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SECTOR IN-DEPTH
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Non-Financial Corporates - Global

Distressed Exchanges on the Rise

» **Distressed exchanges are on the rise.** The frequency of distressed exchanges as a share of total defaults has increased in recent years as out-of-court restructurings have become more attractive relative to in-court insolvency proceedings such as US Chapter 11. Factors driving the increase include the greater presence of private equity sponsors as owners of rated high yield companies, the growth of the distressed debt asset class, the weakening of corporate debt covenants, and tighter credit access for companies in bankruptcy.

» **Distressed exchanges capture credit events**. We include distressed exchanges in our definition of default in order to capture credit events whereby issuers effectively fail to meet their debt service obligations but do not actually file for bankruptcy or miss an interest or principal payment. These events are similar to out-of-court restructurings.

» **Our forecast calls for approximately 150 defaulters over the next 12 months**. We currently forecast that the global speculative grade default rate will increase to 4.6% in April 2017 from 4.0% in April 2016. This baseline forecast implies approximately 150 defaulters over the next twelve months. Given current distress in the energy sector and the increasing number of Exploration & Production companies executing distressed exchanges, we estimate that distressed exchanges will constitute about half of all defaults in the coming year, up from an average of near 40% since 2009. As a result, we expect approximately 75 distressed exchanges over the next 12 months, which would represent a 50% increase from the 50 distressed exchanges recorded during the last 12 months.

» **We use a fundamental approach in assessing potential distressed exchanges**. Our approach for determining whether a transaction is a distressed exchange employs fundamental credit analysis to assess whether two necessary and sufficient criteria for distressed exchanges are met: 1) does the transaction allow the issuer to avoid an eventual default event? and 2) does the transaction result in a loss to creditors relative to the value of the debt obligation's original promise?

Distressed exchanges on the rise

The frequency of distressed exchanges as a percent of total Moody's defaults has increased sharply to nearly 40% of defaults on average since 2009, up from 10% on average in the years prior to 2009 (see Exhibit 1). In 2015, for example, distressed exchanges made up 42% of all Moody's defaults globally. (See Distressed Exchanges Remain Frequent, Thanks to Oil and Gas, PE Firms).

A number of factors have contributed to the rising tide of distressed exchanges in recent years, making it more likely that distressed companies and their creditors will continue restructuring out of court to avoid the often-costly and uncertain outcomes associated with lengthy in-court insolvency proceedings. Certainly, by reaching voluntary out-of-court restructuring settlements, shareholders and company managements can benefit by avoiding insolvency proceedings that often make equity worthless and can further reduce the value of a company's assets and operations. Factors that have contributed to the rise of distressed exchanges include:

» **The increased presence of private equity sponsors as owners of rated high-yield companies**. Such owners often have relatively more experience and resources when it comes to negotiating with banks and other creditors. Our studies have shown that companies owned by private equity sponsors are more likely to execute distressed exchanges than other companies with non-sponsor owners.

» **The ongoing development of the high-yield debt markets and the growth of distressed debt investors**. The growth of distressed debt investors has increased the number of buyers of distressed assets. Such buyers of distressed debt, for example, may have the express intent of taking a controlling equity stake in a distressed company (i.e., exchanging debt for equity) or simply earning a high return on debt purchased in the secondary market.

» **The weakening of covenants**. Weaker covenants in recent years makes it easier for companies to restructure their balance sheets. For example, the lack of negative pledge covenants in senior unsecured bond indentures can make it easier for companies to successfully execute a bond exchange in which more senior (typically second-lien) debt is offered in exchange for unsecured debt, effectively subordinating bond holders who do not participate.

» **Tighter credit access for companies in bankruptcy**. Compared to the period prior to the financial crisis, terms of credit access have generally been tighter for companies in bankruptcy seeking to obtain financing (e.g., debtor in possession loans), thereby increasing the costs and uncertainties associated with bankruptcy. While credit conditions for debtor in possession financing have eased in the last couple of years, maturities remain shorter and interest rates higher than they were before the financial crisis.

» **The severity of the 2008-09 downturn and the current distress among E&P companies**. Knowing that eventual credit losses are highly probable, and given the uncertainty around eventual outcomes in bankruptcy, distress creates incentives for both companies and creditors to negotiate out-of-court restructurings. Additionally, the wave of distressed exchanges that occurred during and immediately following the financial crisis demonstrated the cost saving benefits of such restructurings.

