise significantly and the essential freezing up of liquidity available for either temporary or permanent financing--the downward draft on recoveries could be material.

Changes in the debtholder mix

In the two most recent market contractions, 2000-2003 and 1990-1992, most secured leveraged loans were originated and held by banks, which booked the loans at par value and held them to maturity. If a borrower defaulted on a loan, the lead and participating banks often had a strong common interest in achieving par (or near par) recovery in order to avoid credit losses, which could rapidly reduce or eliminate profits made from lending. Institutional investors have since substantially replaced banks as the chief participants, holding more than 60% of widely syndicated loans--up from less than 20% in 2002. These institutional holders often don't have the same incentives that banks do in pursuing ultimate recovery after a default. They may have shorter holding periods, limited interest in par recoveries, and, in some cases, may rely on strategies (such as loan to own) with only a secondary focus on debt recovery.

The rise of liquidation

Historically, most U.S. companies that have filed for bankruptcy have sought to reorganize under Chapter 11 of the U.S. bankruptcy code rather than liquidate their assets. When feasible, reorganization has benefited not only the borrower, but also lenders, in the form of generally higher recoveries. As the current credit crunch has deepened, it has become more difficult for companies to reorganize, in part because the financing critical to fund reorganizations--typically so-called debtor-in-possession (DIP) financing--has become increasingly scarce. As a result, some borrowers find themselves pushed toward liquidation instead of reorganization (or into debt exchanges in the place of insolvency altogether). To the extent that liquidations increase in U.S. insolvencies, we expect that post-default recoveries will be materially lower than they will be under reorganization. (See "Liquidation Increasingly Likely In Some Post-Default Recoveries," published Jan. 7, 2009.)

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The rise of debt exchanges

In some cases, U.S. issuers are turning to debt exchanges as an alternative to court-supervised insolvencies. One form of this transaction involves a company offering to exchange unsecured bonds for secured debt. Where the secured debt is at parity with existing secured debt, the exchange generally has the potential to lower secured debt recoveries.

Recoveries Remain Issue Specific

With the outlook for recoveries clearly lower in this credit cycle, it seems relevant to ask why debtholders should expect any material recovery at all. But Standard & Poor's stresses that even now, recoveries and the key factors driving them remain specific to individual borrowers and debt instruments. As the dispersion of recovery ratings and the comparable dispersion in historical recoveries shows--even during years yielding the lowest recovery values--there will likely be some recoveries that come in high while the bulk drift lower (and some that come in at zero, though the mean recovery may be higher). In this type of market, we stress that it is all the more important to maintain focus on issuer- and issue-specific dynamics driving prospective recoveries, as estimated in our recovery ratings.

Click on this link to see other articles in "Special Report: Leveraged Debt And Recovery: Why Lenders Face Diminished Recovery Prospects."

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