

SPECIAL COMMENT

Distressed-Exchange Defaults Surged in 2009, and Many Could Default Again

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- » During 2009, the number of distressed-exchange defaults by non-financial companies rated by Moody's worldwide surged to nearly 100.
- » About three-quarters of these companies remain very low rated, at Caa1 or below, and many remain at high risk of near- to medium-term default.
- » About one-quarter are rated in the higher, single-B category, typically because their distressed exchanges addressed a large portion of their capital structure, or operating performance improved.
- » Historically, distressed exchanges have been reasonably successful in improving issuers' creditworthiness, but it is too soon to tell if that will hold true in this cycle.
- » We expect many fewer distressed exchanges in 2010, given expectations for a declining default rate, healthier capital markets and a nascent economic recovery.
- » A huge peak in debt maturities from 2012 to 2014 and high debt burdens at many low-rated companies make another wave of distressed exchanges likely down the road.

Overview

Many non-financial companies that defaulted via distressed exchange in 2009 remain at risk of another default. While distressed exchanges helped many companies deal with near-term liquidity pressures and lowered debt levels, in many cases they were no magic bullet for the underlying problems that landed them in distress in the first place.

In 2009, the number of distressed exchanges completed by non-financial companies rated by Moody's worldwide surged to nearly 100. Distressed exchanges are exchanges made by distressed issuers at discounts to par that have the effect of allowing the issuer to avoid a bankruptcy filing or payment default. Distressed exchanges are considered defaults under Moody's definition. About three-quarters of the companies that had distressed-exchange defaults in 2009 remain very low-rated, at Caa1 or below. Approximately 30% are rated Caa2 or below, indicating high risk of near- to medium-term default.

The rest of the companies that had distressed exchanges are rated higher, in the single-B category, generally because their distressed exchanges addressed a large portion of their capital structure, or they saw improvements in operating performance.

It is too early to make a final judgment on the performance of the 2009 distressed exchanges. While distressed exchanges clearly put some companies on steady ground, for many others they were a temporary fix that only postponed the need to address excessive leverage, weak liquidity or other difficulties. Many companies that completed distressed exchanges remain low-rated because they did not fundamentally improve an unsustainable capital structure or they face difficult company-specific or industry-wide challenges.

Moody's definition of default

Three types of events constitute default events under Moody's definition of default:

- » A missed or delayed disbursement of an interest or principal payment
- » A bankruptcy filing or legal receivership by the issuer
- » A distressed exchange whereby 1) an issuer offers creditors a new or restructured debt, or a new package of securities, cash or assets, that amount to a diminished financial obligation relative to the original obligation and 2) the exchange has the effect of allowing the issuer to avoid a bankruptcy or payment default.

Moody's definition of default is intended to capture events where debt issuers fail to meet their debt service obligations as outlined in original credit agreements and indentures, and which subject those creditors to economic loss. Importantly, economic losses suffered as a result of changing market conditions or changes in the credit quality of the issuer are not events of default under Moody's definition, as long as the issuer is meeting the terms of its debt obligations.

Moody's includes distressed exchanges in its definition of default in order to capture credit events where issuers effectively fail to meet their debt service obligations, but yet do not actually file for bankruptcy or miss an interest or principal payment. These events can be thought of as being similar to voluntary out-of-court restructurings. This contrasts with opportunistic exchanges completed by financially healthy issuers that see a chance to reduce debt levels at attractive valuations.

Slowdown in pace of distressed exchanges likely in 2010 after surge in 2009

Distressed exchanges came in large numbers in 2009, and we expect there to be far fewer in 2010.

Last year, defaults via distressed exchange contributed significantly to a surge in Moody's global speculative-grade default rate to 13% at the end of 2009, almost triple the 2008 year-end level. Distressed exchanges accounted for a higher-than-average 34.9% of total initial defaults in 2009, compared with 23.5% in 2008 and just 11% during the period 1983 through 2007.

Several factors accelerated the pace of debt exchanges in the first half of 2009. Many speculative-grade companies lacked access to the capital markets to refinance their debts, and concerns about the availability of debtor-in-possession and exit financing increased the uncertainty surrounding bankruptcy filings, making distressed exchanges a more practical option in some cases. For financially healthier companies, low trading prices for existing debt presented an opportunity to exchange debt at attractive valuations and reduce leverage, although these transactions were not viewed as distressed exchanges.

