Europe, Middle East/Africa, Asia
Special Report

International Corporates: Update

Liquidity Risks Recede; Fundamentals Remain Weak

Analysts

Richard Hunter
+44 20 7417 4362
richard.hunter@fitchratings.com

Group Credit Officer
John Hatton
+44 20 7417 4283
john.hatton@fitchratings.com

Europe
Industrials
Monica Klingberg Insoll
+44 20 7417 4281
monica.insoll@fitchratings.com

Retail, Leisure, Consumer Products
Edward Eyerman
+44 20 7682 7456
edward.eyerman@fitchratings.com

Energy/Utilities
Andrew Steel
+44 20 7682 7486
andrew.steel@fitchratings.com

Telecom, Media, Technology
Michael Dunning
+44 20 7417 6343
michael.dunning@fitchratings.com

Middle East and Africa
Raymond Hill
+44 20 7417 4314
raymond.hill@fitchratings.com

Asia Pacific
Tony Stringer
+852 2263 9559
tony.stringer@fitchratings.com

Portfolio Review
Claudia Deutschmann
claudia.deutschmann@fitchratings.com

Related Research

- *Global Economic Outlook (March 2009)*
- *European Corporates in 2012 (June 2009)*
- *Sovereign Ownership Impact on Corporate Ratings (June 2009)*
- *Corporate Forecasts: Macro-Level Assumptions (April 2009)*
- *Refinance Risk: Corporates in Europe, the Middle-East & Africa (March 2009)*
- *Refinance Risk: Asia-Pacific Corporates (March 2009)*

Are "Green Shoots" Emerging for Corporate Cash Flows?

Fitch Ratings' corporate analysts remain broadly sceptical of any incipient global economic recovery in corporate credit quality, although forward-looking rating actions indicate a meaningful deceleration in the rate of decline. Fitch's house view on economic recovery remains that headline economic growth may be evident during the last two quarters of 2009, but that the impact of this in reversing current and forthcoming cash flow erosion for corporates will not be felt until mid-2011. The agency remains of the view that economic growth over this period of recovery will remain anaemic, and will coincide with a number of structural shifts for selected sectors prompted or accelerated by the recession.

Corporate rating actions may nonetheless have passed their peak of intensity, as Fitch's forecasts adjusted to this outlook during Q408 and Q109. While Fitch expects the overall tone — more negative than positive actions — to continue through 2009, as Fitch's actions thus far have been based on the agency's forecasts rather than Q408 and Q109 results, Fitch expects the pace and intensity of actions in the remainder of the year to remain below that of Q109 in the central case. Fitch also describes below some additional outliers to this central case.

More colour on Fitch's medium-term expectations for individual sub-sectors can also be found in the comment *Europe in 2012*, published 22 June 2009.

Thoughts for the Day

This report summarises Fitch analysts' current views on:

- The contrasting performance of cyclical versus non-cyclical sectors, with the former bearing the overwhelming brunt of year-to-date rating actions
- The intensity of rating actions in the first half of 2009, and the slowing — but still negative — trajectory going into the remainder of 2009 and 2010
- The influence of the current state of the bank market on corporate credit, and the varying picture in Europe and Asia
- Those issuers in Europe and Asia with stronger negative rating momentum, measured by "double-dipper" actions (i.e. ratings lowered and left on negative outlook or watch), and a review of contrasting pressures on the investment-grade and speculative-grade universes
- Record bond market activity for European corporates, with even a rapid tail-off in issuance during H209 unlikely to threaten investment-grade liquidity at the portfolio level
- Emerging event risk through mergers & acquisitions, and reasons why the next M&A wave may be less damaging to credit ratings than previous waves.

The report concludes with a look at a number of issues that exist outside of Fitch's central rating case for European and Asian corporates. These issues do not currently drive rating actions, but represent the most serious variables that could affect current rating trajectories.

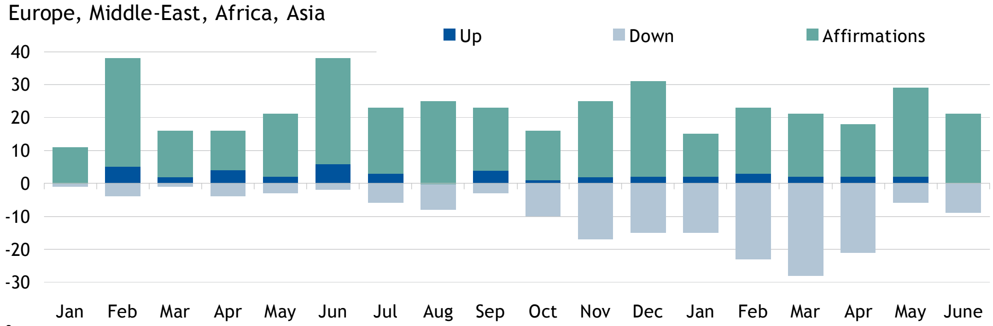
- Ratings affirmations have continued during the recession
- Despite sharp downgrade actions in individual cases, monthly average downgrades remain below 1.5 notches

