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Leveraged Finance:

Leveraged Loan Defaults Continue To Climb In Western Europe As The Slowdown Exposes Structural Weaknesses

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Companies with highly leveraged capital structures are having a difficult time of late coping with the dislocation in credit markets that began in mid-2007 and the severe downturn in the global banking sector that followed in September 2008. Speculative-grade issuers (that is, those with a public rating or private credit estimate in the 'BB+' category or below) with weak liquidity and a material shortfall in their business performance have been particularly hard hit, we believe, many having to approach their lenders to restructure their debt or waive financial covenants.

In Europe, these factors led to a substantial rise in the number of defaults among Standard & Poor's Rating Services' portfolio of speculative-grade corporate and leveraged-loan issuers during the first and second quarters of 2009. As a result, we estimate the default rate among speculative-grade companies is likely to peak at just under 15% in the second half of 2009, although we anticipate that the decline thereafter will be only gradual.

Default Rate Climbs To 11% In Mid-2009

Within our survey population, there were 48 defaults in the six months to June 30, 2009. This compares with six defaults in the same period last year and 40 for the whole of 2008. Of the half-year total for 2009, 42 are issuers with private credit estimates, while only six are publicly rated industrial speculative-grade issuers (see table 1).

The trailing 12-month default rate (by number) at the end of June 2009 was 11.0%, more than double the revised rate of 5.3% at the end of December 2008 (see chart 1). Notably, the default rate of 11.9% in our private credit estimate portfolio was far higher than the default rate of 7.6% for publicly rated speculative-grade companies.

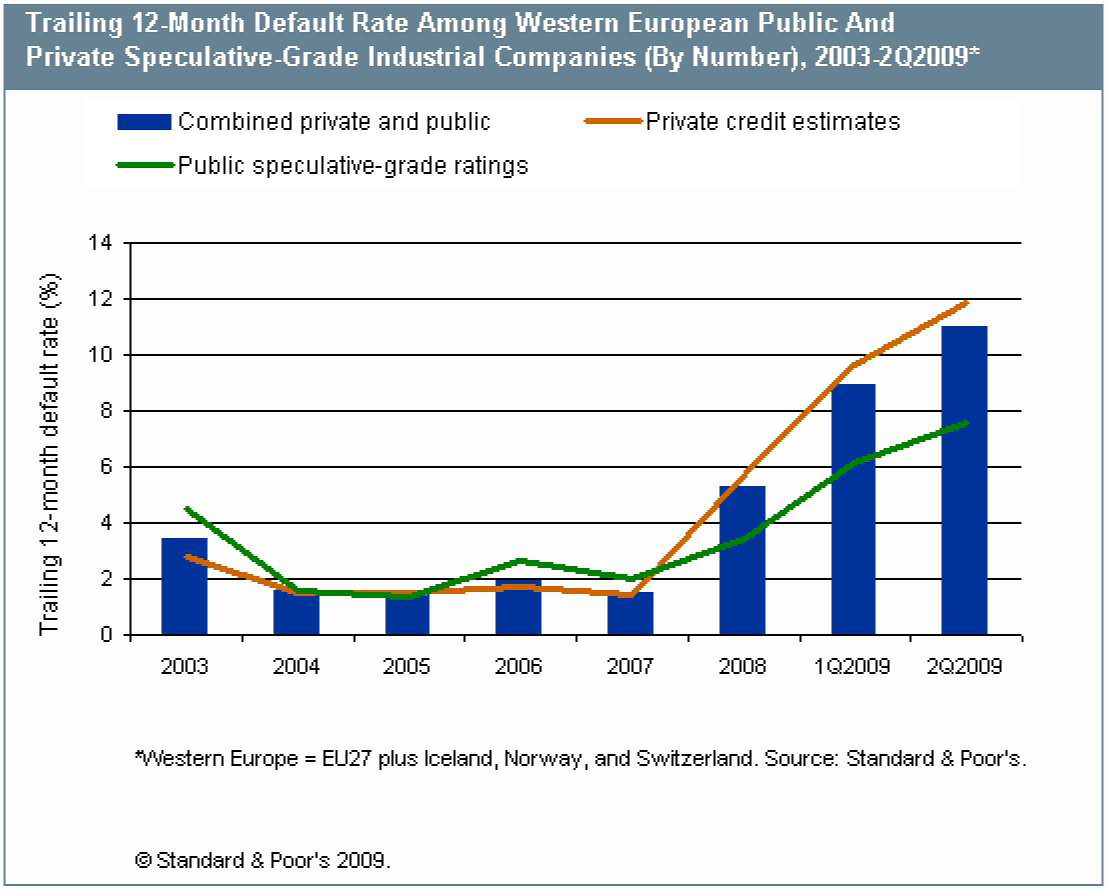
Table 1

Default Rate Among Western European Public And Private Speculative-Grade Companies, 2003-2Q2009*