In the second half of 2009, the pace of all defaults, including distressed exchanges, slowed as the debt markets strengthened and macroeconomic conditions stabilized, which set the stage for improving financial performance for many companies. In the fourth quarter of 2009, there were 18 non-financial corporate distressed-exchange defaults, or 19% of the year's total. In the first quarter of 2010, there were just eight. In light of this slowdown, continued stability in capital markets and prospects for economic recovery, we expect far fewer distressed exchanges in 2010 than there were in 2009.

Distressed exchanges by industry

The non-financial companies that executed distressed exchanges in 2009 represented a range of industries. Media, homebuilding-related and manufacturing industries together accounted for more than one-third of the total distressed exchanges completed by non-financial companies in 2009.

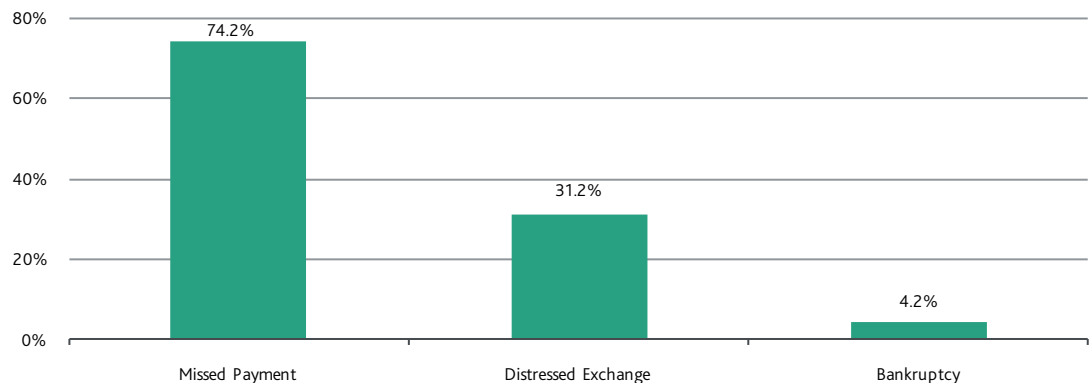
Distressed exchanges in 2009 by industry

Media	15%
Homebuilding/building materials/real estate	13%
Manufacturing	9%
Consumer Products	8%
Telecommunications	6%
Automotive	5%
Energy	5%
Technology	5%
All other	34%
Total	100%

Distressed exchanges historically have helped to stabilize capital structures

During the period 1973 to 2004, distressed exchanges were reasonably successful in improving issuer creditworthiness. As shown in the chart below, about 31% of the issuers that completed a distressed exchange during this period subsequently defaulted, either through another distressed exchange, a missed interest payment or bankruptcy. By contrast, nearly three quarters of the issuers that missed a debt payment subsequently defaulted. Issuers emerging from bankruptcy had only a 4% probability of another default.

FIGURE 1
Probability of subsequent default event, 1973-2004



Source: Moody's Investors Service

Ratings remain low for many companies that had distressed exchanges

Most of the companies that defaulted via distressed exchange in 2009 continue to carry low ratings. Among those that still have ratings, about three quarters are rated Caa1 and below and about 30% are rated Caa2 and below, indicating high risk of near- to medium-term default. Generally, the companies rated Caa2 and below completed distressed exchanges that were not large enough to materially improve their capital structure. For instance, Clear Channel Communications Inc. (Caa2, stable) and Harrah's Entertainment Inc. (Caa3, negative) are each rated Caa2 or below, and Moody's view is that their capital structures remain unsustainable over the intermediate term. By sector, more than half of these Caa2-and-below issuers are in the hard-hit media, homebuilding/real estate and gaming industries.

Some companies are in better condition from a ratings perspective. About 26% of the companies that completed distressed exchanges in 2009 are rated in the higher, single-B category. The single-B companies typically completed exchange transactions that represented a large portion of their capital structure, and they have tended to demonstrate improving operating performance. Ford Motor Co. (B2, rating under review for upgrade) has shown the most rating momentum since it completed a distressed exchange in April 2009, with its Corporate Family Rating (CFR) rising four notches to B2 from Caa3.

Since the closing of the distressed exchanges that were completed in 2009, Moody's has taken more positive than negative rating actions. Just over 20% of the companies that completed distressed exchanges in 2009 had their CFRs upgraded through April 30, 2010, generally reflecting improving conditions in the capital markets and the economy. However, none of these companies have been upgraded to a rating above B2, which is five notches below investment grade. A large portion of the upgraded companies completed a refinancing of at least a portion of their capital structure after their distressed exchanges. The ratings improvement for these companies mirrored the improvement in Moody's ratings of non-financial corporate debt issuers broadly.

