

Leveraged Finance:

Eyes Are Focused On Speculative-Grade Markets' Recovery, But Credit Risk Remains

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Table Of Contents

Risk Persists In Leveraged Corporate Credit

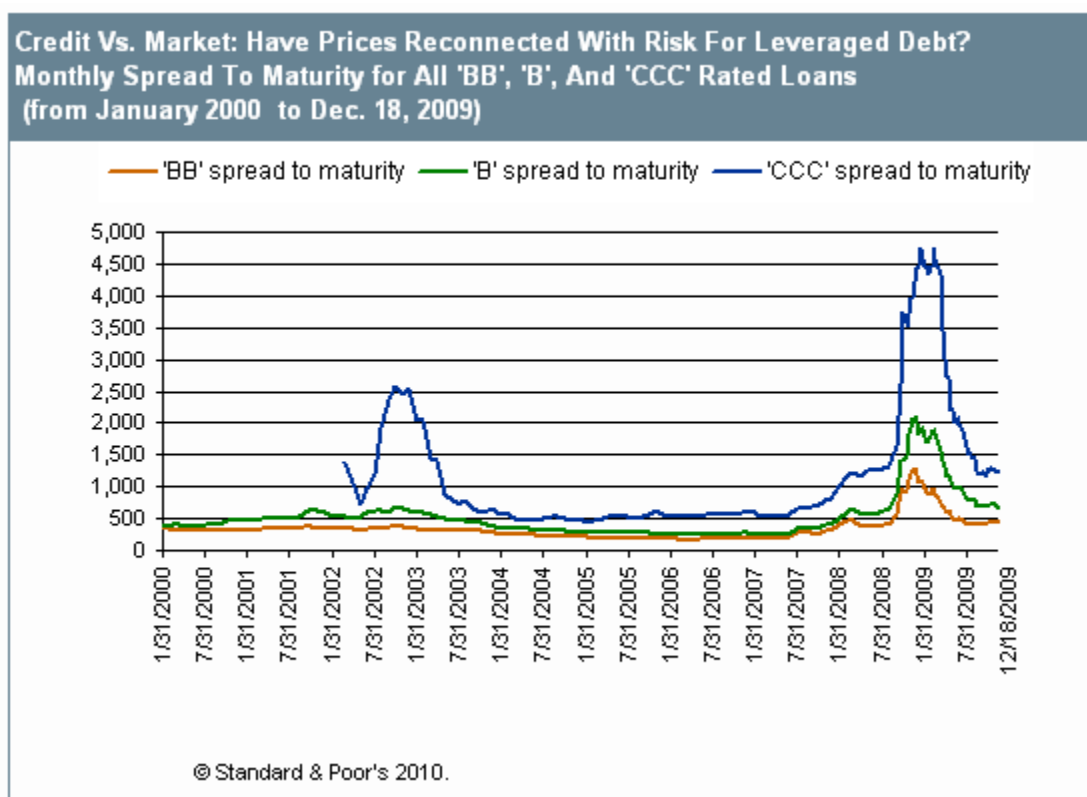
Looking Ahead

Leveraged Finance:

Eyes Are Focused On Speculative-Grade Markets' Recovery, But Credit Risk Remains

Speculation on what the "new normal" will be for the speculative-grade debt markets in the years following the recent credit turmoil may be premature. Standard & Poor's Ratings Services expects that sharply swinging prices of speculative-grade debt in a period of little more than a year has the potential to delay a return to more sustained patterns for both market and credit trends. Since the second half of 2008, spreads on the companies in the S&P/LSTA Leveraged Loan Index, which includes the most liquid names in the U.S. leveraged loan market, have experienced both a record rise and a rapid recovery (see chart 1).

Chart 1



Against this backdrop, market focus has understandably centered on the recovery in bond and loan prices from the white-knuckle lows of early 2009. But Standard & Poor's cautions that focus also needs to extend to the ongoing risk embedded in speculative-grade credits, as well as the factors driving this risk. While global market pricing and credit information is limited, Standard & Poor's ratings on U.S. and European speculative-grade bonds and leveraged loans, together with market data from Standard & Poor's Ratings Services and Leveraged Commentary & Data (LCD), offer insight into both the current market profile and some of the key factors that will likely drive credit risk in these regions where debt markets are the most developed.

