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**Leveraged Finance:**  
**Time Between Loan Breach And  
Default Shortens In Europe As  
Recession Sets In**

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## Leveraged Finance:

# Time Between Loan Breach And Default Shortens In Europe As Recession Sets In

Financial covenants are primarily designed to alert lenders to the financial state of a borrower in time to allow them to take appropriate action. Theory, however, may be different from practice: A study by Standard & Poor's Rating Services among highly leveraged companies in Western Europe suggests that as defaults have risen over the past 12 months, the time between a covenant breach (or waiver request) and a payment default or restructuring has shortened considerably. The study suggests that, in general, borrowers and lenders have less time to take remedial action than they might have had in the past.

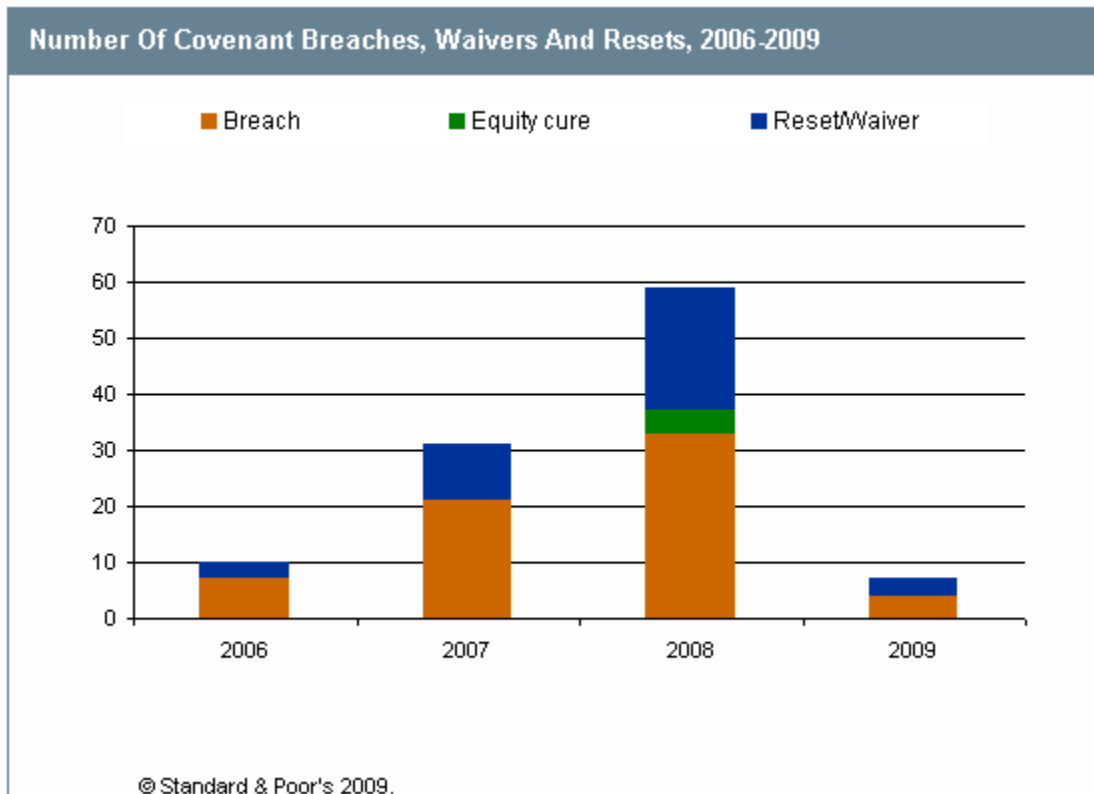
Why might this be? One explanation could be that covenant terms have become more generous. Financial covenants on transactions structured from 2005 to 2007 provided on average 3% more headroom than in previous years, according to data from Standard & Poor's Leveraged Commentary and Data (LCD). Under this explanation, companies likely experience larger declines in EBITDA or higher rises in total debt before triggers are breached. In addition, more permissive debt-repurchase provisions appear to be the basis of many recent corporate debt buybacks.

