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Distressed Exchanges in Europe

Summary Opinion

Over the past year a number of European corporate bond issuers have entered into debt-for-equity swaps or other distressed exchanges in order to reduce the strain of overleveraged balance sheets and allow these companies the opportunity to continue to operate as going concerns. Distressed exchanges have been particularly prevalent within the European telecommunications and cable sectors where slower-than-expected cash flow growth and sizeable debt burdens resulted in the need for some type of balance sheet restructuring.

The purpose of this special comment is to revisit Moody's approach to distressed exchanges in the context of what has occurred over the past year within the European market. In this regard, the report will examine at what point in its rating process Moody's determines a default to have occurred through a distressed exchange and what ratings factors are taken into consideration as a company contemplates and proceeds through the process of implementing a particular type of balance sheet restructuring.

A distressed exchange is one of three events which Moody's defines as a default for the purpose of its default rate statistics. Importantly, Moody's uses its own definitions of default (which may differ from legal definitions) and makes its own determination as to when a default event has occurred[1]. Because Moody's ratings incorporate both probability of default and severity of loss, ratings will continue to reflect expectations as to the recovery prospects for different creditors once a company announces its intention to enter into a balance sheet restructuring through some type of distressed exchange or once it becomes apparent to Moody's that such an exchange will be necessary (and a default is forthcoming). Key recovery considerations include:

- The expected timing of restructuring
- Subordination issues with respect to the company's consolidated capital structure
- The mix of cash, new debt securities, and equity comprising the distressed exchange
- The expected enterprise value of the issuer post-restructuring

Moody's believes that recovery prospects for bondholders of European companies involved in distressed exchanges have been particularly poor. This is especially true for companies within the European telecom/cable industries as Moody's believes that many of these companies will be extremely challenged to eventually generate positive cash flow (and provide value for creditors who have exchanged their debt obligations for equity) following their proposed restructurings. Furthermore, the amount of cumulative free cash flow to be generated following a restructuring, if any, remains highly uncertain.

1. *See also Moody's Special Comment, Moody's Approach to Distressed Exchanges, July 2000, which gives a comprehensive overview of the distressed exchange category within Moody's definition of default, the reason behind the definition, and the criteria we use in applying it*

Moody's Definitions of Default

Revisiting Moody's prior research, a distressed exchange is one of the following three events which Moody's defines as a bond default:

- There is a missed or delayed disbursement of interest and/or principal
- A bankruptcy filing or legal receivership occurs, or
- There is a distressed exchange where (i) the issuer offers bondholders a new package of securities that amount to a diminished financial obligation (such as debt or preferred stock, or debt with a lower coupon or par amount), or (ii) the exchange had the apparent purpose of helping the borrower avoid default

This special comment will focus on distressed exchanges, which are the most subjective of the three classes of default and may apply in a wide variety of circumstances. By including distressed exchanges in its definition of default, Moody's is not seeking to broaden the central idea of what constitutes a default. Rather, we are seeking to capture credit events that carry the same basic negative credit characteristics associated with non-payment and bankruptcy, but which have avoided these more extreme outcomes. One of the goals of including distressed exchanges in our default definition is simply to get the timing right. Many situations that ultimately result in non-payment or bankruptcy begin with distressed exchanges. In these cases, the distressed exchange can be thought of as the initial default event.

Facing the prospect of default, corporate issuers sometimes seek to restructure their liabilities to relieve the immediate financial pressure:

- The issuer can make a tender offer, agreeing to pay cash for all or a portion of an outstanding debt security, usually at a price above the trading price, but well below the face amount
- The issuer can make an exchange offer, through which an offer is made to substitute the current outstanding securities for a new package of securities which may include: cash, new bonds, stocks, other securities, or a combination thereof
- The issuer can repurchase (either in the market or in private negotiations) just that amount of debt securities to allow it to make timely payment on the remaining outstanding securities

Only the first two of the above options consist of an exchange offer. When an issuer buys back its own debt at depressed prices in an open market transaction, there is no event of default by Moody's definitions. The key feature, for the purpose of determining distressed exchanges, is not whether the transaction is voluntary, but whether the transaction (1) is entered into to avoid an unambiguous default; and (2) the terms of the transaction are materially inferior to debt holders' existing claims.

In order to gain a consensual and rapid remedy to immediate financial distress, a firm may offer debt holders exchange terms that are substantially below their legal claims but better than what they might expect in a bankruptcy settlement. For certain subordinated debt holders such an exchange offer could mean the difference between recovering pennies on the dollar or getting nothing at all. A distressed firm uses the threat of bankruptcy to achieve a "consensual" agreement with its debt holders.

