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European Default Update: Serial Defaulters Pressure Europe's Corporate Sector

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European Default Update: Serial Defaulters Pressure Europe's Corporate Sector

Standard & Poor's Ratings Services' latest quarterly analysis of the default rate for European speculative-grade companies (that is, those rated 'BB+' and below) shows that it has risen above 7% for the first time since the second quarter of 2010. Within recent reported defaults (particularly private defaults) are a high proportion of companies defaulting for a second and even a third time. In the absence of a material improvement in the economic outlook for the region, the still-weak credit quality of our private credit estimates portfolio, together with a less tolerant approach toward borrower-friendly amend-to-extend (A-2-E) transactions, suggests to us that this trend is likely to continue. We note that lenders' attitude toward forbearance is already hardening in certain countries, resulting in rising defaults in France and The Netherlands in particular.

Overview

- Ten EU-30 speculative-grade corporates (including private credit estimates) defaulted in the second quarter of 2013 on total debt of €8.7 billion, compared with 12 corporates and €2.4 billion in the first quarter.
- Over the past 12 months, 52 EU-30 speculative-grade companies have defaulted (11 publicly rated; 41 private credit estimates) carrying €31 billion of debt.
- The trailing-12-month speculative-grade default rate by number in the second quarter of 2013 was 7.5% (combining public and private portfolios) compared with an upwardly revised 7.6% for the first quarter.
- The default rate by value rose to 3.7% at the end of June 2013, from a revised 3.1% at the end of March 2013.
- Our 12-month default rate forecast (by number) to September 2014 of 6.5% is heavily influenced by the still-weak credit quality of a significant proportion of the credit estimates cohort.

Credit Estimates Dominate The Default Rate By Number

There were 10 corporate defaults in the second quarter of 2013, resulting in a trailing-12-month (TTM) EU-30 speculative-grade corporate default rate (combining our public rating and private credit estimate portfolios) of 7.5%. This rate is in line with our upwardly revised 7.6% default rate from the first quarter and continues to reflect a steady stream of credit estimate defaults, some of which have been slow to report (see table 1 and chart 1).

The default rate is heavily influenced by the low credit quality of our private credit estimates portfolio, of which 55.4% sits at the 'b-/ccc' level. This is either because credit estimates at this level remain vulnerable after restructuring for various reasons (including still-stretched balance sheets) or are continuing on probation. Other, highly leveraged, credits are still hoping that business conditions might pick up sufficiently to facilitate a refinancing on reasonable terms before their debt matures in 2013-2014.

Of the 10 defaults in the second quarter, three were publicly rated entities that missed making an interest payment. They comprise Netherlands-based integrated logistics services provider CEVA Group PLC (CEVA), which defaulted for the second time; Netherlands-based telecoms holding company Magyar Telecom B.V.; and Spain-based gaming

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company Codere S.A. There was also a default by a confidentially rated Greek shipping company. The six private credit estimate defaults were all pre-2008 transactions, of which three had previously defaulted.

We note that since the start of 2011, only eight of the 106 defaults have been investments or transactions where new public ratings or credit estimates were assigned from the beginning of 2009. Of these eight, only three are private credit estimates, and none of the other five public defaulters had credit estimates prior to obtaining public ratings. The key takeaway is that more than 90% of defaults in the past two-and-a-half years relate to transactions originated at the height of the 2006-2008 bull market.

Serial defaulters stretch the default cycle

A notable feature of recent defaults is the high proportion of companies defaulting for a second or third time. Since the start of 2011, 44% of all the corporate speculative-grade defaults in this dataset are repeat defaults, with three defaulting for a third time. This is a key reason why the current default cycle is proving to be so protracted, and, in the absence of a material improvement in the economic outlook, the increasing frequency of A-2-E transactions suggests that this trend is likely to continue. A repeat default occurs when an entity's corporate credit rating or private credit estimate is raised from 'D/SD' (Default/Selective Default) after a default or restructuring then suffers another default. Our default definition covers failure to pay; bankruptcy filings; and financial restructurings that we consider to be distressed exchanges, including some A-2-E transactions.

