

Will Recovery Rates Be Unusually Low in this Default Cycle?

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Introduction/Agenda

- **Loans historically a high recovery asset class**
 - **But in last few years, increasing use of loans in rated issuers liability structures**
 - **And economic downturn conditions appear likely**
- **What will be the impact on recoveries?**
- **Use Moody's LGD assessment framework to examine**



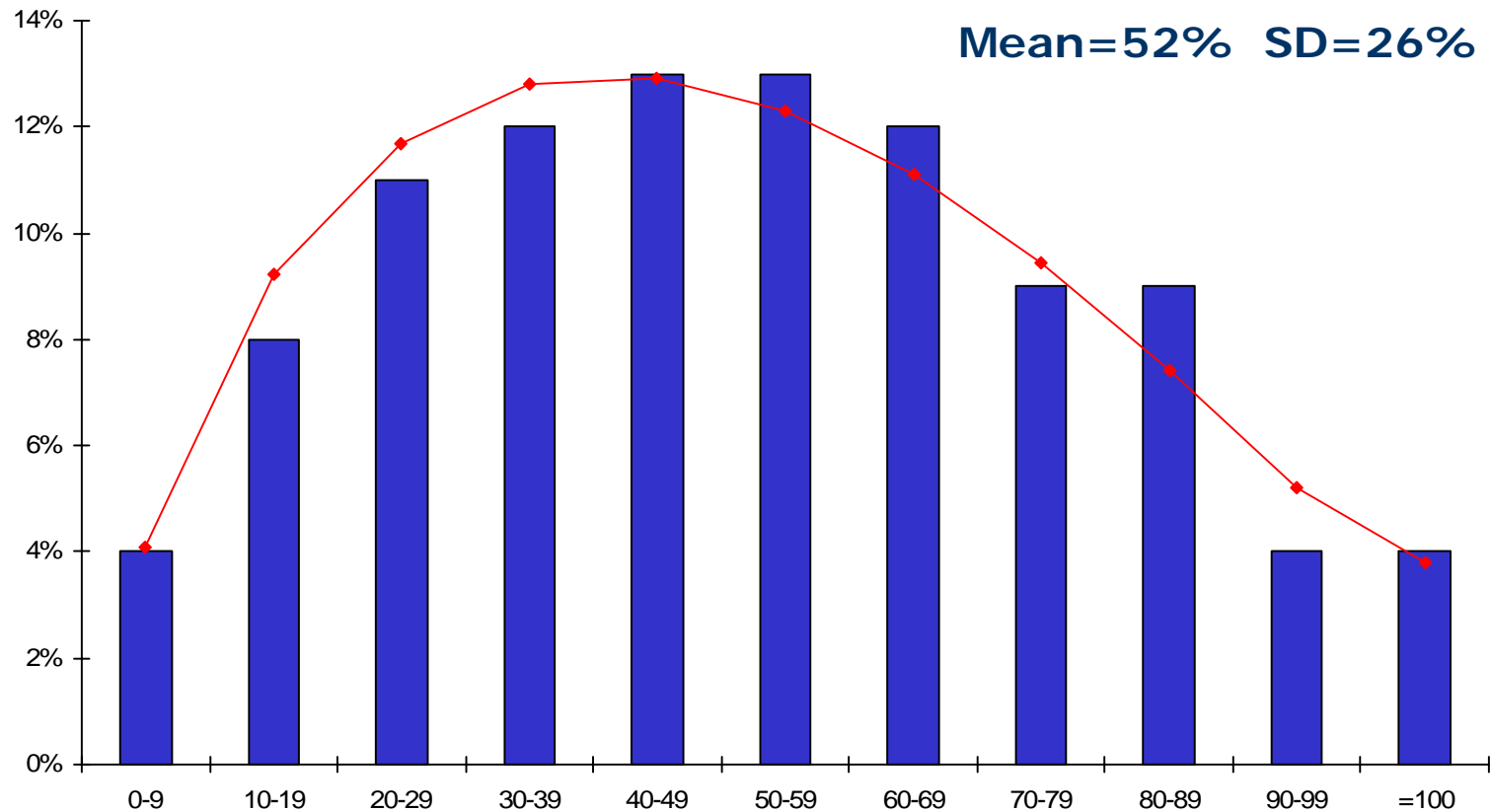