## Covenant Breaches Soar As Economic Conditions Worsen

This loosening of financial covenants has coincided with one of the most difficult European economic environments for the past 30 years. By our count, there were 34 speculative-grade corporate defaults in 2008, representing a default rate of 4.5%, more than three times as high as that recorded for 2007. We anticipate that in 2009 this will rise to between 11.5% and 14.7% for our universe of speculative-grade corporate ratings and private credit estimates (see article titled "Leveraged Buyouts Are Fueling Surging Defaults In Western Europe," published April 8, 2009, on RatingsDirect).

Our covenant research of more than 750 speculative-grade public ratings and private credit estimates of European companies shows 59 covenant breaches or waiver requests in 2008, compared with 31 in the previous 12 months, an increase of 90% (see chart 1). To date in 2009, only seven companies appear to have breached their covenants or requested waivers. While this figure seems low, considering the fundamental difficulties facing speculative-grade European companies, we expect additional breaches will be reported in the first quarter of 2009. In some situations, lenders may elect to begin restructuring negotiations rather than reset covenant terms and continue with current capital structures which, in the context of current conditions, may involve unsustainable amounts of debt.

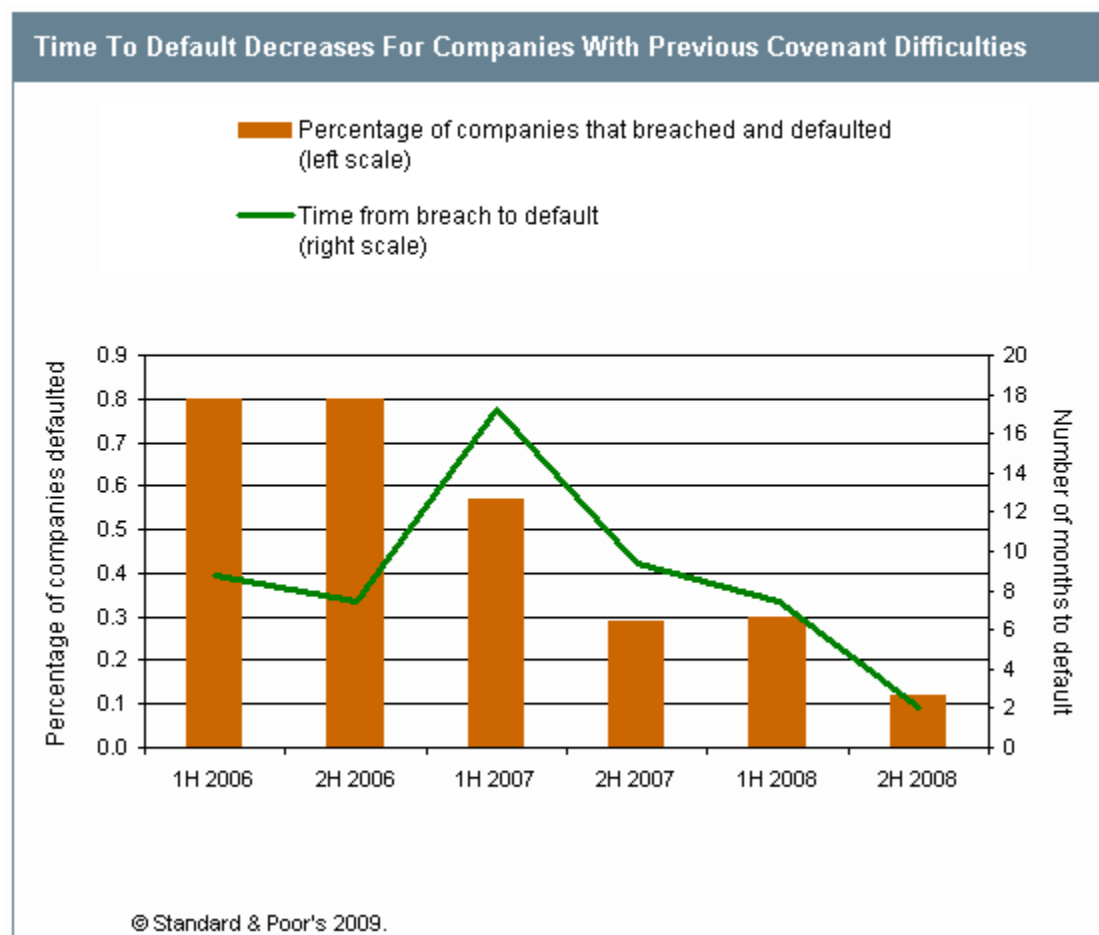
Chart 1



## What A Difference A Year Makes

Since 2006 there have been 107 covenant breaches, waivers or equity cures among our portfolio of highly leveraged European companies. Of these instances, 30, or 30%, have defaulted or restructured. Our study indicates that the average time to default from the covenant breach or waiver request fell to just 6.5 months in 2008. This compares with an average of 8.0 months for 2006 and 12.0 months for 2007.

