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Leveraged Finance:

European First-Lien Recovery Rates Remain Strong As Issuance Volumes Near 2006 Level

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Issuance volumes in the European leveraged finance market have made an impressive recovery from the global financial crisis, reaching €124 billion in 2013, compared with €133 billion in 2006. The speculative-grade European nonfinancial corporate default rate has also declined significantly, to 5.9% at year-end 2013 from 7.2% at year-end 2012 (for further details see "A Changing Market Composition Points To A Lower Corporate Default Rate On The Horizon In Europe," published March 10, 2014, on RatingsDirect), and recovery levels for senior secured debt remain strong.

This is the third edition of Standard & Poor's Ratings Services' empirical study on European defaulted debt instruments, covering a 10-year period to 2013 from 2003. The issuers of these instruments at the time of default had either a Standard and Poor's corporate credit issuer rating or a Credit Estimate. Since our second publication, we have been able to gather recovery information on an additional 45 issuers, an increase of 181 instruments (see table 1), increasing our data set to include 855 defaulted debt instruments totaling $147.3 billion from 218 issuers (see "Europe's Senior Loan Market Continues to Deliver A Strong Recovery Performance," published June 25, 2013, on RatingsDirect).

The methodology we use in this report is predominantly the same as that used for the Standard & Poor's LossStats database. Significantly, versus studies conducted in the U.S., our data includes issuers with Credit Estimates and also interim recoveries, which at 81% make up the majority of our data set (see Appendix 2 for further explanation of terms).

Overview

- Despite a significant increase in our data set, average recovery levels have not changed dramatically since our 2013 study, and first-lien recoveries remain strong, at 76%.
- On average, capital structures have lower recoveries when companies use senior secured bonds and super senior revolving credit facilities to completely refinance senior secured bank debt.
- Second-lien facilities continue to achieve similar mean recoveries to mezzanine facilities, despite these facilities being considered a secured instrument, albeit on a second-priority basis.
- However, recovery results for both instruments in the majority of cases (71% of second-lien recoveries and 87% of mezzanine facilities) are predominantly binary, meaning that they are either 100% or 0%.

Table 1 highlights the mean and median recoveries and standard deviation for the increased data set. As shown, for all debt instruments, there has been no significant change in these metrics since the last publication (see Appendix 2 for a definition of terms).

Table 1

Summary Of Results

	No. of instruments	Increase in $ debt (%)	Amount debt (bil. $)	Increase (%)	Mean (%)	Median (%)	Standard deviation (%)
First lien	598	30.3	90.5	18.1	75.5	90.0	28.8
Second lien*	72	20.0	17.9	19.6	35.7	10.0	41.6
Mezzanine*	123	16.0	17.2	16.5	35.9	1.5	45.0
Senior unsecured	46	39.4	18.9	17.4	46.7	38.0	34.8
Subordinated	16	0.0	2.8	0.0	29.0	1.8	40.9

*Mean and median results are less indicative of actual recoveries, given that results in the majority of these cases are binary.

First-Lien Recoveries In Europe Remain Strong Despite Dilution From Secondary Trading Prices

Although first-lien mean recoveries remain strong at 76%, the overall result is two percentage points lower than in our second study. One contributing factor is that we have updated 71 first-lien interim recoveries with secondary trading prices since our previous study. This is the first secondary trading price available post recovery, which we believe is most reflective of the market price of the actual recovery at the time, and is the same methodology as observed in the U.S. This has resulted in lower recoveries than we initially estimated, with mean and median first-lien recoveries of 47% and 37%, respectively. In part, this is because at the time of default, the companies either exchanged or reinstated the facilities, at which point we would have assumed a recovery percentage at par. However, it appears that the market views these facilities less favorably. Nevertheless, the prices can fluctuate and we continue to update them as the interim recoveries transition to final.

Only two instruments that were included in the previous study have transitioned from interim to final, with one recovery percentage increasing and one decreasing from interim levels. Therefore, at this stage, there is not enough evidence to depict a certain trend expected for final recoveries.

The European first-lien results, including these interim secondary prices, are consistent with the long-term averages that we have observed in the U.S. loan market, which only includes final recoveries. The U.S. loan market has a mean recovery rate of 74%, although this is over a much longer period to 2013 from 1987 and does not include bonds (see "Recovery Study (U.S.): Are Second Liens and Senior Unsecured Bonds Losing Ground As Recoveries Climb?," published Dec. 16, 2013).

In Europe, nearly 50% (300 of 598) of first-lien instrument lenders recovered 90%-100% of their initial investment, with only about 5% recovering 0%-20% (see chart 1). We obtain similar results if we view recoveries by value rather than by the number of instruments (see chart 2).

