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**Leveraged Finance:**  
**Many U.S. Speculative-Grade  
Corporate Borrowers May Breach  
Loan Covenants This Year**

**Primary Credit Analyst:**

Ana Lai, CFA, New York (1) 212-438-7895; ana\_lai@standardandpoors.com

**Secondary Credit Analyst:**

Jackie E Oberoi, New York (1) 212-438-2895; jackie\_oberoi@standardandpoors.com

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## Leveraged Finance:

# Many U.S. Speculative-Grade Corporate Borrowers May Breach Loan Covenants This Year

Covenant compliance and liquidity problems have been one of Standard & Poor's Ratings Services' top credit concerns for speculative-grade U.S. corporate debt issuers since the onset of the credit crunch in 2008. Maintaining covenant compliance amid declining operating results and tightening covenant packages is becoming increasingly difficult.

The number of companies seeking covenant relief surged in 2009. According to Standard & Poor's Leveraged Commentary & Data, a record 206 loan issuers have sought less restrictive covenants through June 30, 2009, up from 60 during the first six months of 2008 and 148 for the full year of 2008. Bank loan amendments have constituted the bulk of lenders' activity in 2009, as opposed to new loans.

We recently performed a covenant survey of 350 U.S. speculative-grade issuers from select nonfinancial corporate sectors. Our findings have led us to believe that the receipt of covenant amendments doesn't necessarily result in an improved credit position, and that asset-based facilities are viable financing alternatives when cash-flow-based credit facilities are scarce. As a result, we expect a deleveraging of speculative-grade capital structures at the end of the current credit cycle.

## Tight Credit Markets Are Proving Costly For Speculative-Grade Borrowers

The credit markets have changed drastically since mid 2007, when abundant liquidity and cheap financing fueled record loan volumes. In the current tight credit markets, lenders are generally reducing loan exposure and tightening lending standards. Banks are generally more reluctant to extend credit to lower-rated entities. For instance, Bi-Lo LLC, an operator of supermarkets in the South, filed for Chapter 11 in March 2009 because of its inability to refinance a maturing term loan.

In granting loan amendments, lenders often demand higher pricing and better protection, through steep interest rates increases, reduced loan commitments, tighter covenants, and more collateral. In some cases, lenders are also requiring a partial paydown of bank debt. Lenders structure new loans with a more traditional set of covenants that includes two or more covenant restrictions, thereby offering lenders better protection. This represents a complete reversal in covenant protection levels from the recent past. In 2006 to 2007, institutional lenders often structured credit facilities with almost no, or very little, covenant protection. "Covenant-lite" facilities (loans with no maintenance financial covenants) had been the instrument of choice for many issuers during the leveraged buyout boom, until credit conditions worsened around mid 2007.

While many corporate issuers have negotiated temporary relief (typically for about four quarters) through costly amendments that gave them extra covenant cushion to weather through the recession, many remain vulnerable to potential covenant breaches if they're unable to turn around operating performance as covenants reset after the relief period. While covenant relief provides improved financial flexibility, increased borrowing costs in times of dwindling cash flow hardly help restore credit protection measures.

## Looking Ahead, We Expect More Covenant Breaches

We recently conducted a covenant survey that included about 350 U.S. speculative-grade issuers from select nonfinancial corporate sectors. The survey focused on the companies' current covenant compliance status and our expectations for future compliance. The results revealed that about 26% of the borrowers we looked at are, in our view, at serious risk of potentially breaching covenants over the next six months. We attribute this to the fact that more than 40% of these borrowers are facing tighter covenants--such as step-downs in debt leverage requirements or step-ups in fixed-charge coverage requirements--by the end of 2009. Although most corporate issuers are currently operating with adequate headroom of about 25% over their most restrictive covenant, we expect covenant tightening and declining earnings to contribute to thinning covenant cushions.

