

# Truth or Consequences

Understanding default risk and its ramifications

*Jeff Wallace and Jim Simpson*

**M**any treasurers are too complacent about their company's default risk, thinking that a default can't happen to them and, if it does happen, their lenders will be forgiving. The latest annual Standard & Poor's default and transition study shows otherwise: Over a five year period, a surprising number of investment grade and speculative-grade companies will experience credit deterioration due to poor operating results. These poor operating results will also cause technical and hard defaults.

While lenders may forgive a minor technical default such as missing a notification deadline by a few days, more serious technical defaults can quickly spiral out of control. In fact, as soon as a default is reported, the company is not in control.

Whether hard or technical, any default gives lenders the contractual right to earn penalty interest and call the debt. To remedy the default, the company is negotiating from a position of weakness the amount of the waiver fee and the penalty interest, and avoiding new, onerous covenants, increased pricing, forbearance, and Chapter 11.

## What happens in a default

Defaults can be categorized as hard or technical. Hard defaults, as defined by S&P, are missed payments, distressed debt exchanges and bankruptcy filings. Technical defaults are any other kind of covenant violation, such as failure to provide required notices, other non-financial covenant failures, exceeded permitted baskets limits and broken covenant ratios.

When a default of any kind occurs, the company must report the event promptly to lenders according to the requirements of the debt agreement. Otherwise, this is financial fraud. With cascading cross-defaults, other lenders may need to be notified as well.

Lenders will immediately want to know the specifics of the default, the default date and what steps the company has taken or proposes to take to remedy the default. The longer the period of default, the larger the penalty interest and the bank has even more justification for higher waiver fees.

Auditors will want to know the default date because issued financial statements may need to be restated. ASC 470-10-45-11 requires the defaulted debt(s) to be classified as short-term for any covenant violation. There may also be a material SOX deficiency citation.

What the lenders will require in satisfaction to waive the default is a complex calculation of:

- The company's current credit standing, which may not as good as it was when the debt was originally negotiated because the breached covenant may also be a symptom of poor operating results.
- The evaluation of the company's management, which allowed the default to happen, especially if there was no warning from the company about it. One covenant violation always raises the question about what other covenants the company may be failing.
- The current economic conditions of the company's industry.
- Current credit market conditions. If the company's pricing is now underwater to due previous favorable pricing, this is a golden opportunity for the lenders to improve their loan book.

There's always lost treasurer credibility with senior management. Any treasurer who has been through a serious technical default never wants to be in that position again. "It was the worst month of my life. Every day I thought I would be fired", a client treasurer speaking of a technical default when he overlooked the 144A registration deadline for some junior notes.

### Default risk increases over time

Every year S&P publishes the hard default and transition experience of their ratings over the most recent 30 years. Transition experience refers to what percentages of companies were upgraded or were downgraded or became non-rated. The chart below shows the five year S&P experience for their BB-rated global corporates for 1982-2012 (Figure 1).

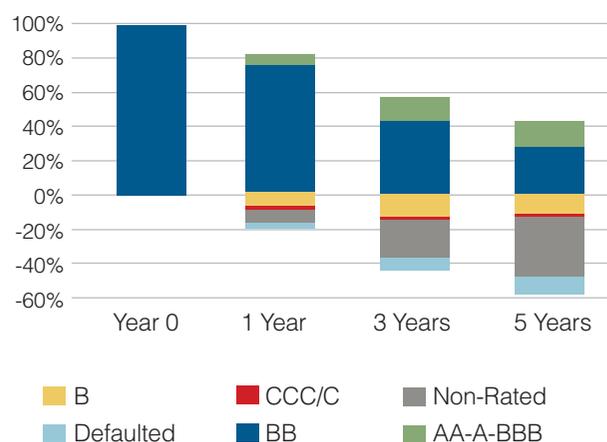
The next chart shows that this magnitude of significant changes and general deterioration happens to both investment and speculative-grade companies (Figure 2).

### Estimating technical default risk

We use a lower and upper bound methodology for estimating the five year probability of a technical default:

- As a lower bound, we believe—and so does 93 percent of "2012 AFP Debt Compliance Survey" respondents—that the risk of a technical default is at least equal to the hard default rate.
- The upper bound is a function of the frequency of technical defaults associated with the stress of credit downgrades, defaults and becoming non-rated.

**Figure 1: How BB Ratings Change Over 5 Years**



Source: S&P 2012 Global Corporate Default Study and Rating Transitions, Table 21.

**Figure 2: S&P's 5 Year Rating Transition Rates for Companies Rated A to CCC/C**



See "Managing Default Risk Justifies a Strong Debt Compliance Process" at [debtcompliance.com/articles](http://debtcompliance.com/articles) for detailed calculations.

Source: S&P 2012 Global Corporate Default Study and Rating Transitions, Table 21.

Using the BB transition rates from S&P in the chart below, we see that the lower bound is nine percent, S&P's hard default rate. To estimate the frequency of technical defaults due to transition changes, we take into account these considerations:

- In general, rating declines will be preceded by technical defaults, with two-notch declines having a higher percentage of technical defaults than one-notch declines.
- Rating declines are not linear: A drop from BB to B reflects a greater credit decline than a drop from A to BBB.
- Hard defaults most likely incurred technical defaults first.
- Companies generally become non-rated because the public debt has been bought out due to a refinancing or from the company being acquired, with the former more likely as credit risk increases.

The chart and table below shows how we calculated the BB technical default estimate and a summary of our estimates for the A to CCC/C credit ratings.

In the “2012 AFP Debt Compliance Survey,” performed in collaboration with Debt Compliance Services, 401 respondents were asked to estimate the probability of a hard default, which we have compared to the S&P experience. (Figure to the right)

The investment grade companies slightly overestimate their default risks, which does them no harm. However, the speculative grade companies are seriously underestimating the long-term default risk of companies with their ratings.

Adverse selection may be one

From Initial BB Rating To:	5 Year BB-Rated Transition Rates*	DCS Weighting	Technical Default Risk
AA or AAA	0.1%		
A	1.2%		
BBB	12.5%		
B	11.3%	20%	2.3%
CCC/C	1.4%	40%	0.6%
Non-Rated	35.6%	30%	10.7%
Hard Default	9.0%	60%	5.4%
<b>100.0%</b>			<b>18.9%</b>

\* Per S&P 2012 Global Corporate Default Study

Lower Bound (Hard Default Rate)	9.0%
Upper Bound	18.9%

DCS Range Estimate of Technical Default Risk		
Credit Rating	Lower	Upper
A	1%	8%
BBB	2%	10%
BB	9%	19%
B	21%	39%
CCC/C	46%	56%

AFP Debt Compliance Survey		S&P 2012 Default Study
S&P rating	Average 5 year hard default probability estimated by publicly rated companies	Cumulative 5 year hard default rate
A	2.3%	0.6%
BBB	3.0%	2.2%
BB	5.0%	8.4%
B	4.2%	20.2%

cause for their underestimation; if the speculative grade treasurers really believed they had significant default risk, then perhaps they might not be working at the company!

Regardless of the reasons, by underestimating their long-term risk, these companies are likely to implement inadequate debt compliance practices, which we see

in the “2012 AFP Debt Compliance Survey” data. And in years 3-5, when these companies need to be the most vigilant and proactive, they may have new, inexperienced compliance staff following an inadequate process.

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