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Leveraged Finance:

As Credit Quality Declines, What Happens To Recovery Prospects?

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Eighty percent of all Standard & Poor's Rating Services' corporate credit rating actions for speculative-grade companies in the past six months did not lead to any recovery rating change, highlighting that recovery prospects are frequently independent of changes in the probability of default for speculative-grade companies.

Many of these credit rating actions related to deteriorating business conditions, and in some cases resulted from structural changes such as covenant amendments, equity injections, debt buybacks, debt restructurings, or additional parental support.

Where these types of restructuring take place and prove to be effective, the stabilized financial position of the affected company can lead to an improvement in issuer creditworthiness. However, if the restructuring fails, such changes can often have detrimental effects on recovery prospects for the company's lenders.

Therefore, as credit quality declines, it is increasingly important for lenders to properly assess the effect of such restructurings in terms of both probabilities of default and of recovery prospects for specific debt instruments.

Mapping Of Recent Rating Actions

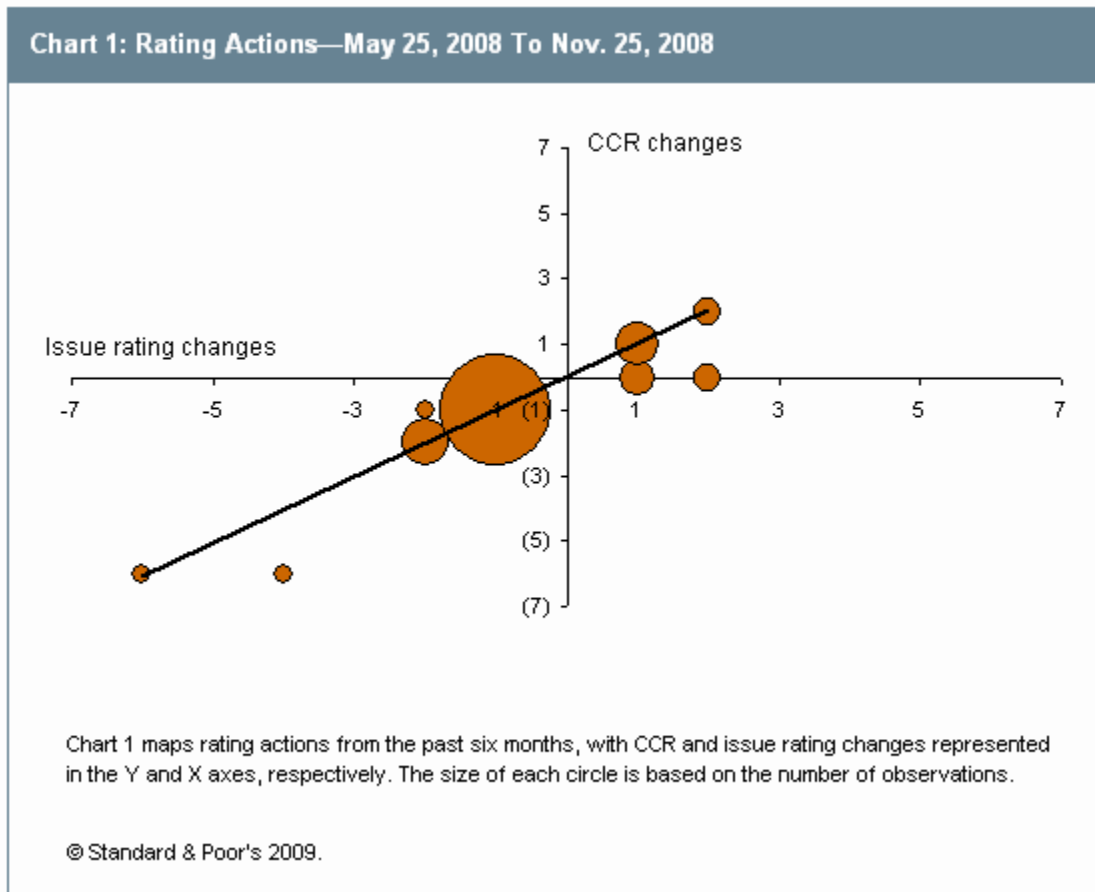
We studied rating actions on about 150 publicly rated speculative-grade industrial companies in Europe, Middle East, and Africa for the past six months to map the changes in both corporate and recovery ratings.

