European businesses struggle to manage debt

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A first estimate of European companies' ability to cope with their debt loads has shown that the number to default on riskier loans will quadruple by next June.

The number of defaults on European leveraged loans will rise from 10 over the past year to 38 by June 2009, according to Standard & Poor's. This is equivalent to a rise in the rate of default from 1.55 per cent to 5.8 per cent.

In the US, many junk-rated corporates and private-equity backed companies fund themselves with publicly rated bonds. Hence default rates give a clear picture of the level of distress.

In Europe, these companies raise a greater proportion of funding in the leveraged loan market. Here, ratings are mostly private, based on confidential company information, and available only to lenders.

So estimating the level of financially distressed companies is difficult. S&P gives private ratings - so-called credit estimates - to 648 companies in Europe.

This is the first time S&P has produced an estimate on default rates for European leveraged loans, 80 per cent of which are from private equity-backed companies.

Publicly-rated debt tells a different story. In Europe there has been only one publicly rated bond default - for French drinks maker Belvedere - since June 2007.

According to S&P, the rate of default on European junk bonds will rise to 4.1 per cent by June 2009, equating to 10 defaults.

European defaults have not accelerated in the same way as in the US, where the default rate on leveraged loans jumped to 2.58 per cent in June from 0.26 per cent at the end of 2007.

European leveraged loans have withstood the economic headwinds so far because of easier terms, such as looser debt covenants. Moreover the past 12 months have seen private equity funds pumping hundreds of millions of euros into portfolio companies to avoid defaults.

As the economic environment weakens, S&P believes lenders and sponsors will be more unforgiving, leading to the quadrupling in defaults.

Ian Hazelton, chief executive of Babson Capital Europe, one of the largest leveraged loan managers in Europe, believes defaults are only part of the story.

"I would expect any forecast of leveraged loan de-faults to be reduced by consensual restructurings before default as long as the private equity owners perceive there is value in the equity of the business," he said.

"Monthly reporting should identify default risk well in advance and avoidance is in most parties' interests."

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