STANDARD & POOR'S

Global Credit Portal
RatingsDirect®

April 26, 2010

Assessing The Recovery Effects Of Changes In The Capital Structure, Out Of Court Restructuring, And The Business Risk Profile Of EMEA Telecoms Operators

Recovery Analyst:
Carlo Castelli, CFA, London (44) 20-7176-3670; carlo_castelli@standardandpoors.com

Secondary Credit Analyst:
Taron Wade, London (44) 20-7176-3661; taron_wade@standardandpoors.com

Table Of Contents

When Refinancing Can Enhance Recovery Prospects

Weighing The Benefits Of Shifting The COMI To The U.K.

Business Risk Profile Drives Valuation Assumptions

Recovery Assessments Take On A Renewed Significance

Related Criteria And Research

Assessing The Recovery Effects Of Changes In The Capital Structure, Out Of Court Restructuring, And The Business Risk Profile Of EMEA Telecoms Operators

Covenant amendments, debt restructurings, and refinancing can have a material effect on recovery prospects for speculative-grade (that is, those with long-term issuer credit ratings of 'BB+' and below) telecommunications operators in Europe, the Middle East, and Africa (EMEA). Loose documentary provisions and covenants, for example, can often mean that lenders might not be able to act on early signs of underperformance, depressing the stressed valuation and recovery. The higher the available liquidity, the higher the stress required to drive the company to default and, therefore, the lower the stressed valuation and recovery. Similarly, in terms of the capital structure, the higher the committed payment (in terms of debt amortization requirements), the earlier the hypothetical default and the lower the operating stress, which drives up the valuation and recovery prospects at default.

Out of court restructurings following a shift in the center of main interest (COMI) and differing assessments of a company's business risk profile also have the potential to affect ultimate recovery prospects for senior and subordinated creditors.

In this article, Standard & Poor's Ratings Services analyzes how debt restructuring, a change in COMI, and differences in a company's business risk profile might affect creditors' ultimate recovery.

When Refinancing Can Enhance Recovery Prospects

Debt restructuring and refinancing can materially affect our recovery assumptions through their impact on operating stress on a path to default, and by their effect on valuation and ultimate recovery prospects. While not all refinancing and debt restructurings are positive from a creditor's perspective, we believe the experience of Virgin Media Holdings Inc. (B+/Stable/--) shows how recovery prospects can improve for some lenders through a refinancing. In late 2008, Virgin Media obtained agreement to roll over its 2009-2011 bank amortization payments to 2012 and relax its covenants in return for a 20% repayment of the outstanding senior secured debt. Virgin Media was able to fund the repayment partly through available cash on balance sheet and partly through an unsecured bond issue.

For recovery purposes, the deferral of the amortization payments and maturity profile led to an extension of our hypothetical default date (to 2012 from 2010). This, along with a loosening of control by Virgin Media's lenders (in terms of less stringent covenants), suggests that in our hypothetical default scenario the business could deteriorate further before reaching a payment default. On this occasion, we applied harsher stress on Virgin Media's operating performance, reducing projected EBITDA at default by a further 10% from about £900 million to approximately £800 million, leading to a lower stressed valuation at default (to £4.42 billion from £5.05 billion). However, this negative impact was more than offset by our projections of slightly lower leverage and a different mix of outstanding liabilities at default (with a lower proportion of senior secured debt in the capital structure; see chart 1), following the partial repayment of senior debt through the cash available on balance sheet and proceeds from the

high-yield bond issue. So despite the lower projected stressed enterprise value at the hypothetical point of default, the reduced estimates of priority debt led to increased recovery prospects for unsecured and junior-lien lenders (see chart 2). As a result, following the refinancing we revised our recovery rating on the unsecured notes to '5' (10%-30% expected recovery) from '6' (0%-10%) and on junior-lien debt to '2' (70%-90%) from '3' (50%-70%).

