Article Title: ARCHIVE | Criteria | Corporates | Recovery: Getting the Measure of Bank Loan Ratings in Europe Data: European bank loan ratings (BLRs) are on the increase. Although the majority of rated loans remain U.S.-based, a growing number of BLRs are being assigned in Europe as institutional investor participation rises in the market (see chart). At Dec. 26, 2001, public European BLRs numbered 129 against total rated bank loan facilities of 1,136 worldwide, with an aggregate value of $140 billion and $944 billion, respectively. Chart 1 Furthermore, Standard & Poor's has also performed credit estimates on a significant number of bank loans for managers of collateralized debt obligation (CDO) vehicles, and other investors that require a rating before being able to buy into a facility. It is expected that as the market for BLRs continues to grow, there will be an increase in publicly rated loans versus credit estimates. This market expansion will also lead to the publication of further research on bank loan methodology (the subject of this article), European insolvency regimes, and transferability, as well as other topical issues. In addition, research will be leveraged from Standard & Poor's Portfolio Management Data (PMD) on the European bank loan and mezzanine markets. With growth in the BLR market likely to continue, there is a need to clarify how Standard & Poor's approaches such rating assessments, to provide a better understanding of the rating process and identify the criteria used. Rated Bank Loans Reflect Core Influence of Corporate Credit Rating The starting point for any BLR is the issuer's corporate credit rating (CCR), which reflects the fundamental creditworthiness of the company concerned, but not priority or preference among its obligations. The BLR, on the other hand, is a measure of ultimate recovery and timeliness to recovery of a specific obligation in a post-default scenario. Bank loans, like other types of debt, may be notched up or down from the CCR, reflecting the priority of payment in bankruptcy and recovery prospects. To be notched up, for example, means full recovery of the rated obligation is usually expected within 24 months of default. Key drivers of BLRs are: Debt seniority and facility terms; Stressed collateral value (to reflect a bankruptcy scenario); and Legal considerations. In practical terms, and providing there are no offsetting factors, bank loans are generally rated according to the guidelines outlined in table 1. Table 1 Notching Guidelines for Bank Loan Ratings in Europe NOTCHING ACTION LOAN FACTORS Notched up Secured and stressed collateral cover is at least 100%. Covenants protect the position of the creditors. Insolvency regime is creditor friendly. No change from the CCR Secured but stressed collateral cover is less than 100%. Secured but unfavorable insolvency regime. Unsecured with no subordination issues. Notched down Unsecured and significant priority ranking secured debt exists. Subordinated to other claims. At holding company level where operating subsidiaries have their own obligations. CCR--Corporate credit rating. Evaluating Debt Seniority and Facility Terms The first step in determining a notching action is to assess the priority ranking of a specific debt issue or bank loan in a company's capital structure. Both the position of the borrower (in the company's organizational structure) and the obligation (in the borrower's capital structure) are important considerations when rating any debt issue. To the extent that certain obligations will have a priority claim on the company's assets, lower ranking obligations are clearly at a disadvantage. Moreover, it does not matter if the priority of the claim is contractual (that is, senior debt relative to subordinated debt) or structural (operating company debt relative to holding company debt). As a rough measure of free asset availability, Standard & Poor's evaluates the percentage of priority liabilities relative to all available assets. When this ratio reaches certain threshold levels--20% for investment-grade issuers, 15% and 30% for speculative-grade credits--the disadvantaged debt is rated one or two notches below the CCR. These guidelines on threshold levels can be mitigated by a number of factors, however, including restrictions on subsidiaries from incurring external debt and the provision of upstream guarantees (that is, a guarantee from one or more operating companies to the holding company). Covenants package. The impact of covenants is also evaluated. Loan documentation for most borrowers includes financial covenants, as well as pari passu and negative-pledge covenants to protect lenders. Many loan