Chart 2



More specifically, the study shows that in the second half of 2008, the average time from a financial covenant breach to a payment default, distressed debt exchange, or restructuring contracted to 2.0 months from 7.5 months in the first half of the year (see chart 2). In our view, this contraction occurred as current conditions have dramatically changed the negotiation environment for covenant breaches. In the first half of 2008, when it was less clear how the global downturn would evolve, lenders would usually accept the requisite fees and higher spread margins in return for consenting to proposed covenant amendments. With new business plans in place and covenants set at a higher level, lenders could hope for a turnaround and eventual full repayment of debt.

This outcome is probably no longer realistic. Instead, the lack of predictability of business performance and the lack of available credit appears to have altered lenders' approaches to dealing with distressed borrowers. We understand that debt buybacks, equity injections, and asset and business unit sales are increasingly the subject of negotiations between lenders and borrowers. In cases where these options are not available, more radical action in the form of financial or operational restructuring may be required. Creditors will typically express a preference for avoiding formal insolvency, but we understand that the inability of lenders to make new money available is significantly affecting the outcomes of restructuring negotiations.

Shareholders may seize the initiative by injecting new capital in return for substantial debt write-downs, often

reflecting a stressed valuation based on a liquidation scenario. We understand that about 90% of European leveraged loans are used to fund leveraged buyouts by financial sponsors. What's more, the structure of these loans generally enables private equity firms to inject new equity capital into their portfolio companies if necessary. Such occurrences increased to 40% in 2008, from 30% in 2007 and 20% in 2006.

We understand that private equity firms' decisions on whether to inject new equity are based solely on whether contributing new equity, combined with a more appropriate capital structure, would likely generate attractive risk-adjusted returns for the benefit of their limited partners. In the past, market participants argued that reputational risk would encourage sponsors to continue to support portfolio companies in difficulty, as failure to do so might hamper the sponsors' ability to raise debt finance in the future. However, this argument is no longer valid, in our view. Where private equity firms decide not to contribute equity, we believe they are prepared to allow third parties to take ownership of the company as shown by the restructuring of Italian yachtmaker Ferretti. A plan from Ferretti's owner, Candover, a U.K.-based private equity sponsor, was rejected and an alternative proposal that appeared less punitive for lenders was accepted by those lenders, according to Standard and Poor's LCD. This alternative plan includes an equity injection from management and an agreement that a third party, Mediobanca, will buy a 45% stake in the recapitalized company.

Friction often develops between stakeholders in distressed companies. In cases where financial sponsors wish to maintain equity control by injecting new capital, this can result in debt write-downs for both junior and senior lenders, often in return for only limited equity participation. We observe that lenders often agree to such proposals because lender groups are disparate, hampered by a lack of liquidity, and unable to take control of, and turn around, the company. While it is too soon to opine on the probability of success of such tactics in current conditions, they could have implications for structuring future transactions, in particular with regard to the rights of senior lenders and the value of collateral security.

