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Leveraged Finance:
**Charting The Evolution Of
Post-Default Recovery Prospects At
U.K.-Based Countrywide**

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As Default Rates Rise, Recovery Ratings Face A Stiff Test

Standard & Poor's Rating Services' recovery ratings provide our opinion on the estimated recovery potential for debt instruments. We use a fundamental, scenario-based analysis of what we see as the factors most likely to precipitate a payment default, followed by our assessment of the value that would be available to repay creditors.

As default rates rise in Europe, our recovery ratings will be tested. Investors will compare our recovery expectations and the underlying default scenario analysis with actual recoveries and events. In fact, defaults by speculative-grade companies are accelerating, with a rate of 10.2% in the 12 months to the end of June 2009, up from 5.3% at the end of 2008. We expect that the number of defaults will rise substantially in 2009. Our current estimate for defaults in our universe of speculative-grade companies with corporate and recovery ratings, as well as credit estimates outstanding, is 11.7%-14.7%.

One of the European companies that defaulted in 2009 was Castle HoldCo 4 (rated D/--/-- on May 8, 2009), the holding company for U.K.-based real-estate services provider Countrywide PLC. The company's revenues were hit by a downturn in the U.K. economy and the dislocation in the housing market. Although the company made efforts to streamline costs, this provided little benefit because of the severity in the drop in trading and the company's highly leveraged financial profile. Standard & Poor's first assigned a corporate credit rating and recovery ratings to Countrywide's debt in April 2007, near the peak of the credit bubble. At that time, we estimated recovery expectations for the senior secured bonds of 30%-50%. This is significantly lower than the average recovery prospects for senior secured debt in Europe.

Our Recovery Ratings On Countrywide Reflected Poor Recovery Prospects For Some Lenders

We initially assigned a recovery rating of '1' to the group's proposed senior secured £100 million revolving credit facility (RCF), reflecting our expectation of a very high (90%-100%) recovery of principal and pre-petition interest in the event of a payment default. We assigned a recovery rating of '4' to the proposed £470 million senior secured floating-rate notes due 2014, reflecting our expectation of an average (30%-50%) recovery of principal and pre-petition interest in the event of a payment default. At the time the transaction was funded, we did not assign a recovery rating to the group's £170 million senior unsecured notes due 2015. However, in March 2008, when we expanded our recovery ratings to all unsecured speculative-grade debt issuance, we assigned a recovery rating of '6' reflecting our expectation of negligible recovery of principal and pre-petition interest in the event of a payment default. All three of the recovery ratings remained the same from first assignment to default.

Although the recovery rating on the RCF was indicative of our expectation of a very high recovery, the recovery rating of '4' on the £470 million senior secured notes was well below our average recovery expectations of about 70% in Europe for other senior secured debt.

Our Methodology Identified Two Unusual And Negative Elements In Countrywide's Debt Structure

Standard & Poor's methodology for recovery analysis falls into three broad steps: identifying the major business risks and simulating a path to default; valuing the enterprise at default; and constructing the waterfall of payments according to the security structure, intercreditor arrangements, and insolvency regime to determine recovery to different classes of debtholder.

In many cases, the security structure and waterfall of payments remains relatively static over time. In the case of Countrywide the main elements of the structure were as follows:

- Three classes of debt: superpriority RCF, senior secured debt, and senior notes;
- The comprehensive security package provided to the senior secured debtholders, including share pledges, asset security, and intercompany guarantees. Very limited security was provided to the holders of senior notes, although the senior notes benefitted from a comprehensive guarantee package.
- A clear waterfall, supported by an intercreditor agreement ensuring that recoveries were distributed to the RCF ahead of the secured notes, which in turn ranked ahead of the senior notes.
- Supportive insolvency regimes for secured creditors with the UK being the main country of operation.

Unusual features in the Countrywide transaction included a payment-in-kind (PIK) 'toggle' option granted to lenders on a £100 million tranche of the senior secured notes. This option allowed the issuer to pay interest in cash or PIK form at its discretion until 2011. Thereafter this tranche was to revert to cash interest only. The second unusual feature was the provision of a sizeable RCF relative to the working capital needs of the company.