Chart 1

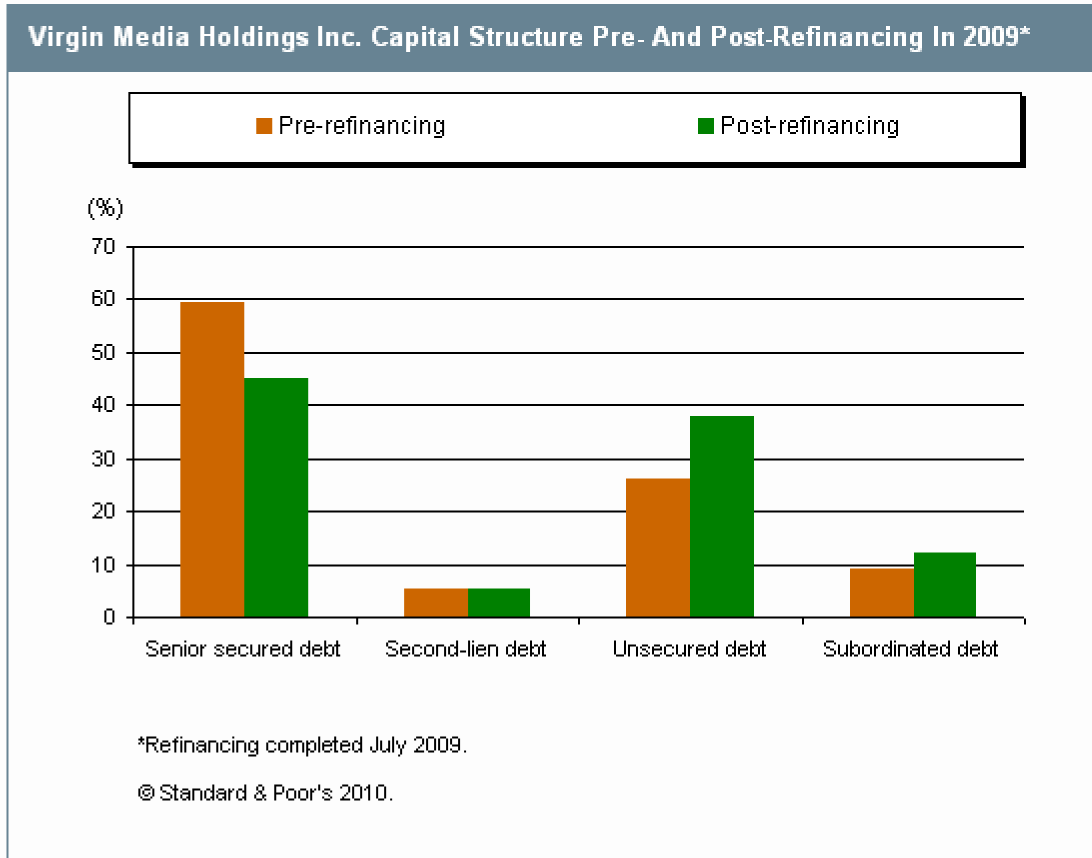
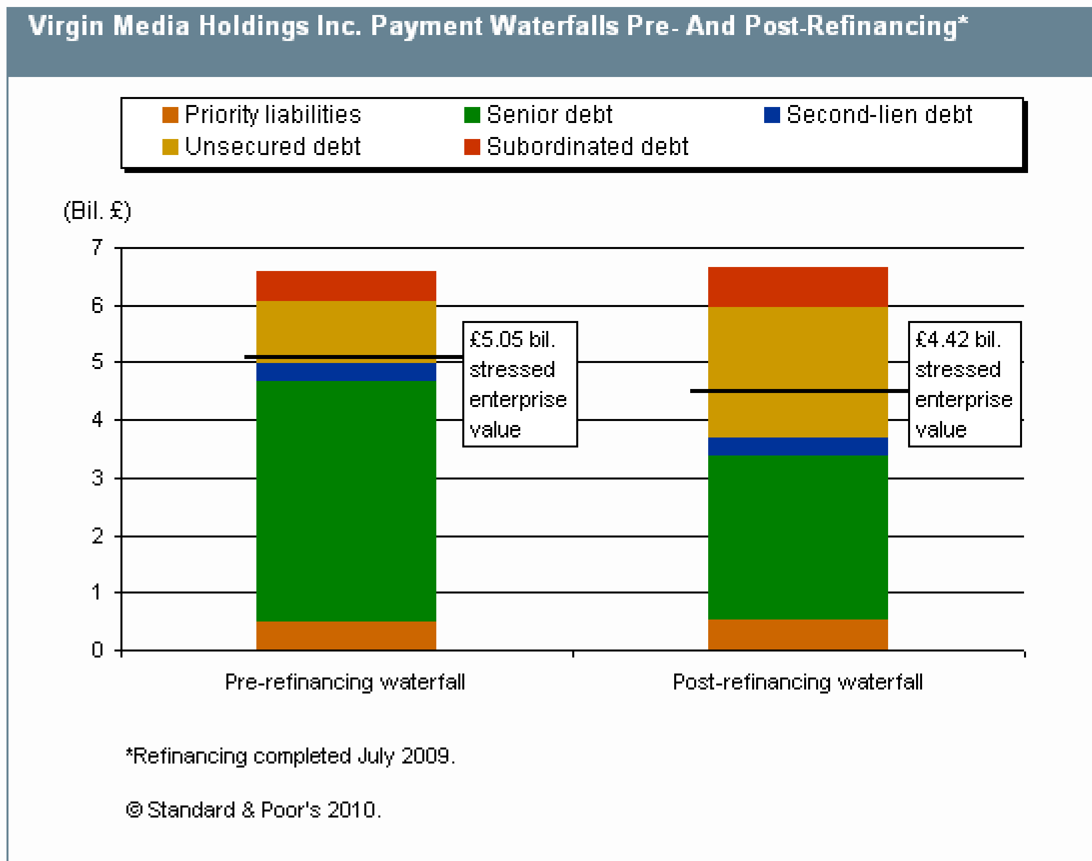