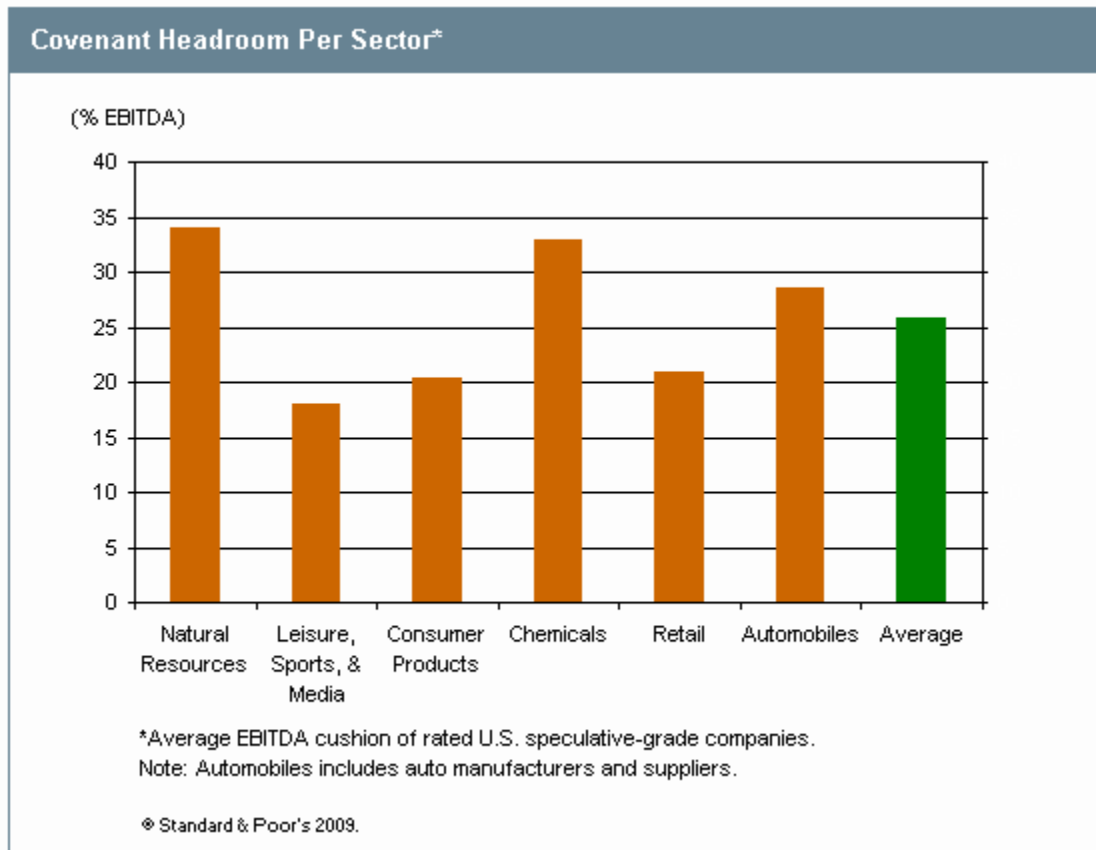
For many in our survey, the most restrictive covenants involve a debt leverage covenant that monitors both debt levels and operating performance. A lot of borrowers put their capital structures in place during a very debtor-friendly environment, when liquidity was abundant and credit terms favorable. During the leveraged buyout boom, covenants were set with comfortable headroom at origination, but were scheduled to become more restrictive over time, as lenders expected credit metrics to improve through sales and profit growth or through debt reduction with free cash flow. But these projections are now much less likely to materialize due to worse-than-expected operating results and a dire economic outlook.

As issuers approach lenders for covenant amendments or waivers, we expect that many (though not all) will be able to obtain temporary relief. On the other hand, lenders try to protect their downside and gauge their potential recovery prospects. Pushing an issuer into default could result in much weaker recovery under current market conditions. Issuers with viable business models and sustainable capital structures would likely secure relief, while weaker operators, or those with excessive leverage and unsustainable capital structures, may not. These weaker players may ultimately need to restructure.