Table 1

European Public And Private Speculative-Grade Default Rate (By Number) 2003-2013*

	Private Credit Estimates			Public Speculative-Grade Ratings			Combined
	No. of entities§	Defaults	TTM default rate (%)	No. of entities§	Defaults	TTM default rate (%)	TTM default rate (%)
2003	180	5	2.8	111	5	4.5	3.4
2004	263	4	1.5	126	2	1.6	1.5
2005	334	5	1.5	163	2	1.2	1.4
2006	461	8	1.7	185	4	2.2	1.9
2007	544	8	1.5	183	3	1.6	1.5
2008	607	35	5.8	170	5	2.9	5.2
Q1 2009	600	26	10.0	169	4	5.3	9.0
Q2 2009	591	24	13.4	168	2	6.5	11.9
Q3 2009	588	22	16.1	168	6	9.5	14.7
Q4 2009	590	15	14.8	167	4	9.6	13.6
Q1 2010	577	5	11.4	172	1	7.5	10.5
Q2 2010	565	9	9.0	178	3	7.9	8.7
Q3 2010	547	7	6.6	191	1	4.7	6.1
Q4 2010	533	7	5.3	199	0	2.5	4.5
Q1 2011	523	8	5.9	212	1	2.4	4.9
Q2 2011	500	5	5.4	225	1	1.3	4.1
Q3 2011	496	4	4.8	234	0	0.9	3.6
Q4 2011	484	12	6.0	236	2	1.7	4.6
Q1 2012	474	7	5.9	249	3	2.4	4.7
Q2 2012	454	8	6.8	256	3	3.1	5.5

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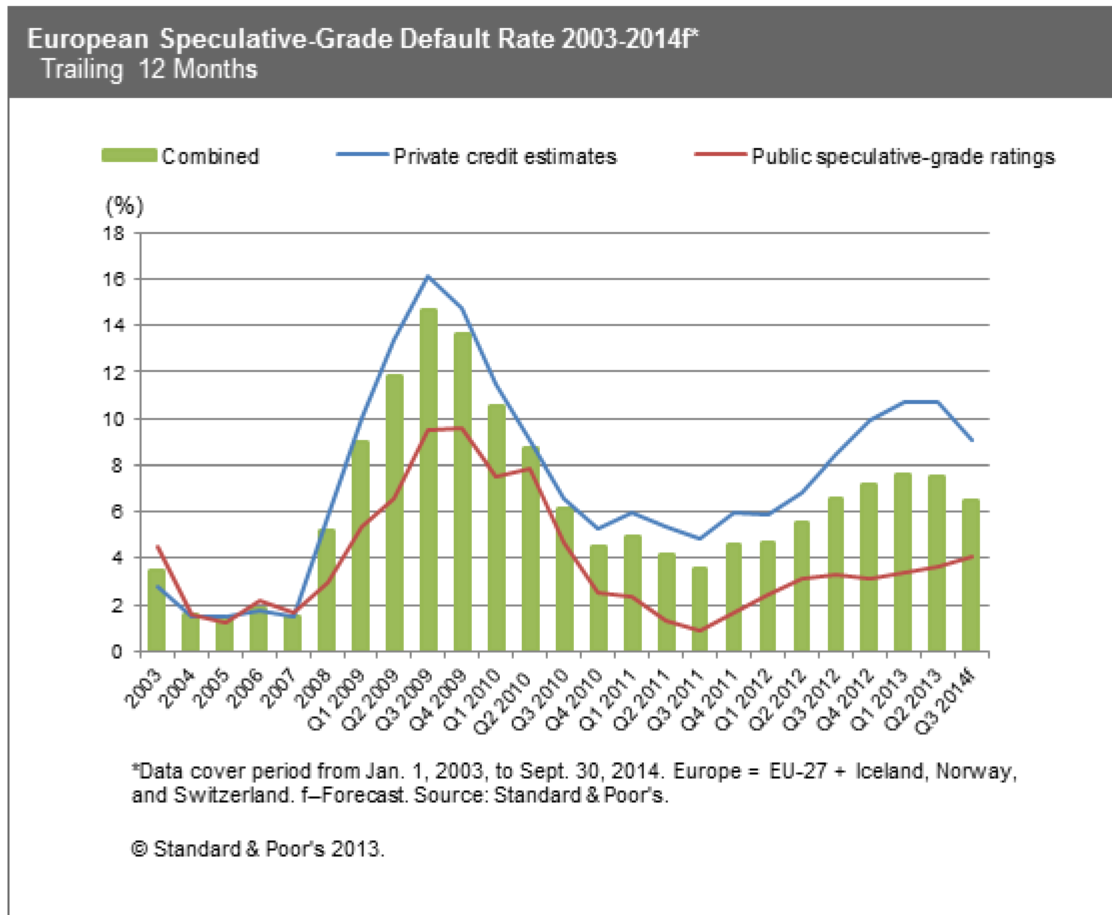
Table 1

European Public And Private Speculative-Grade Default Rate (By Number) 2003-2013* (cont.)							
Q3 2012	457	12	8.5	273	1	3.3	6.6
Q4 2012	425	15	9.9	285	2	3.2	7.2
Q1 2013	402	8	10.7	298	4	3.4	7.6
Q2 2013	385	6	10.7	306	4	3.6	7.5

*Data cover period from Jan. 1, 2003, to June 30, 2013. §Average no. of entities in database over period. TTM--Trailing 12 months. Europe--EU-27 + Iceland, Norway, and Switzerland. Source: Standard & Poor's.

