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Leveraged Finance:

Leveraged Buyouts Are Fueling Surging Defaults In Western Europe

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Leveraged Finance:

Leveraged Buyouts Are Fueling Surging Defaults In Western Europe

With a deteriorating economic environment, poor corporate results, and restricted access to liquidity for the more vulnerable companies in Western Europe, Standard & Poor's Ratings Services believes the acceleration in defaults that occurred in the fourth quarter of 2008 will continue through this year and possibly into 2010. We also believe that debt-financed leveraged buyout transactions (LBOs) will be at the forefront of this increase.

The downturn in the real estate and construction sectors, the sharp rise in unemployment, reduced consumption and investment, and the liquidity squeeze have converged, prompting a significant increase in defaults in the leveraged finance market. As a result, we estimate that between 90 and 112 Western European firms on which we have either a public rating or a credit estimate in the speculative-grade (that is, 'BB+' or lower) category could default in 2009. This would represent a default rate of between 11.7% and 14.7% for our universe of 765 corporate ratings and credit estimates. What's more, we believe the default rate could remain in the same range in 2010. Our previous estimate was in the range of 8.7% to 11.1% (see article titled "Weakening Performance And Liquidity Drive European Credit Trends From Bad To Worse," published Dec. 17, 2008, on RatingsDirect).

Were our estimated speculative-grade default rate to materialize, it would surpass the previous peak of 12.0% established in the 2001-2003 downturn. However, the issuer universe today is not directly comparable, as there were very few credit estimates in 2001. This is because the market for collateralized loan obligations (CLOs) was just beginning. By comparison, the average speculative-grade default rate in Western Europe since 1994 is 3.3% (see article titled "2008 Annual European Corporate Default Study and Rating Transitions," published March 13, 2009, on RatingsDirect).

We believe that sectors likely to remain under distinct pressure include consumer-related industries (auto, nonfood retail, and lodging and leisure), residential and commercial building and development, and commodities. The commercial property market, in particular, could in our opinion be due a severe correction in 2009 given corporate retrenchment. We also believe that the capital goods sector may well suffer, given much-reduced investment prospects. Conversely, we consider that regulated utilities, telecommunications incumbent operators (both fixed-line and mobile), pharmaceuticals firms, and branded consumer-product companies, most of which are investment grade, are likely to be more sheltered from the current steep downturn.

From previous default patterns during economic downturns, we observe that a benign period is typically followed by four years of above-average default rates with two peak years in year two and year three. Assuming a similar pattern (which is not at all certain), the cumulative speculative-grade base-case default rate for 2008-2011 for Europe could range between 30% and 35%.

Lenders Need To Strike A Balance On Write-Downs

Looking at the specifics of the current downturn, we make a number of observations. First, given the extent of defaults and write-downs driven by early stage restructurings, exactly how much are senior lenders prepared to write down? Where institutional investors represent a significant proportion of the senior lender group, a balance needs to

be struck: Capital structures require stabilization, while the damage to CLO portfolio collateralization tests must be contained. If write-downs are insufficient, additional restructuring may soon be required. Therefore, in our view, more severe write-downs now could result in fewer repeat defaulters in 2010-2011.

Nevertheless, the long-term issue in our view relates to the refinancing risk for the 2005-2007 vintage of LBOs. Although only 8.8% of leveraged loans mature between 2010 and 2012 according to Standard & Poor's Leveraged Commentary and Data, 45% of outstanding institutional loans, amounting to €65.3 billion, mature in the following two years, and a further €47.4 billion mature in 2015. In our opinion, this issue will arise in late 2010, and during 2011. The risk is that refinancing may be very difficult to arrange at that time for companies unable to retire their debt by maturity. Alternatives to refinancing may include sales of the business to trade buyers, management, or other private equity sponsors. This is likely to extend the default cycle because many of these companies would need to be restructured, involving a write-down of debt in return for equity, prior to new ownership.

Defaults In The Fourth Quarter Of 2008 Push Rate Up To 4.5%

Since our last report that looked at leveraged finance defaults (see article titled "European First-Half Loan Default Rate Stable So Far, But A Sharp Jump Is Plausible," published Sept. 3, 2008, on RatingsDirect), we see the economic and financial environment as having become far more difficult for leveraged corporates and LBOs. From mid-2008, we believe the market has been braving a cyclical downturn that, transformed by the collapse of Lehman Brothers, turned into a global financial crisis.