When the credit markets are tight, adequate liquidity for funding operating needs is critical for speculative-grade issuers. A covenant breach could impair an issuer's ability to tap critical credit facilities to fund its operations, which, in most cases, represent the main source of liquidity as operating cash flow dwindles. In more extreme situations, a covenant breach resulting in a technical default that is not cured within the grace period could precipitate a cross-default with other secured debt obligations.

Across sectors, total leverage covenants are generally the most constrictive type of financial covenant among speculative-grade issuers. Leisure, sports, and media issuers have the most narrow average EBITDA spread over financial covenants compared with other groups we studied, with about an 18% cushion. Consumer products and retail borrowers, with a 20% and 21% average EBITDA cushion over their most restrictive financial covenant, respectively, have less headroom than the overall average of 25%. In general, deteriorating levels of EBITDA caused by the recession are driving the weakness in these sectors, which has resulted in lower levels of consumer discretionary spending. While the current headroom for automobile companies (including auto suppliers) remains at about 28%, 46% of the issuers in this sector face tightening covenants over the next six months. We expect the steep downturn in automotive demand in North America and the production shutdowns by major automakers' top customers to pressure operating results and future covenant compliance.

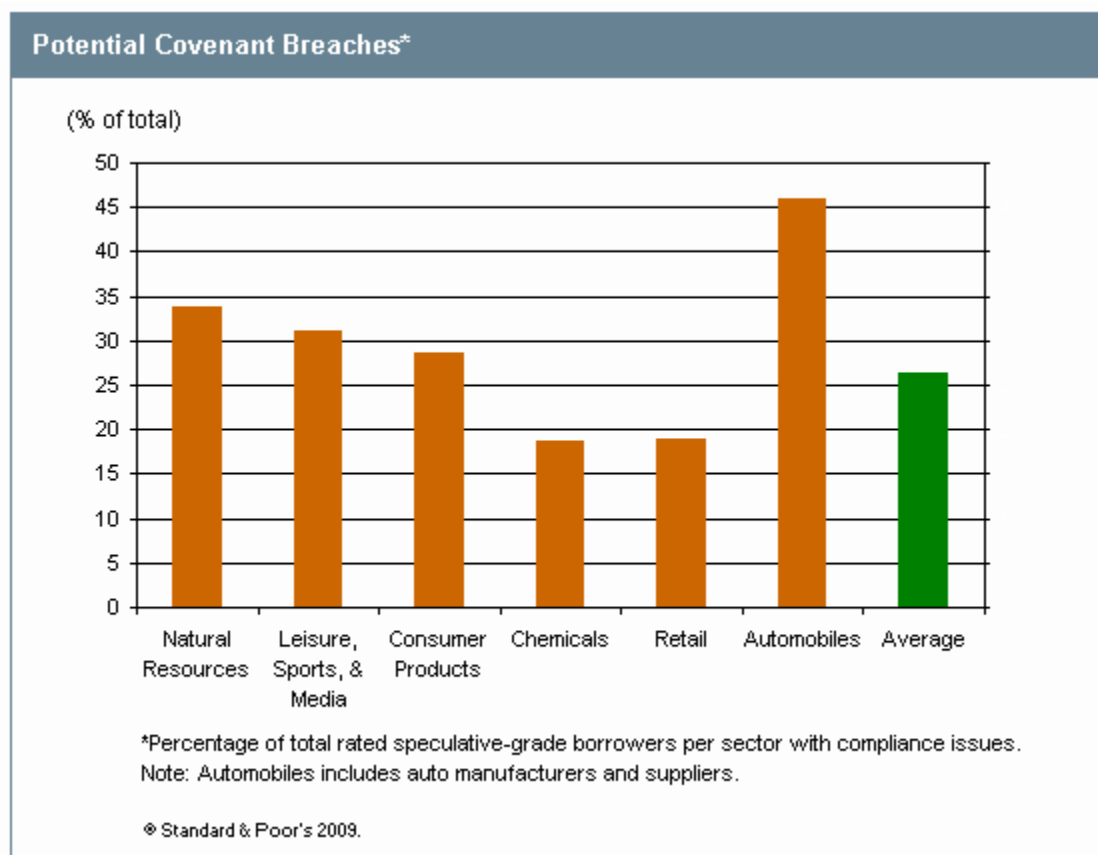
Chart 1



Natural resources borrowers (including building materials, forest products, and metals and mining) and chemical borrowers face the least restrictive average EBITDA cushion over financial covenants, with 34% and 33% headroom, respectively. However, for these two sectors, we see a relatively high percentage of speculative-grade companies with springing covenants that come into effect if revolver availability falls below a certain threshold.

Approximately 45% of rated issuers face tightening covenant levels over the next six months. Given our expectations for continued weakness in the U.S. economy and subsequent further weakening of operating performance for companies in most sectors, we expect that the EBITDA cushion over financial covenants will narrow in the next several quarters. Furthermore, we believe that about 26% of speculative-grade borrowers could face compliance issues by the end of the year. The result is likely to be a wave of additional amendments or waivers, as well as technical defaults that could lead to bankruptcy filings.

Chart 2



## Covenant Compliance Problems Often Weaken Credit Ratings

As part of Standard & Poor's surveillance efforts, we monitor covenant compliance on an ongoing basis and forecast future compliance based on our projections. Failure to comply with financial covenants, or even weak performance that leads to a potential failure to comply, will likely result in a rating downgrade or an outlook revision. Downward rating actions are appropriate because covenant problems are generally symptomatic of poor operating performance. At a minimum, a covenant breach may block a company's access to an existing revolving credit facility, impairing liquidity and financial flexibility during times of lower-than-expected cash flow. At the other extreme, it could cause debt acceleration if an issuer can't cure the technical default.