	--Private credit estimates--			--Public speculative-grade ratings--			--Combined private and public--
	Number of companies¶	Number of defaults	Trailing 12-month default rate (%)	Number of companies¶	Number of defaults	Trailing 12-month default rate (%)	Trailing 12-month default rate (%)
2003	180	5	2.8	111	5	4.5	3.4
2004	263	4	1.5	126	2	1.6	1.5
2005	334	5	1.5	147	2	1.4	1.5
2006	461	8	1.7	152	4	2.6	2.0
2007	567	8	1.4	152	3	2.0	1.5
2008	609	35	5.7	146	5	3.4	5.3
1Q2009	604	24	9.6	146	4	6.2	8.9
2Q2009	598	18	11.9	146	2	7.6	11.0

*Western Europe = EU27 plus Iceland, Norway, and Switzerland. ¶Average number of companies in our database over the period. Source: Standard & Poor's.

Chart 1



In the first half of 2009, the companies that defaulted collectively held outstanding debt of €30.3 billion prior to default. This is almost equivalent to the €28.8 billion of total debt held by those companies that defaulted in the second half of 2008. The composition of defaults in the two periods is very different, however. The 42 private credit estimate defaults in the first half of 2009 carried outstanding debt of €18.8 billion, a sharp increase from the €8.4 billion owed by the 29 private credit estimate defaults in the second half of 2008.

By contrast, in the first half of 2009, only six publicly rated speculative-grade companies defaulted in Western Europe, and their outstanding debt totaled €11.6 billion (see table 2). This amount represents a sharp fall from the €20.4 billion of debt owed by the five companies that defaulted in the second half of 2008. (Within that figure, €18.9 billion {equivalent}, or 93% of the total, resulted from the default of LyondellBasell Industries AF S.C.A. on Dec. 30, 2008.)

Table 2

Summary Of Publicly Rated Speculative-Grade Corporate Defaults In Western Europe, 1H2009*

Company name	Country	Industry	Debt amount (mil. €)	Default date
Akerys Holdings S.A.	France	Real estate	238.60	Feb. 10, 2009
Castle HoldCo 4	Cayman Islands	Real estate	870.59	Feb. 17, 2009
Bite Finance International B.V.	Lithuania	Telecommunications	291.70	March 19, 2009

Table 2

Summary Of Publicly Rated Speculative-Grade Corporate Defaults In Western Europe, 1H2009* (cont.)				
Sensata Technologies B.V.	Netherlands	Aerospace/automotive/capital goods/metal	1,953.48	March 31, 2009
NXP B.V.	Netherlands	High technology/computers/office equipment	4,816.67	April 2, 2009
Thomson S.A.	France	Consumer/service sector	3,416.60	May 7, 2009

*Western Europe = EU27 plus Iceland, Norway, and Switzerland. Source: Standard & Poor's.

Default Rate By Value Stood At 8.3% At End-June 2009

The 12-month default rate by value, combining both public ratings and private credit estimates, was 8.3% at the end of June 2009 compared with 4.5% at the end of December 2008 (see table 3).

Because of the smaller average size of those companies for which we provide private credit estimates, the 12-month default rate by value at the end of June 2009 stood at 7.7%, up from 3.4% at the end of December 2008. These figures are based on the latest available data prior to June 2009 for total debt owed by those speculative-grade companies in our private credit estimate database. In total, the drawn debt outstanding for these companies was €353.9 billion.