Chart 1



Default Rate By Value Ticks Up To 3.7%

By value, the €8.7 billion debt exposed by the 10 defaults in the second quarter was slightly above the quarterly average experienced since 2009, reflecting three large defaults with outstanding debt of more than €1 billion (CEVA €2.6 billion; and two large French credit estimate defaults). The average amount of debt held by defaulting entities was a material €980 million and €790 million, respectively, for public speculative-grade and private credit estimates defaulters. In aggregate, the TTM default rate by value ticked up to 3.7% from a revised 3.1% at the end of the first quarter of 2013 (see table 2), but is still well below the 4.9% average over the last cycle that started in 2008.

Despite a gradual erosion in the number of private credit estimates in our portfolio as loan issuers refinance and investors in collateralized loan obligations slowly run down their portfolios, outstanding debt held by EU-30 private credit estimate corporate issuers remains significant at €218 billion. Of this amount, comprising both senior and junior funded debt, about €76 billion is held by companies with 'b-/ccc' credit estimates at the end of June 2013, of which 45% or €34 billion resides in the 'ccc' categories. Within the most vulnerable 'ccc' category, 40% of the outstanding debt is held by Spanish companies, much of which remains real estate-related. French companies are next in line, holding 25%, followed by German companies with 17%. Only 10% was held by U.K. companies at the end of June 2013.

Table 2

European Public And Private Speculative-Grade Default Rate (By Value) 2008-2013*

	Private Credit Estimates			Public Speculative-Grade Ratings			Combined
	No. of defaults	Value (bil. €)	TTM default rate (%)	No. of defaults	Value (bil. €)	TTM default rate (%)	TTM default rate (%)
Q1 2008	1	3.02	--	0	0.00	--	--
Q2 2008	5	0.71	--	0	0.00	--	--
Q3 2008	6	0.97	--	1	0.44	--	--
Q4 2008	23	7.45	3.4	4	19.98	5.6	4.5
Q1 2009	26	14.21	6.6	4	3.35	6.5	6.6
Q2 2009	24	11.98	9.8	2	8.23	8.8	9.3
Q3 2009	22	9.27	12.1	6	5.10	10.1	11.1
Q4 2009	15	5.40	11.5	4	4.89	5.9	8.7
Q1 2010	5	0.69	8.2	1	0.00	5.0	6.5
Q2 2010	9	9.25	7.9	3	2.47	3.4	5.5
Q3 2010	7	2.79	6.2	1	2.17	2.6	4.2
Q4 2010	7	1.39	5.2	0	0.00	1.2	2.9
Q1 2011	8	2.86	6.6	1	0.37	1.3	3.4
Q2 2011	5	1.77	3.6	1	0.41	0.8	1.9
Q3 2011	4	5.96	4.9	0	0.00	0.2	2.0
Q4 2011	12	4.92	6.3	2	3.17	0.9	2.9
Q1 2012	7	4.65	7.1	3	10.52	2.8	4.2
Q2 2012	8	1.37	6.4	3	1.99	2.8	4.0
Q3 2012	12	5.52	6.6	1	0.46	2.6	3.8
Q4 2012	15	6.12	7.2	2	4.14	3.1	4.3
Q1 2013	8	1.67	6.2	4	4.37	1.9	3.1
Q2 2013	6	4.76	8.3	4	3.91	2.1	3.7

*To June 30, 2013. Europe--EU-27 plus Iceland, Norway, and Switzerland. TTM--Trailing 12 months. Source: Standard & Poor's.