## **Weak Performance Lies At The Heart Of Most Covenant Problems**

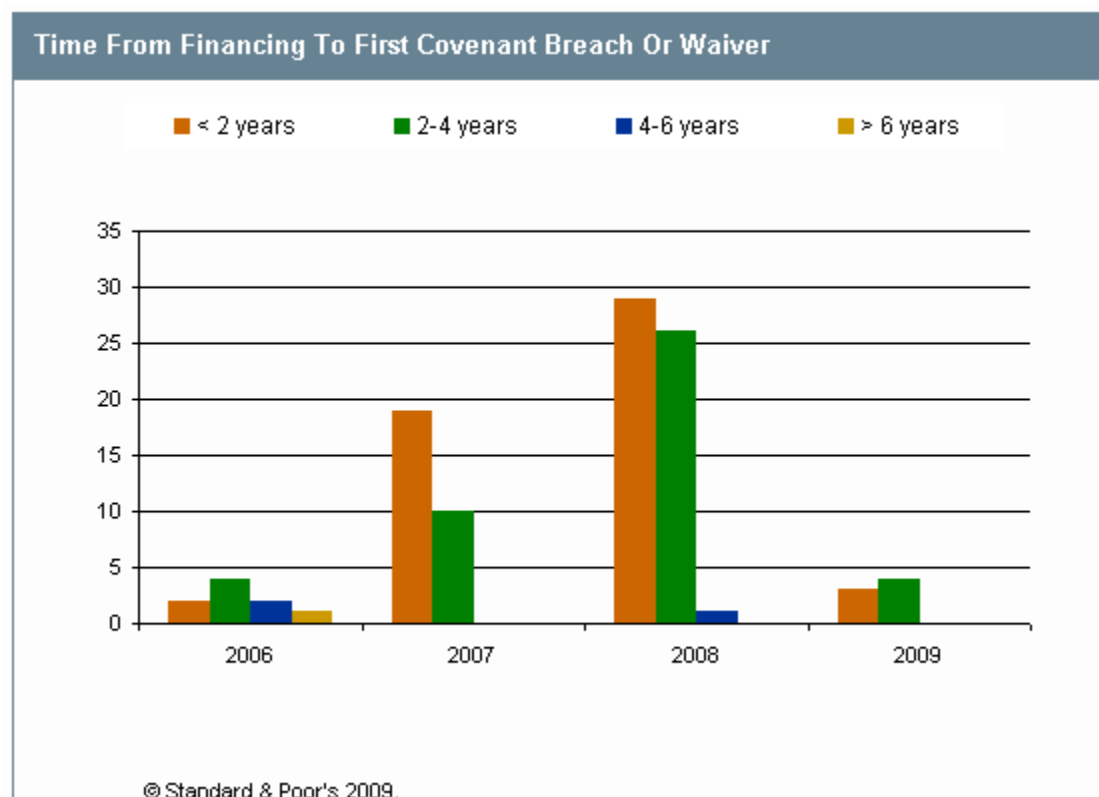
Our study also shows a decrease in the time between the original financing and the onset of difficulties in meeting covenant tests (see chart 3). The number of companies experiencing covenant difficulties within two years of their last financing has increased to 29 in 2008, from 19 in 2007 and two in 2006. In our experience, transactions undertaken at the height of the market between 2006 and 2007 often had little amortization. In addition, borrowers' business plans featured aggressive growth projections that were clearly vulnerable to a downturn. Borrowers unable to meet their covenants often find themselves with additional problems as conditions deteriorate. Our study identifies eight companies that have breached their covenants, or asked for a reset or waiver, more than once since 2006.

We see weak operating performance as the common theme for most of those companies. When private equity sponsors purchased portfolio companies during the boom years, many of those companies predicted aggressive and steady EBITDA growth rates, which helped justify high purchase multiples. However, we understand that since mid-2007 many companies, particularly those operating in sectors that are dependent on consumer demand or in highly cyclical or seasonal businesses, have struggled to meet these projections.

Rising prices for raw materials affected many companies that breached their financial covenants in 2007 and 2008. These rising costs increased working capital requirements and damaged many borrowers' liquidity positions.

Separately, borrowers in the gaming and leisure sector, which represent 7% of covenant breaches or waivers in our study, have had trouble complying with their financial covenants. The gaming and leisure sector appears separately affected by regulatory risk independent from the cyclical downturn. Most gaming and leisure companies suffered a drop in demand due to the smoking ban in the U.K., which hampered their earnings growth.

Chart 3



When viewed by transaction vintage or the year of their most recent financing activity, we observe how quickly many of these companies ran into trouble (see table). Nearly one-half (43%) of the companies with breaches or resets in 2008 were either financed, refinanced, or recapitalized in 2007. The pattern is similar for 2007, in which 45% of the companies that had breaches or resets were financed in 2006.