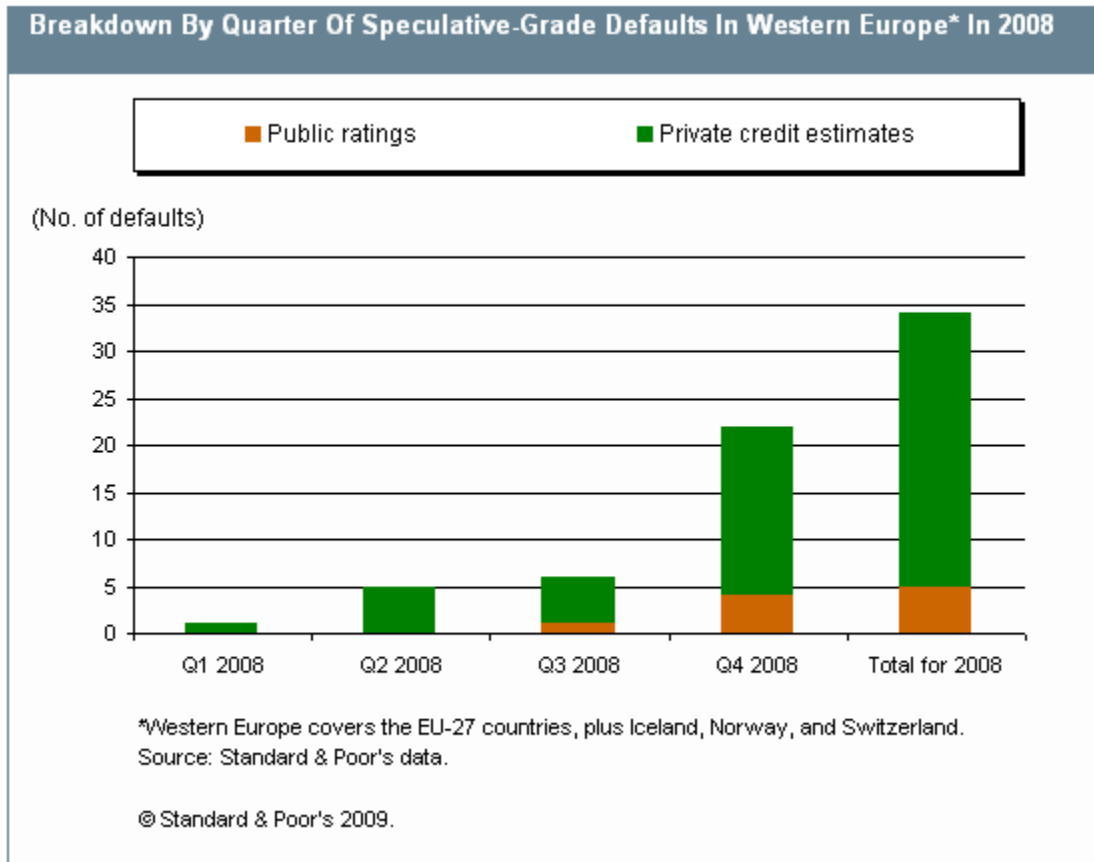
The result is that budgets of leveraged companies have been thrown into disarray. Moreover, financial covenants, commonly thought as toothless due to their generous terms, have tightened now that corporate earnings have fallen. We understand that this covenant tightening has triggered a wave of amendment and waiver requests. Furthermore, with the disappearance of new lending capacity from the debt markets, companies and their affiliates have found themselves restructuring, sometimes ahead of an actual covenant breach.

We understand that liquidity remains scarce for cyclical 'BBB' rated corporates, let alone for borrowers that have speculative-grade credit risk profiles. Many of these companies termed-out debt at very attractive levels in 2006-2007. However, we understand that many are struggling to manage their liquidity with the demands being placed on working capital in the current market environment or to stay within their financial covenants. We see the risk to currently vulnerable companies being that their lenders have neither the appetite nor the capacity to provide new financing to help them through the downturn. Although governments are acting on these problems, their efforts appear more focused on recapitalizing banks and channeling liquidity toward small and midsize enterprises and investment-grade issuers through central bank initiatives such as permitting the European Central Bank to participate in repos of corporate debt rated as low as 'BBB-', as well as increasing the amount and term of repo refinancing. Similarly, the Bank of England has established an asset-purchase facility involving targeted secondary market purchases of high quality debt. This facility is designed to indirectly improve the availability and cost of funding for U.K. corporates.