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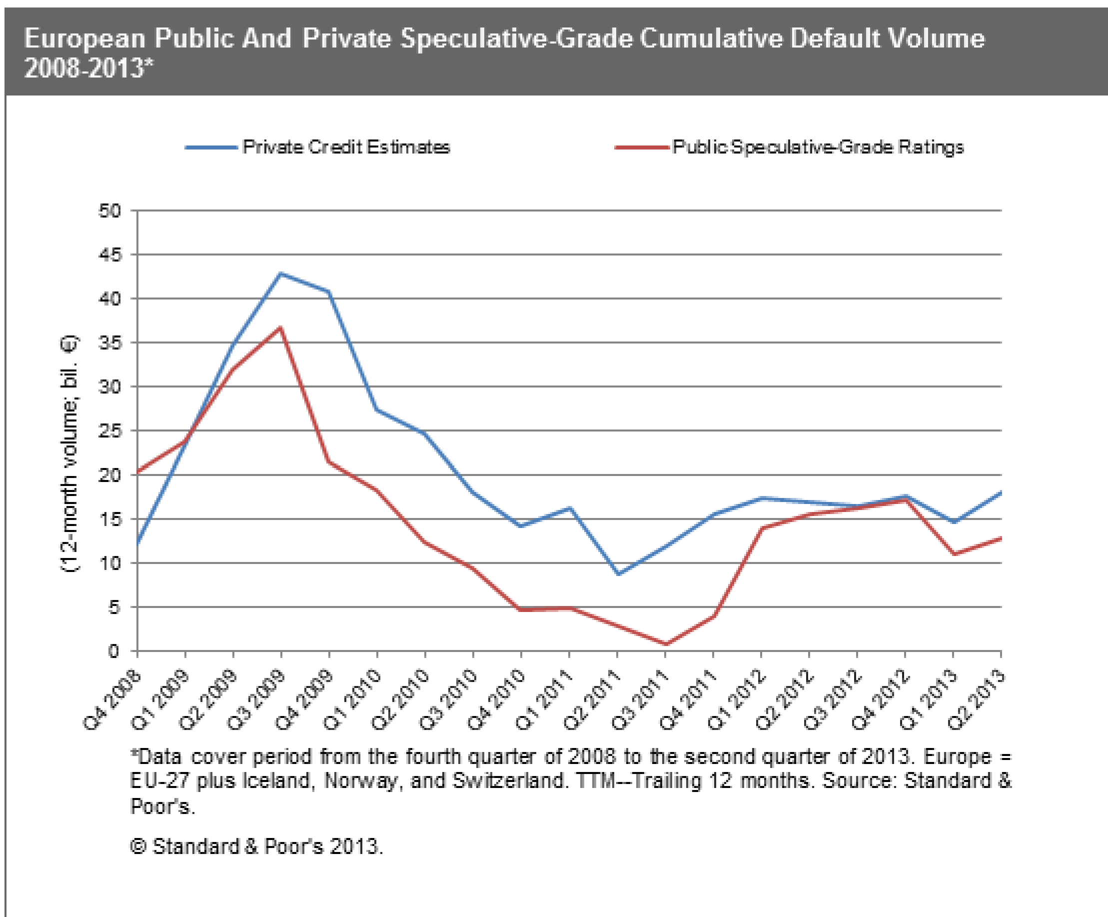
Chart 2



Transportation Defaults Spike At 18%

The business environment continues to test the transport industry and two of the second-quarter defaults arose in the shipping (a confidential rating) and transport logistics segments (CEVA). These defaults mean that the TTM default rate in the transportation industry rose to a record 18.2% for the speculative-grade corporate portfolio that we track (see table 3).

Overcapacity continues to dog the shipping sector as new ships are delivered, and this, combined with slower-than-anticipated growth in global trade and high bunker fuel costs, is playing havoc with the industry's economics.

CEVA's default was triggered by missed interest payments just prior to a major restructuring in the second quarter of 2013. The company's financial performance has been weakened significantly by the global supply chain industry's volume shift to (cheaper) oceanic transport from air transport, and by its exposure to the weak southern European economies in its contract logistics business.

In the media and entertainment sector, the 10.6% default rate remains well-above average, led by print publishing

firms (including those in the Yellow Pages segment) suffering from the structural shift toward digital media. Spain-based gaming company Codere was a high-profile public default in the second quarter caused by a missed payment. The company is wrestling with an unsustainable capital structure, weak operational performance in Argentina and Mexico, and the effect of higher gaming taxes in Italy.

The retail sector, an early casualty of the recession, is struggling against rising unemployment, declining real disposable incomes, and depressed consumer expenditure—notably in the peripheral countries of Europe. The most recent quarter saw two French retail defaults, further highlighting the current deterioration in the economic environment in Europe's soft core. These, together with a credit estimate default by an Italian food service business, pushed the TTM default rate for the sector to 9.9% from 4.0% in 2012.

Table 3

European Speculative-Grade Corporate Default Rate By Industry Sector 2008-2013*

		Default rate* (%)					
	No. of entities	2008	2009	2010	2011	2012	LTM Q2 2013
Transportation	39	4.9	7.5	4.8	7.4	10.5	18.2
Business services	47	1.4	13.3	4.5	1.7	16.4	13.2
Media and entertainment	104	4.5	14.3	6.7	6.4	8.5	10.6
Retail/restaurants	71	5.1	22.7	2.6	7.0	4.0	9.9
Chemicals, packaging, and environmental services	45	10.6	19.0	1.7	3.9	13.5	9.4
Utilities	14	0.0	0.0	0.0	0.0	0.0	7.4
Telecommunications	32	3.3	11.5	8.0	3.3	3.2	6.7
Homebuilders/real estate	51	11.3	22.6	0.0	3.9	2.0	5.9
Automotive	34	9.5	23.7	2.5	4.9	2.6	5.8
Consumer products	51	7.1	13.0	1.6	6.4	13.2	5.7
Capital goods	43	1.7	10.0	3.8	7.0	4.7	4.8
Forest products	30	0.0	0.0	0.0	0.0	0.0	3.5
Health care	64	3.2	3.3	3.2	3.3	5.0	3.4
Technology	21	5.0	22.2	9.5	0.0	4.7	0.0
Oil and gas	21	0.0	0.0	4.5	0.0	4.1	0.0

