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Leveraged Finance:

U.S. Corporate Borrowers Are Hardly In The Clear As Debt Maturities Loom And The Economy Bumps Along

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Leveraged Finance:

U.S. Corporate Borrowers Are Hardly In The Clear As Debt Maturities Loom And The Economy Bumps Along

Amid some signs that the U.S. economic recession has reached its nadir, it might be easy to believe that the worst may soon be over for corporate borrowers. But add the mixed signals on consumer spending and consumer confidence to the historic six- to eight-month delay in corporate defaults, sprinkle with signs of a still-tight market for leveraged loans, and it seems likely that any economic recovery will be preceded by a prolonged bumping along the bottom.

Standard & Poor's Ratings Services expects defaults to remain at a high level in the second half of this year and into the first half 2010 as the economy stays limp and companies face a surge in maturing debt that they will need to refinance. As it stands, U.S. nonfinancial corporate borrowers are on pace to default on almost $700 billion in debt this year--dwarfing the 2008 total of $104 billion.

"Given where we are in the credit cycle, the continuing slump in the economy, and the years-long deterioration of credit quality among corporate borrowers, it won't be a surprise to see 230 or so defaults this year," said Standard & Poor's Managing Director John Bilardello. "It all depends on companies' ability to weather this economy and then refinance at rates affordable for their business."

Borrowers rated in the 'B' category (which includes 'B-', 'B', and 'B+' ratings) and below, in particular, may find it difficult to attract lenders and reasonable rates. This could be a major problem given that almost half of all Standard & Poor's corporate credit ratings are in the 'B' category or lower--the result of market conditions in the years leading up to mid 2007 that let speculative-grade companies borrow at what were, historically, investment-grade interest rates.

The end of fast and cheap money means a significant portion of the lowest-rated companies now may not be able to find lenders, even if nascent signs of stabilization in the credit markets take hold. Those borrowers that do find committed lenders and investors may be disinclined--or unable--to pay prevailing rates.

"If the weakest credits don't pull the trigger on more expensive financing, some may not survive," Mr. Bilardello said.

Signs Of Life

While still tentative, signs are mounting that the U.S. economy may soon rebound. New home sales in June rose at the fastest rate in more than eight years, and earlier this month, the government reported that new home construction rose to the highest level since last fall. Meanwhile, existing-home sales rose nearly 4% in June, the third straight monthly gain.

However, while these reports suggest that home sales and starts are beginning to stabilize, we expect prices to decline further. And although stocks have rallied in the past few weeks, it would seem premature to declare the

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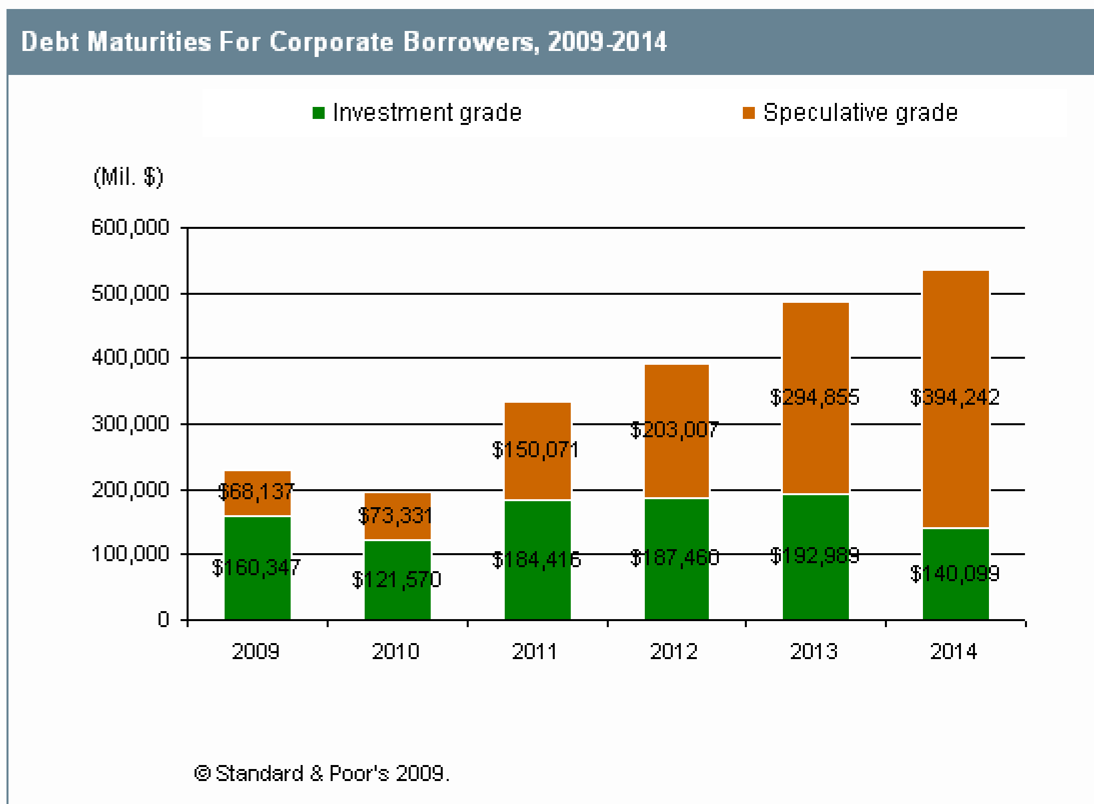
return of the wealth effect that is essential to a turnaround in consumer spending. In fact, consumer confidence waned in late July to its lowest level since April amid pessimism about the economy and unemployment.