In such a circumstance, the degree to which an exchange offer is voluntarily accepted is immaterial. Such terms amount to an "offer you can't refuse" which is not the case with a typical open market transaction.

For example, European alternative telecommunications provider Colt Telecom (B3 senior implied rating - negative outlook) has continued to utilise its strong balance sheet to buy back its bonds which have been trading at a significant discount as investors question the overall viability of Colt's business plan. As of July 31, 2002 Colt had bought back approximately GBP 308mm (face or accreted principal amount) of its GBP 1,555 unsecured notes in open market transactions at prices significantly below face or accreted value.

Because Colt has over GBP 1bn in cash on its balance sheet (as of June 30, 2003; versus approximately GBP 1.2bn in debt), the company's buybacks were determined by Moody's not to be a default under the distressed exchange criteria as (1) the company was facing no liquidity issues as a result of servicing its debt burden; (2) the "exchange" was actually an opportunistic purchase of debt in the secondary market; (3) there were no accompanying re-statements to the terms of unpurchased and outstanding debt obligations. Despite the strength of Colt's balance sheet, the company's B3 rating (negative outlook) reflects the considerable uncertainty as to Colt's longer-term ability to grow its operating cash flow to a level that supports its on-going capital expenditures and service the company's debt burden.

Corporate Restructuring - Rating Implications

Once a company announces its intention to enter into a balance sheet restructuring through some type of distressed exchange or once it becomes apparent to Moody's that such an exchange will be necessary, Moody's rating will continue to reflect the high probability of default and expectations as to the recovery prospects for different creditors. Key recovery consideration factors include the following:

EXPECTED TIMING OF THE RESTRUCTURING

The expected timing of a restructuring is an important driver of recovery estimates not only from a NPV valuation perspective but also in the context of any potential funding constraints which may exist prior to completing the restructuring process and in turn may prevent value creation (from operations) during the restructuring process. In addition, significant business deterioration can occur during a restructuring as key vendors, employees, as well as both existing and targeted customers, may be lost as a result of the uncertainty surrounding the longer-term viability of a business.

Moody's ratings will reflect the likely liquidity sources afforded to a company during its restructuring negotiations and the potential impact any liquidity constraints may have on the company's operations. Furthermore, Moody's will take into consideration the fact that negotiating and carrying out a restructuring proposal can be a considerable drain on management resources (which could otherwise be more focussed on a company's operations). Finally, the potential for key employee, customer, and vendor losses during the restructuring process is an important business risk which must be taken into consideration when evaluating the future prospects of a company that is going through a balance sheet restructuring.

Case Study: NTL
Spending Cuts Can Also Be Costly

NTL Incorporated, which announced it was exploring restructuring alternatives in January of 2002, embarked on a drastic cost cutting initiative in order to conserve its liquidity during its restructuring process. The company liquidity conservation plan incorporated significant staff reductions, decreases in marketing spend, and CAPEX reductions, including a decision to only install new services to those customers that offer the most attractive economic return (higher spending customer and/or those with lower capital intensive installation requirements).

NTL's spending reductions were one of the main reasons for the significant loss of customers experienced by the company during the first half of 2002. During this period, NTL's UK consumer operations reported a loss of over 5% of their household customers amounting to over 70k customer losses per quarter. While the need to reduce cash burn was apparent, it is clear that the resulting cutbacks have resulted in negative operating trends which will eventually need to be reversed going forward.

Another point of concern with respect to NTL's prospects post-restructuring is the fact that the company is generating minimal operating cash flow (defined as EBITDA less CAPEX) despite operating the business for cash and significantly reducing capital expenditures. For the six months ending June 30, 2002 NTL reported EBITDA (after corporate expenses) of US$ 478.5 and CAPEX of US$465.6. Given the significant amount of debt (and related debt service costs) which is expected to remain with NTL (over US $7bn), the company must grow operating cash flow significantly before it is able to service even its reduced debt load and even more so before it is able to provide value for its prospective new equity holders.

NTL announced in April of 2002 that it would withhold interest payments on two note issues. One month later, the company filed for protection from creditors under Chapter 11 of US Bankruptcy Code.