Good News: The World has not Come to an End

Headlines in a time of economic stress inevitably focus on downgrade actions, and on those sectors most affected by downgrades. In an average year, roughly 10% of a typical corporate mid-investment-grade rating portfolio may be downgraded, with on average 80% remaining unchanged. As a result, while far from the average 8:1 ratio to downgrades still seen in Q108, rating affirmations have continued throughout the recession. During the turbulence of recent months, downgrade actions have increased sharply; but as Chart 1 indicates, have only outnumbered monthly affirmations in the first four months of 2009. In May 2009 and June 2009, affirmations have once again gained the upper hand, albeit only marginally.

Chart 1: Overall Rating Actions[a], 2008-09

Europe, Middle-East, Africa, Asia



[a] excludes actions driven by sovereign constraint/support

Source: Fitch

Despite many individual high-profile cases, the severity of rating downgrades should also not be over-stated. Even where multi-notch actions have been present in individual cases and sub-sectors, corporate downgrades over the portfolio have averaged less than 1.5 notches per action in each month throughout the crisis thus far. While profitability has shrunk across the board, the majority of companies remain profitable, and company results for 2009 so far are coming in broadly in line with those (lower) levels forecast by Fitch's analysts.

- Cyclical issuers, unsurprisingly, dominate in downgrade statistics
- Portfolio now reviewed under Fitch's *Weak Until 2011* stress assumptions
- Negative actions expected to outpace positive actions for the rest of 2009
- Pace of downgrades has nonetheless slowed since the Q109 peaks

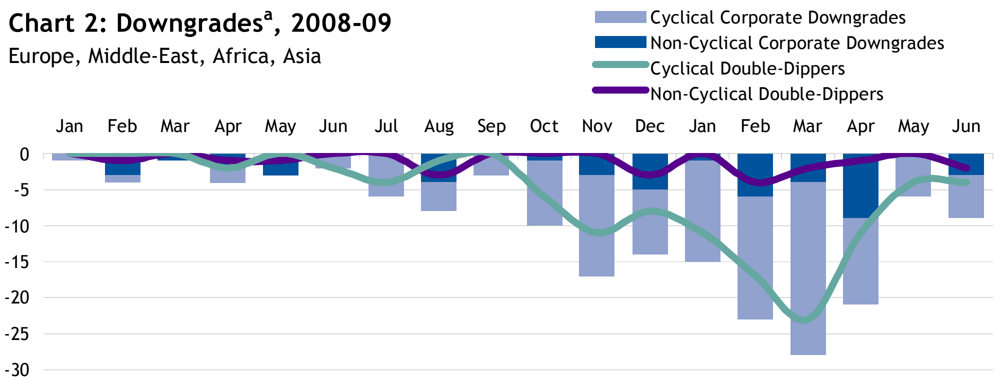
Good News: Non-Cyclical Corporate Sectors Represent Relative Stability in Rating Terms

Caveat: Downgrades will Still Outpace Upgrades in the Portfolio

Rating actions and outlooks support the intuitive belief that non-cyclical sector ratings should perform better in a cyclical downturn. A corpus of 'A' and 'BBB' category names exists which display a broad level of stability, and from which peers affected by the "super-cyclical" downturn are pulling away on the downside.

Chart 2: Downgrades[a], 2008-09

Europe, Middle-East, Africa, Asia



[a] excludes actions driven by sovereign constraint/support

Source: Fitch

As *Chart 2* shows, corporate rating actions during Q109 and Q209 were heavily concentrated in cyclical sectors. Non-cyclical names have fared better. At the same time, the latter continue to face the same array of idiosyncratic risk factors that led to current rating categories, creating little upward pressure on their ratings.

So was Fitch not Rating Through the Cycle?

The difference in rating performance can to a large degree be explained by the effect of a super-cyclical downturn. The super-cyclical nature of the current recession exceeded Fitch's original, conservative, rating case assumptions, with a greater impact on issuers with stronger cyclical exposure than on other issuers.

Overall, the Fitch internal forecasts which drive ratings have now incorporated the *Weak Until 2011* stress assumptions described in the report *Corporate Macro Assumptions: April 2009 Update*, published 15 April 2009. As such, the pace and intensity of future negative rating changes is expected to moderate in H209.