We viewed these features, along with the absence of financial maintenance covenants, as broadly supportive of credit quality by providing additional flexibility to the group. However, from a recovery perspective, we viewed these features as negative: we believed they could potentially adversely affect the valuation of the business and the amount of debt claims outstanding by the time of default. We believed that the ability to pay interest in kind and the availability of the RCF created the potential for lower profitability at default. This is because Countrywide's financial performance would be able to deteriorate more severely than might otherwise be the case if the company had a higher interest burden or more constrained liquidity. Indeed, our default scenario at inception, incorporating the risk of a severe housing market downturn, highlighted that the company was likely to achieve break-even EBITDA at best by the time of a default.

Low profitability at default and our view of poor medium-term growth prospects also translated into a lower stressed valuation, reducing recovery prospects for lenders. This was further compounded by the superpriority status of the RCF, which pushed secured bondholders down the waterfall, making them more vulnerable to losses, in our opinion.

Countrywide Underwent A Scheme Of Arrangement Restructuring

On Feb. 17, 2009, Standard & Poor's Ratings Services lowered to 'SD' from 'CCC' its long-term corporate credit rating on Countrywide, following the group's failure to honor its coupon payment due under its senior secured

notes and its proposed scheme of arrangement. We lowered the corporate credit rating to 'SD' and not 'D' because we understood, based on information received, that the company had not defaulted on other financial commitments. However, on May 8, 2009, we lowered the rating to 'D' following court approval for the proposed scheme of arrangement. The scheme allowed the company to reduce its debt through a lender write-down alongside an injection of £112.5 million of fresh equity. The company's debt burden was reduced to £175.0 million, including the repayment in full of its RCF. We consider this to represent recovery of 37% for the senior secured lenders (see table 1). As per our general criteria, we consider the completion of a distressed exchange offer—including through a scheme of arrangement—as equivalent to a default (for more information, see article "General Criteria: Rating Implications Of Exchange Offers And Similar Restructurings, Update," published on May 12, 2009, on RatingsDirect).

Table 1

Castle HoldCo 4 (Countrywide) Actual Recoveries Versus Expected				
Amount	Seniority	Initial recovery rating (% recovery expectation)	Actual recovery	Comments
£100 mil.	Revolving credit facility	1 (90%-100%)	100%	Fully repaid.
£470 mil. (split between cash and toggle tranches)	Senior secured floating-rate notes	4 (30%-50%)	37%*	Lenders agreed to convert their debt into 35% of the newly restructured company and new senior secured notes issued with a face value of £175 million.
£170 mil.	Senior notes	6 (0%-10%)	0%	Holder will swap their debt for 5% in new equity.

*Nil value attributed to equity.

These schemes are popular for both lenders and companies because they allow the various parties with economic interest to achieve a compromise. The schemes can preserve value because they are typically put in place before a company runs out of cash and a payment default occurs. Furthermore, they avoid a lengthy bankruptcy process that can affect the trading side of the business by undermining creditor confidence. However, some lenders can get lower recoveries through this process than they would otherwise receive as only 75% of creditors need to give approval, so those with smaller economic interests are at risk of being squeezed out.

We Revised Our Default Scenario For Countrywide Several Times In Response To Market Conditions

The variable elements of our recovery analysis included our default scenario, which we revised as market conditions changed (although our recovery ratings remained the same). Our initial analysis highlighted that, by the time of default, the company's EBITDA might be negative. This was largely a result of the potential severe revenue decline under our default scenario in the event of a significant weakening in the housing market. This created a challenge for valuing a business where EBITDA multiples are typically used as benchmarks for valuation. In order to overcome this, we forecast profitability forward past our hypothetical point of default to what we considered would be an 'average' level of profitability across the cycle. We used this level of EBITDA for the terminal valuation in our discounted cash flow model and as the benchmark for our market multiple analysis. Table 2 shows how these variables evolved over time.

Given our assessment of Countrywide's strong market position, well-respected brands, and established branch

network across the U.K., we believed the company would be more likely to default due to high leverage than because of a fundamental business problem. Because of this we also believed that the company would be valued as a going concern following any default.