There were very few downgrades among the companies with distressed-exchange defaults in 2009, reflecting the very low ratings they already had when they completed their exchanges. The vast majority of these companies had a lower CFR at the closing of their distressed exchange than they had six months prior, likely reflecting weakening operating performance or a deteriorating liquidity profile leading up to the exchange. However, only two of the non-financial corporates that completed distressed exchanges in 2009, Fairpoint Communications Inc. and Muzak Holdings, Inc., subsequently filed for Chapter 11.

Private equity-backed distressed exchanges have shown better rating performance

Among companies that defaulted in 2009, those with private equity (PE) backing were more likely to execute distressed exchanges¹. The private equity-sponsored companies also tended to have higher ratings upon the completion of the distressed exchange than the broader group of companies that completed distressed exchanges.

As shown in the table on the following page, 32% of the PE-backed companies that completed distressed exchanges were rated in the single-B category as of April 30, 2010, compared with 22% of the companies without private equity involvement. Even more significantly, only 23% of PE-backed companies were rated Caa2 or below, compared with 36% of non-PE companies.

¹ Please see our Special Comment, "[Private Equity 2009: Nearly Half of Defaults, But Better-Than-Average Recovery Prospects](#)," March 2010

This differential may reflect certain benefits of private equity ownership, such as the PE firms' access to capital, strong relationships within the capital markets, and financial sophistication. The gap could also reflect the relative size of the distressed-exchange transactions or differences in the industry composition of the PE-backed companies.

Rating Distribution for Non-Financial Issuers Completing Distressed Exchanges in 2009

CFR AS OF 4/30/10	ALL ISSUERS	NON-PE	PE-BACKED
B2 and B3	26%	22%	32%
Caa1	43%	42%	45%
Caa2 & below	31%	36%	23%
Total	100%	100%	100%

The largest 2009 distressed exchanges have not been magic bullets

To date, the ratings performance of the non-financial companies that completed the six largest distressed exchanges of 2009 (ranked below by amount of debt exchanged) compare unfavorably to the overall population of issuers that completed distressed exchanges.

Most of the companies that completed large distressed exchanges in 2009 continue to be rated Caa1 or below. Two of the six are rated Caa2 and lower. Another one, Fairpoint Communications (ratings withdrawn), filed for bankruptcy and had a CFR of Ca at the time of the rating withdrawal. While these companies had large debt exchanges, in most cases they were not large enough to substantially improve a highly leveraged capital structure. Of the six, only Ford has been upgraded to the single-B category. However, NXP B.V. is considering an initial public offering to take advantage of improving conditions in the semiconductor industry. If this offering is consummated and accompanied by substantial debt reduction, positive rating momentum could follow.

Largest 2009 Distressed Exchanges: A Closer Look

LARGE DE'S OF 2009	APPROXIMATE \$ DEBT EXCHANGED (BILLIONS)	CFR @ 4/30/2010
Ford Motor Company	9.8	B2
Harrah's Entertainment, Inc.	6.0	Caa3
Freescale Semiconductor, Inc.	2.8	Caa1
FairPoint Communications, Inc.	2.5	WR*
K. Hovnanian Enterprises, Inc.	2.2	Caa1
NXP B.V.	1.1	Caa2

*Ratings withdrawn upon bankruptcy filing

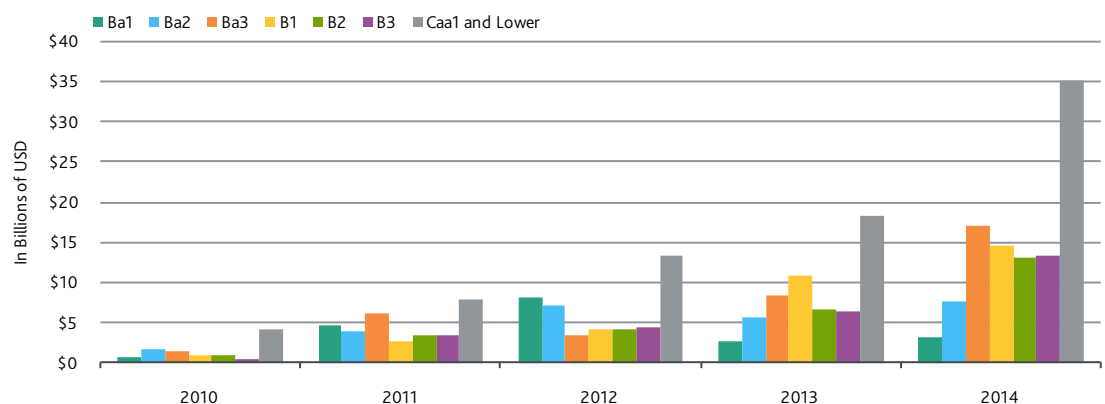
Two Distressed Exchanges, Two Different Rating Trends

