MOODY'S INVESTORS SERVICE

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Non-Financial Companies – North America

A Closer Look at Distressed Exchanges

Summary

Since the global financial crisis, distressed exchanges (DEs) have become a much more common avenue of default for non-financial companies in North America. We expect that distressed exchange will continue to be a prominent type of default as the drivers of DEs remain in place. Distressed-exchange defaults produce higher average recovery rates for investors than do defaults via missed payment or bankruptcy, according to our analysis of 322 distressed exchanges between 1990 and 2016. Further, companies that execute distressed exchanges are more likely than not to avoid a subsequent default for at least three years after the initial exchange.

» **Distressed exchanges have surged since the financial crisis.** Distressed exchanges accounted for 26% of default events in 2008, 36% in 2009 and an average of 39% from 2010-16, well above an average of 10% from 1990-2007. Eighty-seven percent of the distressed exchanges reduced debt and 40% enhanced liquidity.[1]

» **We expect distressed exchanges to continue to be a common form of default because their main drivers remain in place.** Such drivers include the presence of private equity sponsors as owners of high yield companies, the growth of the distressed debt asset class, the weakening of corporate debt covenants and the incentives of senior lenders who are often better off after distressed exchanges.

» **Distressed exchanges produce higher recoveries.** Ultimate recoveries for holders of senior unsecured bonds averaged 70% in distressed exchanges,[2] compared with 40% for bankruptcies. Other debt classes also saw higher recoveries for distressed exchanges. A likely explanation is that companies that initiated distressed exchanges were under less credit stress than those that underwent bankruptcies. In addition, issuers had to make the exchanges somewhat attractive to induce bondholders to accept them. Finally, distressed exchanges avoid costly litigation, leaving more economic value for creditors. However, for companies whose initial distressed exchanges could not avert subsequent bankruptcies, the senior unsecured bond recovery dropped further to 21% in the subsequent bankruptcies.[3]

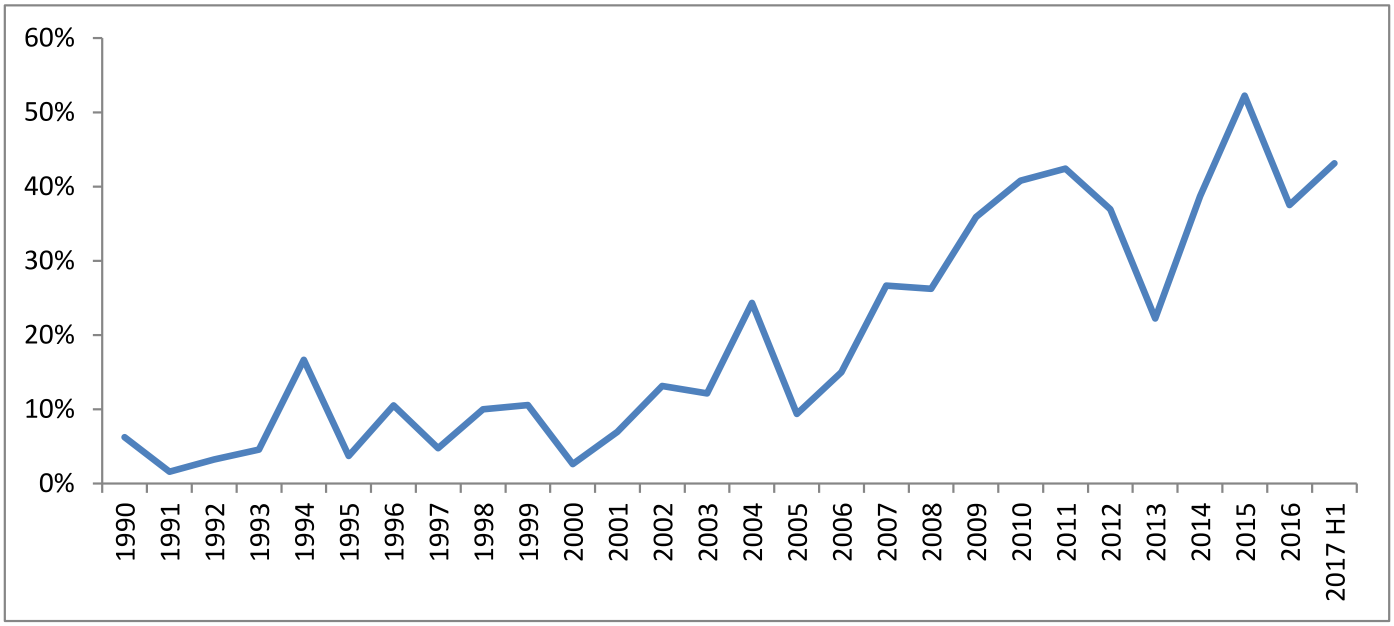
» **Two-thirds of distressed exchanges do not subsequently redefault**. Among 218 companies that completed distressed exchanges during 1990-2013, in 67% of the cases the issuer did not encounter a subsequent default within three years of the initial distressed exchange.