Moody's Approach to LGD

- **What determines LGD?**
 - **Position of debt in liability structure (i.e., debt above and debt below)**
 - **Uncertain enterprise value (EV) at default resolution (i.e. "firm-wide recovery rate")**
 - **Moody's approach is to explicitly recognize high uncertainty regarding EV**



High uncertainty regarding firm-wide recovery

Firm-Wide Recovery Rate Distribution



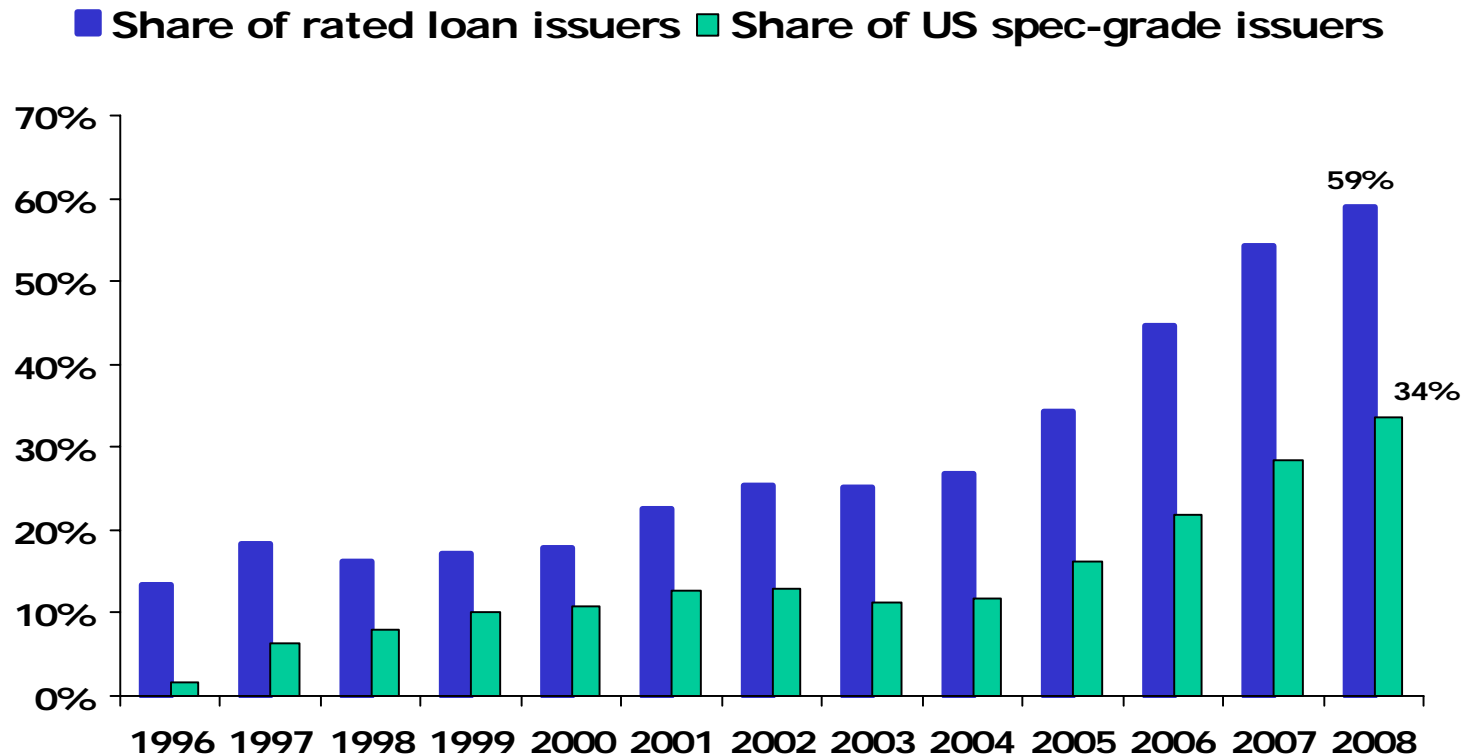
Growth of loan-only issuers driving average loan shares higher