SUBORDINATION ISSUES WITH RESPECT TO THE COMPANY'S CONSOLIDATED CAPITAL STRUCTURE

In a distressed exchange, subordination issues drive recovery as the allocation of any new security package typically reflects a relative distribution of value similar to that which would occur in a bankruptcy scenario[2]. This stands to reason as certain stakeholder are unlikely to agree to the terms of a distressed exchange if their relative position vis-à-vis other stakeholders is materially weaker than it would be in a bankruptcy scenario (where certain creditors may benefit from structural, effective, and/or contractual seniority). Overall, the goal of a distressed exchange is to provide improved recovery prospects (on absolute terms) for all stakeholders by avoiding the expensive and time consuming elements of a bankruptcy proceeding[3].

2. *See also Moody's Special Comment Series: Bankruptcy and Ratings: A Leveraged Finance Approach for Europe - Part II: U.K., March 2000; Part II: France, June 2000; Part III: Germany, November 2000; Part IV: Italy, May 2001; Part V: The Netherlands, November 2001*

3. *Recovery rates are negative functions of both the duration of bankruptcy and capital structure complexity. The successful coordination of (perhaps numerous) creditor classes outside a court-administered restructuring enhances recovery prospects across the capital structure, even if senior creditors offer concessions to junior creditors. See Moody's Special Comment, Debt Recoveries for Corporate Bankruptcies, June 1999.*

Recovery estimations for different classes of creditors will reflect the issuer's consolidated capital structure and resultant expectations as to the distribution of the new security package amongst different creditors. In the leveraged bond market in Europe, senior unsecured bond issues are typically located at a holding company situated above the operating company where the assets reside. As such, the senior unsecured bondholder are often subordinated to a material amount of senior debt, including senior bank facilities (which are typically secured) and trade obligations at the operating company level, thus reducing recovery prospects for the senior unsecured bondholder[4].

Moody's ratings will incorporate both issues related to the subordination to senior creditors as well as issues resulting from the potential "leakage" that may result from consideration being paid to junior stakeholders (typically equity and preferred stockholders). While these junior stakeholders may have little or no residual claim in a bankruptcy/liquidation scenario, consideration is often provided to these stakeholders in a restructuring scenario (albeit it is typically minimal) in order to expedite the process and incentivise these investors to agree with a proposed restructuring. For example, Pan-European cable provider UPC recently announced a restructuring agreement in principal whereby existing preferred and common equity shareholders would receive approximately 2% of the company's equity post-restructuring. In a bankruptcy scenario, these stakeholders would almost certainly be left with nothing.

Many of the proposed European balance sheet restructurings envisage a debt equity swap for the senior unsecured bondholders while bank debt and trade payables at the operating company are not affected. In these instances, a determination must be made as to the expected residual value to be afforded to equity holders following the proposed debt/equity conversion as a significant amount of senior obligations (and resultant debt service costs) will remain. In many cases, additional debt in the form of debtor in possession loans or other debt financing will be added to meet funding obligations during and/or after the restructuring process.

THE MIX OF CASH, NEW DEBT SECURITIES, AND EQUITY CONSIDERATION

In a distressed exchange, creditors may exchange their existing obligations for cash, new debt obligations, equity, or a combination of any or all of the three. In the European corporate market, distressed exchanges have typically taken the form of a debt for equity swap as cash resources have been required for liquidity purposes and the likely ability to support any additional debt (particularly if any material amount of senior debt remains in the capital structure) has been extremely limited (even if the debt is restructured under more favourable terms)[5].

Obviously, cash is the most easily measurable of the three potential elements of compensation. When compensation is provided with new shares or debt obligations a determination must be made as to the value inherent in these obligations. In the case of new debt obligations, creditors may be required to accept terms which may be less favourable than that which would normally be expected from a risk/return perspective. In these instances, some sort of discount should be applied to the face value of these obligations in order to more appropriately reflect the inherent value of these obligations.

The value of any equity consideration will largely be driven by the amount of debt expected to remain in the capital structure post-restructuring and the assumptions as to the expected enterprise value of the issuer and the resultant residual value afforded to equity holders.

Case Study: TASA

New Securities May be Impaired Relative to Face Value

In May of 2002, Telefonica de Argentina Sociedad Anonima (TASA; 98% owned by Telefonica SA) announced an exchange offer in which the company offered $850 principal at 9.875% with a maturity date of July 1, 2006, plus $150 in cash ($50 will be payable in connection with an early tender) in exchange for $1000 principal at 9.875% due on July 1, 2002.

While the aggregate amount of the cash and notes (face value) offered in the exchange equalled that of the original issue, the value of new bond issuance was clearly impaired (relative to face value) in Moody's opinion. Argentina's economic difficulties and the substantial financial deterioration of TASA, itself, constrained the company's ability to service its foreign currency debt. For these reasons, Moody's downgraded TASA's long-term foreign currency rating to Ca (consistent with Argentina's sovereign ceiling) from Caa1.