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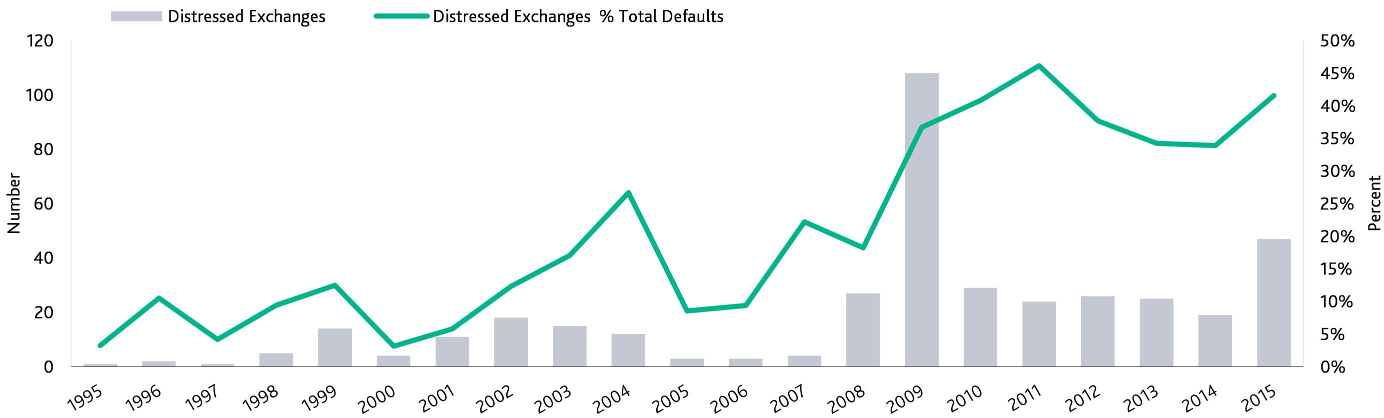
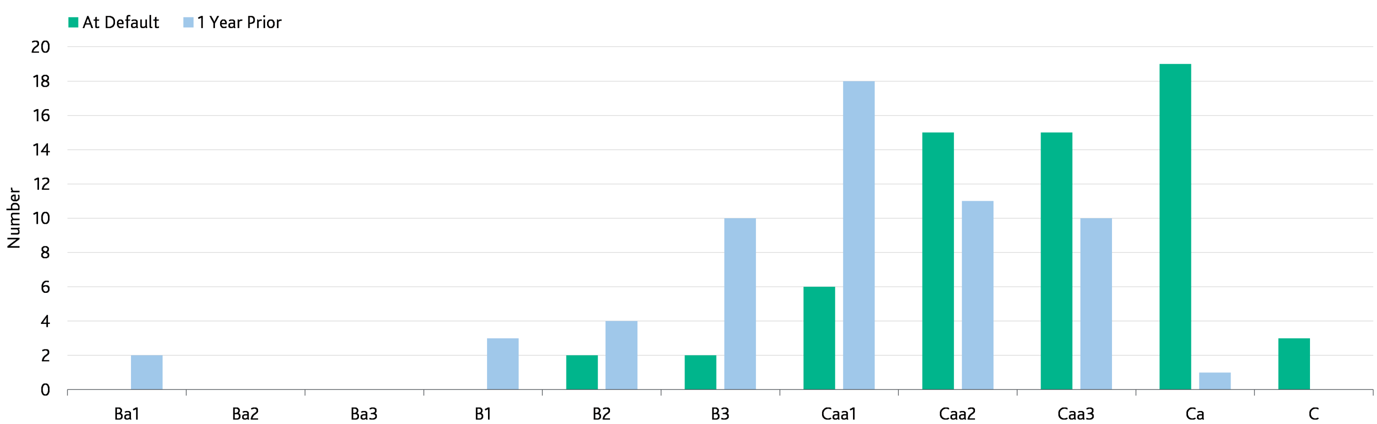
Exhibit 1
A Rising Tide of Distressed Exchanges



Source: Moody's Investors Service

Of the 62 distressed exchanges completed since January 2015, 28 (45%) were completed by energy companies, mainly in the exploration and production industry. As reflected in Exhibit 2, 40 of the 62 (65%) companies had senior unsecured ratings of Caa1 or lower one year prior to their distressed exchange. Only two companies had ratings higher than B1 one year prior to their distressed exchange. These two companies were Chesapeake Energy Corporation (Caa2 negative) and California Resources Corp. (Caa1 negative), both rated Ba1 one year prior. Both companies reduced debt by executing exchanges of senior unsecured notes for 2nd lien secured notes whereby holders realized significant losses. Also shown in Exhibit 2, 52 of the 62 (84%) companies had ratings of Caa2 or lower at the time of default. The Appendix on page 8 includes a list of all Moody's distressed exchanges globally since January 2015.