Table 3

Western European Public And Private Speculative-Grade Defaults (By Value), 2H2007-1H2009

	--Private credit estimates--			--Public speculative grade ratings--			--Combined private and public--
	Number of defaults	Value (Bil. €)	12-month default rate (%)	Number of defaults	Value (Bil. €)	12-month default rate (%)	12-month default rate (%)
2H2007	8	1.0	--	0	0.0	--	--
1H2008	6	3.7	1.3	0	0.0	0.0	0.7
2H2008	29	8.4	3.4	5	20.4	5.6	4.5
1H2009	42	18.8	7.7	6	11.6	8.8	8.3

*Western Europe = EU27 plus Iceland, Norway, and Switzerland. Source: Standard & Poor's.

Auto, Homebuilders And Real Estate, And Consumer Products Sectors Top The Default List

By sector, auto and auto suppliers (six defaults), homebuilders and real estate (seven), and consumer products (five) represent 38% of total defaults in the first half of 2009. These sectors were disproportionately represented in relation to their combined weight of 22.2% in the data set. Overall, media and entertainment account for the greatest number of defaults (nine) in the half-year. This represents 18.8% of the total, which is marginally above the sector's 14.6% weight in our database (see table 4).

Table 4

Number Of Defaults Of Western European Speculative-Grade Companies By Sector, 2003-1H2009*

(Combined datasets)

	2003	2004	2005	2006	2007	2008	1H2009	Sector weight (%)	1H2009 default rate (%)¶
Metals, Mining and Steel	0	0	0	0	1	0	2	1.6	33.3
Automotive	0	1	0	5	2	4	6	5.4	29.3
Paper and Forest Products	0	0	0	0	0	0	1	0.9	28.6
Homebuilders/Real Estate	0	0	0	0	0	7	7	7.7	24.1
High Technology	1	0	0	1	0	1	2	2.6	20.0
Media and Entertainment	2	1	0	2	2	5	9	14.6	16.4
Consumer Products	1	1	0	2	2	5	5	9.1	14.5
Chemicals, Packaging, and Environmental Services	0	0	1	1	1	8	4	9.0	11.8
Transportation	1	0	1	0	0	1	2	4.8	11.1
Diversified	0	0	0	0	1	1	3	10.1	7.9
Retail/Restaurants	1	0	4	0	1	4	3	10.1	7.9
Capital Goods	0	1	0	0	1	1	2	7.4	7.1
Telecommunications	1	0	0	0	0	1	1	4.0	6.7
Healthcare	0	1	1	1	0	2	1	8.5	3.1
Oil and Gas, Exploration and Production	1	0	0	0	0	0	0	2.6	0.0
Aerospace and Defense	0	0	0	0	0	0	0	1.2	0.0
Utilities	1	1	0	0	0	0	0	0.5	0.0
Total	10	6	7	12	11	40	48		

*Western Europe = EU27 plus Iceland, Norway, and Switzerland. ¶1H09 default rate annualised. Source: Standard & Poor's.

Downturn Hits German And Spanish Companies Hard

In the first half of 2009, Germany (11 companies), the U.K. (8), and Spain (7) accounted for 62% of the defaults by companies for which we provide private credit estimates (see table 5) with the proportion of German and Spanish companies that defaulted higher than we would expect from their weighting in the portfolio. We believe this reflects the high percentage of German leveraged-loan issuers that are manufacturing- rather than service-related: Germany, for instance, is significantly exposed to the downturn affecting auto suppliers. In Spain, the severe economic downturn and lack of domestic bank support appear to have undermined more companies across a broader range of sectors than we would anticipate, based on the weight of Spanish companies in our combined portfolio. On the other hand, the number of companies that have defaulted in France is notably low. We believe that this is due partly to the low concentration of French leveraged buyouts (LBOs) in the industrial equipment, auto, and building and property development segments, which have been particularly hard hit by the economic downturn. In addition, we see that consumer-facing businesses in France are faring better in the recession than their peers in other European countries because consumers in the latter are generally more highly indebted.

