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Credit Trends:

Q&A: What's In Store For Recoveries On European Corporate Debt?

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In the following series of questions and answers, Standard & Poor's Senior Director David Gillmor talks about the prospects for post-default corporate recoveries among European borrowers.

This article was written in conjunction with a series of Q&A sessions conducted for Standard & Poor's CreditMatters TV.

Questions And Answers

What do we expect regarding recoveries in Europe this year?

It depends entirely on where a lender is in the capital structure. For holders of senior secured debt, empirical averages have been 65% to 70% recoveries in Western Europe. We expect pretty similar recoveries for senior secured debt this time around.

It gets more interesting as you go further down the capital structure. For holders of senior unsecured debt – what in Europe is essentially speculative-grade bonds – historical averages have been about 40% recovery, and for about two-thirds of these holders, we are forecasting that kind of recovery level.

For the other one-third, we project recoveries of less than 10%, so that's a big difference this time around. The primary reason for that is the sheer level of senior secured debt that ranks ahead of the unsecured debt.

For the senior secured debt, it's similar to the U.S. The spreads and standard deviations are almost exactly the same. For second-level debt, there is more of a bias toward the lower end in Europe, but that's partly because of the jurisdictions. There are a number of jurisdictions – for example, France, Spain, the old Soviet republics – where we think recoveries for more senior tranches will be lower, but recoveries on lower-ranking debt will be much lower.

Are there factors beyond where a debt holder ranks in the capital structure?

We would expect borrowers with so-called covenant-lite loans to take slightly longer to default, but those kinds of deals with very loose covenants didn't really take hold that much in Europe. We saw comparatively few deals that were truly covenant-lite, so it hasn't been as big a factor as it has been in the U.S.

In Europe, the primary reason for the low recoveries on unsecured debt is the sheer level of senior secured debt ranking ahead. Also, we had the rise of second-lien loans, which also rank ahead of the unsecured debt.

In the U.S., we've seen a change in who holds debt, going from buy-and-hold lenders to hedge funds or institutions looking to trade. Does the same hold true in Europe?

It is exactly the same in Europe. In 2008, the balance shifted from the more than 50% standard bank lender to a majority of institutional lenders for senior tranches, which was quite a big benchmark to pass.

The most interesting aspect of all this has been that many market observers expected institutional lenders to be much more cut-and-run than traditional bank lenders – that old-style bank lenders would be much more patient and supply new money when necessary, to keep borrowers going through a difficult period in order to maximize value. The expectation was that institutional lenders wouldn't have such patience and would not make similar decisions. But so far, anecdotally – and bearing in mind that there have been comparatively few examples – they are behaving in a similar manner. So that particular scenario hasn't yet taken hold.

How will default rates affect recoveries?

There have been comparatively few defaults in Europe. The percentages have increased dramatically, but the volumes are still low. Last year's default rate was approximately 10%. In absolute terms, we're talking about 60 or 70 assets, of which only about 15 to 20 were publicly rated. In 2010, we're expecting the default rate to be 8% to 9%.

So, the evidence we've got in public ratings is slim. Having said that, there are one or two conclusions we can draw. The first on senior secured debt is that our expectations for recovery have been very similar to actual recoveries. That may be because those recoveries are more certain by virtue of the debt being higher in the capital structure, where fewer things can go wrong.

Down the structure, we find significant variety among recoveries. We've seen quite a few in the middle, where we would expect 30% to 70%. But we're seeing slightly more than we expected close to 100%, and slightly more near zero. We've seen a broad range, but keep in mind that it's very difficult to extrapolate because we've had very, very few examples.

Is message here that investors shouldn't simply expect full recovery on secured assets, and that there's an even wider range of possibilities for unsecured assets?

Absolutely. In fact, the phrase "senior secured" is widely bandied-about to mean many, many things. Investors must be careful to know where they are in the capital structure and understand what is truly senior secured and what's just called senior secured but may be contractually or structurally subordinated.