The magnitude of the downgrade is typically more severe for highly speculative issuers, such as those rated 'B' or lower. We have lowered ratings on borrowers that we deem very likely to miss a financial covenant over the next year to the 'CCC' level in many cases. This is because we believe that failure to meet financial covenants could lead to a liquidity event. In general, speculative-grade issuers do not have the internal liquidity to continue operating if they were to lose access to their revolvers or have debt accelerated--and a default would be a likely outcome.

A growing trend among highly speculative credits is to wait longer than in the past to seek amendments, rather than take a more proactive approach to covenant management. We believe that borrowers are doing this to save costs, since they know their cost of capital will increase significantly if their lenders grant amendments. Instead, they retain

favorable terms that were given at the loan origination. In these cases, where the EBITDA cushion over financial covenants is less than 5%, we generally have lowered ratings to the 'CCC' category since the chance of a covenant breach is high.

While the shrinking EBITDA cushion over financial covenants for more highly rated speculative-grade issuers is also a concern, the magnitude of a downgrade has generally not been as severe if we believe that the company can remain in compliance or can successfully amend covenants ahead of a breach. For example, Cracker Barrel Old Country Store Inc.'s EBITDA cushion over its total leverage covenant slipped to less than 5% in the first quarter of the company's fiscal 2009. We revised our rating outlook on the company to negative, but did not lower our 'BB-' rating because we believed that the company would remedy the problem through debt reduction or by the receipt of an amendment. In June 2009, the company announced a sale-leaseback of its distribution center and some owned stores, which will improve metrics from a covenant calculation perspective and significantly widen its EBITDA cushion. Another example is Cenveo Inc. We lowered our rating on the company by only one notch, to 'B+', in March 2009, when it became apparent that Cenveo was likely to miss its total leverage covenant. We believe, however, that lenders will likely grant the company an amendment.

In some cases, after lenders granted covenant relief or amended covenants, we raised our rating on the borrower to account for its improved financial flexibility. This generally occurs after we lower a rating to the 'CCC' category due to covenant concerns. We then typically raise it back to the 'B-' level after lenders grant relief. In these cases, we no longer deem a liquidity event likely over the next year because we believe that the issuer will meet its financial covenants during that timeframe and, therefore, retain access to its revolving credit facility and not face debt repayment.