- Across all issuers with rated loans, loan share is now roughly 67% of total debt (compared with 50% historical average)
- For issuers with rated loans and bonds, loans comprise approximately 55% of total debt on average
- Approximately 55% of current loan-only issuers received their initial Moody's rating after 2005



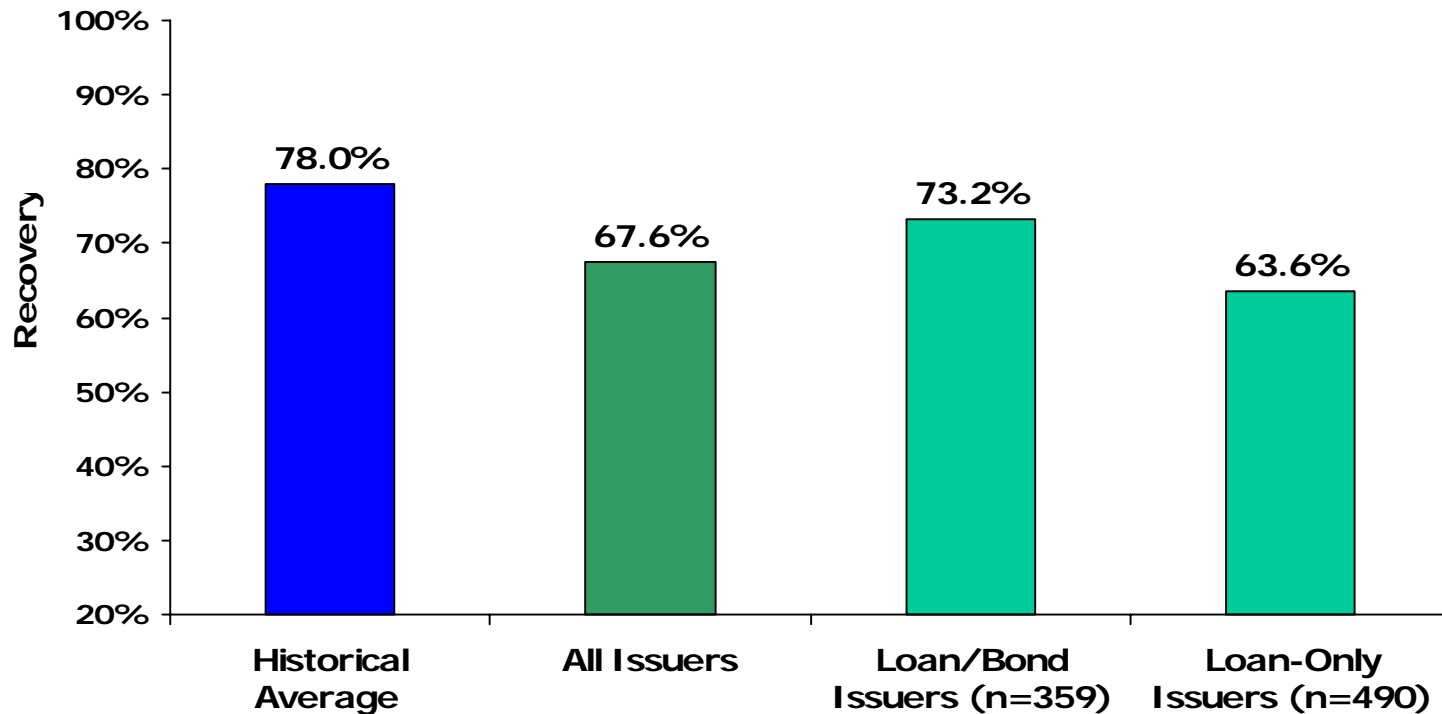
Growth of rated loan-only issuers accelerates