Risk Persists In Leveraged Corporate Credit

Though Standard & Poor's estimates that defaults among speculative-grade industrial and financial borrowers will decline to 6.9% in the third quarter of 2010 (see "Global Bond Markets' Weakest Links And Monthly Default Rates," published Oct. 22, 2009 by Standard & Poor's Global Fixed Income Research group) from over 13% in 2009, we stress that continuing credit pressures have the potential to push default rates back up, especially with any stall or reversal in the current economic recovery. In addition, we expect that post-default recoveries--the second dimension in credit--will, in this cycle, fall below historical averages for all classes of debt (see chart 2). In some industry sectors, recoveries may drop to below the levels we saw in 1990-1991 and 2001-2002--the two credit downturns for which meaningful recovery data is available.

Current Market: Trends In Recovery

Recovery and recovery ratings in current downturn: Beginning decline from record-high historical average recoveries

LossStats Avg Annual Nominal Recovery (%)			S&P Estimated Recoveries* (%)		
	2006	2007	2008	All	'B-' and below†
Senior secured bank loan	84	99	82	76	63
Senior unsecured	71	83	69	38	17
Subordinated bonds	30	47	46	13	9
Mean nominal recovery 1988-2008 (%)					
Senior secured bank loan	82				
Senior unsecured	45				
Subordinated bonds	17				

*Based on recovery ratings as of Sept. 14, 2009. †The 'B-' and below ratings pertain to issuer ratings, not issue-level ratings.

Even with continuing recovery in the speculative-grade markets, Standard & Poor's cautions that refinancing needs, rising interest burdens, cash flow generation risk, difficulties in covering interest, and recovery risk among borrowers will likely drive credit risk.

Refinancing needs

Perhaps the most visible specter hanging over speculative-grade industrial borrowers is the refinancing risk in their capital structures, especially among those that raised large amounts of money at relatively low rates during the expansionary market of 2006 and early 2007. Current refinancings are reducing the amount of loans and bonds coming due over the next few years, but we anticipate that refinancing requirements will remain substantial, since many current refinancings, negotiated amendments, and maturity extensions provide only temporary extensions rather than long-term solutions.

Moreover, speculative-grade issuers may face continuing refinancing challenges from 2012 to 2020, as a result of substantial refinancing required in non-industrial sectors, notably sovereigns and financial institutions. We expect that banks and other financial institutions, both in the U.S. and in Europe, will be seeking debt refinancing for volumes considerably larger than speculative-grade nonfinancial corporate refinancing requirements. While banks and other financial institutions have traditionally focused on investment-grade, as opposed to speculative-grade, investors, it is our view that the simultaneous refinancing requirements in these sectors have the potential to affect market liquidity for speculative-grade nonfinancial corporate issuers.

Rising interest burden

Even companies that successfully refinance for appropriate terms may face rising borrowing costs--generally, interest-only in the speculative-grade bond market and interest plus principal amortization in the institutional and bank loan markets. Investors' repricing of credit risk, as reflected in credit spreads, has resulted in large jumps in interest costs, especially for companies with capital structures that include a significant amount of debt financed at record-low spreads over benchmark rates. Standard & Poor's LCD estimates that yield spreads over LIBOR for loans financed in 2006 and 2007 averaged well under 300 basis points, while yields on 2009 new issues averaged more than twice that.

While we recognize that current low base rates (with many under 1%) may mitigate the effects of rising spreads, some borrowers are paying above the base rate, as a result of earlier interest-rate swaps in which borrowers attempted to control interests costs by exchanging floating rates for fixed rates or LIBOR floors. Moreover, base rates, in our view, are unlikely to remain low for very long, and base rate increases may come at the same time companies are facing rising credit spreads due to refinancing.

Difficulties generating cash flow

In the current economic environment, some borrowers may struggle to develop recurring revenue growth to support the cash flow needed to pay current--and potentially rising future--interest costs. Speculative-grade issuers, in particular, will almost certainly face greater challenges in developing sustainable top-line revenue and cash flow growth, in our view, since they face greater business risk than their investment-grade counterparts.