- Downgrades followed by Negative Outlooks or Negative Rating Watches are a strong predictor of future negative action
- Intensity of downgrades slowed during Q209
- Equity issuance has helped slow the downgrade trend

Good News: Rating Action Intensity is Slowing

Caveat: Momentum Still a Concern

As noted above, a significant number of multi-notch downward actions took place in Q109. The pace of these actions slowed in Q209 as Fitch's revised expectations were rolled across the portfolio — and in some cases as renewed access to the equity markets allowed issuers as diverse as ITV plc, Lafarge SA, GKN plc and Pernod-Ricard SA to bolster funding plans with rights issues.

Two thirds of the multi-notch negative actions since January 2008 occurred in Q109, with more than 85% involving "double-dipper" actions, where a rating was lowered and remained on outlook or watch negative. Of these, only two issuers (a Lithuanian and a Hong Kong telecom company) were in a non-cyclical sector.

Historically, such moves have proved a strong predictor of further negative rating action when compared with the portfolio as a whole.

Single-notch double-dippers were more numerous, and also have some predictive value for future rating actions. Again, of the 50 actions, all but six affected issuers

Table 1: H109 Multi-Notch "Double-Dippers"

Company	Sector	Country	Multi-notch rating action	Current Rating/Outlook	
Lyondell Basell Industries AF S.C.A.	Chemicals	Netherlands	Jan. 02, 2009	[a]	
KazakhGold Group Limited	Natural Resources	Kazakhstan	Jan. 19, 2009	CC	RW Pos [b]
DSG international plc	Non-Food Retail	United Kingdom	Jan. 20, 2009	B	Neg
Mirax Group Holding B.V	Real Estate	Russian Federation	Feb. 17, 2009	C	RW Neg
Peugeot S.A	Automotive	France	Feb. 18, 2009	BB+	Neg
UAB Bite Lietuva	Telecom	Lithuania	Feb. 19, 2009	CCC	Neg
Nine Dragons Paper (Holdings) Limited	Natural Resources	China	Feb. 20, 2009	B	RW Neg
PCCW-HKT Telephone Limited	Telecom	Hong Kong	Feb. 23, 2009	[a]	
Atrium European Real Estate Limited	Real Estate	Netherlands	Feb. 25, 2009	BB-	Neg
ITV plc	Media	United Kingdom	Mar. 04, 2009	BB-	Neg
AU Optronics Corporation	Technology	Taiwan	Mar. 09, 2009	BB-	Neg
Nissan Motor Co., Ltd. ♦	Automotive	Japan	Mar. 09, 2009	BBB-	Neg
Toshiba Corporation	Technology	Japan	Mar. 09, 2009	BB	RW Neg
HeidelbergCement AG	Building Materials	Germany	Mar. 10, 2009	B	Neg
Chartered Semiconductor Manuf'ing Ltd	Technology	Singapore	Mar. 11, 2009	BB-	Neg
Brixton plc	Real Estate	United Kingdom	Mar. 17, 2009	BB	RW Neg
Renault SA	Automotive	France	Mar. 25, 2009	BB	Neg
Gulf General Investment Company P.S.C	Real Estate	Dubai	Mar. 26, 2009	[a]	
Tata Steel U.K. Ltd	Steel	United Kingdom	Apr. 03, 2009	B+	Neg
ThyssenKrupp AG ♦	Steel	Germany	May. 20, 2009	BBB-	Neg
Safilo S.p.A.	Consumer Products	Italy	Jun. 25, 2009	CC	RW Neg

♦ Issuers rated 'BBB-', the lowest level of investment-grade;
[a] since withdrawn; [b] revised to Rating Watch Positive on 26 June 2009
Source: Fitch

Table 2: H109 Single-Notch "Double-Dippers"

