Sign of strength

After hitting record lows in 2007, global corporate defaults have continued to rise rapidly in 2009. Up to 12 August 2009, 201 issuers had defaulted, affecting debt worth $453bn. Indeed, in the first six months of this year, the total number of global corporate defaults surpassed the 2008 tally, and if the current pattern holds, this year's total will be much greater than the previous high of 229, set in 2001. By comparison, 125 corporate defaults were recorded in all of 2008, affecting debt worth $433bn.

While US-based companies accounted for the lion's share of the defaulters, the geographical concentration is partly attributable to the larger population of rated corporates in the US. Of the 201 defaults recorded so far in 2009, 143 were from the US, 34 from emerging markets, 12 from Europe, 10 from Canada, and one each from Australia and Japan.

The number of distressed exchanges has also soared this year. The tally of 66 issuers to date is more than four times the full-year 2008 total and nearly 17 times the count of four issuers in 2007. Missed interest payments are the top reason for default so far this year, accounting for 70 defaulted issuers, followed by distressed exchanges. The number of bankruptcy filings has also surged, with 53 issuers so far this year having filed for bankruptcy protection, which surpasses the full-year 2008 total of 49 bankruptcy-related defaults.

Standard & Poor's second-quarter default update and ratings transitions report found – indeed, as all of Standard & Poor's default studies have – a high degree of correlation between default rates and ratings. It also found that the ability of corporate ratings to serve as an effective measure of relative risk remains largely intact.

Executive summary

- While the absolute level of corporate defaults has risen significantly, the relative default behaviour of ratings remains in line with the historic norm: higher ratings continue to experience lower average default rates, and vice versa.

TRANSITION TABLES AND CUMULATIVE DEFAULT RATES

Certainly, when assessing corporate default rates and ratings, it is important to look at transition rates, which gauge the degree to which ratings change – either up or down – over a particular period. Indeed, transition studies have repeatedly confirmed that higher bond ratings tend to be more stable while speculative-grade debt generally experiences more ratings volatility.

An analysis of transition rates since 2008 suggests that ratings behaviour continues to exhibit consistency with long-term trends, showing a clear negative correspondence between credit rating and default probability. Indeed, Figure 1 demonstrates that investment-grade-rated issuers – globally – exhibit greater credit stability (as measured by the frequency of rating transition) than their speculative-grade counterparts.

For instance, 87.59% of issuers rated A on 1 January 2008 still retained that rating on 31 December 2008, whereas the comparable figure for an issuer rated B was 73.16%. The same relationship holds even when the transition rates are analysed separately for the US, Europe or the emerging markets. Notably, some unusually large transitions from AAA to B and CCC observed in the table are attributable to pronounced deterioration among some monoline insurers, notably FGIC Corp, FGIC UK, and CIFG Guaranty.

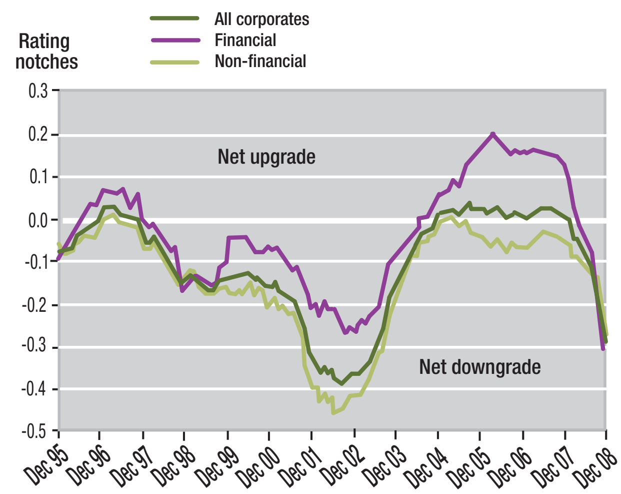
Figure 1: Global corporate transition rates (%)