Chart 2



Weighing The Benefits Of Shifting The COMI To The U.K.

One of the interesting aspects of the recent turmoil has been the change of COMI to the U.K. among a few debtors such as WIND Hellas Telecommunications S.A. (CCC+/Stable/--) and Schefenacker PLC (not rated). This move enables a debtor company to use the U.K.'s prepackaged administration process, one which can be comparatively debtor friendly.

We understand that a change in COMI to the U.K. and an out-of-court restructuring through a scheme of arrangement might offer a debtor the following advantages:

- Reduce timing and costs of insolvency procedures;
- Provide more certainty on priority ranking of different debt instruments in the waterfall; and
- Provide potential upside in terms of recovery expectations for most senior debt, ranking higher up in the capital structure.

However, even these advantages could in our view prove ineffective in the longer term if, post-restructuring, capital structures remain highly leveraged and operating issues are not favorably resolved. In this situation, further restructurings might become necessary and, as a result, additional value could be destroyed, thereby reducing ultimate recovery prospects for creditors.

793637 | 300374394

For more details, see "How A Jurisdictional Migration Affected Recoveries For WIND Hellas' Lenders: This May Not Be The End Of The Story," published April 7, 2010, on RatingsDirect.

Business Risk Profile Drives Valuation Assumptions

A comparison between rated cable operators and alternative network operators (altnets) in our EMEA recovery portfolio highlights how different assessments of business risk profiles can affect recovery drivers such as the stress on operating performance on a path to default, the valuation multiple paid, and other valuation assumptions.

We typically assess the business risk profile for speculative-grade European cable operators as fair or satisfactory (see table 1). This reflects the relatively stable revenues from cable TV services, telephony, and broadband; good resilience to economic cycles; and more stable earnings and cash flow. Our ratings on most EMEA cable operators are constrained by our view of their high leverage, coupled with weak free cash flow generation that results from their high network investments and subscriber acquisition costs. As a result, our recovery analysis for these operators envisages no material or meaningful deleveraging. It also identifies an inability to refinance, combined with operating underperformance, as the typical reasons for default in our hypothetical scenarios.

Table 1

Correlation Of Business Risk Profile And Rating Categories

Business risk profile descriptor	Rating equivalent
Excellent	AAA/AA
Strong	A
Satisfactory	BBB
Fair	BB+/BB
Weak	BB-/B+
Vulnerable	B/B-

Source: Standard & Poor's.

Typically, the business risk profiles of altnets that we rate are weak or vulnerable. This state of affairs reflects significant price pressure in very competitive markets and a relatively weak competitive position for residential customers due to the lack of an own local loop connection to residential households. Other rating constraints are our views of moderate customer concentration, high subscriber acquisition costs (resulting in a long payback period for new customers), and cost structures highly dependent on regulation for interconnection fees and local loop access prices.

Our hypothetical default scenarios for altnets are mainly triggered by declining operating performance as a result of a weakening economic environment and fierce competition. Typically, we assume that significant pressure on prices and increase subscriber churn (that is, customers switching between operators) leads to an erosion in revenues and margins. Altnets are particularly exposed to price and competitive pressure from cable and incumbent telecoms operators due to their lower market shares and smaller scale.

