Article Title: ARCHIVE | Criteria | Corporates | Recovery: Bank Loan Ratings Methodology Applied in England Data: Since Standard & Poor's started assigning bank loan ratings at the beginning of 1996, the number of ratings has been growing consistently. Total loan facilities rated now stands at 1,100, equivalent to debt outstanding of $631 billion. Although the majority of ratings has been in the U.S., now increasing numbers are being assigned in other countries. As of March 2000, 114 bank loan ratings have been assigned outside of the U.S., with an aggregate value of $106 billion. The growth in loan ratings has been stimulated by increased portfolio management, secondary loan trading, use of credit derivatives, institutional investor participation, popularity of collateralized loan obligation/collateralized bond obligation funds, and use of rating pricing grids in loan facilities. Bank loan ratings are issue-specific ratings that take into account the likelihood of full recovery of the rated obligation. Accordingly, where full recovery is expected, bank loan ratings can be "notched" above an issuer's corporate credit rating, which evaluates an issuer's overall capacity to pay its financial obligations. To gain any enhancement above the corporate credit rating, it is usually expected that full recovery will occur within 24 months. The extent of the enhancement depends on several factors, including: Level of collateralization, Nature of the assets given as security, Structure and terms of the obligation, Expected speed of recovery, and Legal environment. Rating Upgrades Most recently, Standard & Poor's raised the bank loan ratings of four U.K. corporate issuers: Capital Shopping Centres PLC, COLT Telecom Group PLC, IPC Magazines (U.K.) Ltd., and Regional Independent Media Funding 2 Ltd. In each case, Standard & Poor's considers that the nature of the security given to lenders, the potential value of assets on default, and the enhanced likelihood of 100% recovery within a relatively short time warrant ratings of a higher level than the corporate credit ratings. Standard & Poor's also believes that the security granted to lenders gives a degree of confidence that there would be full recovery. Secured lenders to Capital Shopping Centres benefit, for instance, from significant overcollateralization from income-producing properties, while IPC Magazines and Regional Independent Media own the rights to a number of valuable and saleable publications in addition to physical operating assets, and COLT benefits from a relatively small loan secured by a high level of assets. Table 1 English Corporate Bank Loan Rating Changes COMPANY REVISEDBANK LOAN RATING PREVIOUS BANK LOAN BANK LOAN CORPORATE CREDIT RATING Capital Shopping Centres PLC AA- A+ £172.5 mil secured facility A/Stable/A-1 IPC Magazines (U.K.) Ltd. BB- B+ £430 mil secured facility B+/Stable/-- Regional Independent Media Group PLC.* BB- B+ £175 mil secured facility B+/Stable/-- COLT Telecom Group PLC BB- B+ £75 mil secured facility B+/Stable/-- *Via special-purpose vehicle. English Bankruptcy Regime These rating actions follow a review of the English. bankruptcy regime as it relates to creditors. Although this article is not a legal opinion, Standard & Poor's believes that the bankruptcy regime in England tends to be more friendly to creditors than several other systems, including those of the U.S. and France. The result is that, in England, secured creditors can have access to their security quickly and determine acceptable asset values subject to market conditions. The review also concluded that English companies that have defaulted or are in a workout situation are more likely to be liquidated than reorganized. Therefore, in most cases, a liquidation or break-up analysis of the collateral is a more appropriate approach to understanding recovery prospects than an enterprise valuation, which assumes the company will be reorganized or sold. Table two, which shows a full list of English secured bank loan ratings, demonstrates that the norm for a bank loan is to be rated at the same level as the corporate credit rating. Where bank loan ratings are not "notched-up" from the corporate credit rating, Standard & Poor's is uncertain that full recovery could be achieved, despite the level of security. Reasons for this uncertainty include: The extent of likely deterioration in the value of assets in a default or workout scenario; Assets that are largely intangible and, therefore, subject to rapid falls in value in a distress scenario; The high level of bank debt compared with the value of the security; and Assets located in jurisdictions where the legal environment is less friendly to creditors. Standard & Poor's previously reviewed the French legal system, and concluded that, in France, upward notching of ratings from the corporate credit rating is unlikely. Standard & Poor's will undertake a review of other European legal systems in the future to ascertain whether or not notching-up might be applied in other countries. It is worth noting, however, that even when bank loan ratings are not notched-up, secured lenders usually can expect to recover considerably more than a typical unsecured creditor. Table 2 U.K. Companies With Bank Loan Ratings