Exhibit 2
Low Ratings for Issuers in Advance of Distressed Exchanges



Source: Moody's Investors Service

Distressed exchanges are default events

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

a) a missed or delayed disbursement of interest or principal payment;

b) a bankruptcy filing or legal receivership by the issuer that will likely cause a miss or delay in future contractually-obligated debt service payments;

c) 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;

d) a change in the payment terms of a credit agreement or indenture imposed by the sovereign that results in a diminished financial obligation, such as a forced currency re-denomination (imposed by the debtor, himself, or his sovereign) or a forced change in some other aspect of the original promise, such as indexation or maturity.

Our definition of default is intended to capture events whereby 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 payment terms of its debt obligations.

We include distressed exchanges in our definition of default in order to capture credit events whereby issuers effectively fail to meet their debt service obligations, but yet do not actually file for bankruptcy or miss an interest or principal payment.[1] These events can be thought of as being similar to out-of-court restructurings. As such, distressed exchanges are usually voluntary transactions that are in the best interests of both issuers and creditors, allowing issuers to reduce debt burdens and allowing creditors to accept an economic loss that they perceive as likely being smaller than the loss that would result in the absence of an exchange.

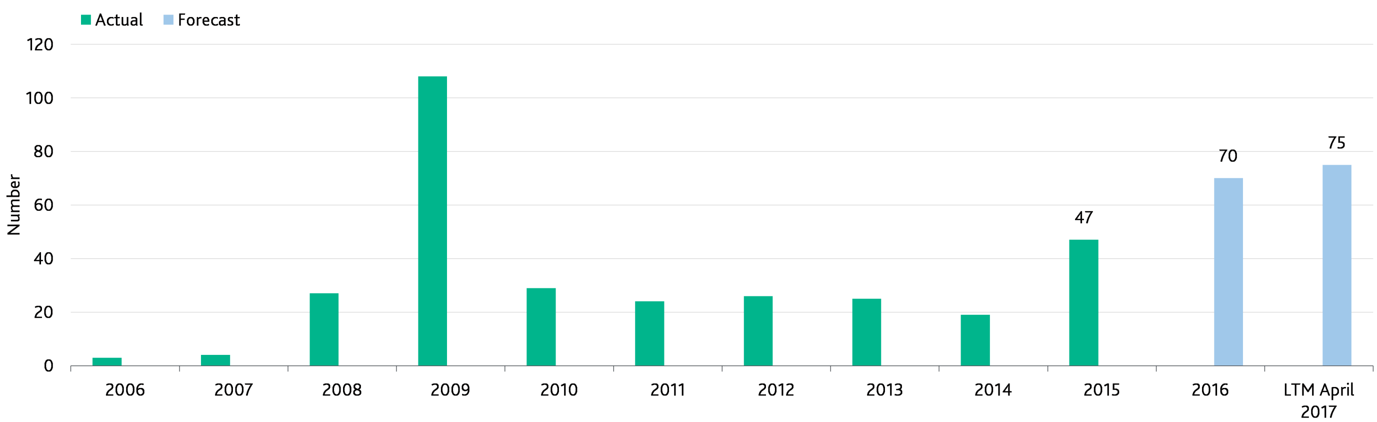
Moody's interprets the term "debt exchange" broadly. All formal debt exchanges and tender offers are potential candidates for distressed exchanges. Additionally, open market and bilateral negotiated purchases of debt are also possible candidates for distressed exchanges. Distressed exchanges are applicable to the debts of all types of issuers including, corporate, sovereign, public finance, structured finance, and project finance issuers.

