Nordic Credit Rating

SECTOR COMMENT

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Nordic Credit Rating's view on distressed exchanges

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According to Nordic Credit Rating's (NCR) Rating Principles, a change in bond terms or tender offers can, under certain circumstances, qualify as a default on an instrument or by an issuer. We generally call such actions 'distressed exchanges', which we view as akin to a distressed restructuring and default under our criteria. This document clarifies our view about which actions qualify as a distressed exchange under our definition. It includes a non-exhaustive list of common and less frequent actions that could qualify as a distressed exchange under certain circumstances. A major factor in our determination is the perceived intent behind such actions.

Under our definition, default on an instrument would occur when the change in terms or tender offer is accepted, i.e. the request or offer in and of itself does not qualify.

NCR'S DEFINITION OF A DISTRESSED EXCHANGE

NCR considers a written procedure to be a distressed exchange when it results in a lower value for the investor due to weaker terms, and/or is carried out in order to avoid a conventional default on an instrument or by the issuer. According to NCR's methodology, an instrument may be assigned a 'D' (default) rating without the issuer being in default. A distressed exchange is a prime example of when the terms of a bond are adjusted to avoid a default by an issuer. However, if an issuer has defaulted on some, but not all, of its outstanding obligations, the issuer rating is set at 'SD' (selective default), with a potential exception for hybrid instruments (see below). Once a distressed exchange is completed, NCR assigns a new long-term issuer rating based on the post-restructuring capital structure and operating fundamentals.

Material change in value

In a distressed exchange, the reduced value of a debt instrument implies a higher risk for bond investors, without adequate compensation. However, the reduction in value and increase in risk should also be significant compared with before the exchange. For example, a written procedure (WP) that allows a change in ownership or adjustment in securitisation may be perceived as implying a higher risk, but would, in most cases, not qualify as a material change in value, or distressed exchange, by our definition. However, extending a bond's maturity beyond the original repayment date, changing the terms or form of repayment, or reducing a bond's principal amount are all likely to qualify as a material change in value to the investor.

NCR's definition of lower value in distressed exchanges may also take into account whether we consider it likely that investors would accept the changed terms if they did not expect them to yield the best return.

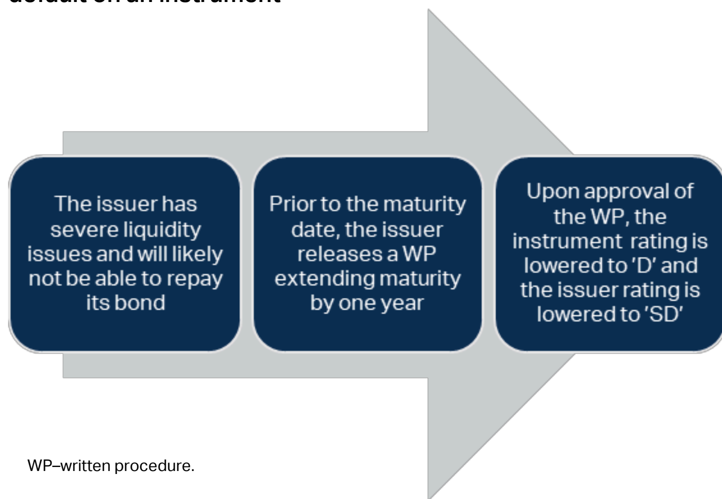
Borrower's intent and timing

The borrower's intent is a key factor in our determination of a distressed exchange. An opportunistic change in terms to reflect a change in the issuer's risk profile or risk sentiment in the market would likely not qualify as a distressed exchange, unless the intent is to avoid a default. For example, a written procedure could take place long before a default is likely, but could still be classified as a distressed exchange if we assess that a default is highly likely and/or that the intent is to avoid a default situation.

Avoidance of a near-term default

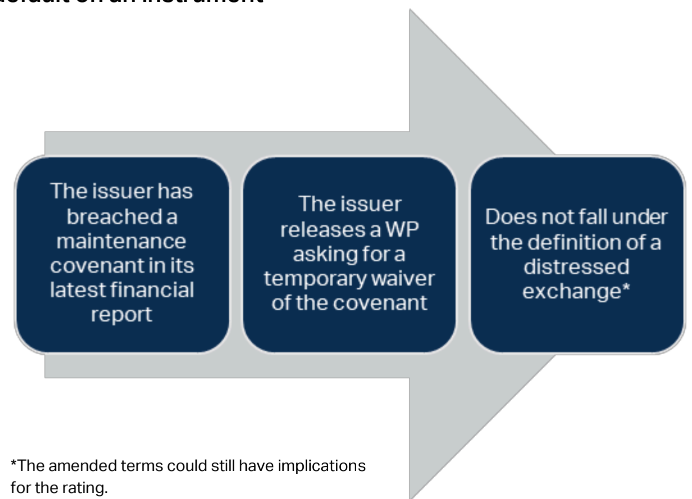
Regardless of whether or not the estimated value for bondholders is reduced, NCR typically considers changes to the capital structure that are deemed necessary to avoid a near-term default as distressed exchanges. For example, investors may be duly compensated for the higher risk following amendments, e.g. a higher coupon rate or added covenants, but the instrument has still undergone a distressed exchange by our definition. NCR's assessment of the underlying intent is always made on a case-by-case basis.

