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Leveraged Finance

Europe
Special Report

European Leveraged Credit Review

Pause for Recovery

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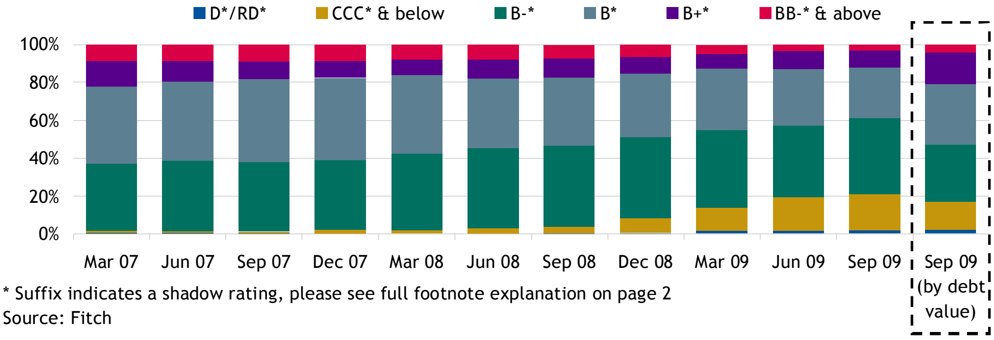
Executive Summary

Ratings migration continued to deteriorate in the six months since Fitch Ratings last published its *European Leveraged Credit Review*, a bi-annual survey that tracks financial performance and rating migration on the agency's "shadow" rated portfolio of European leveraged credits. The agency updates its shadow ratings every six months based on information provided by asset managers. The lag in updating credits by up to six months, with recent rating actions reflecting full Q408 and partial YTD 09 trading reporting may explain why ratings continued to deteriorate whereas secondary market prices improved materially for leveraged credits between end-March and end-September '09. Specifically, the agency witnessed rising defaults and an increase in the number of distressed ('CC') and stressed ('CCC') credits migrating downward from the single-'B' category, reflecting breached debt service covenants and requiring increased remedies in the form of waivers and amendments from sponsors and creditors. In addition the proportion of 'B-minus-and-below' credits rose to 61% by end-September from 54% at end-March.

Chart 1: Evolution of Fitch's Shadow Rating Issuer Default Ratings (IDRs) by Deal Number



* Suffix indicates a shadow rating, please see full footnote explanation on page 2
Source: Fitch

Recent capital market and leading economic indicators signal that the worst of the crisis may be behind the European leveraged credit market, at least for some time. Despite downward rating migration for the portfolio as a whole, many leveraged credits have had a "good crisis" insofar as they continue to generate cash and de-leverage, albeit more slowly than anticipated given the dramatic contraction in economic growth in the aftermath of last year's Lehman Brothers failure. While the agency took few positive rating actions, it continued to affirm Stable Outlooks and assigned Positive Outlooks on a number of credits in resilient sectors. Moreover, the trend towards stabilisation and some upgrades based on cash-flow-generated de-leveraging has accompanied some early Q309 reporting.

The agency's higher rated credits are frequently the large volume borrowers, which supports the long-term resiliency of the market insofar as these are the most likely candidates for capital market exits. Rising optimism regarding potential equity market listings and successful sales to strategic corporate investors may, in turn, attract further liquidity to the European leveraged credit market from yield-seeking, unleveraged institutional investors.

In contrast, and notwithstanding improved sentiment, the broader market continues to struggle under high median leverage levels and weak debt service profiles. Fitch notes continuing underperformance among smaller volume borrowers with limited pricing power as well as among weaker credits in cyclical sectors. These borrowers remain at risk of default unless there is a robust economic recovery that lasts well into 2011. Consequently, a high portion of negative outlooks remain and the de-leveraging progress necessary for a broader market recovery may disappoint as contractual maturities approach in 2012 and 2013.

Specifically, as of Q309, Fitch's distribution of shadow ratings[1], as illustrated in Chart 1, reflects the growing share of credits with an Issuer Default Rating (IDR) of 'CCC' or below (20.8% as of end-September 2009, up from 8.6% in December 2008), signalling non-performing credits for which default is a real possibility. Furthermore, the share of credits rated 'B—*' and below increased to 61% at end-Q309 (47% by debt value), up from 51% in December 2008. Although not all 'B-*' credits are assumed to default in the near term, it reflects the proportion of borrowers that remain at risk of continued underperformance given sustained high leverage and limited time before maturities approach. Fitch also expects a rising number of credits with likely covenant breaches to mid-2011. This will test the willingness of bank lenders and collateralised loan obligation (CLO) managers to maintain a constructive dialogue and negotiate consensual solutions with subordinated debt holders and sponsors, as all parties remain intent on avoiding defaults in time for further economic and capital market recovery.

Defining the Market

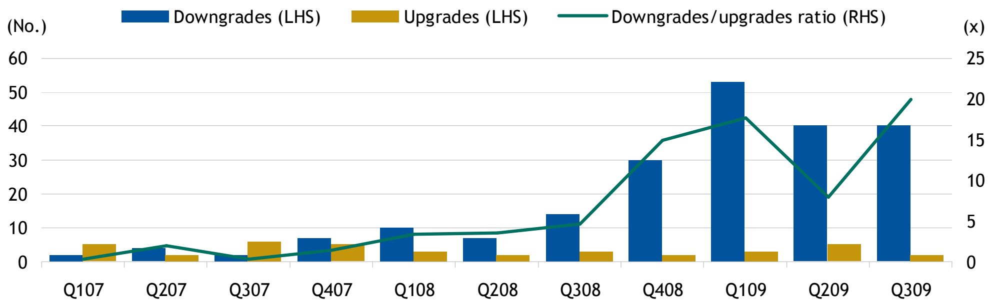
Fitch maintains 283 shadow ratings[1] on European leveraged borrowers, owing on aggregate over EUR290bn. These are point-in-time opinions principally based on private, confidential information supplied by an asset manager on the particular borrower in question. Shadow ratings are not actively monitored (although they are regularly updated), and there is no relationship with the borrower's management or ownership.