Operating stress and valuation multiples strongly influence recoveries...

There are two key drivers of recovery prospects. The first is the level of stress on operating performance on a path to default. Given the revenue growth that we anticipate from the further uptake of triple-play subscriptions (that is, for fixed-line telephony, broadband, and pay-TV services) and the relatively low churn of cable TV subscribers, the

793637 | 300374394

average decline in operating performance at our hypothetical point of default from flat 2008 EBITDA for the cable sector was about 25% (see table 2). This is significantly below the 47% average stress applied to altnets and a positive factor for cable companies in terms of stressed valuation and recoveries at default. A less harsh stress on EBITDA implies a better retained enterprise value at default.

Table 2

Average Recovery Characteristics For Speculative-Grade Cable Operators And Alternative Network Operators

	Cable operators	Alternative network operators*
Business risk profile	Satisfactory/Fair	Weak/Vulnerable
Current leverage (end-September 2009; x)	5.4	4.5
EBITDA haircut (from flat 2008; %)	(25)	(47)
Debt/EBITDA at default (x)	7.0	6.8
Valuation multiple at default (x)	5.6	4.5

*Note: the small sample of rated alternative network operators in Standard & Poor's recovery portfolio may constrain averages.

The second driver of recoveries is the valuation multiple. In our default scenarios, we currently value cable companies as going concerns using a multiple of between 5.20x and 5.75x EBITDA at default, which largely reflects our opinion of the sector's business risk profile assessment and our evaluation of the potential attractiveness of the assets at default. In our opinion, these valuation multiples are supported by valuable fiber-optic cable networks, which currently provide consumers with a bandwidth advantage for broadband services over those incumbents and altnets using traditional copper cable networks; a relatively stable customer base; and high barriers to entry into a consolidated industry (duplicating a cable system is very expensive). Nondistressed acquisition multiples achieved in recent EMEA transactions in the cable sector are mostly between 7x-10x. German cable company Orion (not rated) underwent a restructuring where the implied valuation represented 6.9x 2009 EBITDA.

We value rated altnets as going concerns because of recent consolidation of the industry. However, to reflect the asset-light nature of their business, together with the fact that most altnets have weak or vulnerable business models, we generally apply a lower market multiple (4.5x the average multiple used) on the assumption that the stressed value would essentially be linked to their customer base.

The distressed acquisition of altnet Tiscali UK by Carphone Warehouse (both not rated) in 2009 for an implied EBITDA multiple of about 3.8x represents an interesting valuation landmark, in our view. However, different competitive environments, levels of profitability, network quality and coverage, and readiness or potential for customer churn can affect valuation assumptions and are considered case-by-case.

In our opinion, stresses on valuation and on operating performance are generally fairly well correlated. This is because a default scenario involving lower demand and shrinking business opportunities has a direct and material effect on valuation assumptions in terms of lower multiples. This was the rationale behind our rating action on Versatel's secured debt, which was downgraded by one notch (and the recovery rating revised to '2' from '1') as a result of harsher stress on operating performance on a path to default, reduced post-default growth and profitability assumptions, and a slightly lower valuation multiple.

In our view, lower stress on operating performance and higher valuation multiples support better retained value for cable operators at the hypothetical point of default. Overall, this should lead to better recovery prospects for senior secured debtholders (dependent on capital structure considerations) and the ability to support a higher level of indebtedness. In the 12 months to Sept. 30, 2009, reported adjusted debt to EBITDA averaged 5.4x for cable

operators in our recovery portfolio versus 4.5x for altnets over the same period.

… But leverage and capital structure also play their part

Drawing general conclusions from the ratings distribution for senior secured lenders to cable and altnet operators is not straightforward. This is because under our methodology ultimate recovery prospects not only depend on retained value at the hypothetical point of default, but also on leverage and capital structure considerations (in terms of senior secured debt as a proportion of total debt).

We have observed that cable operators typically have a capital structure consisting of senior secured and subordinated debt instruments. We currently have recovery ratings of '1' on most European cable operators' senior secured debt instruments (see chart 3), which reflects our expectation of very high (90%-100%) nominal recovery in a hypothetical event of default. However, recovery prospects for secured lenders at UPC Holding B.V. (B+/Watch Neg/--), the debt of which has a recovery rating of '3', are slightly lower. This reflects our view of a capital structure with a significantly higher proportion of secured bank debt (approximately 80% of total debt) and a lower proportion of unsecured, subordinated debt.