documents also contain clauses on distribution restrictions, material disposal, and change of control. It is important to assess the materiality of all banking covenants (that is, whether or not they will make a difference if the loan defaults), the effects of exclusions, and the ultimate protection that the covenants may afford to lenders. The higher a company's CCR, the fewer covenants will be required generally by its creditors. That said, strong covenants in themselves will not usually result in higher ratings. Term and amortization. Debt maturity is also material. A short final maturity of three years or less is viewed positively. Long-term issues, which might affect the CCR, may be of concern only after the loan matures. Furthermore, as asset valuations are more reliable over shorter timeframes, these loans are given more benefit for asset-based recovery potential. Amortization also reduces the amount of debt that has to be covered by the value of the assets and, therefore, improves loan-to-value coverage. As a result, if one tranche of a deal amortizes more quickly, or is significantly shorter, than another, such tranches may be rated differently. Assessing Recovery Prospects Either an enterprise or liquidation value analysis will be used to value the collateral, the choice being dependant on the assets collateralized and past experience of the likely outcome of a default in the country concerned. Enterprise value analysis. An enterprise valuation is usually carried out when the collateral comprises the operating assets of a business, where the value depends on the business remaining a going concern and where the applicable legal jurisdiction favors restructuring--Chapter 11 in the U.S. and Redressement Judiciaire in France, for instance. The enterprise value is established by the adoption of a market capitalization approach, in which a company's level of EBITDA at a hypothetical point of default is multiplied by a representative market multiple. Standard & Poor's considers the hypothetical point of default to occur when EBITDA can no longer service debt interest payments. The multiple used in the valuation model is derived from the cash flow model multiple of the borrower's peer group. A multiple of five times is representative of many industries over time. This market multiple is adjusted to incorporate the effect that a filing or threat of bankruptcy might have on asset values. EBITDA is then projected to reflect the decline in cash flow that would normally accompany a default, with any material priority claims deducted from the resulting enterprise value. Liquidation value analysis. A liquidation analysis is normally carried out when the collateral comprises discrete assets with value independent of the business, and where the legal jurisdiction has in the past favored liquidation such as in England and Wales. In this type of valuation, assets are discounted to reflect their estimated value in an insolvency scenario. Important considerations include the type, marketability, and amount of collateral. It is critical to establish whether the asset values can be objectively verified and how likely they are to hold up under various post-default scenarios. Accounts receivables, for example, are more likely to retain value than work-in-progress. Discounts used to value the collateral will vary depending on the type of asset, industry, and country concerned. Insolvency Regimes Exert Influence Over Notching and Shape Views on Collateral The support given by the local bankruptcy regime is fundamental to the likelihood of recovery in a post-default scenario. Unlike the U.S., which has a well-established and tested process under its Chapter 11 procedures, insolvency regimes in Europe vary between individual countries and often have not been tested extensively. An added problem in Europe is the number of companies with cross-border assets in different jurisdictions. Although this research does not represent a legal opinion, Standard & Poor's has reviewed a number of insolvency regimes in Europe and, at present, has agreed to notch up BLRs in the U.K., Germany, and The Netherlands, reflecting the opinion that creditors would be able to take control and realize their collateral over a reasonable period in an insolvency scenario. Collateral. For collateral to be considered in the rating process, lenders should have a perfected security interest in the collateral concerned. Consequently, legal opinions are sought to assess the perfection of security interests within each relevant legal system. The nature of the assets is also important. It can be difficult to perfect security interests on intangible assets such as patents and