Fitch is entirely dependent on the asset manager for timely and complete updated financial reporting every six months (or sometimes sooner, if requested by the agency) for a point-in-time update. Consequently, there is a time-lag before a given quarter's reporting performance will be captured throughout the portfolio. As of mid-October 2009, the agency's portfolio reflects 68% of Q109 financial reporting and, within this, about 39% of Q209 financial reporting.

Ratings Migration

Notwithstanding the lag in capturing the latest reporting data, the performance of a significant number of issuers that came up for review during the period continued to deteriorate rapidly between Q109 and Q309.

Chart 2: Quarterly Evolution of Downgrade/Upgrade Ratio



Source: Fitch

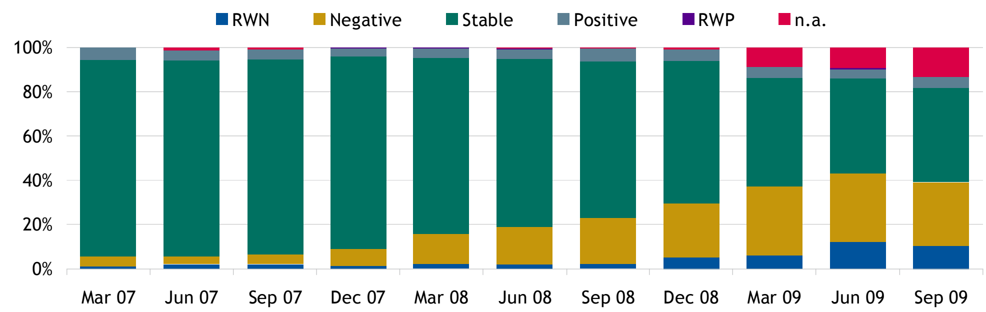
As Chart 2 demonstrates, the downgrade/upgrade ratio for European leveraged issuers jumped to a record high level of 20x in Q309 from 4.7x in Q308. Likewise, 39% of Fitch's shadow-rated portfolio is currently on Negative Outlook/Rating Watch Negative (RWN), indicating a further downward trend. Albeit lower than 43% in June 2009, this is not reflected in an increase in the proportion of Positive Outlooks as yet but corresponds to a rise in the share of 'CCC*' or lower ratings, which do not typically carry Outlooks.

In examining the latest shadow ratings migration statistics, Fitch has observed a clear downward pressure on credit quality and hence ratings, even though the majority of 'B-*' to 'B+'* rated credits have been affirmed since 1 July 2008

[1] The '*' suffix indicates a shadow rating prepared using information provided by an asset manager, rather than directly by a borrower, which is not fully comparable with published ratings. Please see the agency's public website (www.fitchratings.com) under "Resource Library - Ratings Definitions" for a formal description of shadow ratings

(between 75%-78% of credits affirmed, as per Table 1). Excluding the limited sample of ‘BB-*’ rated credits in Fitch’s European shadow rating universe (as per Chart 1) for which a ratings migration analysis is statistically less robust, more frequently than not ratings have moved down (or up) by one notch. However, the frequency of multi-notch downgrade increases as one moves down the rating scale. So far, for instance, when a rating is ‘CCC*’ there is a greater chance that the company will be further downgraded and possibly by more than one notch. Likewise, for ‘CC*’/‘C*’ credits, a liquidity crisis may be imminent or inevitable in the near term and/or will likely result in a coercive debt exchange of some kind.

Chart 3: Evolution of Fitch's Shadow Rating Outlooks



Source: Fitch

Table 1: European LF Cumulative Transition Rates Across NIG Ratings: Since 1 July 08 (%)

From	To BB	BB-	B+	B	B-	CCC	CC	C	RD/D	Total
BB-	5.56	33.33	38.89	11.11	11.11	0.00	0.00	0.00	0.00	100.00
B+	0.00	0.00	75.41	14.75	9.84	0.00	0.00	0.00	0.00	100.00
B	0.00	0.00	2.70	75.23	17.12	4.05	0.45	0.45	0.00	100.00
B-	0.00	0.00	0.00	2.80	78.32	11.19	4.55	0.70	2.45	100.00
CCC	0.00	0.00	0.00	0.00	4.00	52.00	16.00	20.00	8.00	100.00
CC	0.00	0.00	0.00	0.00	0.00	0.00	8.33	66.67	25.00	100.00
C	0.00	0.00	0.00	0.00	0.00	0.00	0.00	12.50	87.50	100.00

Source: Fitch

Table 1A: European LF Cumulative Transition Rates Across NIG Ratings: Since 1 July 08 (No.)

From	To BB	BB-	B+	B	B-	CCC	CC	C	RD/D	Total
BB-	1	6	7	2	2	0	0	0	0	18
B+	0	0	46	9	6	0	0	0	0	61
B	0	0	6	167	38	9	1	1	0	222
B-	0	0	0	8	224	32	13	2	7	286
CCC	0	0	0	0	2	26	8	10	4	50
CC	0	0	0	0	0	0	1	8	3	12
C	0	0	0	0	0	0	0	1	7	8
Total	1	6	59	186	272	67	23	22	21	657

Source: Fitch

Table 2 describes some of the characteristics of low-rated credits (between ‘B-*’ and ‘CCC*’) and juxtaposes these to the stronger performing credits, namely those that are currently on Positive Outlook. While noting the high aggregate notional debt amounts among weak performing credits (EUR64.5bn compared to EUR18.3bn for credits on Positive outlook), the principal credit metrics that differentiate between weak and more robust credits can be summarised as follows: relatively small size measured by the average borrowed debt amounts; high or increasing leverage often combined with prospects of (or actual) covenant breaches; a tight liquidity score (measured as (Cash + undrawn RCF) / (Debt service N+1); and, most importantly, a degree of underperformance to Fitch's original forecasts. In contrast, in all these areas, the margin of manoeuvre is clearly higher for the credits currently on Positive Outlook.