Chart 1

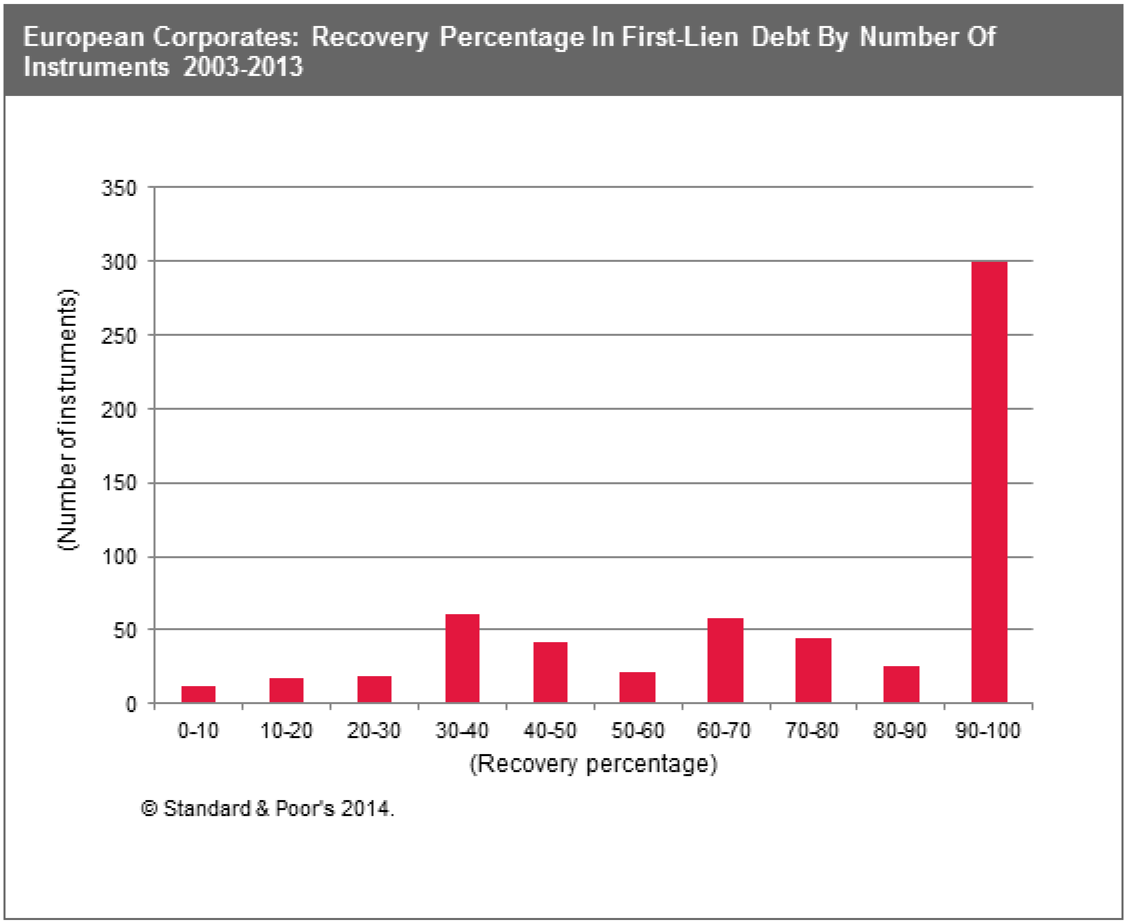
European Corporates: Recovery Percentage In First-Lien Debt By Number Of Instruments 2003-2013
350
300
250
200
150
100
50
0
(Number of instruments)
0-10
10-20
20-30
30-40
40-50
50-60
60-70
70-80
80-90
90-100
(Recovery percentage)
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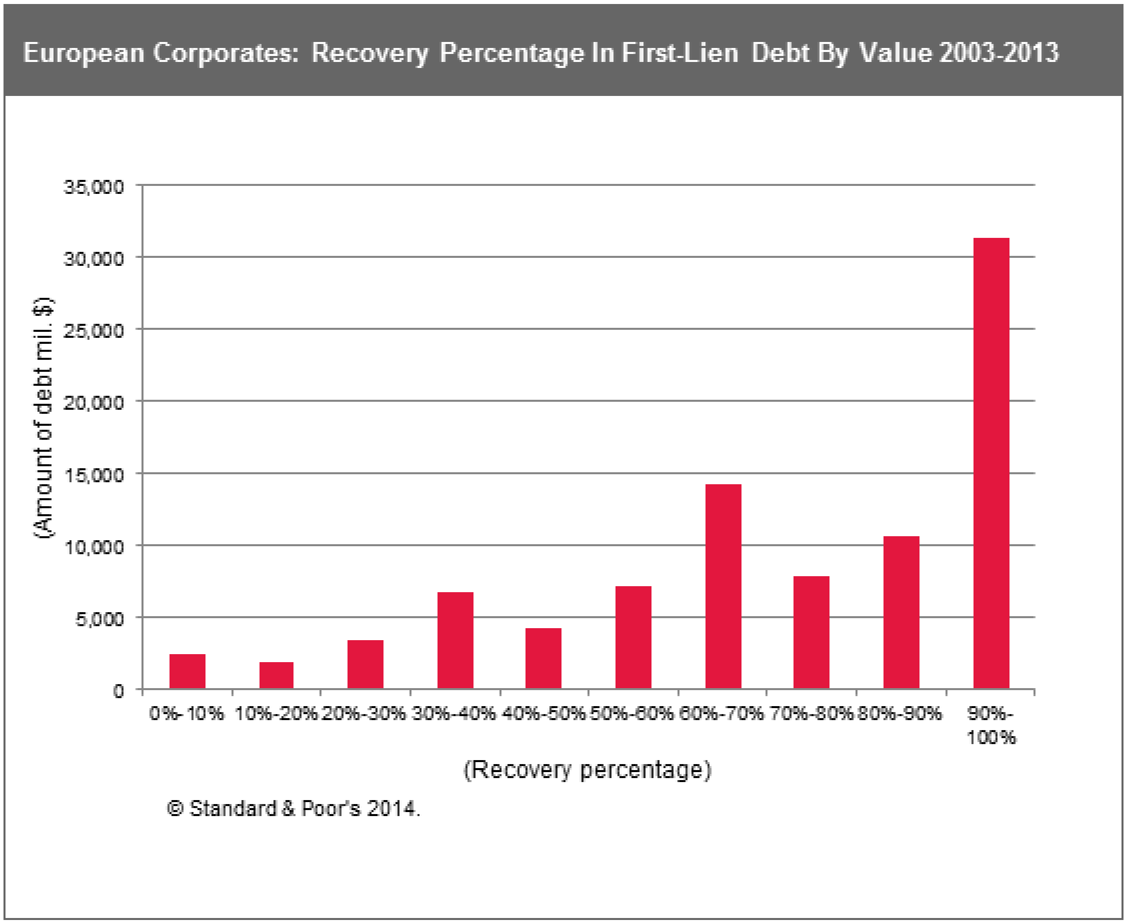
Chart 2