Table 5

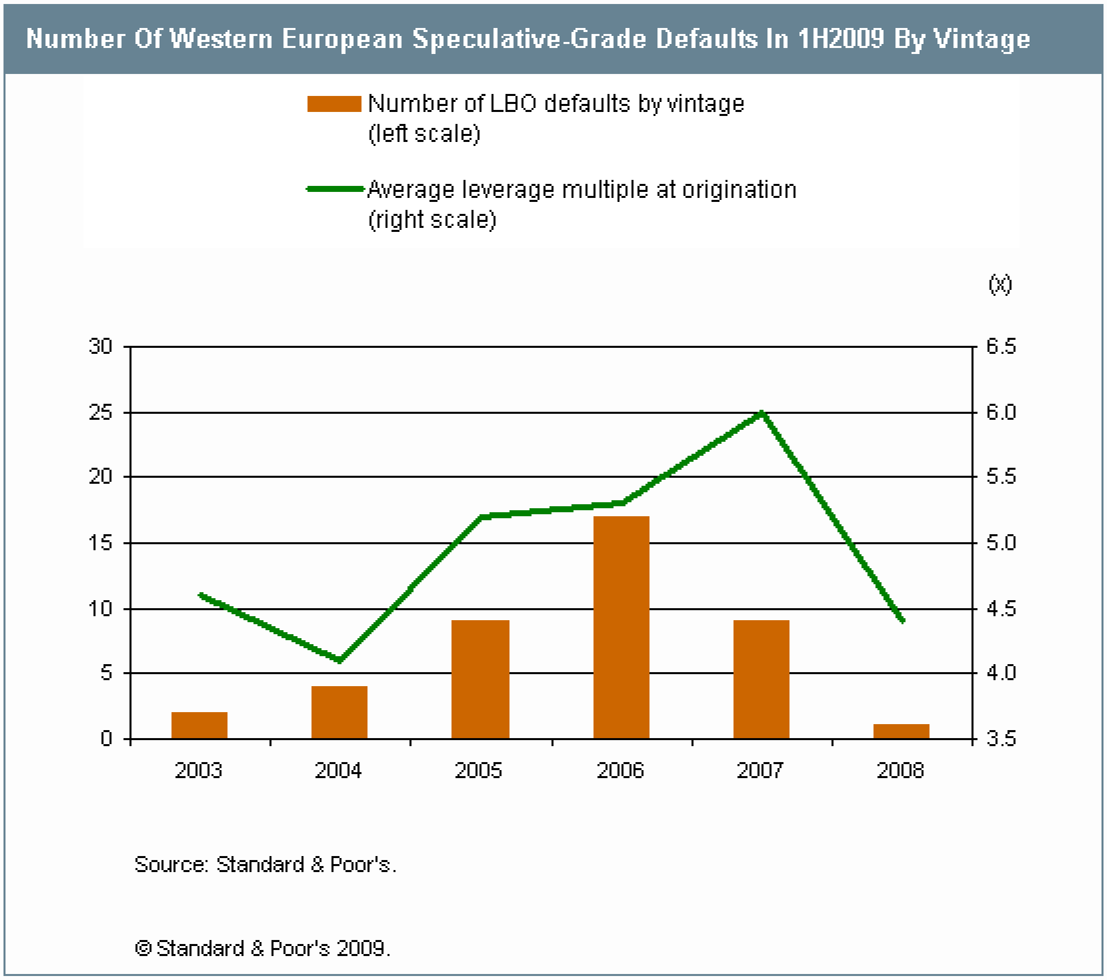
Number Of Defaults Of Western European Speculative-Grade Companies By Country, 1H2009*			
	Publicly rated defaults	**Private credit estimate defaults**	**Country weight in credit estimate portfolio (%)**
France	2	3	21.5
Germany	0	11	16.6
Greece	0	1	0.3
Iceland	0	0	0.0
Ireland	0	1	0.3
Italy	0	3	3.7
Lithuania	1	0	0.0
Luxembourg	0	1	0.3
Netherlands	2	3	9.5
Spain	0	7	7.2
Sweden	0	3	3.1
Switzerland	0	1	2.1
U.K.	1	8	27.0
Total	6	42	

*Western Europe = EU27 plus Iceland, Norway, and Switzerland. Source: Standard & Poor's.

Transactions Completed In 2006 Have Defaulted At A Higher Rate Than Other Vintages

Of the 48 defaults in the first half of 2009, 42 are LBOs, five of which are publicly rated. The average age of the defaulted LBOs is 3.1 years and the median age is 2.9 years. Of the LBOs completed in 2006, 17 defaulted in the first half of 2009; these LBOs had an average leverage multiple (debt/EBITDA) of 5.4x at origination (see chart 2). This compares with the nine 2007-vintage LBOs that defaulted in the same period, with an average original leverage multiple of 6.0x. However, we expect that a significant proportion of transactions that will be restructured in 2010 are likely to be those completed in 2007, as many of those companies are likely to face covenant breaches or liquidity issues on the back of amortization payments.