Distressed exchanges have surged since the financial crisis

During the Great Recession, we witnessed a wave of defaults by Moody's-rated non-financial corporations.[4] Unique to this cycle was a high incidence of distressed exchanges as they accounted for 26% of default events in 2008 and 36% in 2009, compared with 10% in 1990-2007.[5] Since then, the share of distressed exchanges has remained high at nearly 40% on average.

This surge in distressed exchanges since the financial crisis can be seen in Exhibit 1, which shows the annual share of distressed exchanges since 1990. During 1990-2016, we recorded 322 distressed exchange defaults by non-financial corporations in North America. Distressed exchanges as a share of all defaults reached a high of 52% in 2015 when an increasing number of Exploration & Production companies executed distressed exchanges following the plummet in energy prices.

Exhibit 1
Share of distressed exchanges on the rise



Source: Moody's Investors Service

The rising tide of distressed exchanges in recent years can be attributed to a number of causes including:

» The increased presence at high-yield companies of private equity sponsors and senior lenders, who tend to favour distressed exchanges;

» The growth of distressed-debt investors, who often have the intention of taking control in a distressed company by exchanging debt for equity; and,

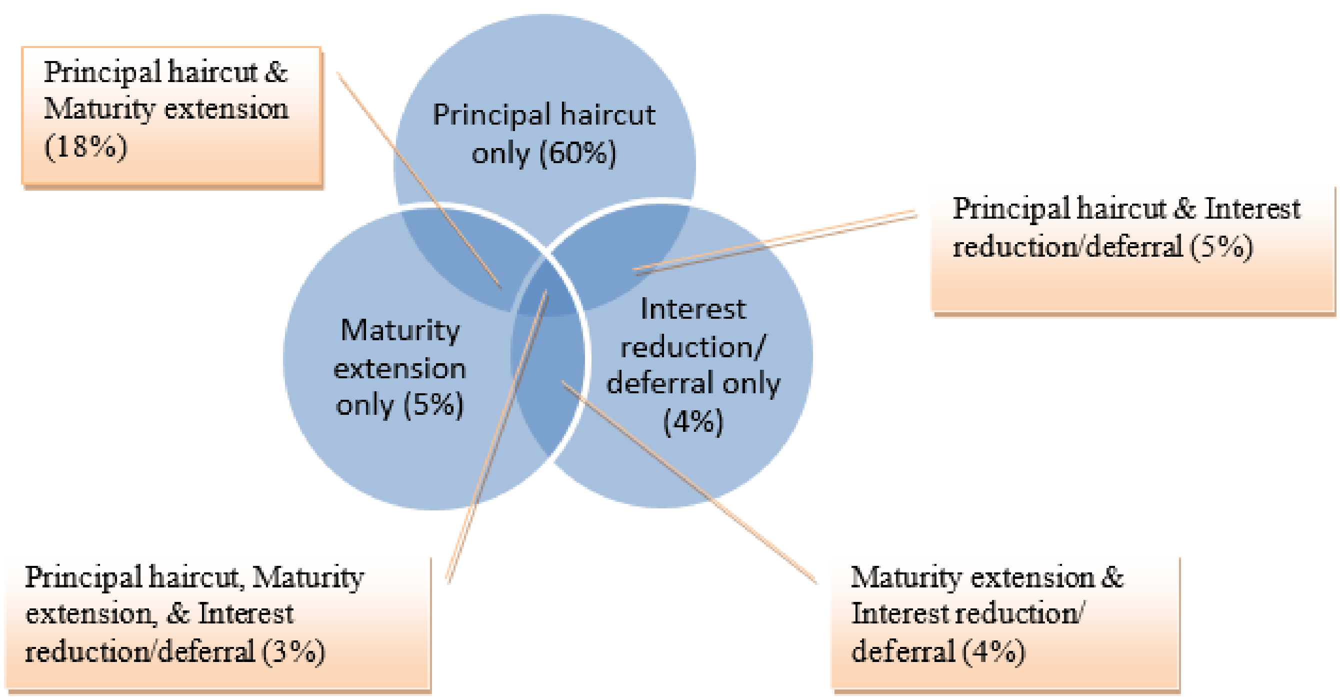
» The weakening of debt covenants, which makes it easier for companies to restructure their balance sheets.[6]