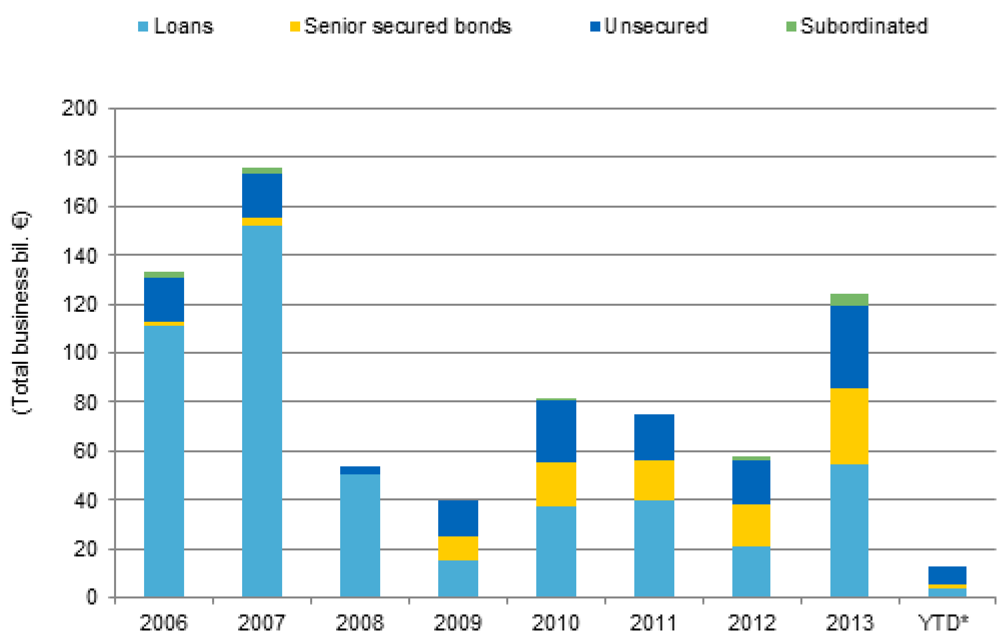


First-Lien Bank Debt Recoveries Outperform Senior Secured Bond Recoveries

Speculative-grade companies have been turning to the European capital markets for financing since mid-2009, when bank lending became limited as a result of the global financial crisis. Secured, unsecured, and subordinated bonds have all gained value in the overall market since a significant low in 2008 (see chart 3).