US spec-grade loan-only issuers



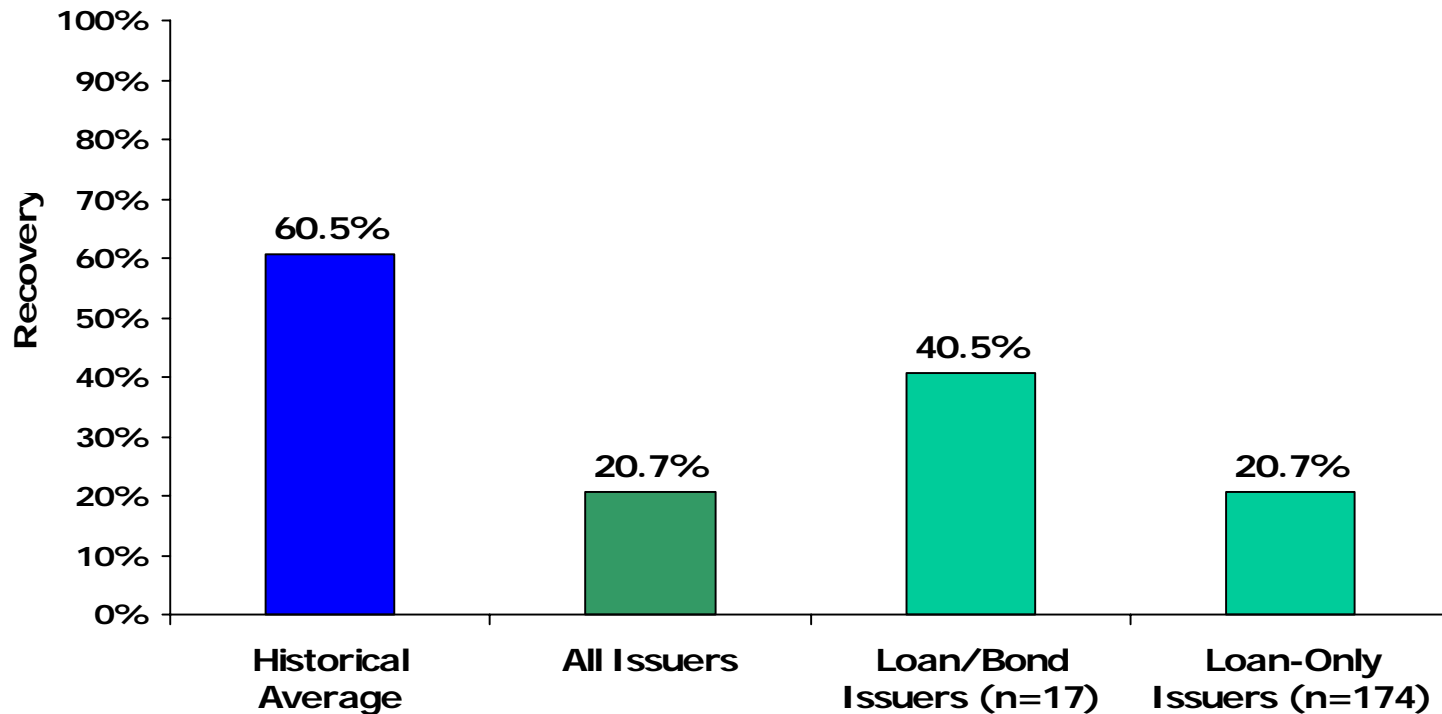
Higher loan shares imply lower expected loan recoveries