#### Year Of Breach Versus Year Deal Last Financed

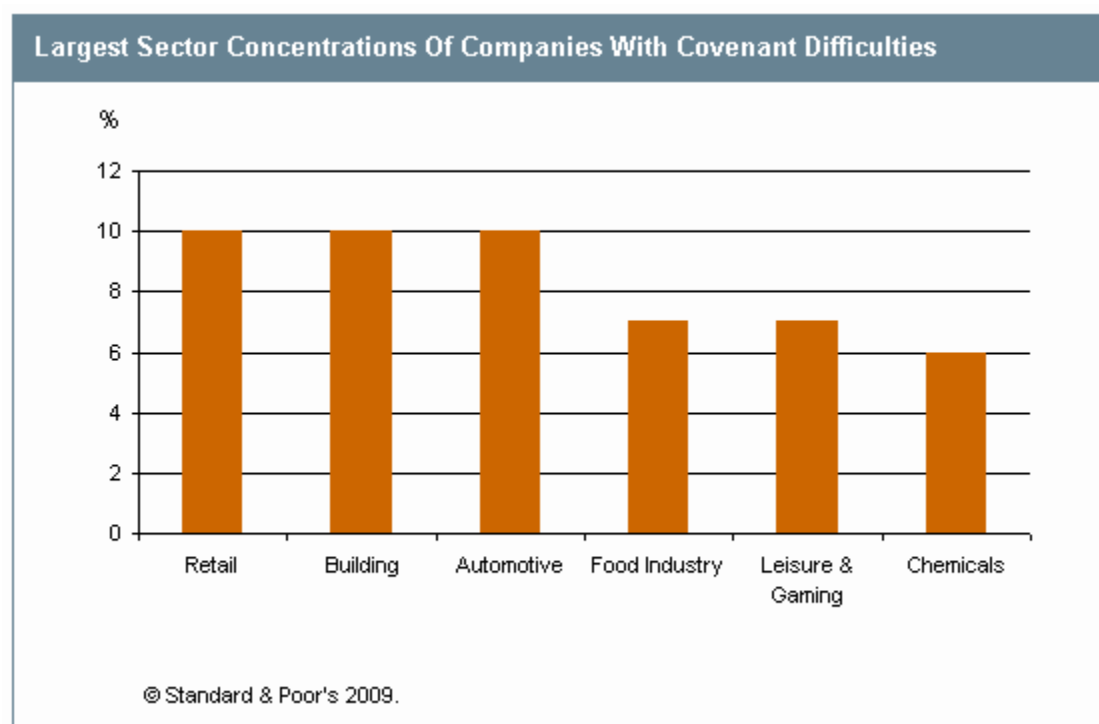
Year Financed	--Year of Breach--				Total
	2006	2007	2008	2009	
1999	1				1
2000	1				1
2001	1				1
2002	1				1
2003	1				1
2004	2	4	1		7

Year Of Breach Versus Year Deal Last Financed (cont.)					
2005	1	6	11	18	
2006	1	13	19	2	35
2007		6	24	5	35
2008			1		1
Total	9	29	56	7	101

## Firms At Greatest Risk Are In Cyclical And Consumer-Related Industries

Borrowers that feature in our study range across a wide variety of industry sectors. However, most sectors represent less than 4% of the companies with covenant difficulties, and 50% of the companies affected are found in the six largest sectors (see chart 4). Unsurprisingly, these sectors are either cyclical or consumer-driven industries: retail (10% of the total), building (10%), auto (10%), food (7%), leisure and gaming (7%), and chemicals (6%).

**Chart 4**



## Outcomes From 2009 And 2010 Will Set The Pattern For The Financing Of Speculative-Grade Companies In The Future

In our view, vulnerable speculative-grade companies face an uphill struggle over the next few years as economic conditions make meeting financial covenant tests more difficult. Not only do many of these companies have highly leveraged capital structures, but with consumer demand for goods and services falling, they will likely find it

increasingly difficult to meet sales and EBITDA projections.

We believe that there will continue to be less time between failing covenant tests and restructurings or insolvency filings, as support from lenders decreases due to capital constraints. How these troubled speculative-grade European companies emerge from covenant negotiations and restructuring processes in 2009 and 2010 will, we believe, ultimately shape the terms and conditions for how they are financed in the medium-to-longer term.

(This study is an update of our previous covenant research article "Loan Breaches By Highly Leveraged European Companies Double As Recession Fears Grow," published Nov. 12, 2008, on Ratings Direct.)

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