Company	Sector	Country	"Double-dipper" rating action	Current Rating/Outlook	
Marks and Spencer Group plc	Food Retail	United Kingdom	Jan. 07, 2009	BBB	Neg
Volkswagen Group	Automotive	Germany	Jan. 08, 2009	BBB+	RW Neg
Calik Holding	Conglomerate	Turkey	Jan. 09, 2009	B-	Neg
Honda Motor Co., Ltd	Automotive	Japan	Jan. 14, 2009	A	Neg
Hyundai Motor Company	Automotive	South Korea	Jan. 14, 2009	BB+	Neg
Kia Motors Corporation	Automotive	South Korea	Jan. 14, 2009	BB+	Neg
OJSC LSR Group	**Construction**	**Russian Federation**	**Jan. 20, 2009**	**B-**	**RW Neg**
Mirax Group Holding B.V	Real Estate	Russian Federation	Jan. 27, 2009	C	RW Neg
Continental AG	Automotive	Germany	Feb. 04, 2009	BB	RW Neg
Interpipe Limited	Manufacturing	Ukraine	Feb. 04, 2009	CCC	RW Neg
AB Electrolux ♦	Capital Goods	Sweden	Feb. 04, 2009	BBB-	Neg
OJSC Kazanorgsintez	**Chemicals**	**Kazakhstan**	**Feb. 04, 2009**	**C**	**RW Neg**
METINVEST B.V.	Natural Resources	Ukraine	Feb. 10, 2009	B	Neg
Cie Gle des Etablissements Michelin ♦	Automotive	France	Feb. 20, 2009	BBB-	Neg
PT Arpeni Pratama Ocean Line Tbk	Transportation	Indonesia	Feb. 26, 2009	B+	Neg
PT Berlian Laju Tanker Tbk	Transportation	Indonesia	Feb. 26, 2009	B	Neg
PT Fajar Surya Wisesa Tbk	Natural Resources	Indonesia	Feb. 26, 2009	B	Neg
PT Pakuwon Jati Tbk	**Real Estate**	**Indonesia**	**Feb. 26, 2009**	**CC**	**RW Neg**
Polski Koncern Naftowy ORLEN S.A.	Energy	Poland	Mar. 02, 2009	BB+	Stable [a]
GKN Holdings PLC	Automotive	United Kingdom	Mar. 03, 2009	BB+	Stable [b]
Cableuropa S.A.	Telecommunications	Spain	Mar. 06, 2009	B	Neg
ASUSTeK Computer Inc.	Technology	Taiwan	Mar. 09, 2009	BB+	Neg
Hitachi, Ltd.	Technology	Japan	Mar. 09, 2009	BBB+	RW Neg
NEC Corporation ♦	Technology	Japan	Mar. 09, 2009	BBB-	Neg
Panasonic Corporation	Technology	Japan	Mar. 09, 2009	A+	RW Neg
Sharp Corporation	Technology	Japan	Mar. 09, 2009	A	RW Neg
Sony Corporation	Technology	Japan	Mar. 09, 2009	BBB+	RW Neg
Roche Holding Ltd	Health Care	Switzerland	Mar. 13, 2009	AA-	Neg
Obrascon Huarte Lain SA (OHL)	Construction	Spain	Mar. 16, 2009	BB+	RW Neg
OAO Nizhnekamskneftekhim	Chemicals	Russian Federation	Mar. 18, 2009	B	RW Neg
Global Yatirim Holding A.S.	Energy	Turkey	Mar. 20, 2009	B-	RW Neg
Fiat S.p.A.	Automotive	Italy	Mar. 25, 2009	BB+	Neg
Lafarge SA ♦	Building Materials	France	Mar. 27, 2009	BBB-	Neg
Brisa Autoestradas de Portugal, S.A	Transportation	Spain	Apr. 02, 2009	BBB+	Neg
Holcim Ltd.	Building Materials	Switzerland	Apr. 03, 2009	BBB	Neg
Tata Chemicals Limited	Chemicals	India	**Apr. 03, 2009**	BB+	Neg
Tata Steel Limited	Natural Resources	India	Apr. 03, 2009	BB+	Neg
Arcelik	Capital Goods	Turkey	**Apr. 06, 2009**	BB-	Neg
Anglo American plc	Natural Resources	United Kingdom	Apr. 07, 2009	A-	Neg
AB Volvo	Automotive	Sweden	Apr. 09 2009	BBB+	Neg
OJSC Kazanorgsintez	**Chemicals**	**Kazakhstan**	**Apr. 27 2009**	**C**	**RW Neg**
BASF SE	Chemicals	Germany	Apr. 29 2009	A+	Neg
OJSC LSR Group	**Construction**	**Russian Federation**	**Apr. 29 2009**	**B-**	**RW Neg**
Adolf Wurth GmbH & Co KG	Materials	Germany	May. 12 2009	A-	Neg
OAO Severstal	Steel	Russian Federation	May. 22 2009	BB-	RW Neg
WIND Hellas Telecommunications S.A.	Telecommunications	Italy	Jun. 05 2009	CCC	Neg
DONG Energy A/S	Energy	Denmark	Jun. 09 2009	BBB+	Neg
Flinders Power Partnership	Utility	Australia	Jun. 11 2009	B	RW Neg
PT Pakuwon Jati Tbk	**Real Estate**	**Indonesia**	**Jun. 18 2009**	**CC**	**RW Neg**
Pfleiderer AG	Building Materials	Germany	Jun. 19 2009	BB-	RW Neg

♦ Issuers rated 'BBB-', the lowest level of investment-grade;
[a] Outlook revised to stable on 28 April 2009 [b] Outlook revised to stable on 19 June 2009
Source: Fitch

in cyclical industries. *Table 2* excludes issuers from *Table 1* also subject to multi-notch actions, and rating actions driven primarily by a rating action on the sovereign, but also highlights in bold three issuers where multiple single-notch "double-dipper" actions occurred during the period.