COMPANY BANK LOAN RATING CORPORATE CREDIT RATING Associated Octel Company Ltd.(The)* BB+ BB/Stable/-- Capital Shopping Centres PLC AA- A/Stable/A-1 COLT Telecom Group PLC BB- B+/Stable/-- Coral Group Trading Ltd. B+ B+/Stable/-- Derby Cycle Corp. B- B-/Negative/-- Dialog Corp. PLC (The) B+ B+/Negative/-- HMV Media Group PLC BB- BB-/Negative/-- IPC Magazines (U.K.) Ltd. BB- B+/Stable/-- Premier International Foods Ltd.* B+ B+/Stable/-- Regional Independent Media Group PLC* BB- B+/Stable/-- Signet Group PLC BB+ BB+/Stable/-- TDL Infomedia Group Ltd. B+ B+/Negative/-- Telewest Communications PLC BB- BB-/Stable/-- TM Group Ltd. B+ B+/Negative/-- William Hill PLC B+ B+/Stable/-- *Via special-purpose vehicle. Bank Loan Rating Methodology As previously mentioned, bank loan rating analysis considers the level of collateralization, nature of the assets, structure and terms of the obligation, and the legal environment. Once asset value is determined, it is compared with the loan being rated to ascertain if a margin of protection exists to cover the loan instrument in full. Collateral Valuation Two types of analysis may be undertaken--liquidation analysis and enterprise value analysis. In most cases, liquidation analysis is likely to be the more appropriate basis of valuation in England, as past experience indicates that liquidation has been more prevalent in the English market than reorganization. Liquidation analysis. Liquidation analysis is intended to give an understanding of what values a company's assets might realize in a stressed default scenario. Collateral may include one or more assets, and, in many cases, a fixed and floating charge is granted over a company's entire assets. Several methods of valuing assets may be used, including appraisals, consideration of recently realized values for comparable assets, and replacement cost (adjusted to take into account aging and technology). For this purpose, it is important to consider the type and amount of collateral, and whether its value is objectively verifiable and likely to hold up during various post-default scenarios. For example, marketable freehold property is likely to retain good value whereas perishable goods, with short shelf lives, are not. Enterprise value analysis. Where it is thought that a company may be sold or reorganized, an enterprise value analysis is undertaken. An enterprise valuation may also be used during a liquidation analysis if the disposal of entire business segments is thought possible. A market-capitalization approach or, in certain circumstances, another methodology--such as discounted cash flow--is used to assess probable enterprise-value levels. Market values are established using normalized earnings at earnings before interest, taxes, depreciation, and amortization (EBITDA) level. Appropriate discounts are used to stress both the cash flow and the rate of capitalization used to determine the value of the business. Normalized EBITDA reflects an average level of future cash flow that the business can be expected to generate over a period of time. This usually is based on both historical and projected data. One-off charges and extraordinary income are excluded from the equation. Historical information is adjusted or excluded when major secular or structural changes have occurred or are anticipated to occur. The normalized EBITDA is then adjusted downward to reflect any decline in cash flow that ordinarily would be associated with a default. The multiple employed in the valuation model typically is derived from the average and specific cash-flow multiples of the borrower's peer group of publicly quoted companies. An adjustment is made to reflect the possible depressive effect of the threat of bankruptcy, with consideration given to the cyclical variability of businesses and to the current stage in the relevant economic cycle. Terms and Structure of Obligations An important consideration is the position of the borrower in the group structure. For example, if subsidiaries were restricted from incurring any external debt, or provided support to the lending entity by way of a guarantee structure, this could have a very positive impact on the