THE EXPECTED ENTERPRISE VALUE OF THE ISSUER

Moody's will base its assessment on a number of factors, including general industry valuations/multiples in the context of issuer-specific growth trends and future growth expectations. Moody's will examine the company's current cash

4. *See also Moody's Special Comment, Rating the Capital Structure: Moody's Approach to Rating Leveraged Loans in Europe, February 2002*
5. *The data on instrument used to satisfy bankruptcy claims in the US are informative: unsecured debt claims are satisfied with new equity and cash 68% of the time. See Moody's Special Comment, Debt Recoveries for Corporate Bankruptcies, June 1999.*

flow generating ability, if any, and then estimate what is an appropriate valuation multiple based on the company's current and Moody's forecasted growth trends.

Any benchmark EBITDA or similar operating cash flow metric will be adjusted to reflect current and expected on-going capital expenditure levels and other cash uses which are not included in EBITDA, EBIT, or other operating cash flow metrics. For example, the EBITDA valuation multiple for a European cable company, which often has a material maintenance CAPEX requirement (in order to maintain its network and replace "churned" customers), may be significantly lower than that of an industrial issuer which may have a business characterised with very low maintenance CAPEX.

Clearly, operating cash flow multiples are just one of a number of means to estimate the valuation of an enterprise and this valuation technique is not always appropriate or feasible (as many of the companies are operating cash flow negative). Other valuation metrics can be based on a discounted cash flow analysis, revenue and subscriber multiples, industry-specific benchmarks, etc. No one valuation measure is right for all companies and often a combination of different valuation techniques may be utilised for any particular company.

Prior to restructuring, a company may attempt to reduce its debt burden through asset sales -- an event which obviously also reduces the expected post-restructuring valuation of the company. While the sale of assets can afford a company additional liquidity (which may be essential for a distressed business), it can also result in the loss of a valuable asset which may generate material amounts of cash flow. Furthermore, if the assets are associated with the company's core businesses, reduced economies of scale and potential negative synergies may result. It should also be noted that the sales price of an asset may be negatively impacted by seller's need to expedite the divestiture process. Finally, asset values may be depressed if the financial difficulties of a particular issuer reflect sector-wide problems.

Recovery Prospects in the Cable/Telecom Sector are Expected to be Weak

Recovery prospects have been particularly poor for the European telecom/cable industry, as reflected in Moody's current ratings and consistent with the historic recovery experience for defaulted bonds of European telecommunication operators[6]. Any residual value afforded to bondholders through a debt to equity conversion is dependent on the prospective ability of these companies to eventually generate cash flow in their restructured form. Even after removing debt service costs, operating cash flow for almost all of the distressed European cable and telecom operators in the chart below (Exhibit 1) is insufficient to cover capital expenditures.

6. *See also Moody's default study:* ***Default and Recovery Rates of European Corporate Bond Issuers, 1985-2001****, July 2002*

EXHIBIT 1:

	Completel	Netia	Song	Versatel	NTL	UPC	Jazztel
Ratings Information							
Senior Implied	Ca	Ca	Ca	Ca	Caa2	Caa3	Ca
Outlook	Negative	Negative	Negative	Negative	Negative	Negative	Negative
Bank Debt					B2:Caa2	B3	
Senior Notes	Ca	Ca	Ca	Ca	Ca	Ca	Ca
Quarter ended 30/6/2002							
(Amounts is mm)	Euro	Dollar	Dollar	Euro	Dollar	Euro	Euro
Revenue (Q2 2002)	**24.10**	**37.46**	**60.70**	**70.45**	**916.40**	**358.92**	**56.60**
Revenue (Q1 2002)	**23.00**	**36.26**	**64.10**	**67.48**	**894.00**	**346.31**	**53.00**
Sequential growth	5%	3%	-5%	4%	3%	4%	7%
EBITDA (Q2 2002)	(6.40)	10.45	10.02	1.88	246.20	60.40	(9.4)
EBITDA (Q1 2002)	(8.00)	7.45	7.86	(3.67)	232.30	48.02	(14.90)
Sequential growth	na	40%	27%	na	6%	26%	na
CAPEX (Q2 2002)	4.70	17.99	33.81	18.55	234.40	70.75	14.30
CAPEX (Q1 2002)	10.90	22.78	26.67	17.18	231.20	102.02	21.60
Sequential growth	-57%	-21%	27%	8%	1%	-31%	-34%
CF before debt service (Q2 2002)	(11.10)	(7.54)	(23.79)	(16.67)	11.80	(10.34)	(23.70)
CF before debt service (Q1 2002)	(18.90)	(15.33)	(18.81)	(20.85)	1.10	(53.99)	(36.50)
Business description:	Headquartered in Paris, France, Completel is a facilities-based provider of local access telecom and Internet services in France and Germany.	Headquartered in Warsaw, Poland, Netia is the leading Polish alternative fixed-line telecom provider.	Headquartered in Stockholm, Sweden, Song provides broadband solutions for data, internet and voice, to large and mid-range businesses in the Nordic region.	Headquartered in Amsterdam, The Netherlands, Versatel is a facilities-based, competitive local access telecom operator with operations in The Netherlands, Belgium, and Germany.	Based in New York, NY and Hook, England, NTL is a large cable communications provider in the UK, Ireland and continental Europe.	Headquartered in Amsterdam, the Netherlands, UPC is a large cable communications provider with subscribers located in 17 European countries and Israel.	Headquartered in Madrid, Spain, Jazztel is a facilities-based Spanish telecom provider.