*Data cover period from Jan. 1, 2008, to June 30, 2013. Data combines rated entities and private credit estimates. Europe--EU-27 + Iceland, Norway, and Switzerland. LTM--Last 12 months. Source: Standard & Poor's.

LBO Defaults Rise Sharply In France And The Netherlands

From a country perspective, the default rate in France and The Netherlands has risen most sharply over the past 12 months. Recessionary conditions in the soft core of Europe have undoubtedly played a part. However, another factor that we believe is playing out, particularly in France, is that lenders appear to be pushing back to a greater extent on A-2-E transactions than they were in 2010 and 2011.

In 2010 and 2011, it was noticeable that lenders to French companies were sympathetic to the practice of forbearance. This enabled debt maturities to be extended to buy time to enable companies to grow back into their balance sheets.

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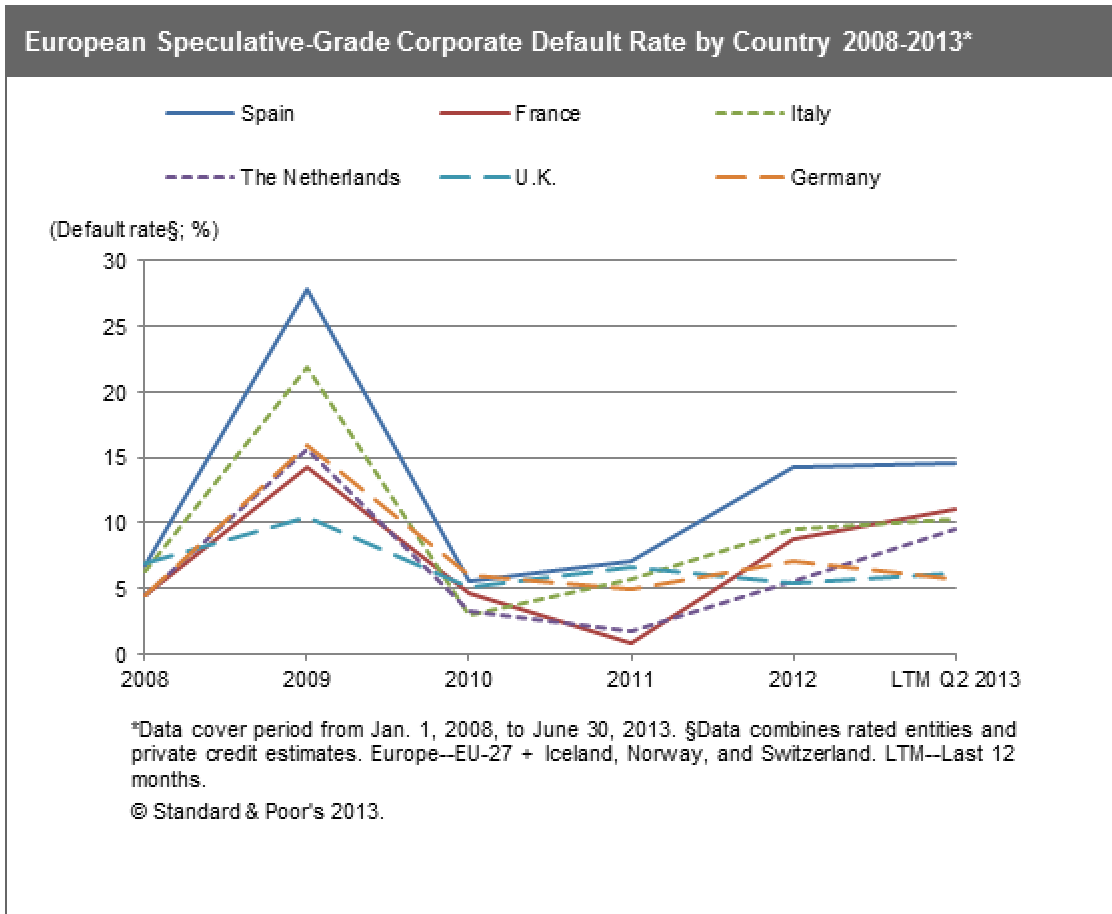
The practice also protected lenders from getting caught up in protracted legal proceedings that in France are relatively favorable to debtors.