rating. Likewise, the rating might improve if the covenants were drawn tightly to ensure that refinancing was necessary before any large, debt-funded acquisition could be concluded. Therefore, it is necessary to appreciate the nature of the borrower and its financial policy. The impact of covenants, if present, also is evaluated. Standard loan documentation for many borrowers includes pari passu and negative pledge covenants to protect lenders. Many documents also contain "material disposal" and "change-of-control" clauses. It is important to assess the materiality of all such covenants, effects of exclusions, and ultimate protection that they may afford to lenders. In most cases, covenants per se will not result in a higher loan rating from Standard & Poor's. Loan maturity also is material. A short final maturity of three years or less is viewed favorably. Long-term issues, which may affect the corporate credit rating, may be of concern only after the maturity of the loan. In addition, since the ability to rely on asset valuations diminishes over a longer time span, the benefit that can be given for asset-based recovery potential is greatest for shorter-term loans. Amortization reduces the amount of debt that has to be covered by the value of the assets and thereby improves loan-to-value coverage. Accordingly, if one tranche of a deal amortizes more quickly, or is significantly shorter than another, such tranches may be rated differently. Legal Considerations The support given by the local bankruptcy regime is fundamental to the likelihood of recovery in the post-default scenario and to the "notching" or the assignment of ratings above the corporate credit rating. Unlike the U.S., which has a well-established and tested process in the Chapter 11 procedures, Europe exhibits very different processes, which, in many jurisdictions, have not been tested extensively. In England, it is normal practice for banks, when lending to highly leveraged companies, to take security by way of a fixed charge over specific assets and a floating charge over the remaining assets. Under English bankruptcy law, the floating charge permits the bank lenders to appoint an administrative receiver to take charge of all the assets of the group in the case of a bankruptcy. This is a quick process that can be put into effect in as short a time as seven days after default. It is then the receiver's duty to maximize the realization of the assets for the sole benefit of the secured creditors--namely the banks. The administrative receiver has a duty of care with regard to the claims of the unsecured creditors, but control rests with the secured creditors, and there is no table for any unsecured creditors at which to sit. For collateral to be given weight in the rating process, lenders should have a perfected security interest in it. Legal opinions are sought to assess the perfection of security interests within each relevant legal system. Security, when given, also has to pass hardening test periods to avoid preferential treatment being given to any one class of creditor over and above others when difficulties arise. The nature of assets also is important. It can be difficult to perfect security interests on intangible assets such as patents and trade marks. These also can be very difficult to evaluate in a default scenario. Similarly, assets that are valued easily, such as cargo containers, may be difficult to trace and recover if they are in a number of countries or locations at the time of bankruptcy. Uncertainty about repossessing some of the security can of course be offset by providing overcollateralization to the lenders to various degrees. The matrices in table 3 place the above-mentioned factors into a systematic framework. Table 3 Ultimate Recovery Matrix CORPORATE CREDIT RATING LEVEL WITHIN 24 MONTHS WITHIN 6 MONTHS WITHIN 60 DAYS 'BB' AND 'B' Reasonably confident of full recovery of principal (over 1x collateral cover, after stress) +1 notch +1 or 2 notches +2 or 3 notches Highly confident of full recovery of principal (over 1.25x collateral cover, after severe stress case) +2 notches +2 or 3 notches +3 or 4 notches Highly confident of full recovery of principal and interest (over 1.65x collateral cover, after severe stress case) +3 notches +3 or 4 notches +4 notches 'A' AND 'BBB' Reasonably confident of full recovery of principal (over 1x collateral cover, after stress) +1 notch +1 notch +1 notch Highly confident of full recovery of principal (over 1.25x collateral cover, after severe stress case) +1 notch +2 notches +2 notches Highly confident of full recovery of principal and interest (over 1.65x collateral cover, after severe case) +2 notches +2 notches +2 or 3 notches