Table 2: Profile of Non-Performing vs. Performing Leveraged Credits

Average ratios/figures	Average total debt (EURm)	Aggregate total debt (EURbn)	Total leverage (x)	(Cash + undrawn RCF)/(debt service N+1)	Last EBITDA performance against original Fitch case (%)[c]
Credits rated 'B-*Negative Outlook/'CCC'[a]	449	64.5	7.4	1.3	-3.2
Credits on Positive Outlook[b]	1,061	18.3	5.1	1.9	26.8

[a] Ratings split as follows: 'CCC*' (27); 'B-*' and Negative Outlook (50)
[b] Ratings split as follows: 'B-*' (4); 'B*' (11); 'B+*' (1)
[c] Based on financial performance information since January 2009
Source: Fitch

Liquidity Metrics

Table 3 shows the main credit metrics and liquidity scores for leveraged borrowers according to their rating profile. Fitch's shadow-rated portfolio has an average debt service cover ratio of just over 1.0x, which is a marked deterioration from an average of 1.5x at average transaction closing. The deterioration is further underpinned by the migration of the portfolio towards lower ratings, with the debt cover ratio going down to 0.8x on average for 'C*'/'CC*' rated deals.

With Net Free Cash Flow (NFCF) cover just at 1.0x, leveraged borrowers are increasingly reliant on operational improvement, asset sales or ongoing access to RCF to service their debt obligations. Including undrawn RCF, the liquidity score is somewhat better (median of 1.6x although it varies by sector). European leveraged borrowers shadow-rated by Fitch have an estimated aggregate amount of debt available to be drawn of EUR25bn under RCFs (average of EUR86m per borrower) — or 9% of the total debt drawn — with EUR19bn available under RCFs — excluding any availability left on remaining committed capex/restructuring facilities; the latter being arguably more difficult to draw in case of financial stress, although Fitch observed some cases where (due to loose documentation) the borrowers were able to draw under these facilities to avoid immediate liquidity issues.

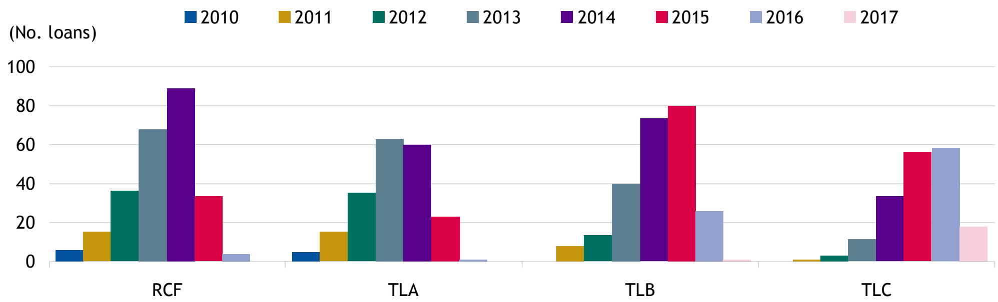
Table 3: Liquidity Metrics for European Leveraged Credits by Sector and Rating

Median ratios	Average rating	"EBITDA/ cash interest" (x)	Cash conversion ratio[a] (%)	NFCF debt service cover ratio[b] (x)	(Cash + undrawn RCF)/(debt service N+1) (x)	Total leverage (x)	Expected total leverage by 2012 (x)
Total portfolio	**B-***	**1.9**	**65**	**1.00**	**1.6**	**6.4**	**5.9**
RLCP	B-*	1.8	61	1.00	1.6	6.6	6.4
Industrials	CCC*/B-*	1.8	56	1.00	1.7	6.5	5.8
TMT	B-*	2.1	69	1.12	1.2	6.3	5.7
Energy and utilities	B-*/B*	2.2	37	0.98	1.9	6.6	6.5
B+*		2.6	56	1.20	2.2	4.8	4.4
B*		2.1	68	1.20	1.7	5.6	5.3
B-*		1.8	66	1.00	1.5	7.1	6.9
CCC*		1.5	59	0.90	1.4	7.7	7.0
CC*/C*		1.5	50	0.80	0.9	8.2	n.a.

* Suffix indicates a shadow rating, please see full footnote explanation on page 2
[a] Cash flow from operations (including capex)/EBITDA
[b] Net free cash flow (before interest)/(interest + debt repayment)
[c] Live transactions monitored by Fitch on a shadow basis as of 30 September 2009
Source: Fitch

For most of the RCF facilities in pre-credit crunch deals, such lines do not need to be repaid before maturity although, if drawn, RCF lines will in all likelihood have to meet an annual clean-down provision (generally for at least 10 working days). This reinforces the point that RCF lines are not designed to be long-term funding. For many fully back-ended transactions (ie, with just bullet TLB/C and lower frequency of TLA), Chart 4 suggests that the rollover of existing RCF facilities will be the first refinancing test in 2012 and beyond.

Chart 4: Debt Maturity Profile by Type of Senior Debt Facility



Source: Fitch

Measuring Execution Risk: Recycled Deals

Approximately 78% of the agency's shadow portfolio consists of 2006 and 2007 peak-of-the-market vintage transactions. Recycled credits were common either in the form of secondary/tertiary buyouts (SBO/TBO) or dividend recaps.

In order to capture the incremental execution risk (namely more aggressive revenue and operating profit growth targets) that accompanied higher leverage inherent in each successive recycling, Table 4 illustrates how a like-for-like sample of the recycled transactions are faring against the aggressive recap assumptions presented at the transaction date. The sample comprises all the recycled deals for which Fitch had received performance data from at least January 2009 onwards. This resulted in a sample size of 22 dividend recap deals and 20 SBO/TBO deals, which contain only six 'CCC-or below' rated credits.