Notes:
Reported EBITDA may exclude restructuring costs and other non-recurring and/or non-cash expenses.
CF before debt service is for illustrative purposes and only reflects cash flow resulting from EBITDA and CAPEX.

Moody's believes that many of these operators will be extremely challenged to eventually generate positive cash flow following their proposed restructurings. Furthermore, the amount of cumulative free cash flow to be generated, if any, remains highly uncertain. Because of these factors, the expected value afforded to bondholders is minimal, as reflected in the existing ratings.

Case Study: Carrier1

Distressed Exchanges Cannot Solve the Underlying Problems of a Business

Significant business deterioration during a restructuring process can sometimes prevent a distressed exchange from being consummated. This was the case with Carrier1, a European "carrier's carrier" of telecommunications traffic, which announced an offer of cash and equity for its senior unsecured bonds on January 4, 2002. On February 1st, 2002, the company announced that it was terminating its exchange offer as a result of continued deterioration in the company's businesses. Subsequently, on February 22, 2002, the company petitioned for bankruptcy with the Luxembourg court.

Carrier1's problems were more related to the viability of its business than to issues relating to its balance sheet. In fact, Carrier1 was net debt negative as recently as March 30, 2001 (less than eight months before the company announced its intention to restructure its debt). Carrier1's business difficulties resulted from the fact that the company was almost completely exposed to the telecommunications carrier market which was characterised by intense competitive and pricing pressure (resulting from lower than expected demand and an excess of supply). As market conditions continued to deteriorate and prospects remained negative, it became apparent that Carrier1's business was not viable. On November 6, 2001, Moody's lowered Carrier1's bond rating from Caa2 to C.

Conclusion:

Distressed exchanges have been a common solution to addressing the issue of over-leveraged balance sheets in the European leveraged finance market over the past year. A distressed exchange is one of three events which Moody's defines as a default for the purpose of its default rate statistics. Importantly, Moody's uses its own definitions of default (which may differ from legal definitions) and makes its own determination as to when a default event has occurred. While Moody's ratings reflect both probability of default and severity of loss, the latter consideration becomes prevalent once it becomes apparent to Moody's that a distressed exchange will eventually be required.

Moody's believes that the severity of loss prospects for bondholders of European companies involved in distressed exchanges have generally been very high (particularly for bondholders of European telecommunication and cable companies) given relatively low enterprise valuations and a significant amount of subordination to senior creditors. Moody's will continue to evaluate the rated debt obligations of creditors involved in distressed exchanges on a case-by-case basis.

Appendix 1:

Selected European Convertible Defaults and Distressed Issuers:

Issuer	Rating	Status	Industry
Versatel	Ca	Restruct. ann'd - Oct. 2001	Telecom
UPC	Ca	Restruct. ann'd - Nov. 2001	Telecom/Cable
NTL Comm. (sr notes)	Ca	Restruct. ann'd - Jan. 2002	Telecom/Cable
NTL Comm. (conv. sub notes)	C	Restruct. ann'd - Jan. 2002	Telecom/Cable
NTL (Delaware) Inc. (conv. notes)	C	Restruct. ann'd - Jan. 2002	Telecom/Cable
Completel	Ca	Restruct. ann'd - Mar. 2002	Telecom
Jazztel	Ca	Restruct. ann'd - Apr. 2002	Telecom
Song Networks	Ca	Restruct. ann'd - May. 2002	Telecom

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