We do not always raise ratings due to covenant relief, however. In some cases, the relief is temporary and the borrower only has a few quarters before covenants revert to original levels--and we believe that the borrower will not comply at the end of the waiver period. In other cases, performance is so weak that we expect the borrower to have difficulty even meeting its amended covenant levels. For example, we maintained our corporate credit rating on Eddie Bauer Holdings Inc. at 'CCC', even after the company obtained temporary relief in April through the end of 2009, because we believed it would not be able to comply with its covenants once they reset. Eddie Bauer filed for bankruptcy protection in June.

### **Issuers struggle to remain in compliance**

Many issuers continue to struggle to stay in compliance even after lenders grant amendments, because of weak operating performance. During the current recession, we've seen borrowers receive covenant relief for a limited period of time, only to have performance deteriorate further, such that they seek a second amendment. While debt levels have remained stable for most borrowers, EBITDA deterioration has been significant and has led to weakening ratios and smaller cushions under financial covenants.

We expect that covenant issues will intensify over the next 12 months, as issuers face step-downs or a general tightening of covenants set at origination, while operating performance remains weak due to the U.S. recession. In our view, about 26% of speculative-grade corporate entities with financial covenants are likely to face compliance issues over the next six months.

### **Receipt of amendments doesn't necessarily result in an improved credit position**

A borrower's receipt of an amendment or waiver does not necessarily translate into a significantly better credit position. Often, waivers/amendments are granted along with much steeper pricing increases, more collateral, and

revised covenants that don't provide much breathing room. Increased costs can include amendment fees and an increased cost of capital, including wider spreads over LIBOR and sometimes LIBOR floors. The result is higher cash flow requirements to meet increased interest costs. In addition, the amendments/waivers often institute more restrictive cash flow sweeps, which limit borrowers' financial flexibility.

## **Financing Alternatives: Asset-Based Facilities**

As traditional lenders become more risk-averse by shrinking credit and tightening lending standards, asset-based loans have emerged as a viable financing alternative to traditional cash flow loans. Asset-based loans are well-secured credit facilities that are tightly structured, allowing lenders to closely monitor loan performance. These credit facilities are providing the necessary liquidity to fund operating needs to borrowers that are struggling with declining operating income but have good assets on their balance sheets. In sectors such as retail (which is particularly working-capital-intensive) and consumer products, many borrowers have resorted to asset-based credit facilities. A number of retailers have successfully amended and extended working capital facilities in 2009, alleviating refinancing concerns. Limited Brands, J.C. Penney Co. Inc., Sears Holdings Corp., Toys 'R' Us Inc., Rite Aid Corp., and The Neiman Marcus Group Inc. are among the borrowers that have obtained asset-based facilities in 2009. Several companies in the agribusiness and apparel sectors either have had, or recently put in place, an asset-backed credit facility to avoid quarterly maintenance covenants.

## **We Expect Deleveraging As Difficult Credit Conditions Persist**

Despite the number of increasing defaults and the grim outlook for credit quality over the next year or two, borrowers with extra liquidity have resorted to debt-reduction initiatives through debt repayment, opportunistic debt buybacks, or, in some cases, distressed exchanges to lower overall debt levels. Others have refinanced maturing loans with bond issues, as well as amended and extended credit facilities, to push out debt maturities, albeit at a steep cost. We expect such financing initiatives to result in a deleveraging of corporate borrowers' balance sheets over the longer term. Companies with viable business models that are able to improve their cost structures in light of declining sales and improve their operating performance would likely emerge with a stronger financial profile. The business profiles of these borrowers could also benefit as surviving companies capture market share from weaker players.

Standard & Poor's expects a turnaround in credit quality once the U.S. emerges from the recession as borrowers renew their focus on financial prudence. We anticipate some overall improvement in speculative-grade borrowers' credit profiles as companies seek to lower their borrowing costs and stabilize their capital structures.

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