These factors have increasingly led debtors to try to restructure out of court. As these reasons are still in play, we expect distressed exchanges to continue to capture a large share of defaults.

The primary motivation for a distressed exchange is to reduce leverage. In a distressed exchange, participating debt holders receive cash, equity, new debt or a combination of the three. Among the 322 distressed exchanges in our sample, 29% were debt-for-debt exchanges, 27% were cash repurchases, 16% were debt-for-equity swaps, and the remaining 28% were some combination of cash, new debt or equity.

Eighty-seven percent of the distressed exchanges led to a principal haircut. Liquidity improvement was another common incentive: 40% of the distressed exchanges resulted in maturity extension for near-term debts, deferral of principal or interest payments, or amendments to payment terms that either converted interest payments from cash to payment-in-kind, reduced coupon rates or both. Exhibit 2 shows the distribution of distressed-exchange outcomes.

Exhibit 2
Most Distressed Exchanges Aimed at Debt Reduction



Source: Moody's Investors Service

Distressed exchanges produce higher recoveries

Distressed exchanges also produce higher recoveries for investors. In Exhibit 3, we present recovery rates for distressed exchanges and other default types measured by ultimate recoveries. The average bond recovery rates have generally been higher for distressed exchanges than for other types of default.[7] For example, the recovery rate averages 70% for senior unsecured bonds in a distressed exchange compared with 40% in a bankruptcy default. A likely explanation is that companies that initiated distressed exchanges were under less credit stress than those that underwent payment defaults or bankruptcies. This coincides with a higher average rating for senior unsecured bonds one year prior to distressed exchanges relative to non-distressed exchanges (B3 vs. Caa1).[8] Sweetening the pot further is the fact that issuers have to make the exchanges attractive to induce bondholders to accept them. Finally, exchanges avoid costly litigation, leaving more economic value for creditors.

Exhibit 3

Recovery rates by initial default type

	Distressed Exchanges		Bankruptcies	
Lien Position	Ultimate recoveries*	Observation counts	Ultimate recoveries	Observation counts
Senior Secured Bond	83%	81	60%	649
Senior Unsecured Bond	70%	372	40%	1200
Subordinated Bond**	65%	137	21%	765

* For issuers that had distressed exchanges, we assume 100% recoveries for bonds that were not part of the exchange. Excluding these bonds from recovery rate calculation will produce a recovery rate of 53% for senior unsecured bonds, which is still higher than 40% in the event of bankruptcies.

** Includes senior subordinated, subordinated, and junior subordinated bonds.

Source: Moody's Investors Service

While recoveries are high in initial distressed exchanges, they decline in subsequent bankruptcies. In Exhibit 4, we look at the change in recovery rates when distressed exchanges fail to prevent subsequent defaults. Again, calculated averages are simple averages derived from ultimate recovery database between 1990 and 2016.[9]

The exhibit shows that bond recovery rates are lower when the initial distressed exchanges fail to prevent the companies from entering into subsequent bankruptcies. For senior unsecured bonds where we have the most observations, the average recovery rate falls to 21% in the subsequent bankruptcies from 74% in the initial distressed exchanges when measured by ultimate recoveries. Note that the sample of Exhibit 4 is different from that of Exhibit 3. To be included in our calculations in Exhibit 4, we require companies to have defaulted more than once, with the same debt type present in both the initial distressed exchanges and the subsequent defaults.