Figure 1. Example of a distressed exchange that qualifies as a default on an instrument



WP–written procedure.

Figure 2. Example of a technical default that does not qualify as a default on an instrument



*The amended terms could still have implications for the rating.

A covenant breach is a technical default, but does not in itself qualify as a default according to NCR's Rating Principles. However, the breach demonstrates a weakness and could lead to bondholders requesting repayment if they disagree with the proposal. For example, if acceleration of repayment is likely, and the issuer is unable to repay the outstanding amount, a written procedure to change or pause covenant requirements could qualify as a distressed exchange. The fact that the issuer has breached a covenant could also have consequences for the issuer's ratings, regardless of the outcome of the written procedure.

Figure 3. Examples of common written procedures or offers

Action	Likely to be defined as distressed exchange	Unlikely to be defined as distressed exchange
Maturity extension	X	
Covenant waiver/adjustment (issuer rating 'B' and above)		X
Covenant waiver/adjustment (issuer rating 'B-' and below)*	X	
Change in form of payment (PIK or similar)	X	
Write-down of principal	X	
Change in ownership stipulations		X
Debt-to-equity swap	X	
Discounted buyback offer	X	
Removed divestment prohibition		X
Change in creditor hierarchy	X	
Removal of or material negative change in security	X	

Note that the items in this list are examples and outcomes. NCR's assessment in individual cases may vary due to our perception of intent behind the action and the risk of default if the action is not taken. PIK-payment in kind. *High likelihood that a covenant breach would result in a default.

REDEMPTION OFFERS

Whether a redemption offer, or buyback, of outstanding debt instruments qualifies as a default is largely dependent on the distinction between opportunistic and distressed buybacks. From a rating perspective, the main difference between the two is the intent. An opportunistic buyback is usually a strategic move to deleverage when there is an opportunity to repurchase outstanding debt, potentially at a slight discount.

A distressed buyback, on the other hand, is usually characterised by a public offer to repurchase partial or full volumes of outstanding debt at a significant discount when there is a significant risk of not being able to fulfil the contractually agreed repayment upon maturity. This is a signal of financial distress, since investors would be unlikely to agree to such an offer if there were not a significant risk of default and expectations of lower recovery in such a scenario. While there is usually no compensation for the write-down in a distressed buyback, the issuer pays de facto in the form of damaged investor confidence, likely limiting future access to the market.

NCR does not set hard limits on the discount in redemption offers in order to classify them as distressed, but there should be a material decrease in value to bondholders. The main determinant for rating impact is the intent behind the buyback, and each situation is assessed individually.

Debt-to-equity swaps

Given that equity is subordinated to debt in the capital structure, a debt-to-equity swap entails lower seniority and less protection than the original commitment, with uncertainty about the ability to recover the investment. We generally consider debt-to-equity swaps as distressed exchanges.

OTHER EXAMPLES

Divestment of a significant portion of assets

Bond terms may include restrictions on the divestment of a significant portion of the business or revenue-generating assets. These are often not defined quantitatively and are consequently subject to interpretation. In addition, such assets may be pledged for secured creditors, as is often the case for real-estate companies, in which the properties are usually used as collateral for banks with a higher priority claim than unsecured bondholders. NCR is unlikely to be the deciding party as to whether a divestment breaches bond terms, and we would consequently be unlikely to classify the instrument as being in default unless the matter is formally settled.

Stand-still agreements or similar

If an issuer is on the verge of defaulting or has defaulted, but is still in negotiations with bondholders, there can sometimes be a formalised stand-still agreement to avoid some bondholders requiring immediate repayment while others are still negotiating. Whether formalised through a stand-still agreement or not, such scenarios will either arise after an actual default has occurred (i.e. after payments are missed), or due to an imminent expected default (i.e. notice that payment will not occur, or expectations that bondholders will require repayment upon a breach of covenants). We would likely define a stand-still agreement preceding an imminently expected default as a default on the instrument(s) in question.

DEFAULTS ON HYBRID INSTRUMENTS

A key characteristic of many types of hybrid capital instruments is the contractual ability to defer payments, temporarily or permanently write down the principal, or convert an instrument into equity. Although NCR considers such actions as a default on the instrument in question, due to the intended loss-absorbing nature of these instruments where a bond's terms allow such actions, the issuer rating is not automatically lowered to 'SD'. Despite market expectations, NCR does not consider a non-call decision on a hybrid instrument as an instrument default, although breaking with investor expectations could affect future access to hybrid debt instruments.

RELATIONSHIP TO OTHER RATED INSTRUMENTS

Direct impact on other rated instruments

Only instruments that have been defaulted on are assigned a 'D' rating; other rated instruments are assigned forward-looking ratings according to our methodologies. In general, we would expect only the instruments directly included in the distressed exchange to be classed as in default. However, other instruments may have cross-default clauses or be indirectly affected, which could have implications for the likelihood of default on and the rating assigned to those instruments.

Cross-default or cross-acceleration clauses

Cross-acceleration clauses in bond terms define whether an acceleration of one instrument, e.g. requested repayment following a breach of terms, leads to an accelerated repayment of some, or all, of the remaining debt. These types of clauses can serve as a link between bank and capital market debt. NCR considers the impact of such clauses when determining the issuer rating, as well as when they could lead to additional instrument defaults. NCR also takes such clauses into account when determining whether an action was taken to avoid a near-term default and should be classified as a distressed exchange.

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