SOVEREIGN STRESS

NON-FINANCIAL COMPANIES FACE AN INCREASED RISK OF CREDIT DETERIORATION DUE TO THE EUROZONE'S WEAK MACROECONOMIC OUTLOOK, SAY COLIN ELLIS AND LOLA CAVANILLES

The financial crisis in Europe has taken a heavy toll on the credit quality of sovereigns and banks, and could yet impact further. In contrast, the credit quality of non-financial companies has been relatively resilient so far. But the risk of significant credit deterioration in this sector is now increasing. Negative rating actions have outpaced positive actions so far during 2012, reflecting both the direct effect on government-related issuers (GRIs) of the European sovereign downgrades in early 2012 and a number of downgrades in cyclical industries and for highly leveraged issuers. Moody's expects this negative credit trend to continue into 2013. Any upward rating potential is likely to be limited to a few well-diversified issuers, such as corporates in industries with reasonably predictable and stable trends, or those issuers focused on deleveraging.

These broad credit trends are also reflected in our industry outlooks. At the moment, the number of stable industry outlooks in Europe, the Middle East and Africa (EMEA) slightly exceeds the negative outlooks in our rating universe. Four industry outlooks have been lowered to negative from stable during 2012, however, and only two industries in EMEA currently have positive outlooks (cable operators and tobacco). This downside risk to ratings primarily reflects ongoing concerns about the potential fallout from the sovereign debt crisis, which has yet to be resolved.

As such, the key challenges for non-financial corporates in Europe remain unchanged. The primary concern is still the weak macroeconomic outlook for the euro area region, reflecting continued sovereign debt stress and related fiscal austerity, very weak business and consumer confidence, bank lending constraints, higher funding costs and volatile capital markets.

The deepening recession is now undercutting corporate revenues and cash flow, causing many companies to lower estimates for financial performance during 2012. For some businesses, sales in faster-growing international markets had previously offset weak domestic activity. But with emerging markets also slowing as well, this support has faded. Revenues and cash flow are declining severely in markets with falling domestic demand, such as Greece and Portugal, and, more recently, Spain. Italy looks to be on the brink of a similar downturn.

Most non-structured locally domiciled issuers (rated at or below the level of the sovereign) are directly exposed to sovereign risk, as they are linked to the same macroeconomic drivers. Corporates and GRIs that are highly exposed to euro area periphery countries remain at the highest risk of downgrade. If the crisis were to re-intensify and further sovereign downgrades ensued, it is worth noting that corporate issuers' ratings may typically only exceed the sovereign rating by one or two notches. In order to do so, corporate issuers must have a fundamentally stronger credit profile than the sovereign, and be insulated from domestic macroeconomic factors to a significant degree.

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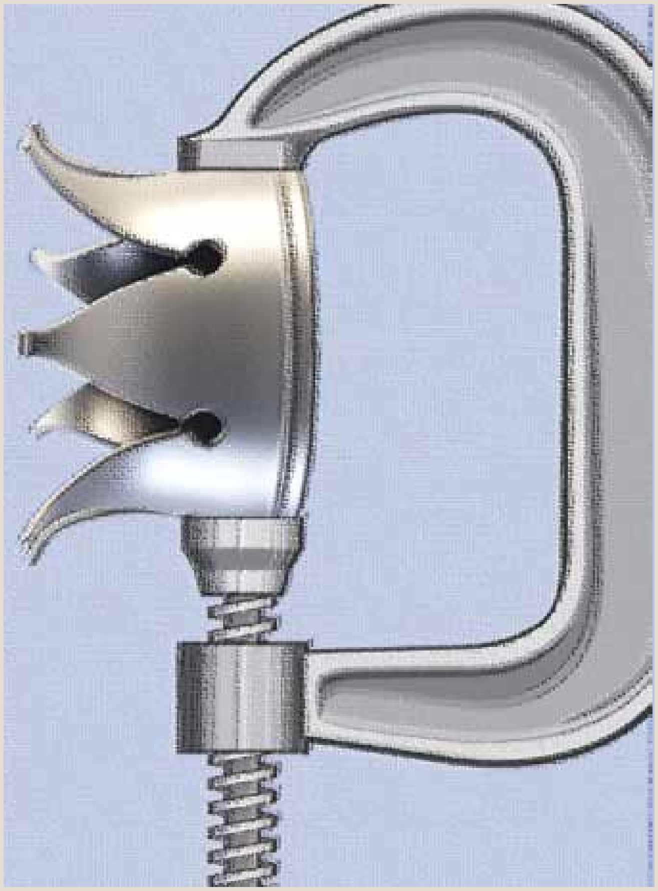
While a surge in defaults is unlikely in the near term, weaker liquidity profiles could result in downgrades for low-rated companies (ie those rated B and below). Although our central forecast is that the default rate for speculative issuers will remain low over the coming 12 months at around 3%, a further deterioration in the economic environment or another flaring of the European debt crisis could trigger liquidity events that may result in distressed exchanges or outright defaults.