Now this trend appears to have reversed, with France and The Netherlands experiencing a rapid acceleration in the TTM default rate to 11.1% and 9.5%, respectively, from 8.7% and 5.6% in 2012; (see chart 3).

Chart 3



Default Rates Diverge Between Our Public And Private Portfolios

The outlook for the European default rate reflects two ongoing trends that have been apparent for a while. Our public speculative-grade portfolio continues to expand (see chart 4), with credit quality on average declining marginally over time, albeit supported by new ratings often assigned at the 'B+' level. By contrast, as shown in chart 5, our private credit estimates portfolio, largely comprising leveraged buyouts (LBOs) originated before 2009, continues to shrink due to a combination of defaults, sales of loans from investor portfolios, corporate acquisitions, and refinancings. Nevertheless, the average credit quality for our mature credit estimates portfolio remains very low at 'b' (and close to 'b-'). In many cases, this is due to a combination of weak operational and financial performance, approaching maturities, high leverage, tight covenant headroom, and "less than adequate" liquidity as our criteria defines the term.

Chart 4

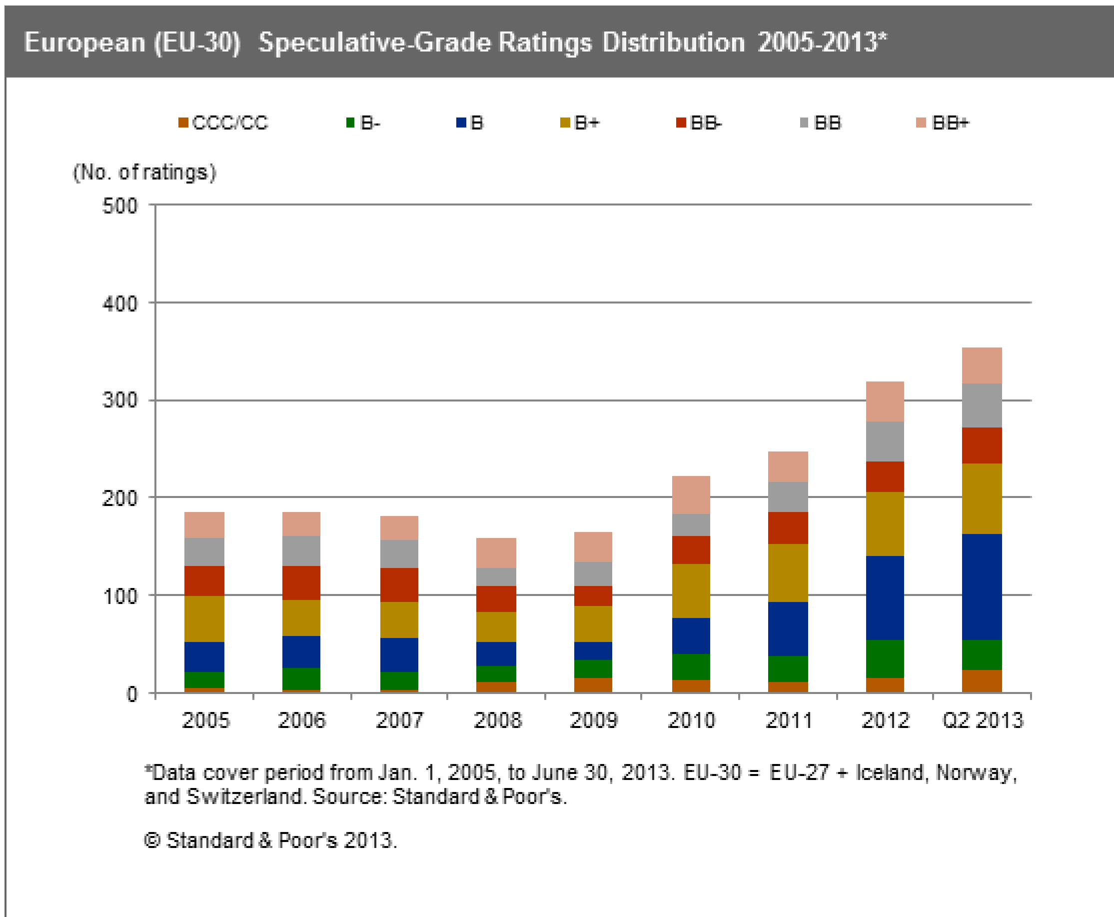
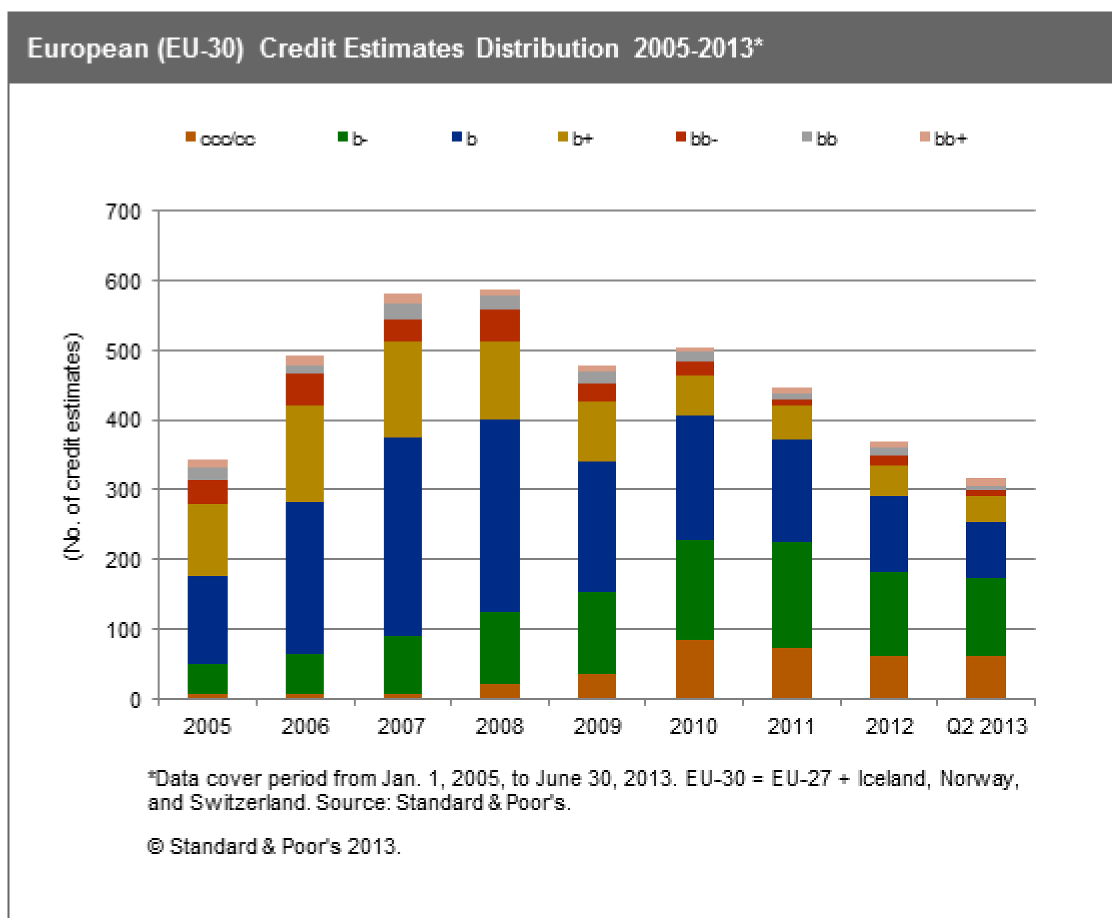