As a proxy for changes in corporate and recovery ratings, we mapped the changes in corporate and issue ratings. The issue rating we apply to the loans and bonds of companies with speculative-grade corporate ratings is based on the recovery rating outcome for the specific instrument being rated and the corporate rating; we do this by notching issue ratings relative to corporate ratings depending on their recovery ratings (see "Appendix 1: Relationship Between Recovery Rating, Issue Rating, And Corporate Credit Rating").

As shown in chart 1, about 80% of the rating actions are triggered by changes in long-term corporate credit ratings, leading to similar changes in issue ratings, whereas recovery ratings often do not change. These actions are graphically located on the trend-line (45 degrees).

However, a material proportion of rating actions (about 20%) are triggered by recovery rating changes, reflecting a change in recovery prospects for particular debt instruments. These changes are most frequently one- and two-notch differences.

Chart 1



Rating actions in this group came from 37 different companies, representing about 25% of the European recovery portfolio. Most of the rating actions were downgrades, representing about 71% and 77% of the changes in long-term corporate and issue ratings, respectively. Most corporate and issue rating actions were +/-1 notch (75%) or +/-2 notches (21%). The outliers are the two defaults: IT Holding SpA (SD/--/--), where the rating was lowered to 'SD' from 'B-' on Nov. 17, 2008, and Belvedere S.A. (D/--/--).

Different Types Of Rating Actions

In this section we analyze the three most common types of rating actions:

- (i) Declining corporate ratings with no changes to recovery ratings;
- (ii) Recovery rating changes linked to changes in corporate credit ratings that affect stressed enterprise valuations; and
- (iii) Changes in recovery ratings as a result of changes in capital structure, security, or documentation.

(i) Declining corporate ratings with no changes to recovery ratings

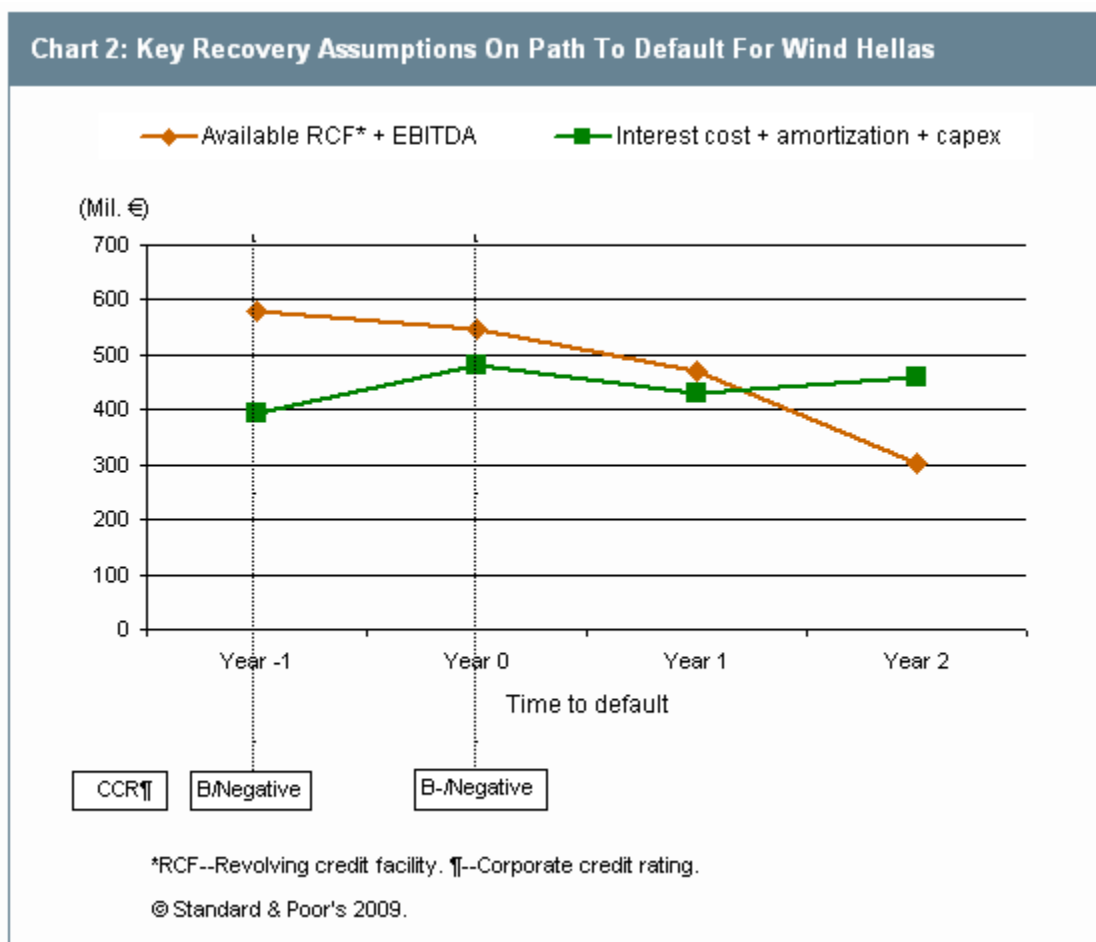
This represents the most common situation where corporate ratings are lowered, while the recovery rating does not change (or, in two cases, changes between the '3' and '4' categories, which does not cause any issue rating change).