These hurdles are evident in the quarterly changes in revenue and EBITDA that public companies in the LSTA index reported. While EBITDA showed small 2.5% quarter-over-quarter growth in the 2009 third quarter, the year-over-year change, which cyclical patterns influenced less, showed that revenues declined by 10.7% and EBITDA by 1.4%, according to LCD/LSTA and Standard & Poor's CreditStats. The fourth quarter may show a more positive quarter-over-quarter growth trend, as a result of the slowly improving U.S. economy. But in our view, year-over-year growth may be distorted because of the record drop in revenues and EBITDA that many industry sectors experienced in the fourth quarter of 2008.

Risk in interest coverage

EBITDA interest coverage remains a key measure of speculative-grade corporate credit strength. Currently, many borrowers and lenders are understandably anticipating that with any macroeconomic recovery will come rising revenues and EBITDA, along with rising EBITDA interest coverage. While this may occur, it can work both ways--any weakness or reversal in the recovery could push EBITDA interest coverage down. In addition, potential declines in EBITDA may occur at the same time as borrowers in both the bond and loan markets face materially rising credit-risk spreads as they refinance. This could accelerate difficulties in covering interest and a deterioration in credit quality.

Post-default recovery risk

Because Standard & Poor's expects default risk to remain above historical levels for speculative-grade borrowers well into 2010, ultimate post-default recoveries (which we define as the recovery lenders receive at the end of a restructuring process) become more important in our analysis, particularly for borrowers at the lower end of the credit spectrum (those rated 'B-' and below).

The current rebound in the leveraged debt markets may help to improve recoveries, as additional liquidity for leveraged and distressed debt improves market valuations for both companies and assets emerging from

restructurings, whether in or outside of formal bankruptcy proceedings. Still, we expect that this trend will only partially offset the effects that high leverage, a shifting investor base, and the rise of complex pledges may have on recoveries.

High debt leverage. Speculative-grade borrowers, especially in the U.S., not only have high levels of overall leverage, but relatively greater amounts of senior secured debt, as even those rated 'B-' and lower were able to add significant senior debt during expansionary market of 2006-2007. We believe such higher levels of debt have the potential to reduce ultimate post-default recovery levels.

Shift in holder mix. Since 2003, institutions have substantially replaced banks as the principal holders of widely syndicated loans. They now hold more than 60%, compared with less than 30% in 2003. In our view, these institutions may have shorter holding periods and a limited focus on specific debt recoveries--and in some cases focus on so-called "loan to own" strategies aimed at control of the borrowers.

The rise of complex pledges. With the expansion of the institutional loan market has come the growth of more complex debt structures--in particular, split pledges, in which separate lending groups split the same collateral. We expect that these types of structures have the potential to reduce cohesion among lenders, even within the same class, and thus lead to lower recoveries.

Potential return of credit amnesia

Many participants in the leveraged debt market may soon forget the turmoil that began just over two years ago. The market from 2006 to mid 2007 was, as Standard & Poor's has argued, marked by "credit amnesia," with pricing not reflecting basic credit profiles: Spreads on the debt of 'B' rated (and lower) issuers dropped to less than 300 basis points. While we have yet to see a comparable pattern in the current recovery, and credit spreads have widened over 2006-2007 levels, we believe some initial signs of credit weakness in new issues have begun to appear. Notably, we see this in the return of leveraged dividend payouts and rising new-issue originations at the lower end of the credit spectrum.

Looking Ahead

The current leveraged debt markets show a general recovery in prices. But Standard & Poor's cautions that credit risks may also affect the speculative-grade bond and loan markets. From a credit perspective, we believe the main upshot of the past year is not so much the recovery of the markets, but the ongoing significance, rather than irrelevance, of credit risk--especially for speculative-grade companies. If the leveraged debt markets' record collapse in late 2008 and the subsequent recovery in 2009 show nothing else, it's the continuing importance of credit for successful investing and financing in the both the speculative-grade bond and leveraged loan markets.

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