Chart 5



From our perspective, many of these private companies find themselves at a different point in the liquidity cycle compared with rated companies that generally have better access to the debt capital markets. This is due both to upcoming debt maturities in many cases as well as reduced appetite of existing bank and institutional lenders to roll over their loan commitments.

To reflect the different position in the liquidity cycle of the two portfolios, this quarter we have applied higher stress factors in our one-year default forecast to the credit estimate dataset. We believe this also aligns with EU regulators' intention to move toward a more consistent classification of A-2-E transactions, which we anticipate will increase the likelihood of some of these vulnerable private companies being restructured.

Consequently, under our base case we now project the TTM default rate to increase slightly to 6.5% (see table 4) by the end of September 2014 from our previous forecast of 6.3% for the end of June 2014. This assumes that the default rate for credit estimates will remain above 9% over the next 12 months due to the weak credit quality of our credit estimates portfolio, with 55.4% at 'b-' or below--slightly higher than the March figure of 52.6%. Nonetheless, we continue to see the number of (legacy) credit estimates being whittled away through refinancing, conversion to public ratings, or repayment of the loans.

Our overall base-case forecast is somewhat lower than the latest actual 7.5% default rate by number as we work through the default cycle and transition away from private credit estimates. In addition, the unusually high number of defaults in the second half of 2012--which will be difficult to repeat in the second half of 2013--is likely to produce a modest easing in the headline default rate from the current level.