For recovery purposes, we look at the key driver for the change, with particular focus on the underlying businesses or financial issues triggering the corporate credit rating revision. In many circumstances, we don't change our key recovery assumptions materially in terms of operating performance, stressed valuation, and waterfall if our hypothetical path to default still represents the most likely default scenario and no material changes have occurred in terms of capital structure, collateral package, and key terms of documentation (examples are shown in table 1 and chart 2 regarding WIND Hellas Telecommunications S.A.).

Table 1

WIND Hellas Telecommunications S.A.	
November 2008	
Change in corporate credit rating	To B-/Negative from B/Negative
Rationale	Weakening liquidity and persistently very high leverage, along with deteriorated broadband performance
Change in recovery rating	Senior secured unchanged at '3'
	Subordinated notes unchanged at '6'
Rationale	No changes in hypothetical default scenario, in terms of operating stress and stressed EV (enterprise value) assumptions

Chart 2



In some circumstances, however, we may significantly revise our recovery analysis as a result of a material change in

key risks and, therefore, the most likely default scenario. Codere S.A. is a good example (see "Recovery Report: Codere S.A.'s Recovery Report Profile," published on RatingsDirect on Oct. 29, 2008), where we revised our path to default following a material change in key business risks faced by the group. This change had no effect in terms of recovery range for senior unsecured creditors.

(ii) Recovery rating changes, along with changes in corporate credit rating affecting valuations

This scenario represents 5% of rating actions. As described above, the recovery approach to potential corporate rating changes is based on understanding any fundamental change in business and financial issues, along with any potential implications for collateral assessment, stressed valuation, and revised waterfall assumptions in terms of the expected outstanding amount at default and the priority ranking of the company's liabilities.

NXP B.V. (CCC/Negative) represents a good case study (see table 2), as the long-term corporate credit rating on the company was lowered as a result of increasing concerns over the group's cash flow generation capability and the announcement of a massive restructuring program. At the same time, the recovery rating on the senior secured notes was lowered following the assumed increased leakage in the security package and a lower valuation of the group and collateral package at our hypothetical default.

Table 2

NXP B.V.	
September–October 2008	
Change in corporate credit rating	To 'B-/Watch Negative' from 'B+/Watch Negative' (now CCC/Negative)
Rationale	i) NXP's liquidity position significantly impaired by restructuring program (about \$800 million); ii) Sale of wireless business but no expectation that significant proceeds would be used to pay down term debt
Change in recovery rating	Super senior revolving credit facility (RCF) remained '1+' Senior secured to '3' from '2' Senior unsecured remained '5'
Rationale	1) Updated (downward) assessment of the stress valuation at default following the recent disposal of the wireless operation to STMicroelectronics N.V. 2) Continued reduction in the percentage of group EBITDA generated within the guarantor group (therefore reducing the collateral available for secured lenders) 3) Increased leakage in the security package. The portion of the EV not captured by the security package (mainly comprising the 61.3% stake in SSMC) would be shared among all creditors (secured and unsecured)