As a consequence of the difficult financial market, Western Europe saw a dramatic increase in speculative-grade corporate defaults in the fourth quarter of 2008. In our portfolio of private credit estimates and publicly rated credits there were 22 defaults in the fourth quarter of 2008 (see chart 1), covering outstanding debt of €26.8 billion. Combining these defaults with the 12 defaults involving €5.0 billion of debt from the first three-quarters of 2008 gives a total tally of 34 defaults and €31.8 billion of debt for the year. This represents a 2008 default rate of

4.5%--almost 3x higher than the rate recorded for 2007.

Chart 1

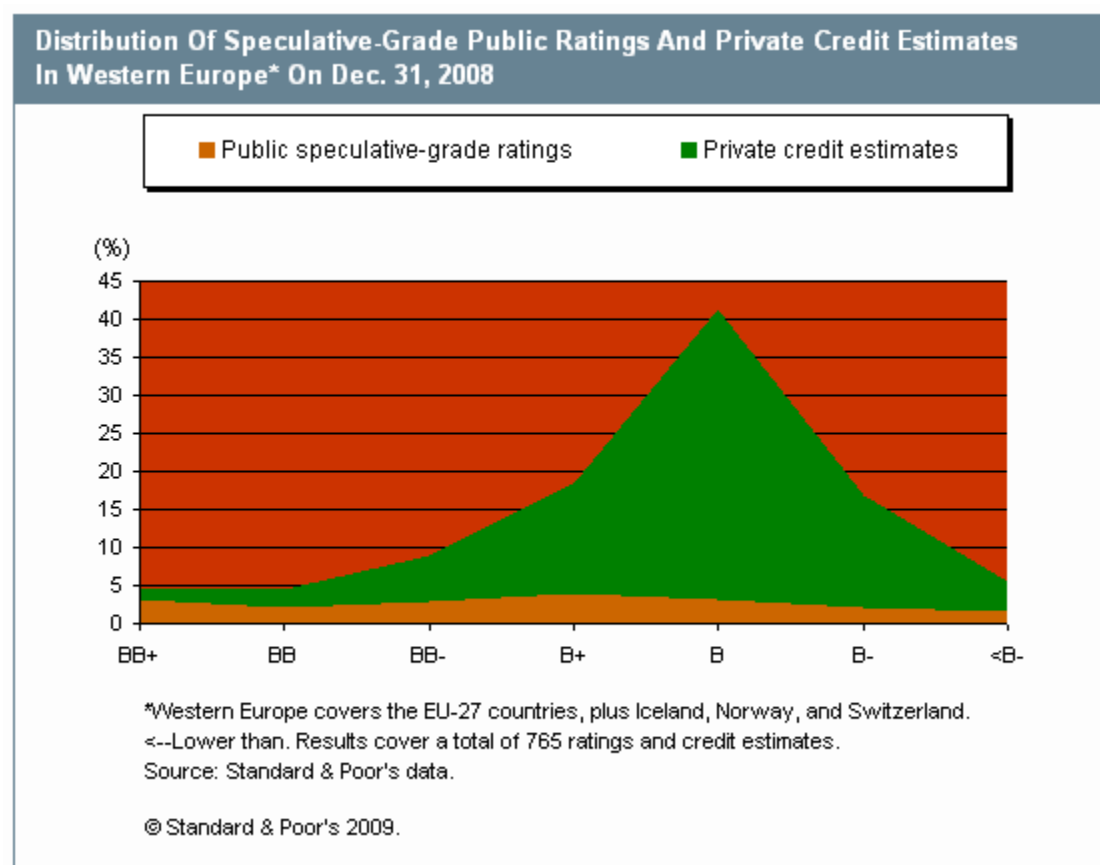


Credit Estimates Provide A Broader Overview Of Credit Trends

In Western Europe at year-end 2008, the number of public speculative-grade ratings for industrial groups or companies maintained by Standard & Poor's totaled 141. However, reflecting the dominant role of private equity in the leveraged finance market over the past seven years, we maintain about 625 private credit estimates on speculative-grade Western European industrials. For this group, which accounts for about 80% of the speculative-grade credits that we manage (see chart 2), the probability of default scores are provided confidentially to CLO managers investing in those industrials' debt.