In our experience, recovery prospects for unsecured and subordinated debt instruments are often highly sensitive to the proportion of priority debt in a borrower's capital structure and valuation assumptions. In our recovery universe of speculative-grade cable companies, we see a clustering in the lowest recovery ratings of '4', '5', and '6', which suggests a high proportion of priority liabilities ranking ahead of unsecured and subordinated debt instruments in the borrowers' capital structures.

Although the sample size is restricted, our conservative approach to stress valuations suggests an even spread (from '1' to '4') of the recoveries expected on altnets' senior secured debt across the recovery rating scale (see chart 4). As a result, the distribution of recovery ratings on altnets' secured debt is more widely spread through the rating scale than appears to be the case for cable operators.

Chart 3

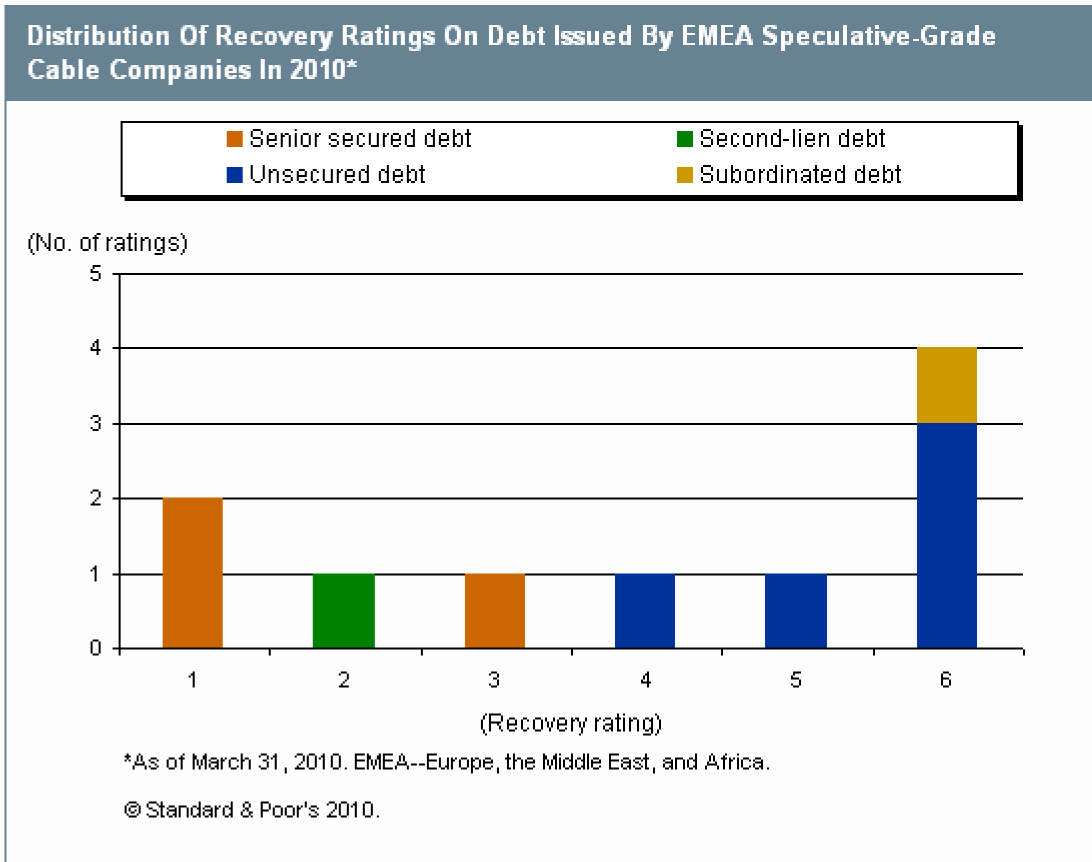
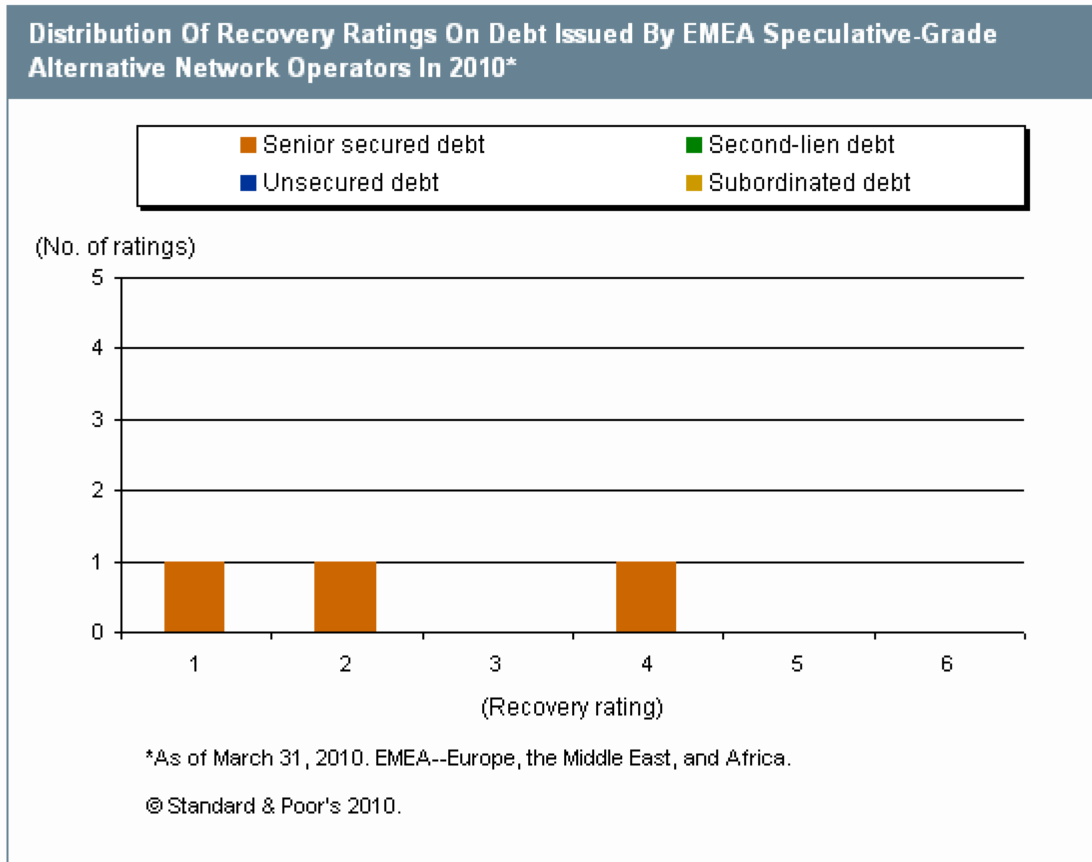