Exhibit 4

Creditors lose more on post DE bankruptcies

	Initial distressed exchanges		Subsequent bankruptcies		Subsequent distressed exchanges	
Lien Position	Ultimate recoveries*	Observation counts	Ultimate recoveries	Observation counts	Ultimate recoveries*	Observation counts
Senior Secured bond	92%	21	52%	38	81%	13
Senior Unsecured bond	74%	119	21%	104	81%	19
Subordinated bond**	65%	23	15%	17	83%	3

* Non-defaulted tranches are included. If we exclude non-defaulted tranches, the average senior unsecured bond recovery rate would have been 55% in the initial DE and 64% in the second one.

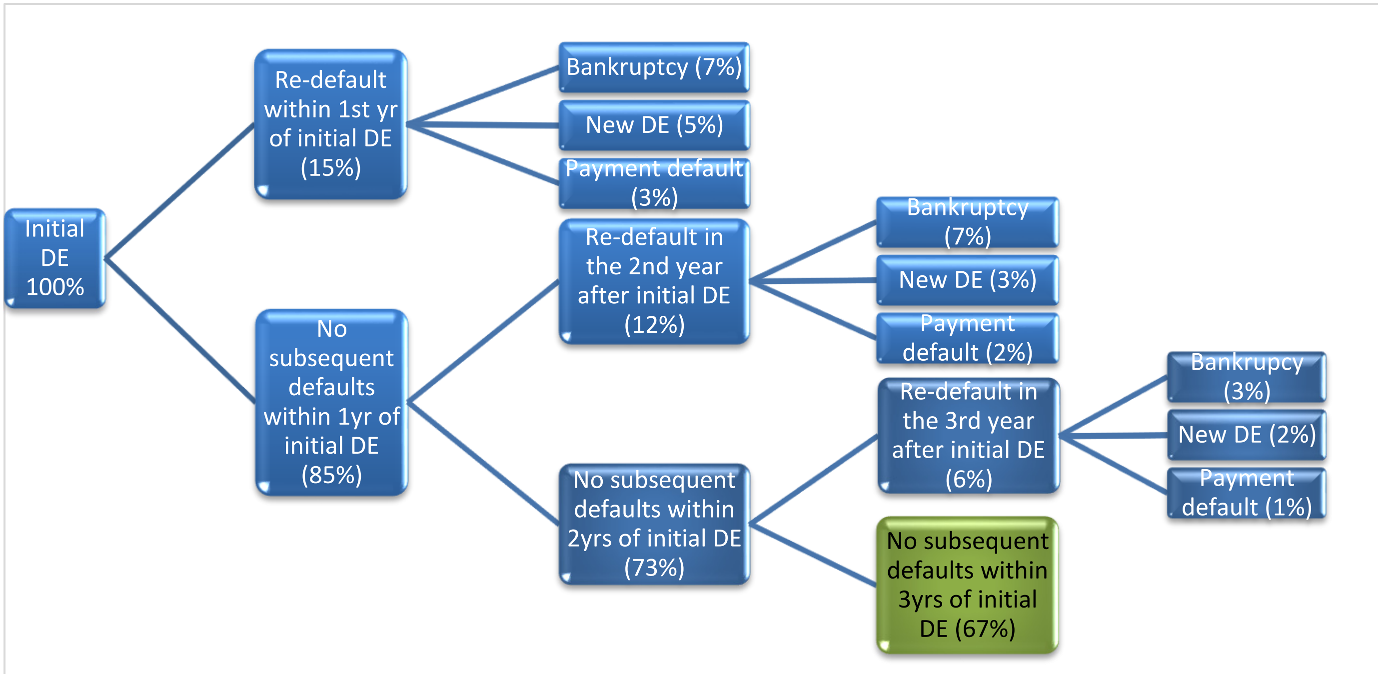
** Include senior subordinated, subordinated, and junior subordinated bonds.