From/To	AAA	AA	A	BBB	BB	B	CCC/C	D	NR
AAA	81.82	6.06	3.00	0.00	0.00	1.01	2.02	0.00	6.06
AA	0.00	77.65	17.23	0.57	0.00	0.00	0.19	0.38	3.98
A	0.00	1.59	87.59	4.92	0.45	0.00	0.00	0.38	5.07
BBB	0.00	0.00	2.57	86.81	3.59	0.27	0.20	0.47	6.09
BB	0.00	0.09	0.00	4.94	77.21	8.26	1.04	0.76	7.69
B	0.00	0.00	0.00	0.14	3.68	73.16	8.08	3.82	11.11
CCC/C	0.00	0.00	0.00	0.00	0.00	11.22	41.84	26.53	20.41

Source: Standard & Poor

THE CORRELATION BETWEEN CORPORATE BOND RATINGS AND CORPORATE DEFAULTS REMAINS MARKED, AS **DIANE VAZZA** REPORTS.

Figure 2: Global corporates' credit quality by sector
Trailing-12-month change in credit quality



Transitions to NR (withdrawal) are not included as a change in this calculation.
Source: Standard and Poor

UNWELCOME RECORDS Despite this general consistency, exceptional volatility in the financial markets is claiming a higher volume of investment-grade financial corporate defaults than normal. Notably, of the 5,966 corporate issuers rated globally since 2008, 15.82% were downgraded by the end of the year – the highest figure since 2002.

Moreover, the downgrade to upgrade ratio moved up to a five-year high of 2.05, while the average number of notches recorded among downgrades rose in 2008 to 1.63 – a rate unmatched since 2002.

Indeed, at the end of 2008, credit trends dipped for the worse in no uncertain terms, and continued into the first half of 2009, with the largest percentage of downgrades alongside a small proportion of upgrades on a quarterly basis in more than eight years.

The consequence of these conditions was that the average Gini ratio (a measure of the relative ability of ratings to differentiate risk) over the 1981-2008 period dropped to 82% as a result of the sharp deterioration of the one-year Gini ratio in 2008 to 65%.

This is not surprising, given the extraordinary volatility in the financial environment during the course of 2008. A measure of change in credit quality – which combines the average change in the frequency of downgrades or upgrades and the magnitude of such rating transitions, weighted by the total number of issuers outstanding in each sector – is shown in Figure 2. Worth noting is the particularly sharp trajectory of decline within the global financial sector, which saw an unprecedented reversal after starting from a net position of strength at the end of 2007.

RESTORING EQUILIBRIUM Yet this rise in corporate casualties comes on the heels of many consecutive years of heady growth. Conditions for debt issuance have generally improved from the credit freeze in 2008. However, they remain unfavourable to companies on the lowest rungs of the ratings ladder. The significant number of originations in the B rating category in previous years suggests continued exposure to default risk. S&P expects corporate casualties to materialise in large numbers over the next 12 months, even beyond the expected turn in the economic cycle.

THE MARKED INCREASE IN WEAKEST LINKS WILL LIKELY LEAD TO FURTHER CREDIT DEGRADATION, AS ENTITIES AT THE LOWER END OF THE RATINGS SPECTRUM TEND TO BE MORE VOLATILE.

Nevertheless, although the absolute level of defaults has increased significantly, the relative default behaviour of ratings remained in line with historic patterns: that is, higher ratings continued to experience lower average default rates, and vice versa.

This aside, poor business prospects and still tight credit conditions are putting pressure on many companies' business models. This is reflected in the sharp rise in downgrades, which includes defaults.

The marked increase in weakest links (defined as entities rated B- or lower, with either a negative outlook or on CreditWatch with negative implications) will likely lead to further credit degradation, as entities at the lower end of the ratings spectrum tend to be more volatile. Currently, the number of weakest links is still at a record high (although it has eased back from its April peak of 300). As at 12 August 2009, the tally stood at 278, with a combined rated debt worth $302bn. This rise is indicative of the glum default outlook and will need to be closely monitored for the remainder of the year and through 2010.

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