(iii) Change in recovery ratings as a result of capital structure, security, or documentation changes

The third scenario represents 15% of rating actions and is probably the most interesting. As part of ongoing surveillance, we review our recovery assumptions according to potential changes in corporate ratings and outlooks, but also as a result of additional credit or structural changes such as covenant amendments, equity injections, debt buybacks, debt restructurings, and revised assumptions on parental support. All these aspects potentially affect key recovery aspects such as lenders' control (loose documentation and covenants mean that lenders might not be able to act on early signs of underperformance, depressing the stressed valuation and recovery), liquidity (the higher the available liquidity, the higher the stress required to drive the company to default and, therefore, the lower the stressed valuation and recovery), or capital structure (the higher the committed payment, the earlier the hypothetical default and the lower the operating stress, driving up valuation and recoveries at default).

Interestingly, as detailed in the Virgin Media Inc. case study, most of the structural changes can lead to bifurcated implications in terms of corporate credit rating and recovery rating, as positive rating drivers in terms of issuer

creditworthiness might negatively affect recovery assumptions.

Case study: Virgin Media Inc.

Table 3

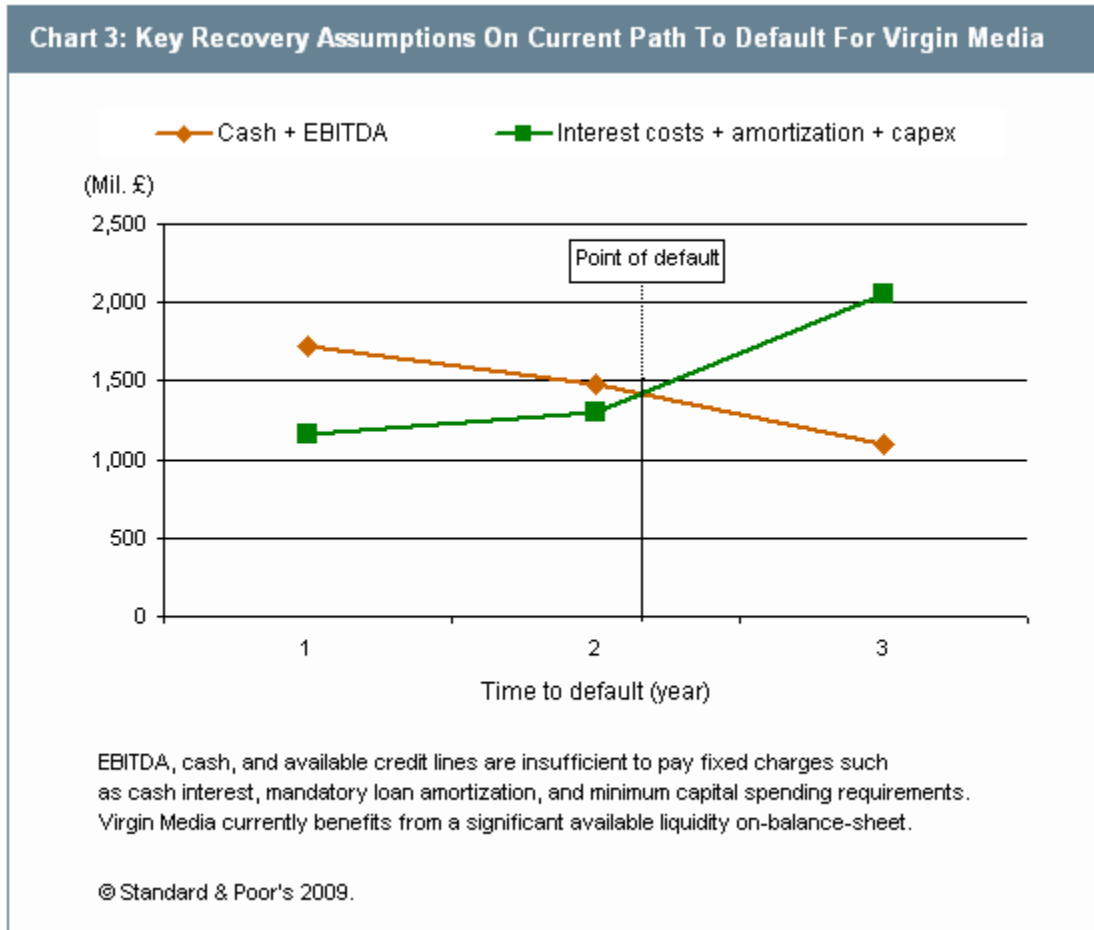
Case Study: Virgin Media Inc.	
Corporate credit rating	B+/Positive
Senior secured debt	Issue rating BB; recovery rating '1'
Second-lien debt	Issue rating B+; recovery rating '3'
Unsecured debt	Issue rating B-; recovery rating '6'