Table 4: Recycled Deals – Performance Below Plan[a]

	Dividend recaps (22)[b]		SBOs/TBOs (20)[c]	
	Original assumptions	Actual	Original assumptions	Actual
Time into the deal (T) (yrs)		2.25 (27m)		1.92 (23m)
Revenue at T yrs (EURm)	783.2	569.4	448.0	394.5
Revenue CAGR	5.7	-9.4	7.0	0.4
Revenue variance (%)		-28.0		-12.0
EBITDA at T yrs (EURm)	130.2	93.6	122.6	90.2
EBITDA variance (%)		-28.0		-26.4
EBITDA margin at T yrs (%)	16.5	16.4	27.4	22.9
EBITDA margin variance (bps)		-10		-450
Total leverage at closing (x)	6.2		7.3	
Total leverage at T (x)		6.8		7.1
Total leverage at yr 3 (x)	4.7		5.7	

[a] Summary performance analytics for a sample of recycled credits reviewed with financial data since January 2009
[b] Sector split by debt (per definitions in Chart 13): cyclical (41%), somewhat cyclical (34%), non-cyclical (26%)
[c] Sector split: cyclical (43%), somewhat cyclical (6%), non-cyclical (51%)
Source: Fitch

The sample of both dividend recaps and SBO/TBOs are, on average, two years into their transaction lives (2.25 years for dividend recaps and 1.9 years for SBO/TBOs). Revenue, EBITDA and EBITDA margin are performing materially below where the initial recycled plans suggested they would be two years later. The fact that actual performance is considerably off the original plans effectively translates into rising leverage, compounding the challenge of refinancing as maturities come due in 2012 and 2013.

The extent underperformance is particularly acute for dividend recaps, whereby revenue growth, which was expected to be 5.7% per annum, has in fact contracted by -9.4% pa. EBITDA margins appear to have held up on the basis of tight cost control. Overall, total leverage by year two (at 6.8x) is materially off the initial target for year three (4.7x). Fitch notes however, that actual performance considerably off original plans may be partially explained by the sample analysed, which is somewhat skewed towards more cyclical sectors.

For SBO/TBOs, a similar pattern of underperformance emerges (seemingly more acute in terms of EBITDA margin contraction). However, cash flows have been less affected, although in this instance this is likely to due to the sample consisting of borrowers in less cyclical sectors. Total leverage by year two is slightly lower than at deal date (7.1x versus 7.3x), although still far higher than the year three target (5.7x).

Revisiting Base Case versus Fitch Case Performance

For the agency's broad industry sectors, namely: industrials; retail, leisure and consumer products (RLCP); telecoms, media and technology (TMT); and energy and utilities, Fitch displays in Table 5 average "base case" versus "Fitch case" performance, measured in terms of deviation in revenues and EBITDA from the original base case and Fitch case projections. Deviation has been captured based on each credit's latest year-end or applicable last-12-month (LTM) period, depending on information provided. Fitch has limited its analysis to a sample of 194 issuers (together representing approximately EUR198bn in total debt outstanding at end-September 2009) for which the agency received some results covering 2009 trading[2]. Also, the agency discloses aggregate performance for a sample of 121 credits rated 'B-*' and below (EUR97.5bn in total debt).

Table 5: Average Performance Versus Base Case/Fitch Case

			Base case		Original Fitch case	
	No.	Total debt (EURbn)	Sales (%)	EBITDA (%)	Sales (%)	EBITDA (%)
'B-*' and below rated credits						
Industrials	42	31.4	-13.8	-28.7	-1.2	-7.4
TMT	27	27.4	-10.4	-15.6	0.3	1.1
RLCP	51	36.6	-10.6	-22.5	0.7	1.2
Energy and utilities	1	2.1	-1.6	5.2	1.8	8.8
Aggregate	121	97.5	-11.5	-22.7	0.0	-1.7
All shadow ratings						
Industrials	56	50.1	-12.0	-23.7	-1.0	-3.5
TMT	50	69.5	-7.7	-10.7	2.4	6.4
RLCP	82	71.3	-7.7	-15.6	1.8	6.2
Energy and utilities	6	6.8	12.4	-5.4	13.2	9.2
Aggregate	194	197.8	-8.3	-16.3	1.5	3.6

Source: Fitch

- The industrials sector continues to record the widest variance against initial base case given the high exposure of some sub-sectors to economic cyclicality and declining order books from H109. In addition, industrials is the only sector where headroom built under the original Fitch case has been insufficient (negative in terms of sales and EBITDA) thereby translating into a high number

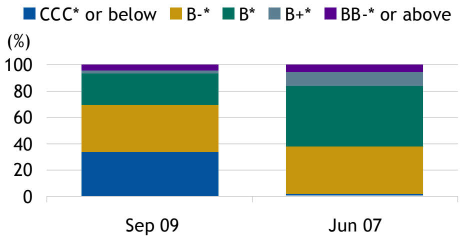
[2] For the 194 issuers, the last month of data *(number of issuers)* is as follows; January 2009 *(16)*, February 2009 *(28)*, March 2009 *(39)*, April 2009 *(30)*, May 2009 *(36)*, June 2009 *(36)*, July 2009 *(7)*, August 2009 *(2)*

of rating downgrades across the sector in recent months. The negative trend is more evident for credits rated 'B-*' and below.

- The RLCP sector also reveals significant underperformance against initial business plans, especially for 'B-*' rated issuers; however, Fitch underlines the heterogeneity of credit profiles across this sector with regard to their sensitivity to the economic cycle. Unsurprisingly, underperformers remain those mostly relying on discretionary consumer income (leisure and entertainment, lodging, certain retail segments). However, the industry credit profile overall is supported by the relative stability of less cyclical or non-cyclical segments (environmental services, certain food and food and retail segments, and healthcare). As can be seen in Table 5, the original Fitch cases for RLCP credits retain some headroom, albeit shrinking, reflected in a growing share of Negative Outlooks.
- Underperformance against the base case in the TMT sector continues to materialise, often driven by publishing and media-related issuers' exposure to the drop in advertising market activity. Here Fitch notes that headroom against the Fitch case remains thin, especially for 'B-*' and below rated issuers. Fitch nonetheless acknowledges the diverging credit profiles within the industry as some cable and telecoms names have demonstrated resilience throughout the downturn given their subscription-based business models and favourable industry fundamentals.