Source: Moody's Investors Service

Two-thirds of distressed exchanges do not subsequently re-default

Companies that complete distressed exchanges are more likely than not to avoid subsequent default during the following three years. Thus, distressed exchanges are effective in achieving one of their primary motivations, which is to avoid bankruptcy or payment default. Among the 218 companies that remained rated after completing distressed exchanges during 1990-2013[10], 146, or 67%, of the issuers did not encounter a subsequent default within three years of the initial distressed exchange. Among the 72 companies that did subsequently default within three years of an initial distressed exchange, 51 either missed debt payments or filed for bankruptcy. Of those, 23 of the defaults occurred in the first year, 20 in the second year and eight in the third year. The data suggest that distressed exchanges helped 77% of companies avoid defaulting in the following three years while for the remaining 23% of cases, they delayed an eventual default.[11] Exhibit 5 lays out the distribution of credit experience for the 218 companies' following distressed exchanges.

Exhibit 5
Distressed exchanges are helpful in avoiding default



Source: Moody's Investors Service

While most distressed exchanges aim for improving capital structures, re-default risk can remain in place post-distressed exchanges as debt reduction tend to be smaller in out-of-court restructurings than in bankruptcies because creditors may want to crystalize losses gradually over time with the hope that losses can be smaller should the economy/business improve. In addition, companies usually keep managements and business strategies largely unchanged after distressed exchanges. In contrast, bankruptcy restructurings are more thorough and sometimes management and strategy may change. Therefore, it is not surprising that in-court restructuring are more likely to prevent a subsequent default. Of the 146 companies that remained rated at the emergence of bankruptcies before 2014, in 136, or 93%, of the cases, the emerged company did not experience a subsequent default within three years of emergence. Among the other 10 cases, seven were payment defaults or Chapter 22s.

The time lapse between the first and second defaults is also different when the initial default is a bankruptcy rather than a distressed exchange. Of the seven subsequent bankruptcies or payment defaults, none took place in the first year following the initial bankruptcy; two were recorded in the second year and five in the third. This indicates that re-default risk is low for bankruptcies relative to distressed exchanges.

Ratings performance around distressed exchanges is strong

Our ratings are low well in advance of distressed exchanges, demonstrating their predictive power. Exhibit 6 shows our issuer ratings from 36 months before the distressed exchange to one year after. The table shows that the median corporate issuer rating is lowered to B3 as early as three years prior to the distressed exchange. The comparable rating falls to Caa1 one year prior to DE and is further downgraded to Caa2 three months before default.

Exhibit 6

Median ratings around distressed exchanges

	Median ratings at X months to default									
Rating Type	-36	-24	-12	-6	-3	-2	-1	0	1	12
Issuer Rating*	B3	Caa1	Caa1	Caa2	Caa2	Caa2	Caa3	Caa3	Caa3	Caa3

* actual or implied

Source: Moody's Investors Service

Following distressed exchanges, rating actions are roughly evenly distributed between upgrades and downgrades. The percentage of issuers being upgraded within a year after a distressed exchange is 22%, which is roughly the same as the chance of downgrade over the same period. [12] The upgrades are likely due to improvements in leverage and liquidity, which suggests that some distressed exchanges result in significant improvement in the troubled companies' balance sheets. On the other hand, the downgrades indicate that some companies remained vulnerable to a subsequent default, possibly with lower recovery prospects.

Appendix

Distressed exchanges explained

Under Moody's definition, a distressed exchange occurs when 1) an issuer offers creditors a new or restructured debt, or a new package of securities, cash or assets, that amounts 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. In other words, distressed exchanges are corporate restructurings whereby creditors suffer losses relative to the original promise and the restructuring has the effect of allowing the issuer to avoid a missed a payment or bankruptcy filing.

In contrast to payment defaults and bankruptcies, which are generally straightforward credit events to identify, assessing distressed exchanges involves subjective judgment and can be complicated in some cases. Between the two components of each distressed exchange, the economic loss element is relatively easy to identify, although it is important to clarify that the economic loss should be measured against the original promise to pay rather than the market value at the time of the exchange. On the other hand, evaluating whether the purpose of the exchange is to avoid a more traditional payment default can be challenging because it is unknown whether an issuer would have defaulted had the exchange not occurred. When examining this second component of a distressed exchange, we mainly consider issuer creditworthiness and the structure of the exchange offer and look at factors such as the company's leverage, liquidity, covenant levels, the size of the offer relative to the total debt, the severity of loss being incurred, coercion of the exchange offers, as well as the source of cash used in the exchange offers. For more detail on Moody's approach to determining distressed exchanges, please see Distressed Exchanges on the Rise, May 2016.