Chart 3

European Leveraged Finance Issuance



YTD--Year to date. *Feb. 28, 2014. Source: S&P Capital IQ.

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This constrained bank lending led companies with noticeably lower corporate credit ratings to tap the high-yield bond market, which changed the way that some companies refinanced their capital structures. The typical structure--where companies use senior secured bonds to partly or fully refinance bank loans, and all the senior secured debt ranks pari passu--remained common. However, an increasing number of companies shifted to refinancing senior bank debt entirely with bonds and a super senior revolving credit facility (RCF).

We believe that the structures with super senior RCFs and senior secured bonds expose lenders to potentially significantly lower recoveries at the point of default than the equivalently ranked bank debt. This is due to an additional layer of senior debt to which the senior secured bonds would rank junior in a default scenario (see "As The European Market Heats Up, Recovery Prospects For Senior Secured Bondholders Cool," published June 18, 2014).

The results from our data set corroborate this supposition, although we highlight that our data remains significantly limited (see table 2). There is a material difference between mean and median recoveries when the structure includes a super senior RCF and secured bonds compared with all bank debt, or when the senior secured notes rank pari passu with the bank debt. In the case of the two structures with super senior RCFs in our study, lenders of those RCFs received full recovery, whereas the mean and median recoveries for the senior secured notes were 39% and 37%, respectively.

Table 2

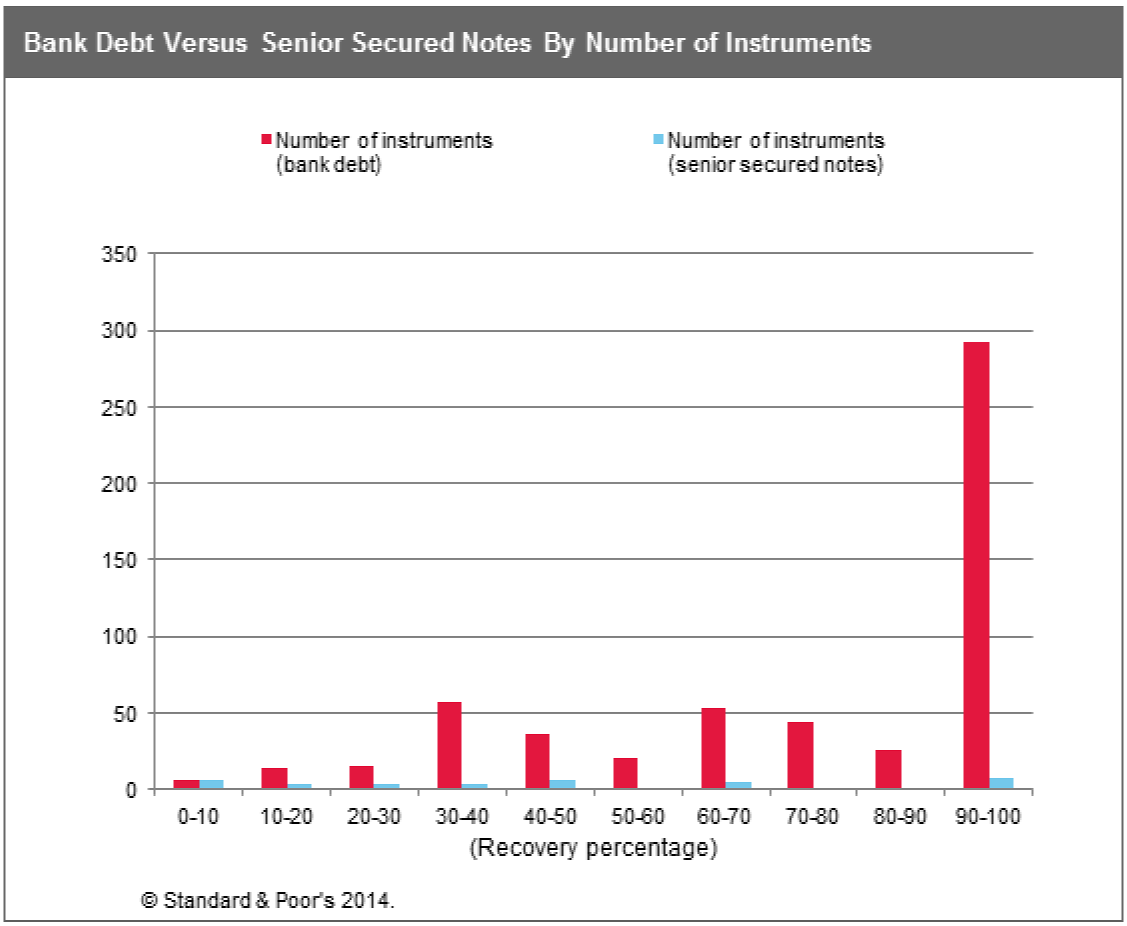
First-Lien Recovery Percentage By Transaction Structure