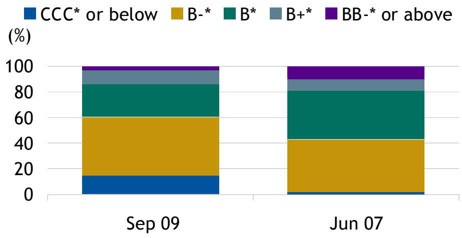
In Charts 5 to 8, Fitch draws a comparison of the IDR distribution by broad sector as of September 2009 and June 2007. Given the flow of negative rating actions undertaken by Fitch over the past months, the average distribution of shadow IDRs has continued to shift from 'B*', prior to the onset of the crisis, to an average of 'B-*', with the notable exception of the energy sector.

Chart 5: Industrials IDR Distribution
September 09 vs. June 07



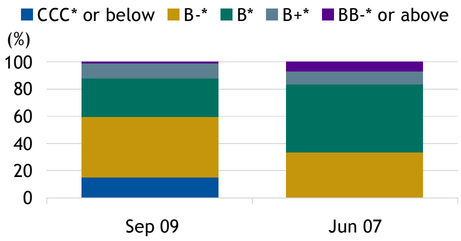
* Suffix indicates a shadow rating, please see full footnote explanation on page 2
Source: Fitch

Chart 6: RLCP IDR Distribution
September 09 vs. June 07



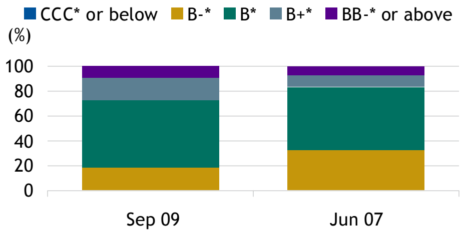
* Suffix indicates a shadow rating, please see full footnote explanation on page 2
Source: Fitch

Chart 7: TMT IDR Distribution
September 09 vs. June 07



* Suffix indicates a shadow rating, please see full footnote explanation on page 2
Source: Fitch

Chart 8: Energy IDR Distribution
September 09 vs. June 07



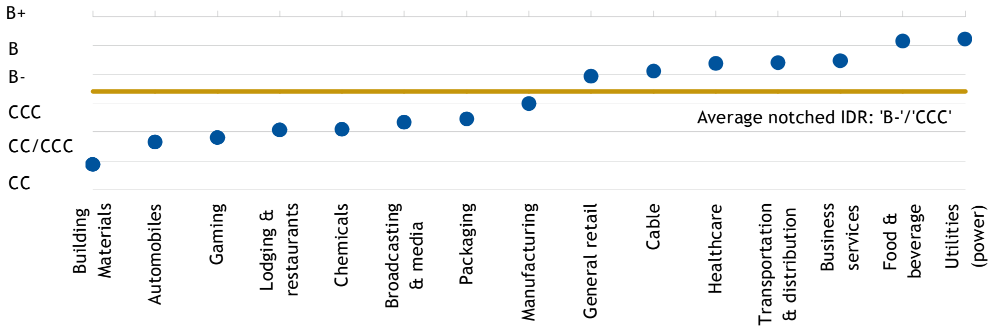
* Suffix indicates a shadow rating, please see full footnote explanation on page 2
Source: Fitch

Notched IDR

With the aim of assessing the industries with the highest level of credit risk, Fitch combines the current average shadow IDR for each sector with the proportion of Stable/Negative/Positive Outlooks and RWE/RWN/RWP assigned for each borrower in its sector. As contemplated in Fitch's "*Global Rating Criteria* for Corporate CDOs" (dated 30 April 2008 and available at www.fitchratings.com), the prospective reduction in the rating stemming from Negative Outlook/RWN will be assumed to be a single notch for the credits on Negative Outlook, whereas two notches will be applied for credits on RWN. This analysis results in an estimate of average long-term credit quality for each industry.

Chart 9 shows the average "notched" IDR for each sector (see text in margin) ranking them in a relative order of ratings. The best performing sectors have better ratings relative to the average credit risk. Based on this analysis, at the end of September 2009, sectors such as food and beverage, healthcare and business services were amongst those exhibiting the highest credit quality with an average IDR of 'B*'/'B+*'. However, the most cyclical sectors such as chemicals, building/materials, gaming/leisure and auto-related — have an average rating of 'CCC*' or lower, confirming trends Fitch had noted in previous *European Leveraged Credit Review* reports. As a result, issuers in these sectors have witnessed most of the restructuring activity observed by the agency over the past nine months although the remaining high concentration of an average "notched" IDR of 'CCC*' suggests that credits in these sectors remain at risk of a forced debt restructuring or default situation in the near-to-mid term. Finally, general retail (underpinned by discounters), cable and to some extent manufacturing, appear to have "average" default risk so far.