Moody's Current LGD Assessments US 1st lien loans



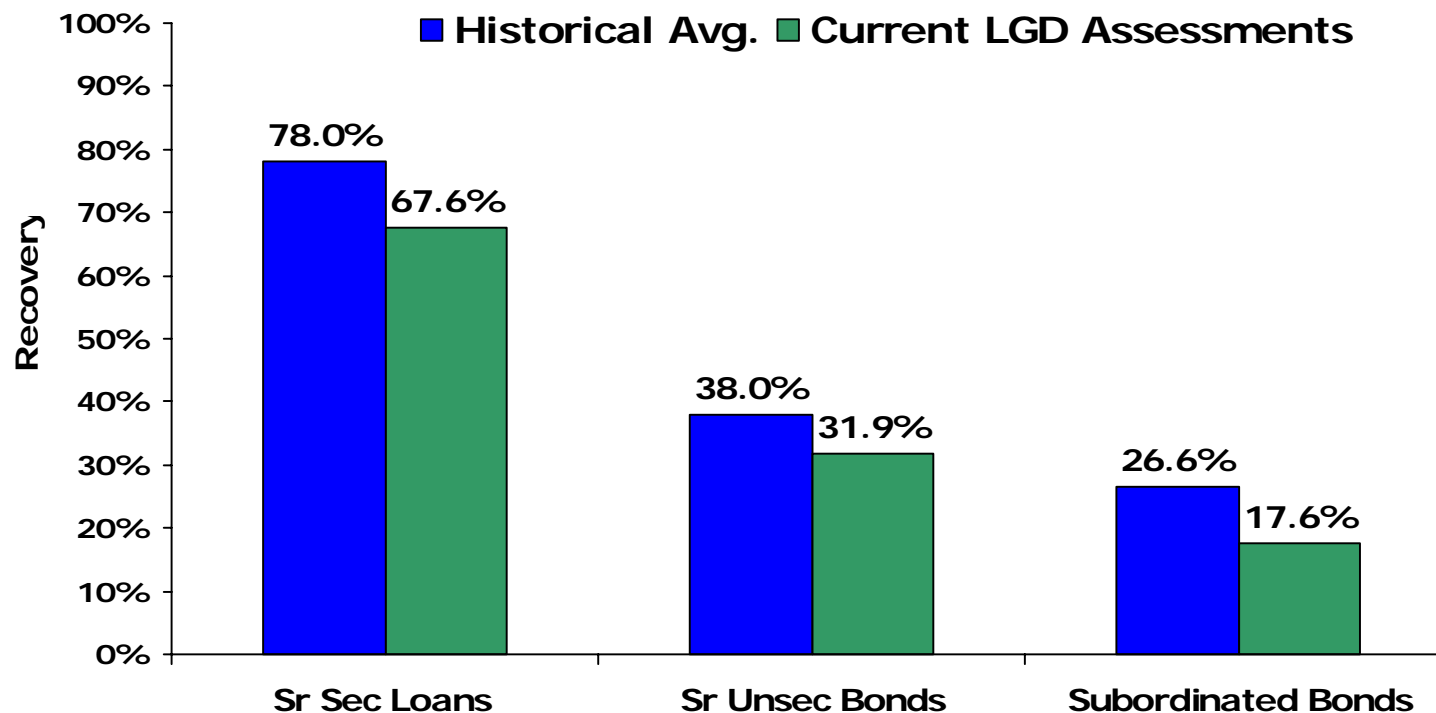
Expected recoveries for 2nd lien loans are low