First-lien debt instrument	Companies	Instruments	Mean (%)	Median (%)
All senior secured bank debt	155	548	77.3	94.2
Senior secured bonds ranked pari passu with bank debt	6	25	67.3	66.4
Super senior RCF and senior secured bonds	2	7	39.2	37.2
All senior secured bonds and no super senior RCF	8	18	43.8	40.1

RCF--Revolving credit facility.

The results also highlight that recoveries are higher in an all-bank-debt structure than in an all-senior-secured-bond structure (see chart 4). This mirrors the recoveries in the U.S., where historically, loans and RCFs have recovered by 74%, while senior secured bonds have recovered 38% on average.

Chart 4



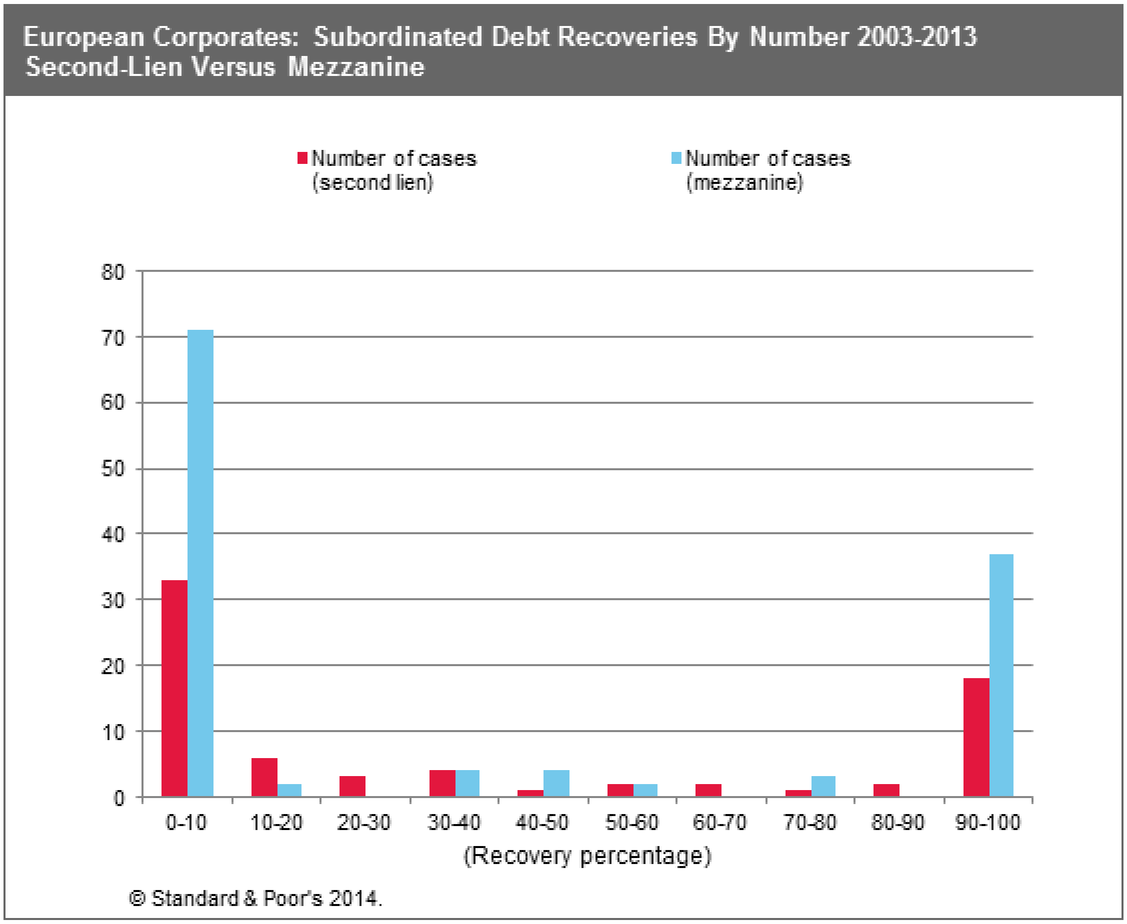
In the U.S., covenant-lite transactions have enjoyed a resurgence in popularity, which appears to have spread to Europe, with global veterinary health company Ceva Sante Animale launching the first European domestic covenant-lite transaction in late March 2014, followed by Deoleo in June. Covenant-lite typically refers to loans that lack financial maintenance covenants and describes many loans extended to speculative-grade borrowers during the leveraged buyout boom that ended in 2007. We currently have no data to indicate whether or not covenant-lite transactions necessarily constrain credit quality, and in our opinion, companies that have been able to issue debt with a covenant-lite structure have often been the better-quality credits. We will track any emerging default trends as covenant-lite transaction volumes increase in Europe and defaults occur.