As table 2 highlights, the changes in our default scenario mirrored the more severe weakening in the outlook for the housing market as well as a worsening in Countrywide's liquidity position. In November 2007, we revised the outlook on the 'B' rating on Countrywide to negative from stable. This change resulted from our view that the housing market slowdown was becoming increasingly pronounced and the credit environment during the summer of 2007 had resulted in a reduced pipeline of business for Countrywide.

The negative outlook remained until November 2008 and our initial recovery assumptions were unchanged through this first outlook transition. We first revised our default scenario in May 2008, when we increased our estimate of the severity of the decline in the company's revenues. We made further moderate revisions to our default-case assumptions in August 2008, but also lowered the valuation multiple to reflect the weaker long-term outlook. Thereafter, we maintained our recovery assumptions throughout the subsequent corporate credit rating changes (see tables 2 and 3).

Table 2

Castle HoldCo 4 (Countrywide) Progression Of Corporate Credit Rating From Assignment To Default					
	--April 2007 to Nov. 2007--	--Nov. 2007 to Nov. 2008--	--Nov. 2008 to Feb. 2009--	--Feb. 2009 to May 2009--	--May 2009--
Corporate credit rating	B/Stable/--	B/Negative/--	CCC/Negative/--	SD	D
Rationale for change	View that the housing market slowdown was becoming increasingly pronounced and the credit environment during the summer of 2007 had resulted in a reduced pipeline of business for Countrywide.		Countrywide's worsening liquidity position during the first nine months of 2008, and our expectation that this position would progressively deteriorate over the next 12 months as transaction volumes remained at depressed levels.	Countrywide failed to honor its coupon payment due under its senior secured notes and noteholders proposed a scheme of arrangement.	Countrywide received court approval for the noteholders' proposed scheme of arrangement.

Table 3

Castle HoldCo 4 (Countrywide) Progression Of Recovery Rating From Assignment To Default				
	--April 2007 to May 2008--	--May 2008 to Aug. 2008--	--Aug. 2008 to May 2009--	
Hypothetical default scenario	i) 30% decline in revenues over three years as a result of the housing market downturn; ii) Deteriorating gross margins as operating costs adjusted with a time-lag; iii) Interest rate increases on variable-rate debt; iv) PIK interest being paid on the £100 million toggle notes from 2008 until default.	Revised assumptions: 45% decline in revenues by default in 2010 compared with 2007.	Revised assumptions: >50% decline in revenues by default in 2009 compared to 2007	
Default year forecast	2010	2010	2009	
EBITDA at default	Nil	Nil	Nil	
EBITDA for terminal valuation	£62 million	£53 mil.	£55 mil.	
Stressed EV	£370 mil.	£320 mil.	£275 mil.	
EV multiple of terminal valuation	6.0x	6.0x	5.0x	
RCF recovery rating	1 (90%-100%)	1 (90%-100%)	1 (90%-100%)	

Table 3

Castle HoldCo 4 (Countrywide) Progression Of Recovery Rating From Assignment To Default (cont.)			
Senior secured recovery rating	4 (30%-50%)	4 (30%-50%)	4 (30%-50%)
Senior notes recovery rating	N/A	6 (0%-10%)	6 (0%-10%)

EV--Enterprise value. RCF--Revolving credit facility. PIK--Payment-in-kind. N/A--Not applicable.

Related Research

- Castle HoldCo 4 (Countrywide) Long-Term Rating Lowered To 'D' On Court Approval For Scheme Of Arrangement, May 8, 2009.
- Castle HoldCo 4 (Countrywide) L-T Rating Cut To 'SD' On Missed Coupon Payment, Feb. 17, 2009.
- Castle HoldCo 4 (Countrywide) L-T Rating Cut To 'CCC' On Liquidity Concerns; Outlook Negative, Nov. 4, 2008.
- Castle Holdco 4 (Countrywide) Outlook To Neg On Tougher Market Conditions; 'B' CCR Affirmed, Nov. 15, 2007.

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