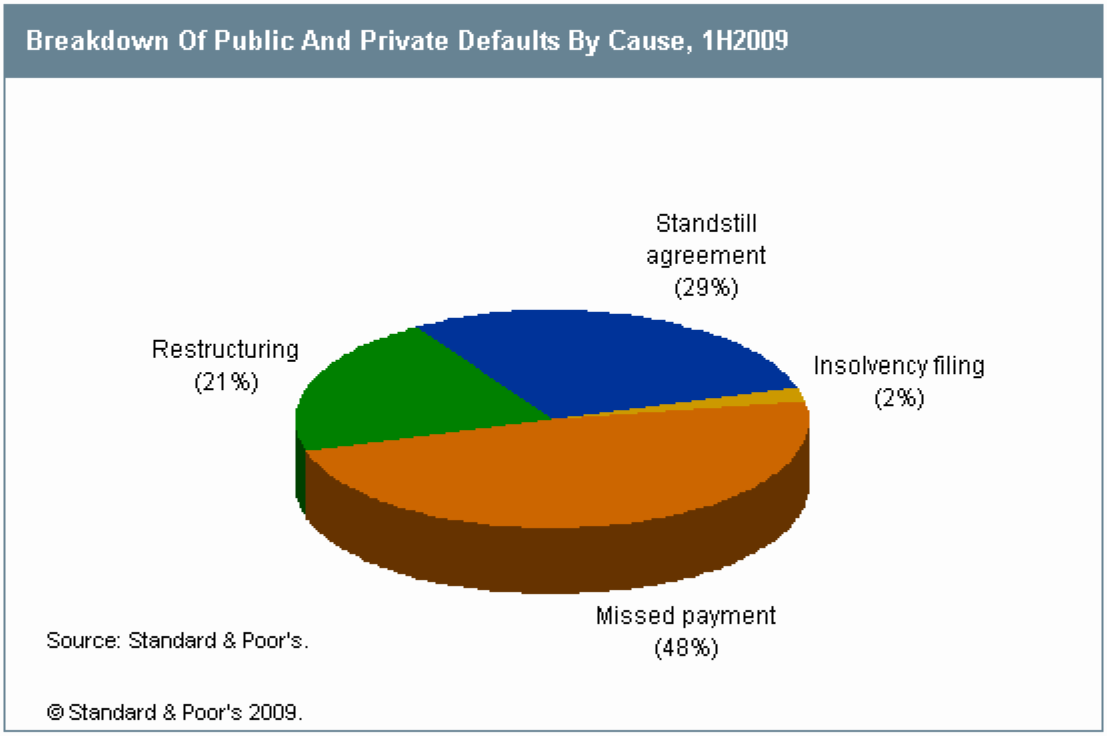
Chart 2



Missed Payments Remain The Most Common Driver Of Default

Of the total number of defaults in the first half of 2009, 48% were caused by the company missing an interest payment (or, occasionally, an amortization principal repayment). For larger LBOs with a wide group of lenders, including institutional investors, we see that it is often in the common interest for the company and lenders to proactively negotiate a consensual balance-sheet restructuring ahead of a prospective breach of financial covenants. This typically results in varying degrees of debt write-down with the lender groups. Companies that are less severely impacted, but still distressed, sometimes use available liquidity to launch exchange offers or buy back debt in the secondary market at hefty discounts. Such restructuring was adopted by 21% of the defaulting companies in the first half of 2009 (see chart 3). Where time is not available, or where the outlook for the business is highly uncertain, it is quite common for companies to arrange a standstill arrangement to buy time for negotiation. This route was used by 29% of the companies that defaulted in the period. Only one company formally filed for insolvency.

Chart 3



European Default Rate Looks Set To Peak In Late 2009, With Only A Gradual Decline

The trailing 12-month default rate (by number) of 11.0% at the end of June 2009 indicates that the full-year rate is likely to be at the upper end of the range of 11.7%-14.7% that we projected in April 2009. (For more details, see article titled "Leveraged Buyouts Are Fueling Surging Defaults In Western Europe," published April 8, 2009. on RatingsDirect.) Thereafter, we anticipate that the default rate will gradually slide back within the range through the first half of next year.