Chart 9: "Notched" IDR Distribution by Sector

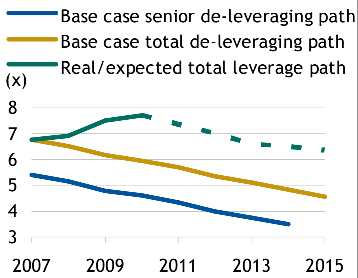


Source: Fitch

Long-Term Refinancing Risk Edges Closer

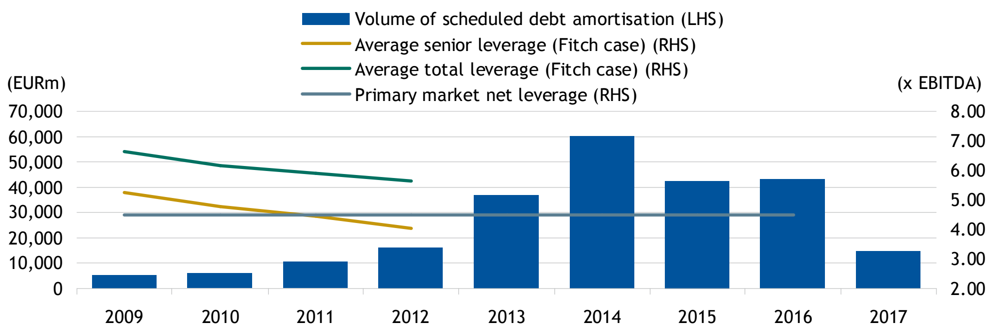
As Fitch has warned since the onset of back-ended maturity profiles from 2004 onwards, refinancing risk continues to be an endemic problem for the European leveraged credit markets that may become acute. The credit crisis and accompanying economic contraction in H109 compounded the refinancing risk by delaying the critical de-leveraging trajectory (see Chart 10A) for the majority of the business plans reviewed by the agency. In many instances, business plans did not factor any cyclicality. With apparent economic stabilisation and anticipated recovery, de-leveraging via greater operating cash flow growth and profitability may put certain leveraged credits in a stronger position to refinance in the equity and debt capital markets or exit via strategic sale before maturities come due although this is unlikely to be an option for many others.

Chart 10A: De-Leveraging Setback Acute for Cyclical Borrowers...



Source: Fitch

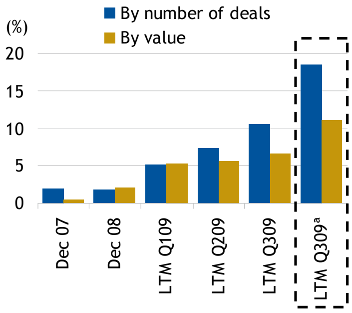
Chart 10: Slow Pace of Deleveraging in Fitch Case for all Shadow-Rated



Note: Excluding C/CC rated credits as a CDE or default situation is expected in the near term or seems inevitable
Source: Fitch

Approximately 78% of Fitch's rated shadow portfolio (by debt amount) refers to borrowers with annual EBITDA in excess of EUR100m (45% by loan count). Generally speaking, these larger borrowers carry better ratings than smaller credits and are, on average, still outperforming Fitch's original forecasts which support a degree of ratings stability thus far for such names. Fitch considers that such large borrowers with proven business models through the economic trough could be candidates for partial exits via IPOs or partial debt refinancing with high-yield bonds. However, the agency warns that considerable de-leveraging via cash flow generation will have to occur before legacy loans, priced at historically low margin spreads, can be effectively replaced with the higher coupons inherent in fixed rate bonds. Unlike the application of IPO proceeds which repay and reduce debt, high-yield bonds will do little to ensure a sustained de-leveraging strategy, although they will buy time provided the interest burden is sustainable.

Chart 10B: Euro Lev Loans Default Rates



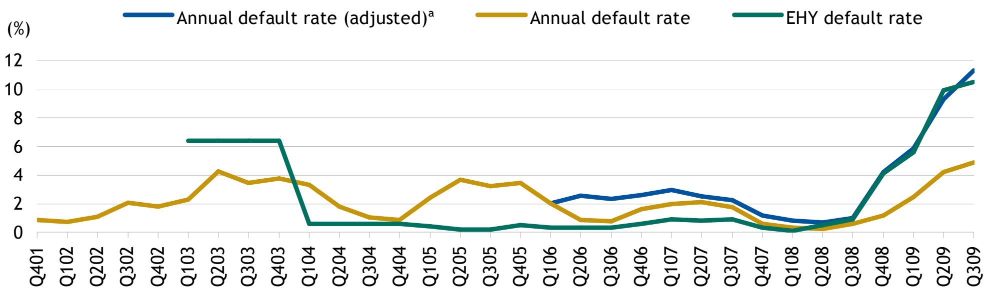
[a] Pro forma for 'C'/'CC' rated borrowers
Source: Fitch

Default Rates: How High Can They Go?

Default rates for European leveraged loans by number of borrowers increased to 10.5% on an LTM basis at end-September 2009, from 1.8% at end-2008. By debt value, LTM default rates stood at 6.6% at end-Q309. However, adjusted for distressed borrowers — namely those 'C' or 'CC' rated loans for which default is imminent or inevitable, or the issuer is already in payment standstill — LTM Q309 default rates would increase to 18.5% (by number) and 11% (by debt value).

A similar trend is evident for mezzanine debt (Chart 11), with a default rate of 5% by debt value by end-Q309 or 11.8% adjusted for distressed borrowers — the highest rate since Fitch started tracking mezzanine defaults back in 2001.

Chart 11: Mezzanine Default Rates are Rising Fast



[a] Adjusted for "distressed" mezzanine deals (rated "CC" or below at time of last update)
Source: Fitch

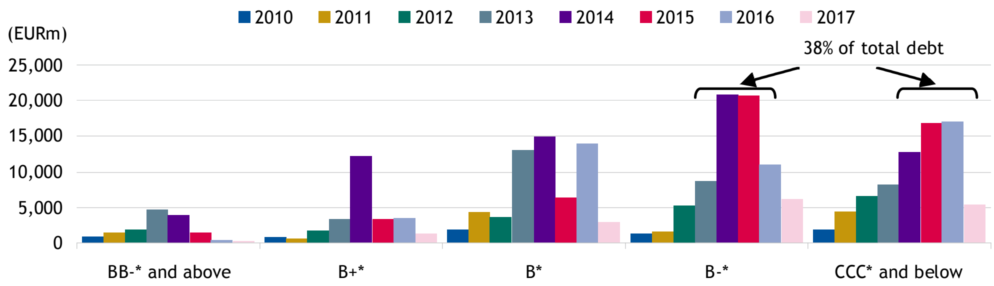
Since July 2008, Fitch registered 24 leveraged loan defaults (either rated 'D' or 'RD') in its portfolio of European leveraged credits. Of these, 18 occurred in the first nine months of 2009 and were primarily concentrated upon the heavily cyclical sectors. The majority of the defaulted borrowers went through a debt-for-equity swap, while others sought some kind of legal protection against creditors. Only three had benefited from an equity cure before defaulting, which can be explained by the very loose covenant definitions and levels that were negotiated in 2006 and 2007, and the speed of the onset of the recession.