Moody's Current LGD Assessments US 2nd Lien Loans



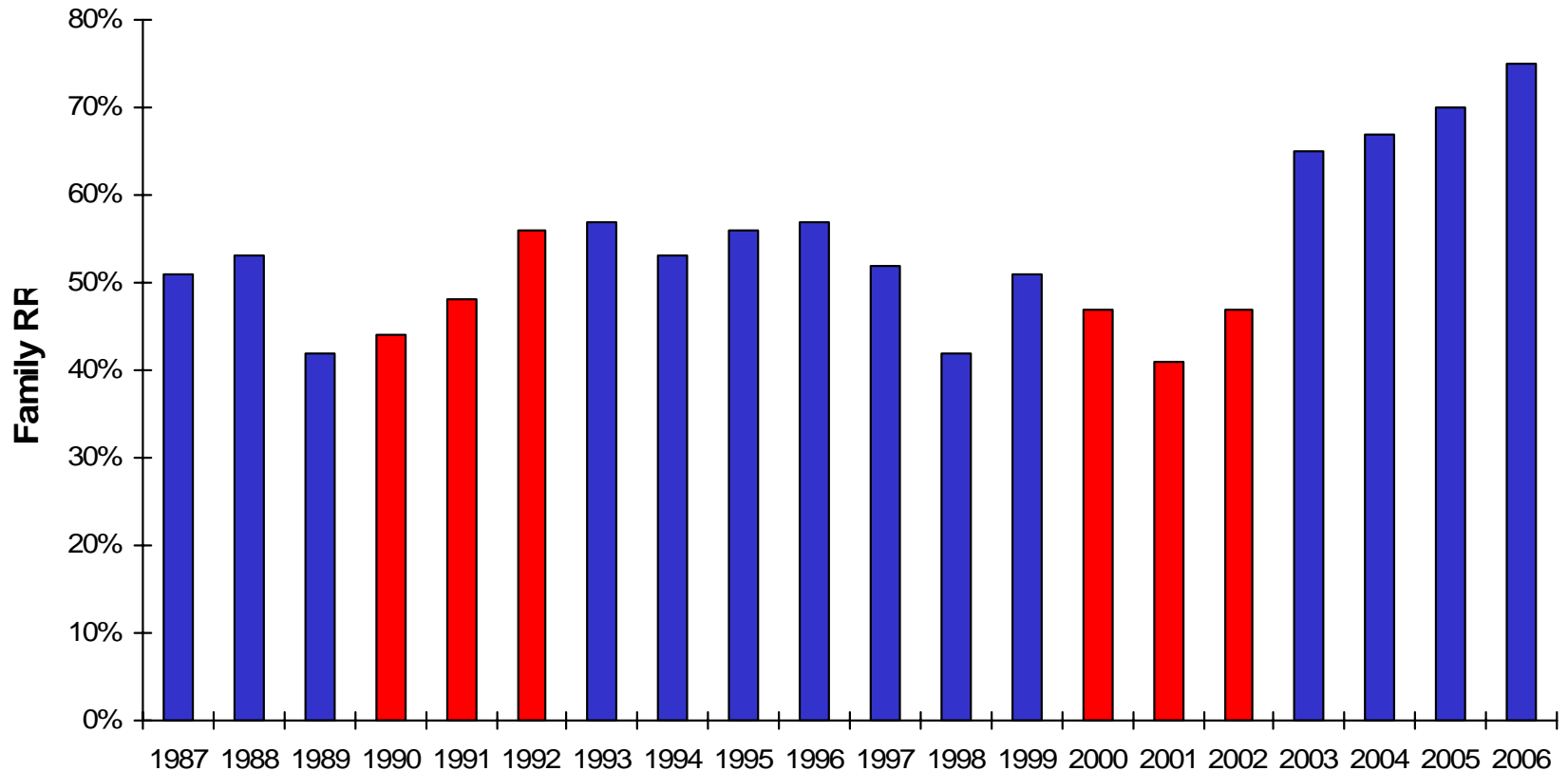
Moody's expects lower loan and bond recoveries due to higher loan shares

Historical data and Moody's current US LGD assessments



What about impact of downturn conditions?