Good News: The Banking System has Stabilised

Caveat: Not Enough for a Strong Corporate Recovery

Government intervention and the support of the banking system has proven widely effective in stabilising the majority of banking systems. Market access and credit ratings are now generally showing signs of stabilisation, which in turn should be supportive of corporate access to external funding.

- EMEA banks' own positions are — broadly speaking — stabilising
- Credit growth remains below trend, and rationing is likely to continue
- In pendulum-fashion, the correction from the easy lending terms of 2007 has led to significantly tougher credit conditions, expected to persist through the next two to three years

Although a stable banking system is a prerequisite for corporate growth, there are significant limits to the stabilisation already witnessed:

- Smaller financial institutions, and financial institutions in a number of non-Asian emerging markets (notably, private sector banks in central/eastern Europe), continue to face significant hurdles in terms of funding costs and market access
- Bank funding in EMEA — even for large, highly creditworthy corporate entities — continues to be expensive, and rationed
- Appetite for cross-border, or new jumbo-sized, syndicated lending remains at extremely depressed levels on a global basis.
- Funding for leveraged credits, in particular, remains heavily constrained.

Even at the more general level of corporate credit supply, in **Europe**, Fitch notes a persisting disconnect between broadly optimistic feedback from financial institutions regarding their capacity and willingness to support the large corporate sector, and feedback from individual corporates and corporate associations which continue to report a less enthusiastic, more rationed environment for bank-sourced funding.

Credit growth statistics through May 2009 indicate that credit growth has turned negative in the US and the Eurozone, and have only remained positive in Japan thanks to delayed drawdowns of committed facilities by local corporates, combined with new abilities to repo corporate loans with the Bank of Japan. Syndicated bank lending to corporates in EMEA shrank in H109 to USD320bn, compared with annual lending having averaged more than USD3,000bn over the 2006-2008 period. Lending has struggled to match the level of facility expiries — with a further USD540bn of expiries occurring in H209, and over USD900bn during 2010.

Supply or Demand?

It is still unclear to what degree this reflects falling demand, as companies downsize investment and operating expenditure, and to what extent it reflects constraint from the supply side. While bank lending will clearly recover in the medium-term, Fitch's current assumption is that, while banks and their government sponsors have made genuine strides in improving capitalisation levels, public commitment to support the corporate sector comes as a secondary consideration to the overwhelmingly conservative dynamic in bank credit decisions. The risk-appetite pendulum, having swung substantially in favour of debtors during 2006 and 2007, has swung an equal distance from equilibrium in the opposite direction. Fitch believes conditions are likely to remain tough for borrowers through 2010.

- Asian banks less constrained
- Strong corporates still having little trouble accessing bank and bond markets
- Non-government-related high-yield market remains largely closed

In **Asia**, the banking sector has generally faced fewer new challenges, and has been continuing to extend credit on a less rationed basis than is the case in EMEA. In addition, although participation by western banks in syndicated loan markets has clearly suffered, local market feedback to Fitch from both bankers and issuers indicates that the club market for local banks is largely filling the gap.

This profile is nonetheless qualified in Asia by the typically lower individual financial strength ratings of banks in the region, and the more varied financial strength and credit ratings of potentially supportive sovereigns.

Credit growth in China deserves a separate mention. While supportive of corporate liquidity in the near-term, Fitch has noted in *Chinese Banks: Soaring Credit Amid Weak Corporate Climate a Concern* (20 May 2009) the risks posed by the dramatic growth in lending in their quest to avoid an economic slump and maintain employment levels. While the Chinese state is clearly able to afford this form of pump-priming, Fitch in the medium-term expects more pressure on ratings to result for the local real estate sector in particular, but also manufacturing sectors if continued unlimited lending distorts the evolution of a more realistic equilibrium between supply and domestic/export demand. The predominance of short-term funding within this "stimulus lending" also gives cause for concern that the current capacity overhang can be shored up until a global corporate recovery gets under way in the next decade.