Outlook for distressed exchanges

Moody's projects that the global speculative grade default rate will increase to 4.6% in April 2017 up from 4.0% in April 2016. This baseline forecast implies approximately 150 defaulters over the next twelve months. Given the current distress in the E&P sector and the increasing number of E&P companies executing distressed exchanges in recent months, we estimate that distressed exchanges will constitute about half of all defaults in the coming year, up from the 40% average since 2009. As shown in Exhibit 3, this translates to approximately 75 distressed exchanges over the next 12 months – a 50% increase from the 50 distressed exchanges recorded during the last 12 months.

Exhibit 3

Distressed Exchanges Expected to Increase in 2016 and 2017



Source: Moody's Investors Service

Moody's approach to evaluating potential distressed exchanges

While missed payments and bankruptcy filings are relatively straightforward events to identify, recognizing distressed exchanges is more subjective and challenging. We can never know with certainty whether an issuer would have defaulted if a particular exchange had not occurred. As a result, evaluating whether an exchange constitutes a "distressed exchange" involves credit judgment.

For an exchange to be distressed, it must have the effect of allowing the issuer to avoid a likely eventual payment default or bankruptcy. Default avoidance can be grouped into two categories:

1. The exchange addresses near-term liquidity pressures that may be driven by maturities or a high likelihood of covenant default that leads to debt acceleration.

2. The exchange alleviates a capital structure that Moody's views as being untenable over the medium term.

Importantly, upcoming debt maturities are not required for Moody's to make a determination that an exchange is distressed. As a general matter, many factors other than debt maturities can cause default, including liquidity or covenant issues and voluntary bankruptcies that are made in the recognition that eventual default is likely despite the lack of current liquidity pressure, or for other strategic purposes.

In assessing whether the effect of the exchange is to allow the issuer to avoid default, we consider the issuer's present and future creditworthiness and the structure of the exchange offer. Often both of these factors need to be examined collectively in context when assessing default avoidance.

A. Issuer creditworthiness

Using fundamental credit analysis, we examine an issuer's creditworthiness in order to assess whether the issuer faces financial distress as indicated by either liquidity pressures or debt service burdens that we view as likely to be untenable over time. For example, for nonfinancial corporate issuers, credit measures we consider on a forward-looking basis typically include leverage, liquidity, profitability, and cash flow. Debt maturity and interest payment schedules over the medium term are also examined as part of Moody's assessment of the issuer's ability to meet future debt service payments.[2]

More generally, Moody's ratings have strong information content regarding issuer creditworthiness. Consequently, a good indicator of creditworthiness is the rating committee assessment when the pending exchange transaction and other updated circumstances have been factored into the rating for the issuer, or the instrument rating in the case of structured finance transactions. Historically, the vast majority of distressed exchanges have involved issuers rated Caa1 or lower at the time of their default, with few instances in which a rating was higher than B2 at the time of default.

B. The structure of the exchange offer

The structure of an exchange offer usually informs as to the effect of the offer, especially when it is viewed in combination with the issuer's current creditworthiness. As such, in assessing default avoidance, we closely examine the characteristics of the offer, including:

» The size of the offer relative to the total debt of the issuer often informs as to the impact of the underlying offer on the issuer. In general, small exchange offers usually do little to improve the creditworthiness of an issuer, unless such an offer is specifically motivated to avoid a small looming debt maturity. As a result, other things being equal, the larger the offer as a proportion of the issuer's total debt and, therefore, the more significant the debt reduction for the issuer, the more likely Moody's is to determine that an exchange offer is a distressed exchange. [3]

» The severity of loss (relative to the original promise) being incurred by the creditors participating in the exchange offer often signals investors' expected likelihood of default absent the exchange offer. Larger discounts relative to par, as measured by market prices, signal a market perception that the issuer is less likely to be able to meet its debt obligations. Moody's makes its own fundamental credit assessment rather than relying upon the market's view as indicated by market prices – but our assessment does consider the eventual liquidity implications of a market view that suggests future difficulties in selling new debt to repay existing debt in cash and on time.