Annual firm-wide recovery rates
(red bars: annual default rate > 6%)



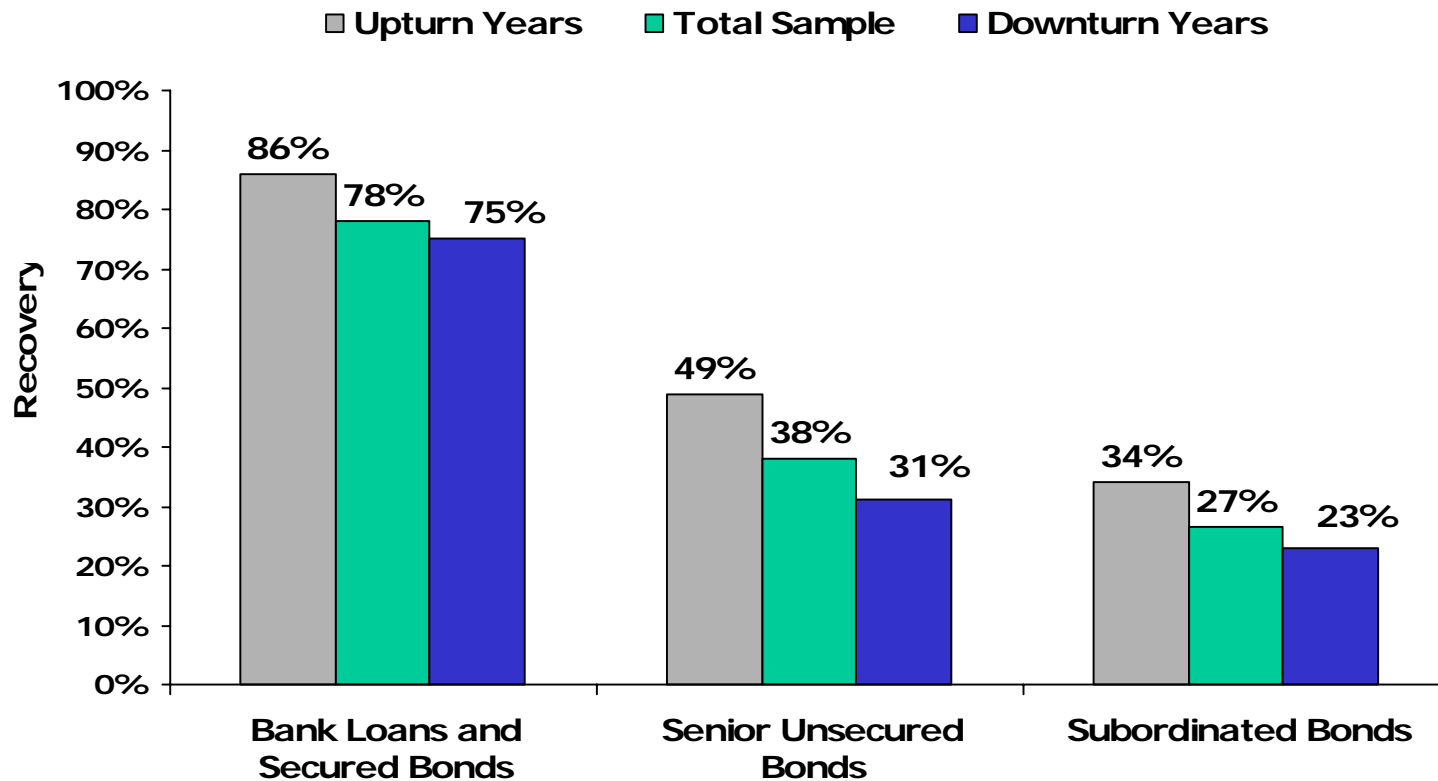
Impact of downturn conditions relatively modest historically

- Average firm-wide recovery rate moves from 52% for entire sample versus 47% in downturn years
 - majority of historical defaults observed during downturn conditions
 - modest impact on Moody's LGD assessments (maximum of 8% points higher for any debt)
- Impact depends on debt's position in the liability structure
 - largest impact on mezzanine debts