In a recent amendment to the senior facility, the group obtained agreement to roll the 2009-2011 bank amortization payments to June 2012 and loosen covenants in return for a 20% repayment of the outstanding A (term loan A) tranches. The lack of significant amortization requirements in the short term would be positive for liquidity and probability of default risks; however, this could be negative overall for recoveries.

As the amendment is still dependent on the satisfaction of certain conditions such as the full 20% paydown of the term loan A, we have not yet revised the recovery ratings on various tranches.

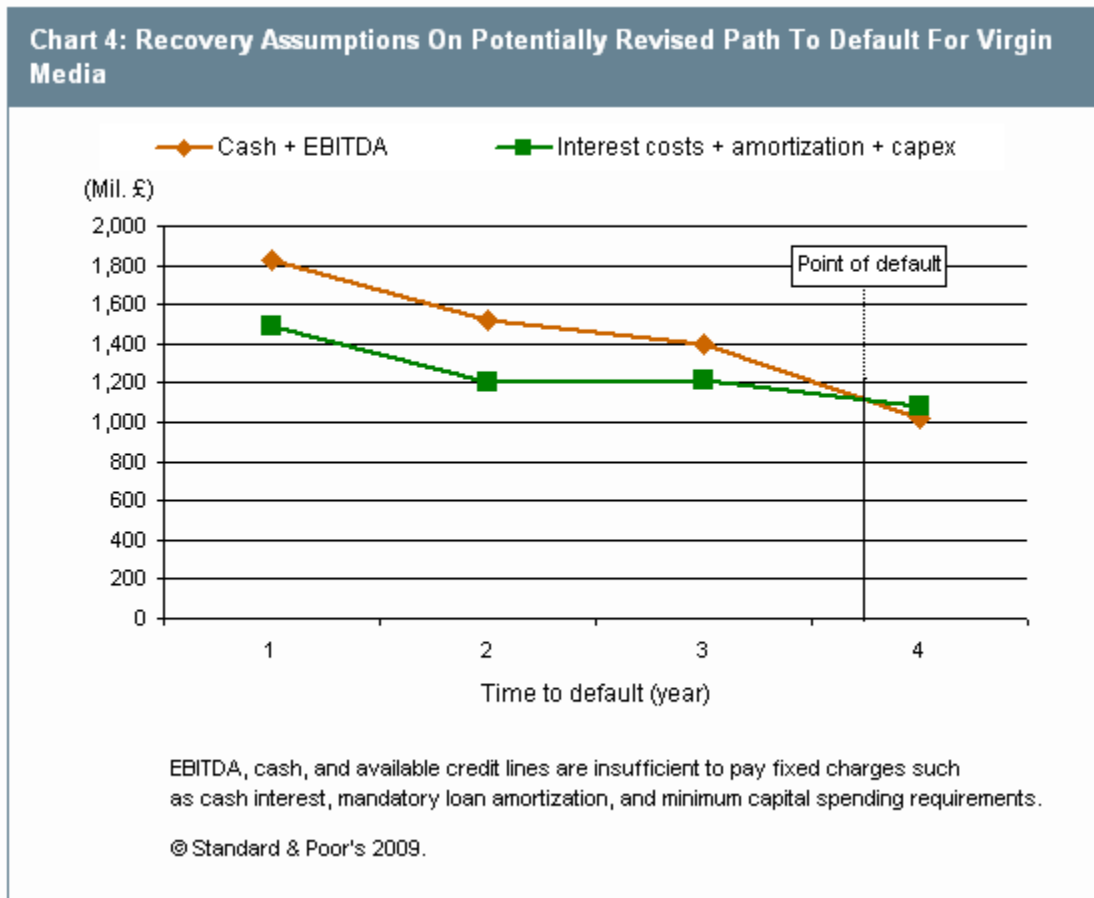
Our current hypothetical default scenario reflects the pre-amendment structure and assumes the company's inability to cope with its significant debt amortization payments in 2010 (see trend of interest payment, debt repayment, capital expenditure, and EBITDA of our hypothetical default scenario in chart 3).