Chart 4



Recovery Assessments Take On A Renewed Significance

While the European economy appears to be slowly recovering, many speculative-grade companies still face high leverage and operating challenges. We expect the default rate to fall to 8.7% in 2010 from 12.8% in 2009. Although this is a drop, the level that we anticipate for 2010 is still substantially higher than the long-term average of about 4%. Given the expectations of continuing defaults, investors have expressed continued interest not only in issuers' probabilities of default but also ultimate recovery prospects for particular instruments. Historically, recovery ratings have been relatively stable and independent of probability of default assessments. However, recent experience suggests that debt restructuring, refinancing, and changed business risk profile assessments could materially affect key recovery aspects such as stress on operating performance, valuation, and waterfall assumptions.

Related Criteria And Research

- EMEA Speculative-Grade Telecoms Companies Show Their Resilience In Recession, April 26, 2010
- How A Jurisdictional Migration Affected Recoveries For WIND Hellas' Lenders: This May Not Be The End Of The Story, April 7, 2010

Additional Contact:
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

Copyright (c) 2010 by Standard & Poor's Financial Services LLC (S&P), a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved.
No content (including ratings, credit-related analyses and data, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P. The Content shall not be used for any unlawful or unauthorized purposes. S&P, its affiliates, and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the Content even if advised of the possibility of such damages.
Credit-related analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P's opinions and analyses do not address the suitability of any security. S&P does not act as a fiduciary or an investment advisor. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.
S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.
S&P may receive compensation for its ratings and certain credit-related analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

The McGraw·Hill Companies