So far this year, Germany, the UK, Italy and France have led issuance in Western Europe. Russia has dominated emerging

DEFAULTS DURING 2012

By the end of September 2012, there had been seven defaults of non-financial corporates in EMEA. These were Petroplus Holdings and Yell in January, Eircom Group plc in March, PBG in May, Kleopatra Lux 1 S.A.r.l. in June and Nobina in August.

- Eircom – 1y before Caa1 – Rating now withdrawn
- Kleopatra – 1y before Caa1 – Rating now withdrawn
- Nobina – 1y before B2 vs. now Caa1
- Norske Skogindustrier – same rating 1y before and now Caa1
- PBG – Rating assigned on December 2011 at B2 – Rating now withdrawn
- Petroplus – 1y before B1 – Rating now withdrawn
- Yell – 1y before B3 vs. now Ca (Hibu Plc)



market issuance, driven by the support from high oil and commodity prices. Despite a slowdown over the summer, during September we have seen large-scale issuance by European corporates, including those from the periphery countries. This has taken place at much lower yields compared with the period between May and July, and liquidity seems to have improved significantly across our rated universe.

For now, we continue to expect capital market volatility to put pressure on liquidity and refinancing

At the same time, it is also important to note that record levels of high yield issuance during 2012 in part reflect the continued refinancing of past leveraged buyouts (LBOs). In contrast with unrated LBOs, which still face considerable refinancing pressure in the coming years, rated LBOs have largely pushed their aggregate maturities out to 2016 and beyond. Fallen angels continue to show the greatest near-term refinancing needs among speculative-grade issuers, and their proportion of total debt outstanding is higher than for LBOs until after 2016.

Moreover, Moody's expects that potential market disruption linked to the sovereign crisis would also exert further pressure on corporate liquidity via tighter credit conditions and tougher access to finance. Corporate liquidity has already deteriorated in the European periphery countries over the past 12 months, although for most of the European issuers rated by Moody's, it remains solid overall. But this picture could change dramatically if financial market stresses increased.

It is too soon to be certain whether the recent improvement in market conditions reflects a permanent shift, or is instead just a short-term response to hopes of massive central bank action. For now, we continue to expect capital market volatility to put pressure on liquidity and refinancing in the months ahead.

UPCOMING REFINANCING NEEDS REMAIN A THREAT

Moody's estimates that there is a total refinancing need of $1.2 trillion and $363bn over the period 2013-2016 among its rated EMEA investment grade and speculative grade companies respectively.

MAIN HIGHLIGHTS FOR INVESTMENT GRADE ISSUERS:

- These refinancing needs are mainly made up of $380bn in bank debt (2011: $373bn) and $747bn in bonds (2011: $726bn).
- The volume of both bank and bond debt maturities will decline from 2013 onwards, with the exception of $224bn of bond debt maturing in 2014.
- Bond maturities have a concentration on issuers rated A3-Baa1, while bank maturities are primarily represented by corporates rated Baa1.

MAIN HIGHLIGHTS FOR SPECULATIVE GRADE ISSUERS:

- Total bank debt among speculative grade companies for the next four years amounts to $201bn, corresponding to 55% of total outstanding debt in this period.
- The annual peak is $97bn in 2014 (a year ago it was $89bn in 2013).
- Higher rated (Ba) issuers have the greatest refinancing needs in 2012.
- 2013 and beyond have greater concentration in B issuers (LBOs).

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