Chart 3



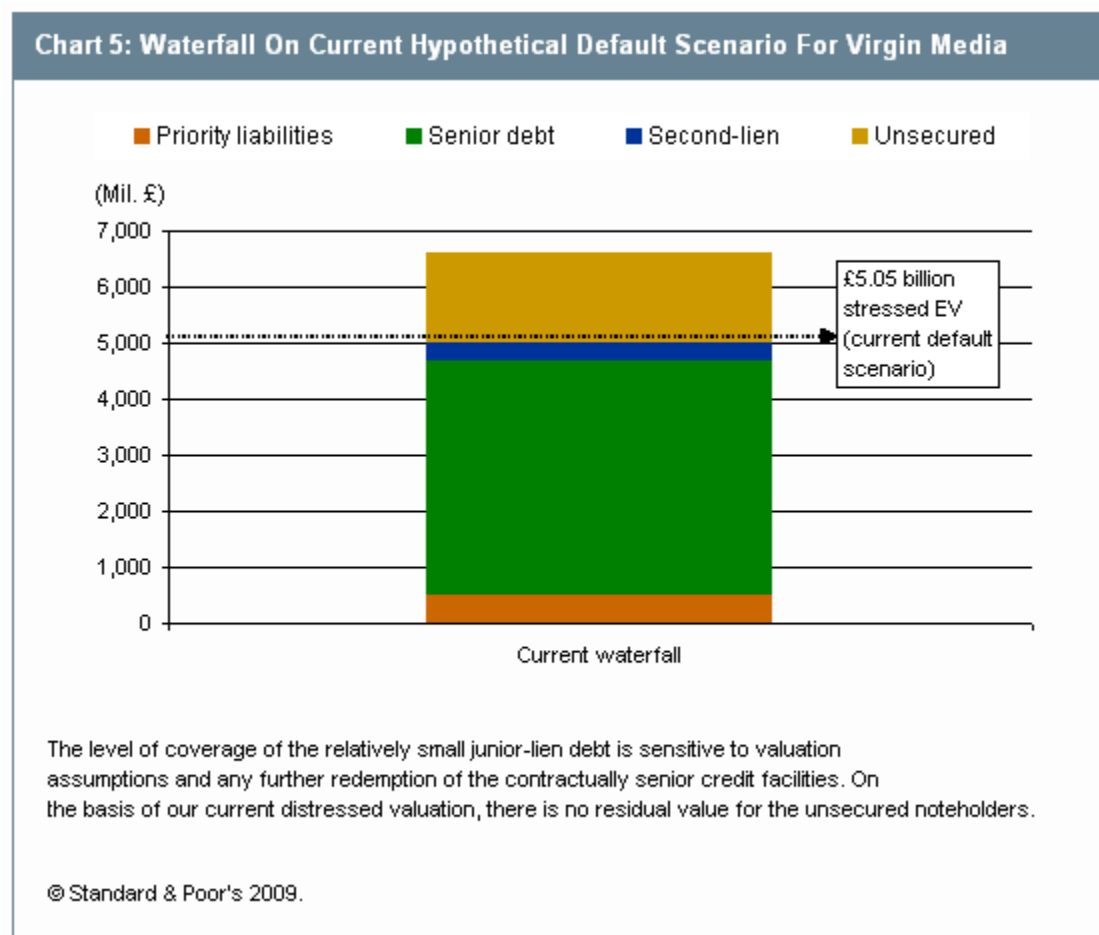
For recovery purposes, the deferral of the remaining amortization payments and the final maturity date of the term loan A tranches and revolving facility, would lead to a possible extension of our hypothetical default date. This, along with loosened control by the lenders (in terms of less stringent covenants), means that the business may have deteriorated further before reaching payment default, leading to lower stressed valuation at our hypothetical default (see chart 4).