Historical recovery data signal modest downturn impact

Downturn years: 1990-92, 2000-02



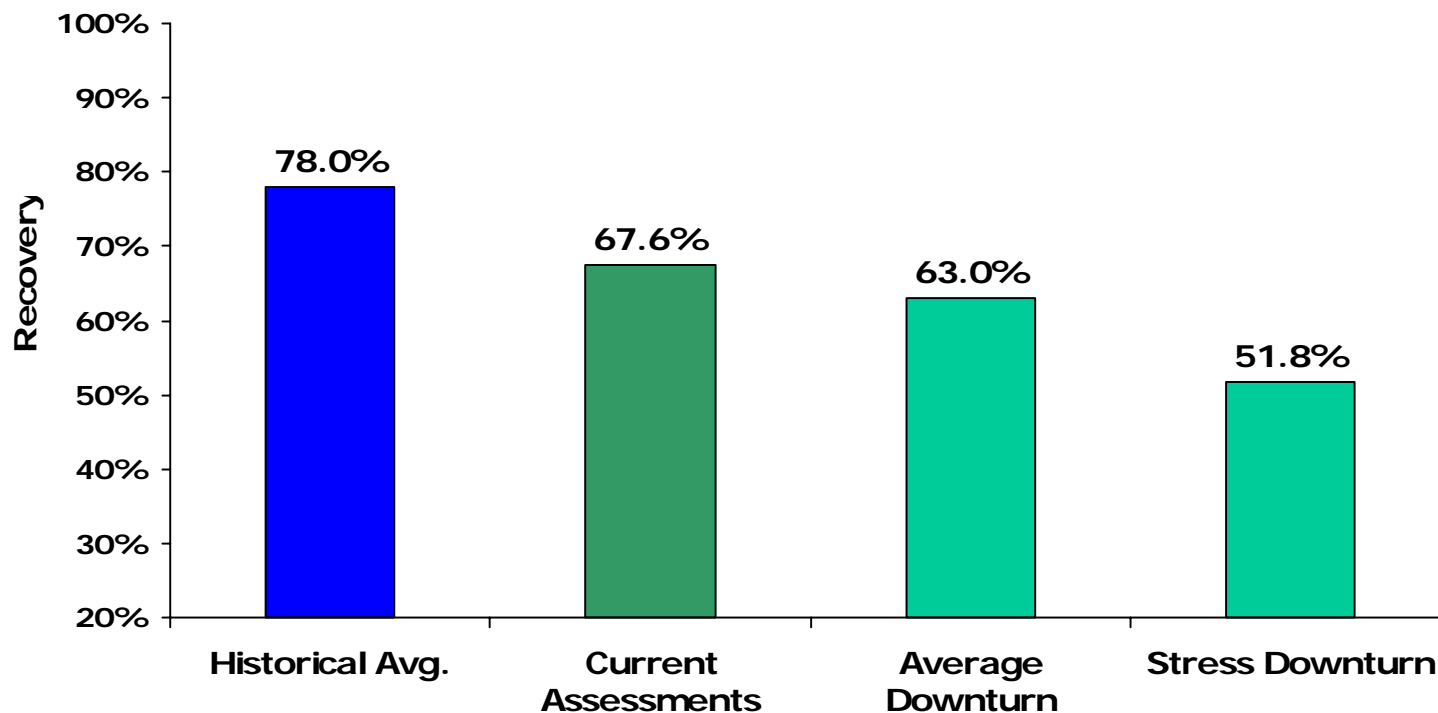
But unusually low firm-wide recoveries are possible

- Downturn firm-wide recovery rates may be outside of historical experience in next 1-2 years:
 - financial and housing crises
 - covenant-lite loans
 - lack of near-term debt maturities
- What is impact if average downturn firm-wide recovery rate moves from 45% to 35%?



High loan shares make loan recoveries vulnerable in stress downturn scenarios

Stress scenario: average firm-wide recovery equals 35%
US 1st Lien Loans



Takeaways

- **Increased loan shares imply lower expected recoveries for loans and bonds—even if corporate family recovery rates remain at 50% historical average**
- **Moody's LGD assessments largely reflect historical downturn conditions—only modest adjustments necessary (approx. 3-5% for loans)**
- **But stressed downturn conditions outside of historical experience are possible and current high loan shares make loan recoveries vulnerable in such a scenario**



Q & A



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