On average private credit estimates are viewed as being as much as one notch lower than for publicly rated entities. This differential reflects what we believe is the more aggressive structuring and weaker credit metrics typically exhibited by LBOs, compared with traditional corporates with credit profiles of 'BB+' or lower.

Chart 2



Private Loan Default Rate Drives The Overall Default Rate Higher

During 2008, we noted 29 defaults in our private credit estimate database (see table 1), of which 27 (93%) relate to private equity owned companies. This resulted in an increase in the 2008 private loan default rate to 4.76%, 3.4x higher than the 1.41% rate for 2007.

Table 1

Breakdown Of Speculative-Grade Defaults In Western Europe* 2003-2008							
Year	Public ratings			Private credit estimates			Combined default rate (%)
	No. of ratings¶	No. of defaults	Default rate (%)	No. of credit estimates¶	No. of defaults	Default rate (%)	
2003	111	5	4.50	180	5	2.78	3.44
2004	126	2	1.59	263	4	1.52	1.54
2005	147	2	1.36	334	5	1.50	1.46
2006	152	4	2.63	461	8	1.74	1.96
2007	152	3	1.97	567	8	1.41	1.53
2008	146	5	3.42	609	29	4.76	4.50

*Western Europe covers EU-27 countries, plus Iceland, Norway, and Switzerland. ¶Average number of credit estimates in database over period. Source: Standard & Poor's.

This default rate is materially higher than the 3.42% default rate for publicly rated Western European speculative-grade entities in 2008. The latter rate is higher than the 2.54% European speculative-grade default rate published by Standard & Poor's Global Fixed Income Research group in December 2008 because the denominator excludes multiple corporate family ratings except where they are different. It's the first year that we have seen the credit estimate default rate higher than the public speculative-grade default rate, and we believe this trend is likely to persist during the next downward phase of the credit cycle. We think this is because the structural protections embedded into LBO deal documentation, and the limited ability of the senior or junior lenders to provide new money, no longer provides the same degree of lender protection as previously.

Indeed, there are signs that this trend could be exacerbated by atypical behavior. We observe that a number of balance-sheet restructurings are occurring earlier than anticipated. One explanation might be that stakeholders are consensually prudently addressing overleveraged balance sheets to preserve longer term value (U.K. real estate services provider Countrywide PLC, and the Germany-based building material company Lafarge Roofing, for example). Less benignly, from a lender standpoint, private equity sponsors may have proposed financial restructurings designed to retain control of the business by offering an equity injection in return for an aggressive write-down of outstanding senior, and most, if not all, subordinated debt. Examples of this action include IMO Car Wash, British Vita, and Ferretti.

The acceleration in Western Europe of the default rate of leveraged loans resembles that observed in the U.S. Data published by Standard & Poor's Leveraged Commentary and Data suggests that the trailing 12-month leveraged loan default rate rose to a 57-month high of 4.35% at the end of 2008, 3.8x higher than the December 2007 rate of 1.14%.

Cyclical Sectors Bear The Brunt of Defaults, So Far

A sector-by-sector analysis of loan defaults suggests that cyclical businesses have suffered disproportionately at this point in the credit cycle (see table 2). The ongoing liquidity squeeze and falling property prices have hit the homebuilding and real estate market hardest. In 2008, there were seven defaults in the sector among the credits that we monitor, amounting to 12.1% of that industry group. In 2007, the figure was zero.

The chemicals, packaging, and environmental services sectors were also caught. Here, seven defaults in 2008 translate into a rate of 10.1%, and include The Netherlands-based LyondellBasell Industries AF S.C.A., which selectively defaulted just before year-end. In the auto suppliers sector, the default rate continues at a high level despite experiencing a steady stream of defaults in 2006 and 2007. Furthermore, we note that this sector has continued to suffer disproportionately in the first quarter of 2009.