- Unprecedented levels of bond market issuance in western Europe
- General sentiment that current activity and tighter corporate pricing could easily cease
- 2009 and 2010 maturities already covered at the aggregate level in western Europe for investment-grade issuers
- Access to G3 currency issuance still limited for most central and eastern Europe issuers
- Asia-Pacific's needs broadly met by domestic banking systems, but speculative-grade refinancing risks loom from 2010

Bad News: Booming European Investment-Grade Corporate Bond Market has some Hallmarks of a Bubble

Caveat: Credit Valuations Implied in Spreads Still Look Realistic

In Europe, bond market issuance by the corporate sector has seen dizzying growth over H109 to exceed EUR300bn (around USD400bn equivalent), a record, and 23% more than the full-year 2008. This growth has occurred across all sectors, and at all levels of the investment-grade spectrum (as well as selected issuance in speculative-grade).

As well as pent-up demand from both corporate issuers and investors, growth has been fuelled by the travails of the banking sector — in a "double-whammy", leading to both a dip in lending from banks and an investor desire to diversify away from senior bank bonds as an asset class. Reports have also continued to reach Fitch of a significant "retail bid", i.e. substantial demand from retail investors for corporate bonds.

The key drivers of this unprecedented level of corporate issuance look fragile from a number of directions. These include:

Booming European Bond Market Issuance - Watermark Not Benchmark

Factors Supporting More Bond Market Issuance	Factors Supporting Less Bond Market Issuance
Current primary market spreads, while offering low all-in rates for corporates, generally continue to compensate investors for the risk-adjusted returns necessary, when the credit ratings of the entities are compared with historical default rates. Higher loss severities in this cycle are a valid concern, but Fitch does not expect the sharp drop in recoveries for speculative-grade names to be replicated in any investment-grade defaults that may occur	As perceptions become brighter for the stability of bank senior debt, this debt class will become less unattractive to investors, and the pool of investor money will be spread more widely across financial institutions and corporates. Suppressed issuance by banks may even "crowd out" corporate issuance if a rally continues in the appreciation of bank stability
Europe has always had a structural deficit in bond market financing, compared with the US. Depressed levels of bank lending may create the conditions for a "step change" in the proportion of corporate funding sourced from the capital markets, supporting further bond issuance	If "risk-free" rates continue on an upward trend, driven by inflation concerns and increasing sovereign debt supply, there is a good chance that bond prices will fall in a manner unanticipated by many retail investors. While retail investors are not currently providing the marginal bid, a sudden exit by this increasingly important investor group may affect overall market dynamics
Alternative sources of medium-term funding — primarily bank-lending — continue to look expensive. Interestingly, local private debt markets such as Germany's schuldschein product seem to be holding up well despite the credit crunch	Tentative enthusiasm in the equity markets may grow (for both public equity markets and an estimated USD400bn of private equity money in Europe), leading to alternative forms of capital which is competitive, at least in the near-term, with the current peak in bank conditions
Fitch anticipates a wave of consolidation across a number of sectors in the period through 2010 and 2011. Given the continued fragility in the banking system, an increase in such M&A-related financing could spur further bond issuance	Supply based on existing corporate needs, including prudent liquidity stockpiling, may simply dry up. Bond issuance in Europe has already exceeded bond maturities for the region by a factor of 3x; has covered 2010 bond market maturities; and may well cover 2011 maturities if the current trend continues. It is unlikely that this level of pre-funding, with the negative carry this implies, will prove economic at the macro level, particularly if benchmark rates continue to trend gently upwards

Source: Fitch

- Bond market issuance can tail off in H209 without hurting investment-grade corporate liquidity at the portfolio level
- Fitch continues, with isolated and already highlighted exceptions, to see liquidity as expensive — but present or available — for the bulk of its rated corporate portfolio
- Levels of disintermediation in Europe likely a high watermark rather than a new benchmark
- Situation sharply different in speculative grade

On balance, despite the likelihood that recent events have made a modest contribution to a secular shift in disintermediation in Europe (i.e. the replacement of bank loans with bond debt), Fitch anticipates that the unusual confluence of weakness in the bank markets and pent-up demand for corporate issuance on both the supply and demand sides, indicate that 2009 will likely be more of a high watermark than the creation of a new benchmark.

More fundamentally, continued access to the bond market is not an issue for Fitch's investment-grade issuers as a portfolio, in terms of 2009 and 2010 liquidity. Any tail-off in this booming issuance, while it will doubtless attract headlines and impact sentiment, does not represent an additional threat to current rating levels at the portfolio level, provided that it does not coincide in an unfortunate manner with forthcoming merger & acquisition activity.