Table 4

European (EU-30) Speculative-Grade Default Projections To September 2014

One-Year Default Assumptions For Ratings/Credit Estimates

Ratings/Credit Estimates	Default Assumptions					
	Base case			Downside		
(% per year)	Public ratings	Credit estimates	Combined	Public ratings	Credit estimates	Combined
>B+	0.6	0.7	--	0.9	1.0	--
B+	2.1	2.2	--	2.6	2.7	--
B	4.3	4.7	--	5.5	5.9	--
B-	6.7	7.4	--	8.9	9.6	--
CCC/CC	23.4	25.1	--	28.6	30.3	--
Default rates						
Percentage	4.1	9.1	6.5	5.2	11.3	8.1
No. of defaults	15	29	43	18	36	54

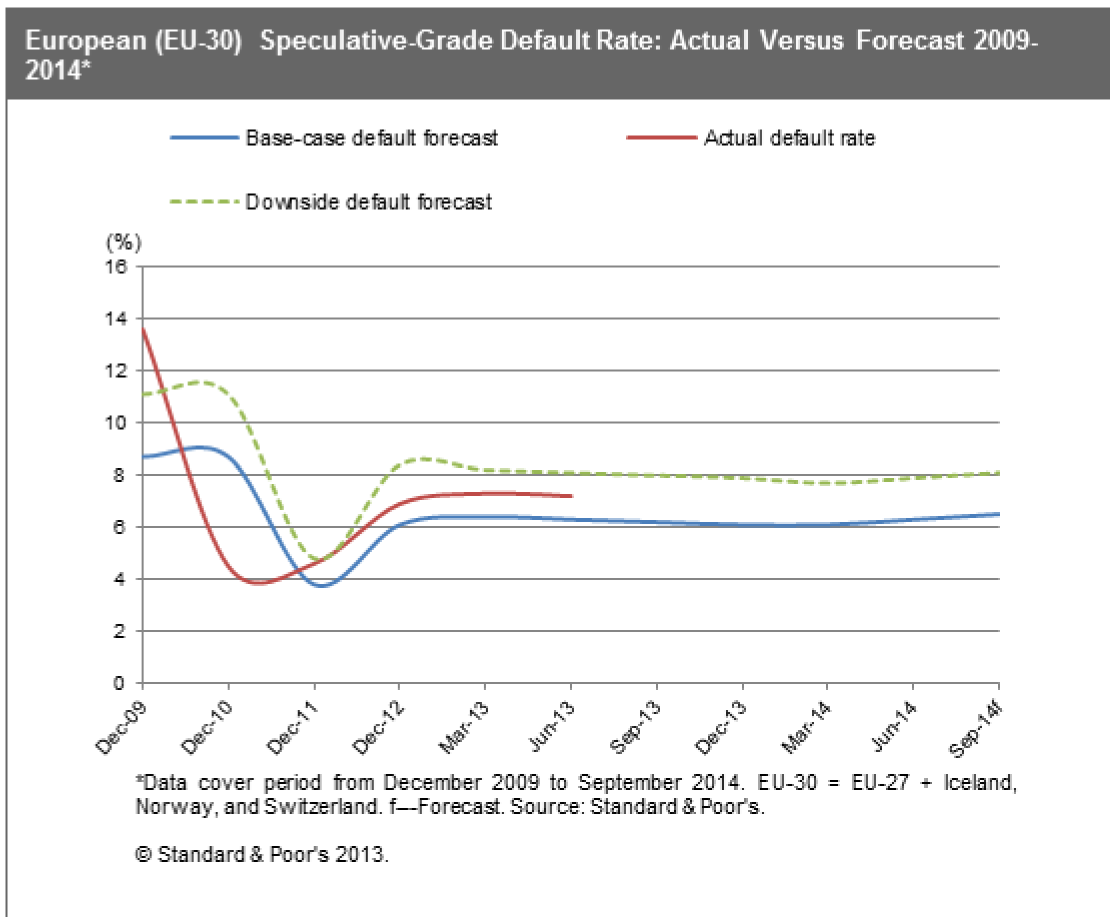
Source: Standard & Poor's.

In our more severe downside scenario, where the European economy slumps into a more severe and extended recession accompanied by more difficult credit conditions in financial markets, we could see the default rate by number rise as high as 8.1%. We project that this scenario would be led by legacy 2006-2008 vintage LBOs, for which we envisage the default rate rising above 11%.

Chart 6 tracks the actual TTM default rate (by number) and compares to our base-case and downside forecasts since the end of 2009. The actual default rate has been about 1% above our base-case forecast in recent years, but well below our downside scenario. On closer scrutiny, the variation against our base-case forecast is solely due to the consistently higher default experience of our private credit estimate portfolio over this period.

This lends support to our revised approach in applying slightly harsher stress assumptions to the credit estimates portfolio to reflect the near-term liquidity risks to which many private credit estimates are still exposed.

Chart 6



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