Standard & Poor's Chief Economist David Wyss believes the economy will bottom out later this year, as the recession has proved to be much longer and deeper than initially expected. U.S. household net worth has dropped 21% since the end of 2007, the result of the sharp decline in the stock markets and home prices. In this light, the credit outlook for corporate borrowers remains negative, with credit deterioration continuing for the remainder of 2009.

First-Half Defaults Surpass Total For All Of 2008

Through the first half of this year, 117 non-financial U.S. companies defaulted on more than $339 billion of debt (including companies involved in a distressed exchange or buyback of debt, as well as other selective defaults), according to data compiled by Standard & Poor's Global Fixed Income Research (GFIR). Spanning nearly all sectors and industries, these bankruptcy filings and missed payments have already far outpaced the totals for all of last year, when 76 U.S. nonfinancial corporate borrowers defaulted on approximately $104 billion of debt.

After an already fast start to the year, the pace of defaults picked up further. In the second quarter, 79 nonfinancial U.S. borrowers defaulted on $252 billion of debt outstanding--an acceleration from the first quarter's 38 defaults totaling $87 billion in debt. And coming years will likely not provide any relief, as maturities for speculative-grade borrowers (in terms of dollar amount) steadily rise through 2014 (see chart).



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Debt Issuance Breaks Through The Ice

Despite no end to talk that the credit markets have yet to thaw in earnest, and the perception that lenders and investors are picking their spots ever more carefully, U.S. borrowers have so far this year already issued nearly as many bonds (by dollar amount) as in all of 2008. This holds true for speculative-grade companies, as well as those with higher ratings.

According to GFIR, speculative-grade borrowers issued $48 billion in bonds in the first half, compared with $35.2 billion for all of 2008. Investment-grade companies, meanwhile, have issued $263 billion, nearly matching the total of $271.3 billion last year.

Naturally, refinancing needs spur issuance--and so it's logical that the debt coming due in 2010 is accompanied by increased borrowing in the bond markets in 2009. Nonetheless, the amount sold by speculative-grade companies may come as a bit of a surprise, given current economic and credit conditions.

A closer look shows that the bulk of speculative-grade borrowing has been done at the higher end of the spectrum, specifically by those in the 'BB' category, at rates much closer to historical norms. And much like the default rate, the pace of issuance quickened in the second quarter. Companies increasingly tapped the markets as borrowing costs for 'BB' corporates narrowed to somewhere in the neighborhood of 500 basis points over LIBOR, from about double that in the first quarter.

Surviving The Recession--Or Not

The availability of financing in the current environment aside, defaults among U.S. corporate borrowers won't likely wane for the next few years, due to the sharp economic recession.

Typically, defaults lag a downturn by six to 12 months. And business growth can sputter, or remain stagnant, for 12 to 24 months after the end of a recession. Given that Mr. Wyss has forecast a trough for the economy in the fourth quarter of this year at the soonest, we expect companies to struggle well into 2010, and perhaps notably longer than that.

We believe this adversity, which first hit companies that rely on consumer discretionary spending, has been broadening. In the coming months, and into next year, defaults and credit deterioration will likely continue to hurt consumer-related industries and may hamper manufacturing sectors as the recession's reverberations work their way through the system.

"Auto companies and leisure- and advertising-related businesses--many of them big names--have borne the brunt of this recession so far," Mr. Bilardello said. "We've now seen the recession's effects moving into late-stage manufacturing, capital goods sectors, and the like. The current cycle of rating downgrades and defaults may slow down, but is far from over," he added.

Indeed, the decline in creditworthiness among U.S. nonfinancial corporate borrowers continues apace, with downgrades in the first half outnumbering upgrades by a more than 10-to-1 ratio. Through June, there were 483 downgrades to just 48 upgrades.

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A Tough Combination: Rising Defaults And Lower Recoveries

Standard & Poor's GFIR group has forecast the default rate for all leveraged credits to reach 13.9% on a per-issue basis by June 2010. Our recovery ratings indicate that post-default recoveries will be generally lower than recent and historical averages for all debt classes. In large part, this is because recoveries tend to decline as default rates rise, due to supply-and-demand dynamics in the restructuring and exit markets for defaulted debt. Simply put, in this type of environment, the number and dollar value of defaulted debt climb relative to the supply of funds flowing into defaulted debt or the assets underlying them.

In addition, we see factors unique to the current cycle that may contribute to lower recovery levels. Among them is a change in the debtholder mix. In the previous two U.S. recessions, banks originated and held most leveraged loans and, thus, shared a strong common interest in achieving a par, or near-par, recovery to avoid credit losses. More recently, institutional investors and non-bank lenders have emerged as the primary holders of widely syndicated loans. These holders may not have the same incentives as banks did in pursing ultimate recovery after default. They may, for example, have a more limited focus on par recoveries if they purchased the loan at a significant discount from par, or may engage in strategies such as "loan to own," in which they seek to use their debt position to gain controlling ownership of a distressed company.

Accompanying this shift have been more complex structures and collateral pledges, such as those that split collateral pledges between separate lending groups or classes. This growth in complexity may reduce cohesion among lenders and result in increased costs and delays, and potentially lower recoveries.

Increasing numbers of liquidations will also likely hurt recoveries. Historically, larger U.S. public companies that have filed for bankruptcy protection have sought to reorganize rather than liquidate their assets. This typically has benefited not only the borrower, but also lenders, in the form of higher recoveries. As the current credit reversal has deepened, however, it has become more difficult for some companies to reorganize, largely because the financing critical to reorganization has become too costly. Many borrowers are now finding themselves pushed toward liquidation, and we expect post-default recoveries to generally be lower as a result.

Whether or not--and to what extent--this proves to be the case, it seems clear that the recent surge in defaults won't soon abate. On the contrary, the second half of this year may see more corporate collapses than any six-month period in recent memory.

Writer: Joe Maguire

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