Bad News: Bleak Position for Speculative-Grade Issuers

Caveat: Banks and CLOs Incentivised not to "Pull the Trigger" … yet

The situation looks much bleaker for speculative-grade issuers. In Europe, an overhang of leveraged loans placed into CLOs faces a medium-term refinancing cliff in 2013, when annual maturities in Fitch's shadow-rated portfolio jumps from EUR15bn to EUR34bn, and stays above EUR40bn in each of the following three years.

In the nearer-term, even cumulative volumes of EUR20bn through 2009, while much more modest, face hurdles to refinance; 60% of Fitch's shadow-rated portfolio of leverage loans in Europe now stand at 'B-*' or below, with 20% at 'CCC*' or below. The portfolio has already seen 15 defaults so far this year; and given high existing leverage (averaging 7x operating cash flows), Fitch expects significant write-downs and low recoveries on defaulting debt to occur in this process. In the public markets, access to the bond market has been limited to well-known 'BB' issuers in stable industries such as telecoms and healthcare.

A similar situation exists to a lesser degree in Asia, where there is growing refinancing risk for a number of speculative-grade issuers from 2010 onwards. These issuers — mainly domiciled in Indonesia and China — raised US dollar-denominated bonds on an opportunistic basis during the 2005-07 period, and will likely struggle to refinance on acceptable terms when these issues start to mature in 2010. Fitch's ratings in both regions already incorporate the heightened default expectations for these portfolios.

Bad News: Event Risk May Recur Sooner than Anticipated

Caveat: The Next Wave may do Less Damage to Credit Ratings

Previous studies by Fitch have indicated that event risk accounts for between 20% and 40% of overall rating actions, depending on the point in the cycle, with the single most common event being a merger or acquisition transaction. The latter accounts for almost 80% of event risk-related rating actions through the cycle.

- Event risk can be a major cause of rating actions
- Cash balances and low perceived valuations will prove tempting to boards

Despite falling to a five-year nadir in volume terms during 2009, M&A risk is back on the table. As corporate issuers have succeeded for the large part in staving off liquidity risks through a mixture of prudent husbanding of resources in 2008 and large-scale bond issuance in 2009, many currently sit with large cash piles, depleted only gradually by net cash flows. Given stricter treasury mandates and low deposit rates, the negative carry on cash balances is not an irrelevant consideration.

More tempting still, perhaps, is the view that depressed equity valuations may offer attractive opportunities for a wave of consolidation whose industrial logic has only been strengthened by the current financial environment. In the absence of strong organic market growth, consolidation becomes a more attractive prospect to many corporate boards. In its recent report, *European Corporates in 2012* (published 22 June 2009), Fitch highlighted the prevalence within Fitch's expectations of near- to medium-term consolidation in a number of sectors, most notably telecoms and manufacturing.

Rating Impact

The credit impact of M&A activity depends on the funding structure employed and the future cash flow and business profile of the merged entity. In previous cycles, certain sectors (oil, pharma, defence) have shown themselves more inclined towards equity-financing, while others (retail, utilities, telecoms, manufacturing) have shown a greater bias toward debt in the funding structure. Rating actions have naturally tended to be negative for transactions that increase leverage with few or unconvincing synergy/business rationales, and neutral (occasionally positive) for equity-funded transactions with clear and demonstrable cash flow and strategic benefits.

- Smaller acquisitions may be cheaper but more complex
- Industrial logic may improve as consolidation wave gathers momentum
- Potential for the forthcoming wave of M&A to be less credit-negative on average than prior waves of M&A

What may well differ in the current environment is the impact and success of smaller bolt-on acquisitions. With specific regard to purchases of distressed companies, where capital structures have become more complex, the forthcoming cycle of M&A transactions may prove more challenging. This may lead to longer rating watch periods resulting in more volatile outcomes, in credit rating terms, than in previous go-rounds. Capital-conscious banks once again sit at the epicentre. Capital concerns make banks reluctant to sell distressed debt held in the banking book. The sheer volume of distressed loans, a number of which will have a more complex cross-border dimension — in addition to the more complex capital structures than in previous waves of distress — will prove challenging for banks.

As a result, smaller bolt-on acquisitions may be more complex but ultimately cheaper than in prior cycles, and thus the scale of negative rating action may be lower than was the case in the past. Equally, as Fitch has pointed out in its prospective look at the Europe of 2012, for larger companies a wave of consolidation in sectors such as telecoms and manufacturing may be heavily supported by industry dynamics — and thus benefit from stronger industrial rationales than applied in previous M&A waves.