- Exchange offers involving subordination or other forms of coercion are, other things being equal, more likely to be viewed as distressed exchanges. Coercion not only signals that creditors are likely to incur losses, but can also signal that the issuer has few financing alternatives and that the effect of the offer is to allow the issuer to avoid default.
- The source of any cash used in an exchange offer may also signal that default avoidance is the effect of the exchange. If new cash is being raised externally in the debt markets, this can signal that the issuer has access to the debt markets and is not in distress. On the other hand, if an existing revolver is being drawn down to finance a discounted tender offer, this can indicate a further tightening of already constrained liquidity.
- Exchange offers involving only cash are, other things equal, less likely to be viewed as distressed exchanges because cash availability typically signals some measure of issuer liquidity. However, there are instances of distressed exchanges where an issuer has ample cash for its needs over the next several years but is viewed by Moody's as being likely to have difficulty meeting its obligations over the medium term. Conversely, exchange offers that are strictly debt-for-debt or debt-for-equity exchanges are, other things being equal, more likely to be viewed as distressed exchanges.

Assessing whether there is an economic loss to creditors

The two necessary and sufficient conditions for an exchange to be deemed a distressed exchange are 1) the exchange has the effect of allowing the issuer to avoid default and 2) creditors incur economic losses relative to the original promise to pay as a result of the exchange. Importantly, the potential for loss is measured relative to the original promise (i.e., par value) and not measured relative to current market prices, as default determination is made on the basis of whether issuers fulfill their original promises to pay.

When market trading prices are available, we often uses these prices to assess whether creditors are incurring a loss as a result of the exchange. For example, if exchanging debt is trading at a substantial discount to par just prior to the closing of the exchange, the implication is that creditors are usually incurring significant losses. [4] [5]

In addition to market prices, and when market prices are not available, we also employ fundamental analysis to evaluate whether an exchange offer provides full par value for the exchanging debt. This analysis can include examining factors such as the estimated economic value of the company's assets and cash flow relative to its liabilities, whether coercion is inherent in the exchange offer, and whether creditors are being compensated at a level that would theoretically be sufficient to induce new investors to purchase the debt that is being exchanged.

Three examples of distressed exchanges

To illustrate our approach to distressed exchange determination, we highlight three hypothetical alternative transactions that if made by an issuer with very weak credit metrics would be viewed as distressed exchanges. Specifically, consider a representative issuer rated Caa1 or Caa2 with very weak credit metrics, suggesting an untenable capital structure and a relatively high probability of default over the next several years. Furthermore, consider that this issuer is contemplating three alternative transactions involving its senior unsecured bonds that make up approximately 30% of its total debt.

1. **Debt for Debt**: In a par for par exchange, the issuer exchanges bonds due in three years for bonds due in seven years, where all other terms (other than the maturity date) remain identical to those on the old bonds. Furthermore, at the time of the exchange the existing old bonds are trading at a deep discount, implying a very high yield to maturity. Following a fundamental assessment of the issuer's creditworthiness, we conclude that default avoidance is present because the maturity extension likely allows the issuer to avoid a default in three years when the bonds mature. Loss is present because the holders of the old bonds are not being compensated for extending the original maturity date, receiving the same coupon despite a significant increase in credit risk following original issuance of the bonds. Since the old bonds can be exchanged into the new bonds, the current trading price on the old bonds also indicates that the value of the new bonds represents a diminished promise relative to original promise under the old bonds (i.e., par at maturity). Since both criteria for distressed exchanges are present, we would classify this transaction as a distressed exchange.
2. **Cash for Debt**: In this case, rather than a debt for debt exchange, the issuer offers to purchase the investors' bonds in the open market at the discounted market price, implying a very high yield to maturity. In this case, if a large portion of the old bonds are purchased, default avoidance is present because in our view the purchases have the effect of allowing the issuer to materially

reduce its untenable debt and help the company avoid an eventual default. Loss is present because the bonds are being purchased at a significant discount to par. As a result, despite liquidity being adequate and the purchases being voluntary, we view these purchases as a distressed exchange because both loss and default avoidance are present.

3. **Debt for Equity**: In this case, the issuer offers to exchange its senior unsecured bonds for equity in the company where the market value of the equity offered is at a discount to the par value of bonds. Assuming a large portion of the bonds are exchanged, the exchange has the effect of allowing the issuer to avoid default given the reduction in the issuer's debt as a result of the exchange. Loss is present because the current market value of the equity received is less than the original promise under the bonds (i.e., par at maturity). Even in cases where the current market value of the equity offered is equal to or greater than the par value of the bonds, we may view a loss being incurred if we believe that holders would be unable to immediately monetize their equity holdings at par value. Since the old bonds can be exchanged for equity, a current discounted trading price on the bonds also implies a loss relative to the original promise under the bonds. This debt for equity swap, therefore, would also be a distressed exchange since both default avoidance and loss are present.