Second-Lien Mean Recoveries Are Identical To Mezzanine Recoveries

Mean recoveries for second-lien instruments continue to mirror those of mezzanine debt instruments, despite the general market perception that mezzanine instruments are subordinate to second-lien instruments. In our view, this perception arises because second-lien facilities are typically secured by assets that are also pledged to higher-priority lenders. In contrast, mezzanine instruments may be unsecured and generally have more prior-ranking debt, and are therefore priced higher to account for this risk. The expectation is therefore that mezzanine instruments would receive lower recoveries than second-lien instruments.

Our data set includes 72 second-lien and 123 mezzanine instruments. The mean recoveries for these two types of instrument are identical, at 36%, showing that these facilities are treated equally in a default scenario. However, as discussed previously, in the majority of these cases the results are binary, meaning that lenders either received close to full recovery or close to zero recovery. Again, the results from the second-lien facilities in this case also mirrored that of the mezzanine facilities (see chart 5).

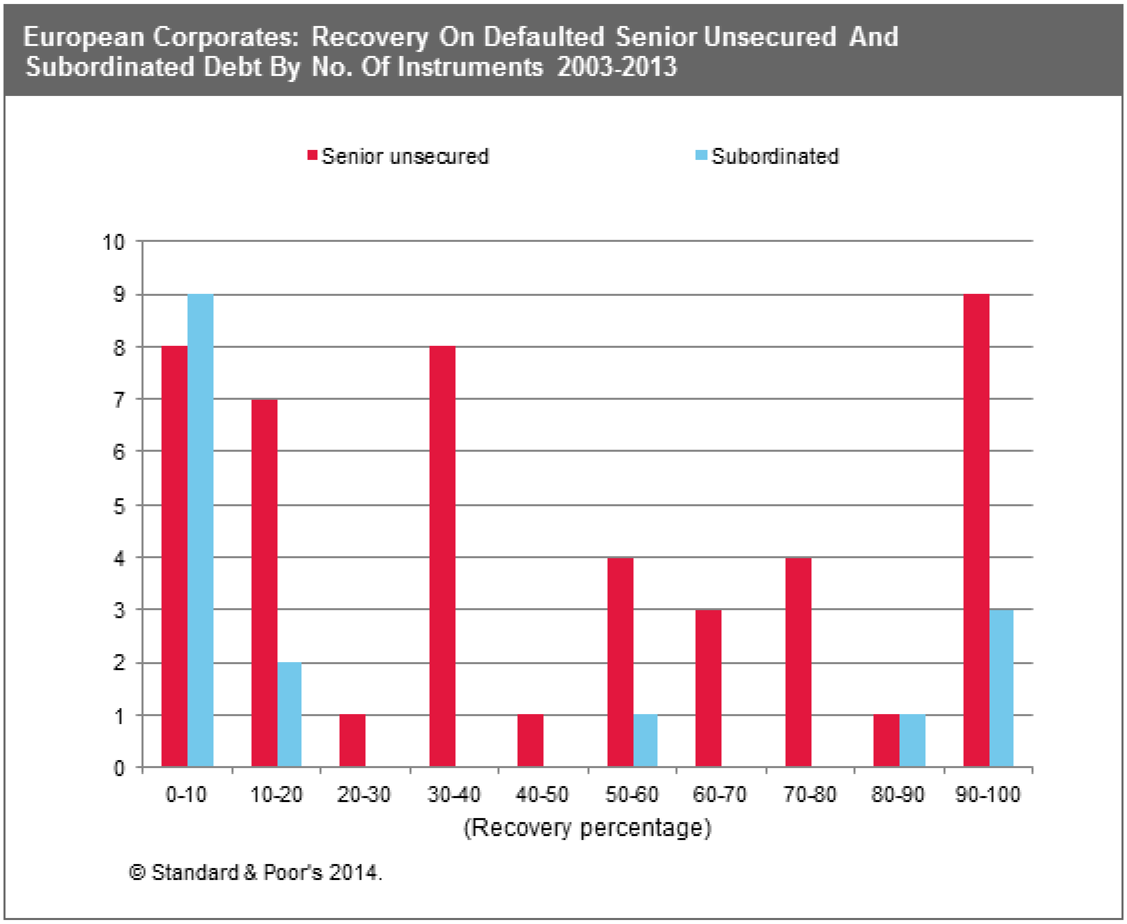
Chart 5



Senior Unsecured And Subordinated Recoveries Continue To Diverge