Given the prominent place of M&A activity in the long-term secular downward trend of corporate credit ratings, however, Fitch would still expect M&A activity to result in more downgrades than upgrades, albeit potentially at a lower pace.

Beyond the Central Case

What other major drivers exist? Fitch's ratings are a blend of a central set of assumptions for each issuer. Fitch also monitors low-frequency but high-severity tail risks that can hit individual sectors or issuers. This results in a "weakest link" approach using the agency's generally conservative central expectations, but one that does not preclude the possibility that worse events can further derail the prospects of an issuer or a sector.

- Supply chain impact could be worse than anticipated
- Leverage could be hidden in expansion of trade creditor days and "debt forgiveness"
- "Shadow banking" provision by corporates could disturb Fitch's current expectations on adequacy of liquidity across the rated portfolio
- Difficult to gauge the full economic impact of multiple SME failures

Some issues beyond Fitch's current central case include:

Supply Chain Failures

Fitch's current expectations for the supply chain effect of constrained credit are of a largely manageable impact on most rated entities. Failures of individual critical suppliers may delay one product, but most Fitch-rated entities do not operate single-product platforms. A mixture of extension of creditor days (effectively supplier financing), tighter scrutiny of supplier creditworthiness and diversification of supplier routes, and, to a much more modest degree where suppliers are critical, some enforced vertical integration, are expected to limit the negative impact on rated issuers' cash flows.

However, there are persistent, high concerns over the access to financing for mid-market/small- to medium-sized (SME) enterprises. There are no obvious parallels for the current degree of global credit shrinkage. Without parallels upon which to draw, it is possible that Fitch's current analysis is too optimistic, and that supply chain interruptions could provoke more significant disruption. This could come if current destocking ends not with reasonable (albeit lower) levels of restocking, but instead with a prolonged period of substantially below-trend levels of consumption and investment, and very low restocking. Equally, restructuring needs in over-banked export-driven economies such as Germany may finally end in the "Grand Reckoning" which Mittelstand companies have feared for the past two decades.

The knock-on effects would include a higher cost of goods sold — as replacement goods were sourced, lower revenues as stock-in-progress were delayed and not made available for sale, higher formal leverage through enforced consolidation, or higher hidden leverage through a large and sustained extension in trade creditor terms. The continuing strain experienced in credit insurance and letters of credit availability for mid-market companies could enter a new level of spiralling credit shrinkage. Failures would in turn further boost unemployment and depress economic recovery.

As a less drastic scenario, corporates may be drawn into "shadow banking" relationships with suppliers and customers, threatening liquidity and ultimately profitability. Issues of vendor financing may acquire a higher position on the list of concerns, with evidence already emerging in aerospace & defence and other capital goods' sectors.

Failure of State Support

- Government financial support for corporates in emerging markets may weaken

As noted in Fitch's report *Sovereign Ownership Impact on Ratings* (published 25 June 2009), a number of ratings within Fitch's EMEA portfolio directly incorporate a level of state support[1]. These ratings already incorporate a detailed analysis of the likelihood of state support for that company's debt obligations (or, conversely, the likelihood that a state may not support a company's debt obligations). In more than 80% of cases, this analysis leads Fitch to rate the entity lower than the owning state, in the majority of cases by multiple rating categories.

Governments around the world are nonetheless facing a significant increase in their own financial burdens. As such, while an across-the-board downward revision of state-supported ratings would over-estimate the risk that one or more sovereigns may not support an issuer in extremis, the minority of ratings most closely aligned to the sovereign are also most exposed to the binary decision to support/not support. Fitch believes it is important for the agency to indicate where it stands on such "binary calls". A deeper recession, a change in political environment, or a worsening of bank systemic strength in one of these countries, could nonetheless spark a "jump to default".

An Unanticipated Upturn

- Fitch's central case may be too pessimistic

Fitch's central case clearly also possesses unanticipated upsides as well as unanticipated downsides. Current destocking may end with an unexpectedly robust restocking process. Companies cut resources hard and quickly at the start of this recession, led in large part by a suspicion that an economic turn was inevitable. Significant areas of economic growth, led by secular trends towards infrastructure spending and higher living standards in key emerging market countries, may help support a more rapid recovery in corporate prospects than currently envisioned. The current recession has not yet seen an emerging market collapse, which is typically also a harbinger of credit rationing to other emerging market and high-yield issuers.

[1] Foreign currency ratings for an additional subset of ratings are also subject to sovereign constraint, generally reflecting the possibility that the sovereign may introduce foreign currency controls which could provoke a default of the corporate on its foreign currency obligations