Discretionary consumer categories, representing more than one-third of the overall portfolio, experienced 12 defaults. This translates into sector default rates that are in line with, or slightly above, the average default rate for the whole year. The retail and restaurants category--which includes clothing and textiles, food, drug, and other retailers, as well as food service providers--experienced a 5.4% default rate in 2008. Media and entertainment and consumer products categories saw default rates of 4.5% and 4.4%, respectively.

Table 2

Breakdown By Sector Of Speculative-Grade Defaults In Western Europe* 2003-2008								
Industry sector(s)	No. of defaults						Sector default rate¶ (%)	Sector weight§ (%)
	2008	2007	2006	2005	2004	2003	2008	
Homebuilders/real estate	7	0	0	0	0	0	12.07	7.59
Chemicals, packaging, and environmental services	7	1	1	1	0	0	10.14	8.90
Auto	3	2	5	0	1	0	7.50	5.24
Retail/restaurants	4	1	0	4	0	1	5.41	9.82
Media and entertainment	5	2	2	0	1	2	4.50	14.27
Consumer products	3	2	2	0	1	1	4.41	9.03
Telecommunications	1	0	0	0	0	1	3.45	3.93
Health care	2	0	1	1	1	0	3.13	8.38
Transportation	1	0	0	1	0	1	2.78	4.71
Diversified	1	1	0	0	0	0	1.32	9.95

*Western Europe covers EU-27 countries, plus Iceland, Norway, and Switzerland. ¶Defaults as a percentage of the number of public speculative-grade ratings and credit estimates in each sector. §Distribution of public speculative-grade ratings and private credit estimates by sector. Source: Standard & Poor's data.

Five 2008 Defaults Involve Debt Of More Than €1 Billion

Of the €31.8 billion of debt owed by defaulting companies, €18.9 billion was issued by the publicly rated LyondellBasell group following the selective default of LyondellBasell Industries on Dec. 19, 2008. The other four defaults where outstanding debt was greater than €1 billion were private credit estimates.

Some €11.4 billion was attributable to the 29 private defaults where the average debt outstanding prior to default was €394 million. That said, 18 (62%) of these private defaults involved small companies with outstanding debt of less than €250 million (see table 3)--loans typically held in loan portfolios by one or two collateral managers at most. In fact, the median amount of debt outstanding prior to default for credit estimates was €169 million.

Almost 40% of defaults occurred in the U.K. (see table 4), a disproportionately high figure compared with the 26% weight of U.K. companies in the combined data set. And of these U.K. defaults, just over one-half are in the building and development, retailing, and chemicals sectors.

Table 3

Breakdown By Debt Amount Of Speculative-Grade Defaults In Western Europe* In 2008		
	Public ratings	Private credit estimates
Breakdown of defaulted debt		
Total debt outstanding (bil. €)	20.4	11.4
Average debt outstanding (bil. €)	4.1	0.4
Median debt outstanding (mil. €)	438.0	169.0
Breakdown of defaults		
Total no. of defaults	5	29
Defaults of more than €1.0 bil. outstanding	1	4
Defaults of more than €250 mil. outstanding	2	7

Table 3

Breakdown By Debt Amount Of Speculative-Grade Defaults In Western Europe* In 2008 (cont.)		
Defaults of less than €250 mil. outstanding	2	18
No. of LBOs in default	1	27
No. of non-LBOs in default	4	2

*Western Europe covers EU-27 countries, plus Iceland, Norway, and Switzerland. LBO--Leveraged buyout. Source: Standard & Poor's data.

Table 4

Country	Public ratings		Private credit estimates		Total no. of defaults
	Defaults with debt of more than €250 mil.	Defaults with debt of less than €250 mil.	Defaults with debt of more than €250 mil.	Defaults with debt of less than €250 mil.	
Belgium				1	1
Finland			1		1
France	1		1	2	4
Germany				2	2
Iceland				1	1
Ireland	1				1
Italy		1		1	2
The Netherlands	1		1	1	3
Spain			1	2	3
Sweden			1		1
Switzerland				2	2
U.K.		1	5	7	13
Total no. of defaults by category	3	2	10	19	34

*Western Europe covers EU-27 countries, plus Iceland, Norway, and Switzerland. Source: Standard & Poor's data.