The mean and median recoveries for senior unsecured debt, as defined by the instruments' legal documentation, at 47% and 38%, respectively, are more favorable than those for second-lien and mezzanine debt, despite lenders mainly considering second-lien debt as secured (see chart 6). Senior unsecured debt had higher mean recoveries than those issued by private companies at 52%, which in our view reflects the benefit of a more liquid public market. In the U.S., mean recoveries on senior unsecured debt (at 43%) are higher than median recoveries at (38%), over 1987-2013.

Chart 6



Subordinated recoveries (see Appendix 2 for an explanation of this term) remain predominantly binary. Of the 16 subordinated facilities that we include in our study, over 50% had recoveries of less than 10% and 16% had 90%-100%. The results are lower than those in the U.S., with mean and median recoveries in Europe of 29% and 2%, respectively, versus 29% and 17% in the U.S. The lower number of data points in Europe may explain these discrepancies.

RCFs Remain An Important Source Of Liquidity Near To Default

Our analysis shows that companies are able to continue drawing on their RCFs as a source of liquidity as they near default. Our study includes 114 RCFs, of which we classify six as super senior and one as an asset-backed lending (ABL) facility (see table 3).

Table 3

Summary Of Statistical Results For RCFs And Super Senior RCFs

	No. of instruments	Utilization	Mean (%)	Median (%)	Standard deviation (%)
RCF	108	76.6	78.2	98.2	28.8
Super senior RCF	6	88.0	100.0	100.0	0.0

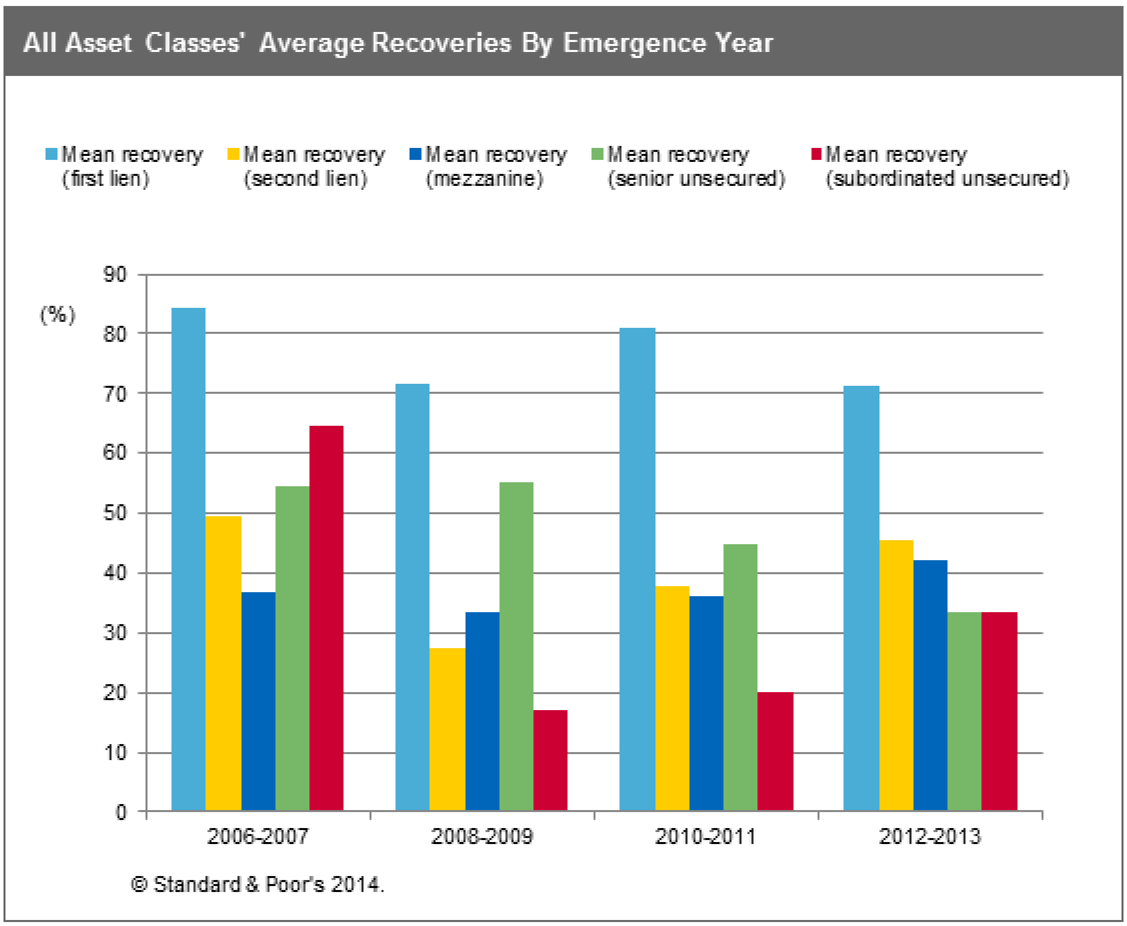
RCF--Revolving credit facility.