Chart 4



Projected EBITDA at default under the new scenario would be about 10% lower than the existing scenario. This could lead to lower overall enterprise value (EV) at default. However, if implemented as proposed, this negative impact would be more than offset by a different mix of outstanding liabilities at default. This follows the partial repayment of senior debt through the available liquidity and proceeds from high-yield bond issuance. This would provide potential upside in terms of recovery prospects for unsecured noteholders and, particularly, junior-lien debt (see waterfall on current hypothetical default scenario in chart 5).

Chart 5



If the estimated lower stressed valuation is combined with a possible scenario of stable senior debt outstanding (part of the 20% repayment of the outstanding term loan A tranches is financed through the issuance of additional secured debt (term loan B) rather than a high-yield bond), recoveries for junior-lien and unsecured debt instruments would be significantly impaired.

The company recently paid down about £300 million term loan A by using part of the cash held on-balance-sheet. However, no rating actions have been taken yet, as no information is currently available on timing and funding for the expected repayment of the additional £187 million term loan A, due by May 10, 2009.

The Cell C (Pty) Ltd. (B-/Stable/--) and Unitymedia GmbH (B+/Positive/--) reports are other interesting case studies on rating actions triggered by recovery rating changes as a result of enhanced parental support and debt buyback, respectively (see "Recovery Report: Cell C (Pty) Ltd.'s Recovery Report Profile," published on RatingsDirect on July 9, 2008, and "Recovery Report: Unitymedia GmbH's Recovery Report Profile," published on RatingsDirect on Oct. 8, 2008).

In the current worldwide economic slowdown--a challenging corporate environment with performance issues increasingly arising and refinancing no longer an option--as a first measure to avoid covenant breaches and payment defaults, borrowers would likely rely on implementing "softer" tools, such as debt rescheduling and amending

covenants.

If problems persist, however, then more radical procedures become necessary, often involving fresh equity to strengthen the balance sheet, and operational restructuring measures aiming to ensure longer-term viability of the business.

All these measures can affect recovery.

As we expect significant corporate restructuring for the next 12-24 months, we foresee a significant number of rating actions. It is likely that recovery rating changes will continue to be independent to corporate credit rating changes, with increased potential for rating actions on recovery ratings. In this context, it will be increasingly important to properly assess the impact of these changes and restructurings in terms of both probabilities of default (long-term corporate credit rating) and recovery prospects (recovery rating) for each debt instrument in the capital structure at default.

Appendix 1: Relationship Between Recovery Rating, Issue Rating, And Corporate Credit Rating

Recovery ratings highlight debt-instrument-specific estimates of post-default recovery for creditors. Table 4 summarizes our issue rating framework. The issue rating we apply to the loans and bonds of companies with speculative-grade corporate ratings is based on the recovery rating outcome for the specific instrument being rated and the corporate rating. We do this by notching issue ratings relative to corporate ratings depending on their recovery ratings. For example, issues with a high recovery rating ('1+', '1', or '2') would lead us to rate the loan or bond above the corporate credit rating (i.e., one notch for '2', two notches for '1'), while a low recovery rating ('5' or '6') would lead us to rate the issue below--or notch down--the corporate rating. There is no difference in the issue rating for debt tranches with recovery ratings of '3' and '4'.

Table 4

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
1	Very high recovery	90-100	+2
2	Substantial recovery	70-90	+1
3	Meaningful recovery	50-70	0
4	Average recovery	30-50	0
5	Modest recovery	10-30	-1
6	Negligible recovery	0-10	-2

*Recovery ratings in certain countries are capped to adjust for reduced creditor recovery prospects in these jurisdictions. Furthermore, the RRs on unsecured debt issued by corporate entities with CCRs of 'BB-' or higher are generally capped at '3' to account for the greater risk that their recovery prospects are impaired by the issuance of additional priority or pari passu debt before default. ¶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.

Related Articles

- "Recovery Report: Codere S.A.'s Recovery Report Profile," published on Oct. 29, 2008.
- "Recovery Report: Cell C (Pty) Ltd's Recovery Report Profile," published on July 9, 2008.
- "Recovery Report: Unitymedia GmbH's Recovery Report Profile," published on Oct. 8, 2008.

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