To estimate European leveraged senior loan default rates in the near term, the outstanding amount of senior debt for the highest-risk borrowers (rated 'CCC*' or below, excluding defaulted borrowers — approximately EUR37bn) is set against Fitch's shadow-rated total senior debt outstanding of EUR235bn. Consequently, the agency estimates that leveraged loan default rates may rise by an additional 16% by the end of 2010 to give a cumulative default rate in the range of 20%-25% since the onset of the crisis in 2007.

Anticipating default rates beyond 2010 will depend on continuing de-deleveraging performance and the outlook for exits or refinancing as contractual maturities come due from 2012 onwards. Given lack of visibility on economic and capital market conditions, much less the ability and willingness of senior loan holders to “term-out” Term Loan ‘A’ and ‘B’ into an all bullet ‘C’ maturity (extending refinancing dates to 2015), any projections on default rates would depend on a range of intangible variables. Fitch measures refinancing risk by assessing:

1. Credit quality measured by the IDR notched by the relative share of outlooks/Rating Watch assigned for each credit in their sectors (Chart 12). Although outlooks reflect the expected direction of a rating over a one-to-two year horizon, it nonetheless provides an indication, based on current information, about the likely credit profile before major debt maturities start to kick in after 2012, and

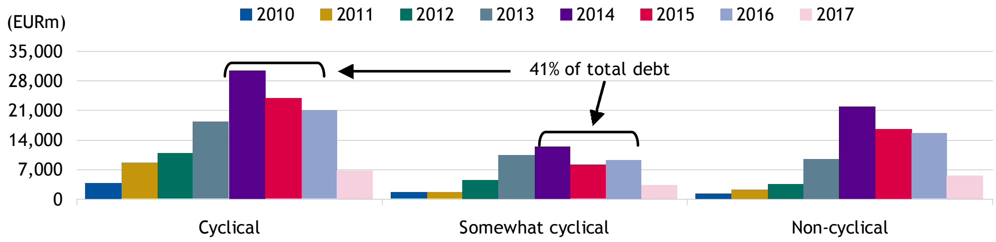
Chart 12: Upcoming European Leveraged Loan Maturities by Credit Quality
Measured as the IDR notched by current outlook/RW



Source: Fitch

2. Cyclical/non-cyclical profile of the sector in question (Chart 13).

Chart 13: Upcoming European Leveraged Loan Maturities by Sector



Cyclical: Aerospace, autos, banking, media, building materials, chemicals, computer & electronics, general retail, manufacturing, lodging, metals & mining, packaging, paper & forest, real estate
Somewhat cyclical: Business services, consumer products, farming, gaming/leisure, energy (oil & gas), textiles, transportation
Non-cyclical: Cable, environmental services, food & beverage, food & drug retail, healthcare, pharmaceuticals, telcos, utilities (power)
Source: Fitch

Measured in debt volumes, the “notched” IDR of leveraged borrowers suggests a fairly high degree of concentration among low quality credits. Specifically, 38% of total rated debt volumes due to expire between 2014 and 2016 refer to ‘B-*’ and ‘CCC*’ or below rated credits. Likewise, when looking at sector split, the concentration among what the agency deems “cyclical” or “somewhat cyclical” sectors (as defined in Chart 13) also points to about 41% of par value loans at risk in case the economic recovery remains anaemic through 2012.

In addition, by range of EBITDA, it is also clear that smaller credits will continue to suffer the most (as highlighted in the LTM EBITDA variance to the original Fitch case forecasts in Table 6) as they display low median profit margins and high financial leverage. These will remain the candidates for near-to-mid term defaults. For the larger and often higher-rated borrowers, a wider array of flexibility exists including

Table 6: Fitch's Shadow Rating Portfolio Break-Up by EBITDA Range

Annual EBITDA (EURm)	No. borrowers	Aggregate debt amount (EURbn)	Median EBITDA (EURm)	Median EBITDA margin (%)	Average rating (IDR)	LTM EBITDA performance vs. original Fitch case (% variance)[a]	Median total debt (EURm)	Median total leverage (x)[b]	Median interest cover (x)[b]	Median (cash + undrawn RCF)/(debt service N+1) (x)
>500m	15	69.7	694	23.5	B*/B+*	7.8	4,221	6.1	2.8	1.4
500m-200m	43	93.1	271	21.6	B-*/B*	6.1	1,814	6.7	2.1	1.3
200m-100m	73	64.7	146	15.3	B-*	6.3	845	5.8	1.9	1.7
100m-50m	77	38.4	69	17.5	B-*/CCC*	0.8	453	6.6	2.0	1.6
50m-25m	49	14.6	37	16.0	CCC*	-3.5	272	7.4	1.6	1.5
<25m	36	7.7	14	9.8	CCC*	-1.9	113	8.1	1.5	1.3

[a] Only including transactions rated by Fitch with updated financial performance as of December 2008 onwards
[b] Lease-adjusted ratios where applicable
Source: Fitch

potential loan extensions, equity injections via IPOs, or partial refinancing of senior debt and extension of total debt maturities — as Virgin Media Inc (BB-/Stable) did in July 2009 via its USD1.3bm total senior note issue. In addition, larger borrowers may benefit from potential asset sales as they attempt to de-leverage and remain eligible for capital market cures in order to avoid defaults.

In summary, anticipating default rates beyond 2010 rests on the condition of the capital markets, their appetite for refinancing legacy transactions and the degree to which economic recovery facilitates the surviving leveraged borrowers' cash flow generation such that they de-leverage towards sustainable levels.

Fitch's Latest Recovery Analysis

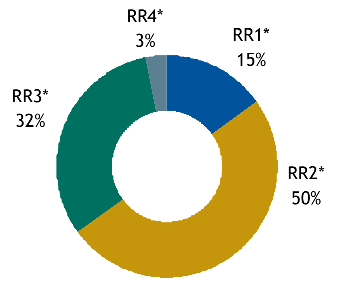
More details on Fitch's Recovery Rating methodology are available in the agency's "*Recovery Ratings - Approach and Process for Corporate Finance*" report (dated 9 August 2005 and available at www.fitchratings.com). An update of Fitch's Recovery Ratings criteria is expected to be released shortly.