trademarks. These can also 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. To take into account all the above-mentioned factors, a BLR notching framework has been established (see table 2). Table 2 Ultimate Recovery Matrix LONG-TERM CORPORATE CREDIT RATING LEVEL WITHIN 24 MONTHS WITHIN 6 MONTHS WITHIN 60 DAYS 'BB' AND 'B' Reasonably confident of full recovery of principal (more than 1 times (x) collateral cover, after stress) +1 notch +1 or 2 notches +2 or 3 notches Highly confident of full recovery of principal (more than 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 (more than 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 (more than 1x collateral cover, after stress) +1 notch +1 notch +1 notch Highly confident of full recovery of principal (more than 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 Recent Bank Loan Ratings Highlight Uncertainty of Full Recovery Experience of rating European bank loans in 2001 shows that a loan is normally rated at the same level as the corporate credit rating (see table 3). Many of the loans in the past 12 months were unsecured and, even where secured, Standard & Poor's was 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. Table 3 Public European Bank Loan Ratings Issued in 2001 ISSUER COUNTRY BANK LOAN RATING CORPORATE CREDIT RATING* Aeroporti di Roma SpA Italy A- A-/Stable/A-2 Alea Group Holdings AG Switzerland BBB- BBB-/Stable/-- Algarve International B.V. Netherlands AAA N/A Assa Abloy AB Sweden A- A-/Stable/A-2 Atlas Copco AB Sweden A- A-/Stable/A-2 Azurix Europe Ltd. U.K. BB B+/Watch Dev/-- British Sky Broadcasting Group PLC U.K. BB+ BB+/Stable/-- Cofinimmo S.A./N.V. Belgium BBB BBB/Stable/A-2 Cognis Deutschland II GmbH & Co. KG Germany BB BB/Stable/-- Corus Group PLC U.K. BBB BBB/Negative/A-3 Dwr Cymru U.K. A- N/A Ericsson (Telefonaktiebolaget L.M.) Sweden BBB+ BBB+/Negative/A-2 Eureko B.V. Netherlands A- A-/Negative/-- European Atomic Energy Community Supranational AAA AAA/Stable/A-1+ Export Credit Bank of Turkey Turkey C B-/Positive/C Gallaher Group PLC U.K. BBB BBB/Stable/A-2 Ineos Holdings Ltd. U.K. BB BB/Negative/-- International Power PLC U.K. BB BB/Stable/-- Invensys PLC U.K. BBB BBB/Watch Neg/A-3 Israel (State of) Israel A- Local currency: AA-/Stable/A-1+; foreign currency: A-/Stable/A-1 Lafarge S.A. France BBB+ BBB+/Negative/A-2 Land Securities (Finance) Ltd. U.K. A+ N/A Messer Griesheim GmbH Germany BB BB/Stable/-- mmO2 PLC U.K. BBB- BBB-/Stable/-- Oman LNG LLC Oman A- N/A Polska Telefonia Cyfrowa Sp. Poland BB BB/Stable/-- RTL Group S.A. Luxembourg A- A-/Watch Neg/A-2 Sodexho Alliance S.A. France BBB+ BBB+/Stable/A-2 Sonera Corp. Finland BBB BBB/Negative/A-3 Telewest Communications Networks Ltd. U.K. BB BB-/Stable/-- Valentia Telecommunications Ltd. Ireland BBB- BBB-/Stable/-- VNU N.V. Netherlands BBB+ BBB+/Negative/A-2 Yell Group Ltd. U.K. BB- BB-/Stable/-- *At Feb. 26, 2002. N/A--Not applicable. It is worth noting, however, that even when BLRs are not notched up, secured lenders usually can expect to recover considerably more than a typical unsecured creditor. The rating evaluations of two large LBOs completed last year-- Yell Group Ltd. and Messer Griesheim GmbH (both BB-/Stable/--)--demonstrate this finding. Yell Group Ltd. Yell was an LBO of the classified directories business of British Telecommunications PLC (A-/Negative/A-2). The group's £1.05 billion ($1.48 billion) bank loan was secured by cross guarantees of all material companies of Yell in the U.K. and U.S., and a pledge of essentially all the assets and undertakings of the guarantors. The bank loan was not notched up, mainly because of the size of the bank debt compared with the value of the security and the nature of the collateral, which consisted largely of intangible assets. The related high-yield bonds were rated two notches lower than the CCR, reflecting the significant size of priority debts ranked above them. Messer Griesheim GmbH. An LBO of a chemicals business, the €1.54 billion ($1.33 billion) bank loan was secured by cross guarantees of all material companies of the Messer group and a pledge of essentially all the assets of the guarantors. Nevertheless, in view of the considerable size of the bank debt, compared with the value of the security and the multijurisdictional location of the collateral, the bank loan was given the same rating as the CCR. The €400 million senior unsecured notes were rated two notches below the CCR, reflecting their lack of security and the significant amount of priority debts ranked higher. Analytical E-Mail Addresses Anne-Charlotte_Pedersen@standardandpoors.com blaise_ganguin@standardandpoors.com dominic_crawley@standardandpoors.com