Appendix: Distressed Exchanges Since January 2015

Company	Default Date	Domain	Industry	Rating at Default	Rating 1 Year Prior
NYDJ Apparel, LLC	6/29/2015	United States	consumer products: apparel & shoes	Caa3	Caa1
Boardriders S.A.	3/9/2016	Luxembourg	consumer products: apparel & shoes	Caa1	
Wilton Brands LLC	8/24/2015	United States	consumer products: household & personal care	C	Caa3
Heckler & Koch GmbH	11/16/2015	Germany	defense: equip	Caa3	Caa3
Alpha Natural Resources, Inc	4/1/2015	United States	energy: coal	Caa2	B3
Venoco, Inc.	4/2/2015	United States	energy: oil & gas - expln & prodn	Caa2	Caa1
Halcon Resources Corporation	4/13/2015	United States	energy: oil & gas - expln & prodn	Caa2	Caa1
Midstates Petroleum Company Inc.	5/21/2015	United States	energy: oil & gas - expln & prodn	Caa2	Caa1
Warren Resources, Inc.	5/26/2015	United States	energy: oil & gas - expln & prodn	Caa1	
American Energy - Woodford, LLC	6/25/2015	United States	energy: oil & gas - expln & prodn	Ca	
Lightstream Resources Ltd	7/14/2015	Canada	energy: oil & gas - expln & prodn	Ca	Caa1
SandRidge Energy, Inc.	8/14/2015	United States	energy: oil & gas - expln & prodn	Caa2	B2
Goodrich Petroleum Corporation	9/8/2015	United States	energy: oil & gas - expln & prodn	Caa2	Caa1
Energy XXI Gulf Coast, Inc.	9/29/2015	United States	energy: oil & gas - expln & prodn	Caa3	B3
Comstock Resources, Inc.	9/30/2015	United States	energy: oil & gas - expln & prodn	Caa2	B3
Warren Resources, Inc.	10/22/2015	United States	energy: oil & gas - expln & prodn	Caa3	Caa1
EXCO Resources, Inc.	10/26/2015	United States	energy: oil & gas - expln & prodn	Caa3	B3
Linn Energy, LLC	11/20/2015	United States	energy: oil & gas - expln & prodn	Caa3	B1
Sheridan Investment Partners II, LP	11/25/2015	United States	energy: oil & gas - expln & prodn	Caa3	Caa2
California Resources Corp.	12/15/2015	United States	energy: oil & gas - expln & prodn	B2	Ba1
Chesapeake Energy Corporation	12/30/2015	United States	energy: oil & gas - expln & prodn	B3	Ba1
Sheridan Investment Partners I, LLC	1/12/2016	United States	energy: oil & gas - expln & prodn	Ca	B3
Vanguard Natural Resources, LLC	2/8/2016	United States	energy: oil & gas - expln & prodn	Caa2	B3
PetroQuest Energy, Inc	2/17/2016	United States	energy: oil & gas - expln & prodn	Ca	Caa1
Jones Energy Holdings, LLC	2/29/2016	United States	energy: oil & gas - expln & prodn	B3	B3
Rex Energy Corporation	3/31/2016	United States	energy: oil & gas - expln & prodn	Ca	Caa1
Stallion Oilfield Holdings, Inc.	12/31/2015	United States	energy: oil services	Ca	Caa3
Ion Geophysical Corporation	4/28/2016	United States	energy: oil services	Caa3	Caa2
Drill Rigs Holdings Inc.	12/6/2015	Marshall Islands	energy: oil services - drilling	Ca	Caa1
Ocean Rig UDW Inc.	12/6/2015	Cyprus	energy: oil services - drilling	Caa3	Caa1
Sidewinder Drilling Inc.	2/12/2016	United States	energy: oil services - drilling	Ca	Caa1
CHC Group Ltd.	8/3/2015	Canada	energy: oil services - offshore support transprtn	Caa1	Caa1
Liberty Tire Recycling Holdco, LLC	3/5/2015	United States	environment: waste management	Ca	Caa2
Nuverra Environmental Solutinos, Inc.	4/15/2016	United States	environment: waste management	C	Caa2
Verso Paper Holdings LLC	1/7/2015	United States	forest products: pulp & paper	Ca	B3
Norske Skogindustrier ASA	2/23/2015	Norway	forest products: pulp & paper	Caa3	Caa3
Norske Skogindustrier ASA	4/11/2016	Norway	forest products: pulp & paper	Ca	Caa3
Constellation Enterprises, LLC	1/28/2016	United States	manufacturing: component - div	Ca	Caa2
Getty Images, Inc.	12/10/2015	United States	media: media services	Caa3	Caa2
Ferrexpo Plc	2/23/2015	Switzerland	metals & mining: metal mining	Caa2	Caa1
Cobre del Mayo, S.A. de C.V.	1/28/2016	Mexico	metals & mining: metal mining	Ca	B3
Cliffs Natural Resources Inc.	3/2/2016	United States	metals & mining: metal mining	C	B1
Zlomrex S.A.	12/24/2015	Poland	metals & mining: steel & specialty metals	Caa2	Caa2
Prospect Holding Company, LLC	3/8/2016	United States	mortgage finance	Caa2	B2
Community Choice Financial Inc.	1/31/2016	United States	non finance conduit	Caa1	Caa1
Savings Bank of Ukraine	9/1/2015	Ukraine	non-u.s. bank	Ca	Caa3
Russian Standard Bank	10/28/2015	Russia	non-u.s. bank	Caa2	B2
Bank Uralsib	11/16/2015	Russia	non-u.s. bank	Caa1	B2
General Shopping Brasil S.A.	10/22/2015	Brazil	real estate finance: reit	B2	B1
Logan's Roadhouse Inc.	10/14/2015	United States	restaurants: family dining	Ca	Ca
Edcon Holdings Limited	7/29/2015	South Africa	retail: department stores	Ca	Caa2
Gymboree Corporation (The)	3/31/2016	United States	retail: specialty	Caa3	Caa3