Larger Transactions Experience a Lower Default Rate in 2008

The relatively low capitalization of many of last year's defaulting companies raises the issue of the default experience for those institutional investors holding larger, historically more liquid credits. Standard & Poor's identified 344 Western European credits held in at least five European cash flow CLO vehicles (not managers). Twelve loans from these CLOs defaulted in 2008, resulting in a trailing 12-month default rate of 3.49%--rather less than for the market as a whole. The outstanding exposure of institutional investors to these 12 credits amounted to about €1.3 billion at end-December 2008. This level of exposure is only indicative, however. We would expect the portfolio impact to be greater on the assumption that managers might have traded out their exposure to these credits prior to default.

Stress Tests Reveal Extent Of Worsening Defaults

In estimating the likely corporate default rate in Western Europe in 2009-2010, we stress our population of speculative-grade ratings and credit estimates in several ways. First, assuming that the third quarter of 2008 marked the point at which defaults started to rise, and our expectation that this trend will continue for several years, we annualize the actual default rate from the second half of 2008. With 28 defaults over this period, of which 22 were recorded in the fourth quarter, the annualized default rates for these two periods stand at 7.5% and 11.7%,

respectively.

The second approach considers the variability in default rates from 1981 to 2008, derived from Standard & Poor's Global Default and Transition Study (see article titled "2008 Annual Global Corporate Default Study And Rating Transitions," published April 2, 2009, on RatingsDirect). The standard deviation of one-year default rates for speculative-grade credits over this period is 2.71%. Given our assessment of the pace and severity of the current economic downturn (which threatens to be as severe as any recession witnessed over the past 30 years), our base-case default projection assumes that defaults may experience three standard deviations. This adjustment, coincidentally, also points to a default rate of 11.7% for speculative-grade credits.

Assuming an 11.7% default rate, and applying the default stresses detailed in table 5 to the speculative-grade bond and credit estimate portfolio at Dec. 31, 2008, results in a base-case projected default rate of 9.8% for publicly rated speculative-grade issuers. The projected default rate for our portfolio of private credit estimates is 12.1%. This reflects the weaker credit profile of those companies (mostly LBOs) on which we maintain credit estimates.

While our updated combined base-case default rate projection of 11.7% may be viewed as high by historic measures, the final element we take into consideration in our worst-case scenario is the fact that average credit quality appears to have been significantly higher at the end of the previous default cycle in 2003. At that time, there was a significantly greater proportion of speculative-grade issuers rated in the 'B+' category or higher. In Western Europe at the end of December 2003, 68.6% of our combined database of speculative-grade ratings and credit estimates were in the 'B+' category or higher, compared with only 35.9% at end-December 2008. Applying three standard deviations to each rating category, based on our Global Default And Transition Study, results in a combined worst-case annual default projection of 14.7% for 2009 and 2010. This breaks out into a 15.2% annual default rate for credit estimates and 12.3% for speculative-grade issuers (see table 5).

Table 5

Speculative-Grade Default Rate Projections For Public Ratings And Private Credit Estimates In Western Europe* In 2009-2010		
	Default rate assumptions (%)	
	Base-case scenario	Worst-case scenario
Breakdown by rating category		
BB- and above	1.8	2.2
B+	4.8	6.1
B	12.0	15.0
B-	17.3	21.7
CCC/CC	49.0	61.4
Breakdown by default type		
Credit estimates	12.1	15.2
Public ratings	9.8	12.3
Combined	11.7	14.7
Projected no. of defaults	90	112

*Western Europe covers the EU-27 countries, plus Iceland, Norway, and Switzerland. Source: Standard & Poor's data.

Appendix: Default Study Methodology

To arrive at the default rate projections identified in this research report, we group our corporate ratings--assigned with the benefit of regular interaction with management teams of issuers--into 17 standard industry classifications. We similarly group our private credit estimates, which are established on the basis of information provided by third parties. Credit estimates are, for the most part, used to assess CLO asset pools.

On Dec. 31, 2008, Standard & Poor's speculative-grade universe in Western Europe comprised 141 public ratings and 624 credit estimates. Geographically, these credits are spread across the 27 countries that make up the EU, plus Iceland, Norway, and Switzerland.

For the purposes of this study, defaults are classified as missed payments, bankruptcy filings, or a distressed exchange under certain conditions as detailed in the article titled "Rating Implications Of Exchange Offers And Similar Restructurings," published Jan. 28, 2009, on RatingsDirect.

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