- » **Ford Motor Co.** retired about \$10 billion of debt through a distressed exchange in April 2009. Moody's has since upgraded Ford several times. In the most recent rating action, on March 17, 2010, we upgraded the company's Corporate Family Rating one notch to B2, while placing it on review for possible additional upgrades. Moody's anticipates continued operational and financial improvements, based on Ford's new product line-up, more disciplined production levels and incentives, a new UAW agreement that reduces overall labor costs, globalization of production platforms, and the company's recent increase in market share in the U.S. Ford's credit metrics were weak in 2009, with a financial leverage ratio that exceeded 13x, and negative interest coverage. But Moody's expects these to improve substantially over the next 12 to 18 months, and considers Ford's current liquidity profile strong enough to deal with the company's continuing challenges, such as high debt levels, a still fragile U.S. economic recovery, excess industry capacity, and the potential for price wars initiated by automotive competitors.
- » **Harrah's Entertainment Inc.** had a distressed exchange in April 2009 that resulted in a net debt reduction of about \$1.8 billion. Despite raising new financing since the closing of the exchange, Harrah's Caa3 CFR and negative rating outlook reflect the company's very high leverage. Debt/EBITDA is over 10 times, a level Moody's believes is unsustainable over the intermediate term. The ratings and outlook also anticipate that a continued decline in gaming revenues across Harrah's largest markets – Las Vegas and Atlantic City – will negatively affect the company's operating performance in 2010.

Another wave of distressed exchanges likely down the road

There is a huge amount of speculative-grade debt maturing in 2012 to 2014, with a large portion of this debt rated Caa1 or lower by Moody's (see Figure 2 below). The favorable terms of many of the financings that were originated in 2005 through 2007 give issuers an incentive to wait as long as possible to refinance. As a result, some may miss a window for market access. In light of these factors, we expect another wave of distressed exchanges down the road. Some of the weakest issuers will likely exchange debt for less than full value.

FIGURE 2
Speculative-Grade Bond Maturities by Rating Category*



*Source: Moody's. See our special comment, "U.S. Refunding Risks and Needs for U.S. Speculative-Grade Corporate Issuers, 2010-2014," February 2010.

Conclusion

It is too early to draw firm conclusions about the effectiveness of the surge of distressed exchanges in 2009. By dealing with near-term liquidity pressures, many firms bought themselves time to benefit from an economic recovery. Yet a large number of companies that executed distressed exchanges remain very low rated, reflecting high leverage, poor liquidity, weak operating conditions or other problems. It remains to be seen how many will ultimately default again, either via distressed exchange or a bankruptcy filing. Historically, distressed exchanges have been reasonably successful in improving issuers' creditworthiness. We also note the large wave of debt maturities in coming years. U.S. speculative-grade issuers face more than \$800 billion in refunding requirements in the period 2010-2014, stemming from robust refinancing and leveraged buy-out activity prior to summer 2007. For companies that remain distressed today, this refunding risk may be a significant challenge.

Related Research:

Special Comments:

- » [Private Equity 2009: Nearly Half of Defaults, But Better-Than-Average Recovery Prospects, March 2010 \(123914\)](#)
- » [Moody's B3 Negative and Lower Corporate Ratings List, First Quarter 2010 \(123627\)](#)
- » [Refunding Risk and Needs for U.S. Speculative-Grade Corporate Issuers, 2010-2014, February 2010 \(122627\)](#)
- » [Corporate Default and Recovery Rates, 1920-2009, February 2010 \(123042\)](#)
- » [Distressed Exchanges: Implications for Probability of Default Ratings, Corporate Family Ratings and Debt Instrument Ratings, March 2009 \(115387\)](#)

Rating Methodology:

- » [Moody's Approach to Evaluating Distressed Exchanges, March 2009 \(115337\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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