Fitch assigns Recovery Ratings on the financial instruments of all corporate issuers rated in the single 'B' category and below, using a bespoke analysis which estimates a distressed enterprise value for the company, and distributes this through the capital structure according to seniority. Fitch's estimates of distressed enterprise values typically represent a significant discount compared with the original transaction multiples. In light of the material adjustments in implied enterprise valuations inherent in the adjustments over the past 18 months in public equity market capitalisations, Fitch continues to review its assumptions of distressed cash flows and EV/EBITDA multiples applied in its recovery analysis on a sector by sector basis. The agency makes selective adjustments where needed — albeit tempered by the recent improvement in benchmark public equity valuations — primarily driven by a change in the industry outlooks (ie, if the recession exposes any structural weaknesses in a given sector) or changes to a company's positioning within its industry.

In comparison with previous default cycles, Fitch's recovery methodology already assumes much reduced recoveries for all debt classes. The weighted average recovery rate (WARR) for the senior debt in the portfolio of leveraged issuers shadow-rated by Fitch in Europe fell to 66% at end-September 2009. This is a reduction from 74% at end-December 2007 (before the onset of the recession and the full impact of the credit crisis). The recent decline in WARR reflects case-by-case changes in Fitch's recovery assumptions rather than any change in capital structures or wholesale amendments to Fitch's methodology. The average shadow recovery rating for senior debt is 'RR3*', which implies recoveries of between 51%-70%.

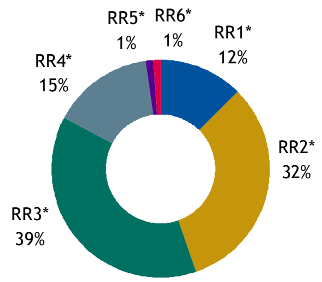
The WARR on mezzanine debt remains quite low at 8.5% ('RR6*'). The expectation of poor recoveries for peak-of-the-market mezzanine loans has been borne out in the latest round of restructurings in Europe — as for example in the IMO Car Wash debt restructuring in the UK. This case, in fact, has also brought the issue of the legal regime to the forefront which will certainly have further repercussions in the availability and cost of junior debt financing in the future. As Fitch reviews its portfolio of leveraged loans, it remains to be seen whether or not an eventual improvement in trading performance along with sustained senior debt de-leveraging strategies and/or increased M&A activity, will lead the expectation that distressed enterprise values could start breaking in the mezzanine debt.

Chart 14: Senior Loan Recovery Rates (YE07)



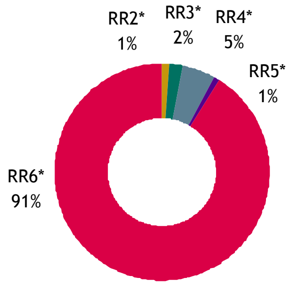
Source: Fitch

Chart 14A: Senior Loan Recovery Rates (Sep 09)



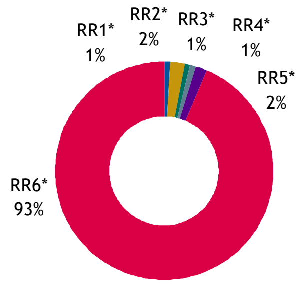
Source: Fitch

Chart 15: Mezzanine Recovery Rates (YE07)



Source: Fitch

Chart 15A: Mezzanine Recovery Rates (Sep 09)



Source: Fitch

Fitch has not seen yet any realised cash recoveries for lenders of European buyouts as debt restructurings to date have taken the form of consensual debt arrangements whereby some portion of cash-pay debt is swapped for payment-in-kind debt and/or equity allowing the borrower to operate under lower debt service burdens and potentially "trade-through" the economic trough before healthier debt service coverage levels are restored. The level of "recoveries" based on the loan amounts that were rolled over in recent restructurings (50% of the original par value on average) appears to confirm Fitch's expectation of aggregate "ultimate" recoveries (51%-70% range). In Fitch's view, such debt restructurings have generally left too much debt in the new structure, often by way of Payment-in-Kind (PIK) debt that is deemed out-of-the-money at the onset) — please refer to Fitch's *"Rating Approach to PIK Loans in Restructurings*" report dated 23 June 2009*)* — thus still resulting in a high proportion of 'CCC*' ratings. Only an actual trade sale, third party equity valuation or voluntary debt refinancing with the participation of new lenders will dictate the ultimate level of effective recoveries for defaulted leveraged loans.

Conclusion: Looking for an Exit

Notwithstanding the aligned effort among debtors and creditors to avoid default and costly write-downs inherent in current conditions, default rates are nonetheless on the rise. Yet the increased proportion of Fitch's shadow-rated portfolio rated 'B-*' and below combined with larger, more resilient performing credits and sectors, indicates the potential for the market to bifurcate into stressed and performing components. Troubled borrowers will continue to rely on extensions and amendments in order to avoid near-term defaults and buy time as economic and capital market conditions improve. Only those that require new capital will be forced to restructure, in which case the agency anticipates existing senior lenders will continue to leave as much debt as possible on the restructured balance so as to avoid capital replenishment among bank lenders or further exacerbate coverage tests among collateralised loan obligations. These tactics remain an option only so long as there remains headroom on senior maturities, a window that becomes narrower as time passes.

For now the majority of small/mid-cap borrowers remain vulnerable to narrow debt service headroom and stubbornly high leverage. Larger credits that maintain debt service headroom and financial flexibility are likely to be eligible for capital market solutions as they approach maturity dates. However, such outcomes depend on both continued de-leveraging and the prevailing capital market conditions in 2011 and 2012, where the agency has little visibility. Although the horizon remains distant, the greatest risk may be borne by subordinated creditors; insofar as legacy senior lenders may be willing to extend maturities on senior debt when they come due, though they are not likely to accommodate subordinated second lien, mezzanine or PIK facilities maturing ahead of them.