The attractions of distressed exchanges are evident to debt issuers. The most common motivations are to improve leverage by reducing debt, to enhance liquidity by extending maturities or changing interest obligations from cash to payment-in-kind, to reduce interest burdens and to relax or remove covenant restrictions and to avoid costs in bankruptcies. With a debt-for-equity swap, for example, a company will benefit from a reduction in gearing, lower interest payments and improved liquidity. The company will therefore be in a better position to survive challenging economic times and will appear more attractive to investors. Banks will then be more likely to provide favourable credit terms when facilities come to be renewed. These benefits, which are real, come at the expense of current creditors who necessarily suffer an equivalent loss.[13]

Why would creditors agree to such exchanges and accept such losses? Clearly because they believe it is better than the alternative. First, debt holders might be offered cash and/or new securities with better-than-prevailing market prices (though still less than par). Second, some debt holders are hedge funds that have previously bought their debt at lower prices and, therefore, will see a gain rather than a loss upon accepting a distressed exchange. Finally, a company might threaten bankruptcy in a "coercive" exchange if debt holders do not accept the offer. In either case, debt holders judge the exchange offer as the better, or at least less painful, course of action.

Indeed, between distressed exchange and bankruptcy, the former is oftentimes preferred because distressed exchanges can be executed quickly and leave the company in a better operating condition. Moreover, the savings in legal and other fees can also be substantial in some cases.[14] Creditors usually expect or hope that they may recover some or even all of the amount of their lending if they choose to participate. Taking this chance may be a better prospect than recovery following insolvency procedures, which may see unsecured creditors and under-collateralized secured creditors receiving only a portion of what they are owed.

Even though distressed exchanges have many obvious advantages, they are not perfect solutions for all distressed companies. One of the challenges in distressed exchanges is the holdout problem, which occurs when one or more creditors have an incentive to reject a deal that collectively benefits all creditors.[15] If most creditors accept a lower-priority claim (like equity) while a few hold out, then the value of the now-senior claim is increased at the expense of the tendering creditors. If more creditors choose to hold out, then a company may not be able obtain enough tenders, therefore preventing a distressed exchange from going through. In contrast, under Chapter 11, as long as one-half of the creditors in each class by number, and two-thirds by value, vote to accept the plan, all claimholders are bound by the terms of the plan.

Endnotes

1 By extending maturity, deferral of principal/interest payments, changing payment terms from cash-pay to PIK etc.

2 This number assumes a 100% recovery rate for senior unsecured bonds that an issuer excludes from its distressed exchange offer. The average will be noticeably lower at 53% if we exclude such senior unsecured bonds from the calculation.

3 For buy and hold investors who are offered a distressed exchange, they are better off with DEs that significantly improve companies' balance sheets and avoid subsequent defaults. On the other hand, they are worse off with initial DEs that fail to prevent the companies from subsequent bankruptcy filings.

4 The universe of this study is Moody's-rated North American non-financial corporates including utilities.

5 The share of distressed exchange were high in 2004 and 2007 but there were only nine distressed exchanges in 2004 and four in 2007.

6 See A Rising Tide of Distressed Exchanges, Moody's Special Comment, May 2016.

7 As loans are usually not involved in most distressed exchanges, we focus on bond recoveries in this table.

8 During 2008-2016.

9 Moody's Ultimate Recovery Database now covers approximately 5,500 debt instruments from more than 1,100 defaulted North American companies, with total liabilities exceeding $1 trillion.

10 We exclude distressed exchanges in 2014-2016 because not enough time has elapsed to determine whether a subsequent default will occur within a three-year time frame.

11 Distressed exchanges are typically not legal defaults.

12 Here, we compare the rating from the date when a company exits a distressed exchange to one year after. We ignore cases where the rating is withdrawn during that period. The percentage of issuers being upgraded (or downgraded) only reflects the direction as opposed to magnitude of the rating changes.

13 See more details in Distressed Exchanges on the Rise, May 2016.

14 Gilson, S., John, K., and Lang, L. found that out-of-court restructurings were considerably less costly than bankruptcies to the Debtor firm in troubled debt restructurings: an empirical study of private reorganization of firms in default, 1990.

15 See Roe, The voting prohibition in bond workouts, 1987.

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