We believe that the peak in the default rate in Europe may occur later in the second half of 2009 as the full 12 months of trading following the bankruptcy of Lehman Brothers translates into a higher level of defaults. We expect that covenant compliance certificates for the end of September 2009 will reveal the true shortfall in revenues and earnings over the last year and this is likely to result in a continued wave of standstills and restructuring negotiations for the most overlevered companies through the balance of 2009. It appears that senior lenders are becoming more favorably disposed to reworking the capital structure where the majority of the losses are borne by second-lien and mezzanine debt holders.

Thereafter, a return to more stable growth in Europe, combined with short-term interest rates remaining low for an extended period, should result in some improvement in business confidence as well as greater visibility regarding company budgets, in our opinion. In these circumstances, where companies are generating sufficient cash to service fixed charges, lenders may choose to waive any threatening financial covenants. This suggests to us that there could be a reduction in the number of nontechnical defaults in the early part of next year.

Nonetheless, we anticipate the reduction in the level of defaults to be quite marginal, with the prospective trailing 12-month default rate (combining public and private datasets) to fall back into the range of 11.7%-14.7% that we forecast through 2010. We see that while many larger companies have aggressively reduced their stock levels over the last six to nine months and adjusted their cost bases to a lower level of activity, many smaller, less diversified companies in the supply chain have not had the same flexibility. Many small and mid-size LBOs in the consumer and business services sectors fall into this category. This is reflected in the continued deterioration in the credit quality of the Western European speculative-grade credits that we keep under review. At the end of June 2009, the percentage of our private credit estimate portfolio standing at 'b-' or lower (excluding defaults) was 28.7%, 5.6% higher than at the end of December 2008, despite 42 companies defaulting in the interim. Our publicly rated industrial portfolio experienced a very similar rise in the first half of 2009: 24.8% of speculative-grade credits were rated 'B-' or lower, up from 19.1% at the end of December 2008.

APPENDIX: Study Methodology

The Scope Of Standard & Poor's European Leveraged Finance Market Database

To arrive at the conclusions in this report, we have regrouped our corporate ratings, which we determine partly through regular interaction with company management teams, into 17 standard industry classifications. We have similarly regrouped our private credit estimates, which we assess on the basis of information provided by third parties. Credit estimates are, for the most part, utilized in the assessment of the asset pools of collateralized loan obligations. On June 30, 2009, Standard & Poor's speculative-grade universe in Western Europe comprised 145 public ratings on discrete groups or companies and 622 private credit estimates. These are spread across the 27 countries that make up the EU, plus Iceland, Norway, and Switzerland.

The Definition Of Default

Standard & Poor's generally considers the following as a default for rating purposes: when a company fails to make a payment of principal or interest, files for bankruptcy, or experiences a restructuring involving a distressed exchange offer that meets certain conditions. The first two categories are usually fairly straightforward and include standstill agreements, through which lenders agree to waive or defer interest or principal payments without adequate compensation.

In Europe, restructurings have become prevalent of late. Stakeholders recognize that many leveraged transactions completed at the top of the market in 2005-2007 have unmanageable capital structures, given current borrowing spreads and the significant shortfall in business performance since the fourth quarter of 2008. The circumstances in which a distressed exchange offer translates into an event of default are clearly articulated in the article "2008 Corporate Criteria: Standard & Poor's Ratings--And Their Role In The Financial Markets," published April 15, 2008, on RatingsDirect.

Debt-for-equity swaps are the most common form of restructuring that we classify as an event of default. However, in recent quarters there has been a greater number of exchange offers and secondary market buybacks for loans and bond instruments trading well below par. In the case of distressed companies, meaning those companies rated 'B-' and below, we view these exchange offers and buybacks as events of default under our criteria, unless they meet certain conditions. (For more details, see article titled "Rating Implications Of Exchange Offers And Similar

Restructurings, Update," published May 12, 2009.)

We recognize that exchange offers and buybacks may, after the fact, improve the financial metrics of a company's balance sheet and may also improve headroom under interest coverage and leveraged covenants. Nevertheless, we consider that they breach the original promise to redeem the relevant debt instrument at par. Furthermore, we see that when the market becomes aware that a company is buying back a material amount of its outstanding debt through covert secondary market purchases, original par lenders can find themselves increasingly disadvantaged if the loans or bonds that they own become highly illiquid.

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