Company	Default Date	Domain	Industry	Rating at Default	Rating 1 Year Prior
Edmentum, Inc.	6/10/2015	United States	services: business	Caa2	B3
Affinion Group Holdings, Inc.	11/9/2015	United States	services: business	Ca	Caa3
Education Management LLC	1/5/2015	United States	services: consumer	Ca	Caa2
Town Sports International, LLC	12/31/2015	United States	services: consumer	Caa3	Caa1
Emeco Holdings Limited	12/15/2015	Australia	services: rental services	Caa2	Caa1
ELO Touch Solutions, Inc.	9/25/2015	United States	technology: hardware	Caa3	Caa3
Maxcom Telecomunicaciones, S.A.B. de C.V.	9/30/2015	Mexico	telecommunications: wireline	Caa2	Caa2
DTEK ENERGY B.V.	4/29/2015	Ukraine	utility: unreg - electr&natural gas	Ca	Caa2
Shale-Inland Holdings, LLC	9/29/2015	United States	whlsl dstrbtn: metals	Caa1	Caa1
A.M. Castle & Co.	2/9/2016	United States	whlsl dstrbtn: metals	Caa3	Caa3

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Endnotes

1 See Rating Symbols and Definitions on Moodys.com for more information on distressed exchanges and default.

2 As a structured finance security is typically issued out of a special purpose vehicle (SPV), there is no long lived underlying issuer of a structured finance security that benefits from a distressed exchange (i.e., reduced debt service obligations) in ways that a fundamental issuer does. The SPV exists only for the life of the structured finance security. As a result, structured finance exchanges, including amendments, can take place for a variety of reasons that often may involve different preferences and rights among different creditor classes or even the preferences of a servicer or intermediary. As such, assessing whether an amendment or exchange of a structured finance security amounts to a distressed exchange can be even more dependent on the unique circumstances and factors involved in the exchange.

3 Exchanges may involve a substantial portion of the issuer's debt and be analogous to an out-of-court restructuring that alleviates an untenable capital structure. In other cases, issuers may execute a series of relatively small exchanges over time to achieve the same ultimate purpose and Moody's will deem the earliest significant transaction (or the earliest significant cumulative aggregation of multiple very small transactions) as being a distressed exchange.

4 While discounts to par do not necessarily reflect distress or expected credit losses, they do reflect that the market value of the debt is currently less than the par value of the debt (i.e. the original promise to pay). For example, debts may be trading at less than par due to increases in the level of interest rates after origination.

5 As a result, nominal exchanges of debt for non-cash consideration at par values can still imply creditor losses if the exchanging debt is currently worth less than par.

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