RCFs were on average three-quarters drawn at the point of default, with high mean recoveries at 78%, and median recoveries converging at 98%. This supports our assumption as part of our recovery rating methodology that companies generally fully draw on RCFs at default. The ABL facility drawings were above 87%, and as the facility received full recovery, we have included it with the other RCFs. All the super senior RCFs received full recoveries, although the dataset is still small, with only six data points.

Recoveries For All Debt Instruments Are Inconsistent By Year of Emergence

First-lien recoveries continue to fluctuate year to year, albeit remaining moderately strong (see chart 7). We would expect that recoveries will have continued to improve from lows seen in 2009, reflecting the upturn in the economy, and improved prospects for companies facing restructuring or exiting bankruptcy as the capital markets began to open again. This was seen in 2010 and 2011. However, there appears to be no apparent trend when also considering the first-lien outcomes in 2012 and 2013. Recoveries for all other asset classes also appear volatile, although the number of instruments in the data set and the high volume of interim recoveries must be taken into account. We will continue to examine these data points going forward to see if any relevant trends emerge.

Chart 7



Appendix 1: Study Methodology

Our third study on European corporate recovery rates includes an additional 181 instruments from our 2013 study to bring the total to 855 instruments. The number of issuers of these instruments has increased to 218 from 173. We have also extended the time period by one year, so that it now spans 10 years from 2003 to 2013. Of these recoveries, only 19% are final. The remaining are interim (mainly debt exchanges) and final recoveries will be subject to change. We assume that if a debtholder receives a portion of equity in exchange for a material write-down, this equity has zero value unless there is evidence to the contrary.

Appendix 2: Explanation Of Terms

Recoveries

We define recoveries as the ultimate recovery rates following emergence from three types of default: bankruptcy filings, distressed exchanges, and non-bankruptcy restructurings. Unless specified otherwise, we base recoveries at the instrument level.

Recoveries are the value that creditors receive on defaulted debt. Companies that have defaulted and moved into bankruptcy will usually either emerge from the bankruptcy or will be liquidated. On emergence from bankruptcy, creditors often receive a cash settlement, new instruments (possibly debt or equity), assets or proceeds from the sale of assets, or some combination.

Interim recoveries

Specifically for European recovery analysis, we use the concept of "interim recovery." This occurs when the defaulted instrument is converted to, or exchanged for, a new instrument with a new maturity date. If there is no reliable trading price, we assume that this new instrument is valued at par.

This is one of the key differences between the methodology of the European study and that of the studies conducted in the U.S. The U.S. secondary debt market in many cases is more transparent and secondary trading prices are more readily available. In general, if no trading price is available, the case would normally be excluded from the U.S. data set. The other key difference between the U.S. and European methodologies is in the valuation of equity, as we discuss in further detail below.

Ultimate recovery

Ultimate recovery is the value of the settlement a lender receives by holding an instrument through its emergence from default. The recovery is based on the amount received in the settlement, divided by the principal default amount. Within Standard & Poor's LossStats database, three recovery valuation methods are used to calculate ultimate recovery.

Senior unsecured debt

We classify instruments as senior unsecured when the legal documentation describe them as such.

Subordinated debt

We classify the following debt instruments as subordinated: (i) convertible bonds; (ii) lower-priority ranking bank debt; (iii) unsecured bonds that are not classified as senior in their documentation.

In all instances, excluding the unsecured bank debt--which is not common in the U.S.--the classification of these instruments is the same in Europe and U.S.

Related Research

- Inside Credit: Leveraged Credit Conditions In Europe Become Increasingly Stretched As Investor Demand Outstrips Supply, April 10, 2014
- European Economic Outlook: Out of Recession, Back in the Slow Lane, March 21, 2014
- A Changing Market Composition Points to a Lower Corporate Default Rate On the Horizon in Europe, March 10, 2014
- Recovery Study (U.S.): Are Second Liens and Senior Unsecured Bonds Losing Ground As Recoveries Climb?, Dec. 16, 2013
- Leveraged Finance: Europe's Senior Loan Market Continues To Deliver a Strong Recovery Performance, June 25, 2013

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