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Leveraged Finance:
**Refinancing Needs Drive Leveraged
Companies In Europe Toward The
High-Yield Bond Market**

Research Analyst:

Taron Wade, London (44) 20-7176-3661; taron_wade@standardandpoors.com

Secondary Credit Analysts:

Paul Watters, CFA, London (44) 20-7176-3542; paul_watters@standardandpoors.com
Marc Lewis, London (44) 20-7176-7069; marc_lewis@standardandpoors.com

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Leveraged Finance:

Refinancing Needs Drive Leveraged Companies In Europe Toward The High-Yield Bond Market

After freezing up in mid-2007, there are signs that the high-yield bond market is starting to thaw in Europe. With traditional funding from banks and collateralized loan obligations (CLOs) in short supply, speculative-grade issuers (that is, those with long-term ratings of 'BB+' and below) are turning to the high-yield market. This could, in Standard & Poor's Ratings Services' opinion, result in a shift toward greater liquidity in the public high-yield market for European corporates and leveraged buyouts (LBOs).

Speculative-grade borrowers in Europe face the greatest refinancing risk in the capital markets. This is because their traditional sources of funding--banks loans and CLO proceeds--have not been available in the market as a result of the financial crisis. Although the European bond market has experienced record-breaking issuance in the first half of 2009, the surge is largely limited to investment-grade issuers, leaving speculative-grade borrowers behind. That picture is starting to evolve, however, as the high-yield bond market starts to free up again in Europe.

The high-yield bond market has a somewhat chequered history in the region, originally taking off after the introduction of the euro in 1999. Growth then stalled between 2000 and 2002, when European telecommunications companies in particular--some of which had been heavy high-yield issuers--failed to meet the expectations of their business plans and were no longer able to tap the market. These companies came under pressure as a result of overestimated demand, intensifying domestic competition, and the significant use of debt to fund acquisitions and operational expansion. However, the LBO boom in Europe from 2003 to 2007 subsequently pushed high-yield issuance to over €30 billion in 2006, more than double the issuance for 1999 (see chart 1). Even so, the European market has yet to mature like its U.S. counterpart, which saw volumes of €109 billion in 2006.

Examining trends in 2009, we find speculative-grade issuance volumes starting to take off in April (see chart 2). The market also appears to have become more accessible to lower-rated investment-grade issuers around that time.

This improved access occurs at an ideal time for leveraged borrowers. While the bulk of refinancing risk, according to Dealogic and Standard & Poor's data, kicks in during 2013 and 2014, the market is likely to become very focused on this risk between now and 2011 (see charts 2 and 3). Most of the high-yield bond issuers so far this year are those with existing bonds and experience of tapping the market. Some companies are issuing subordinated high-yield debt to repay senior secured bank debt, but others are actually replacing senior bank debt with bond debt. If those companies that have not yet tapped the high-yield market were to consider doing so, the market could grow even further. Moreover, the proliferation of high-yield issuance could ultimately give leveraged companies in Europe a broader variety of funding sources and thereby increase market liquidity.

Chart 1

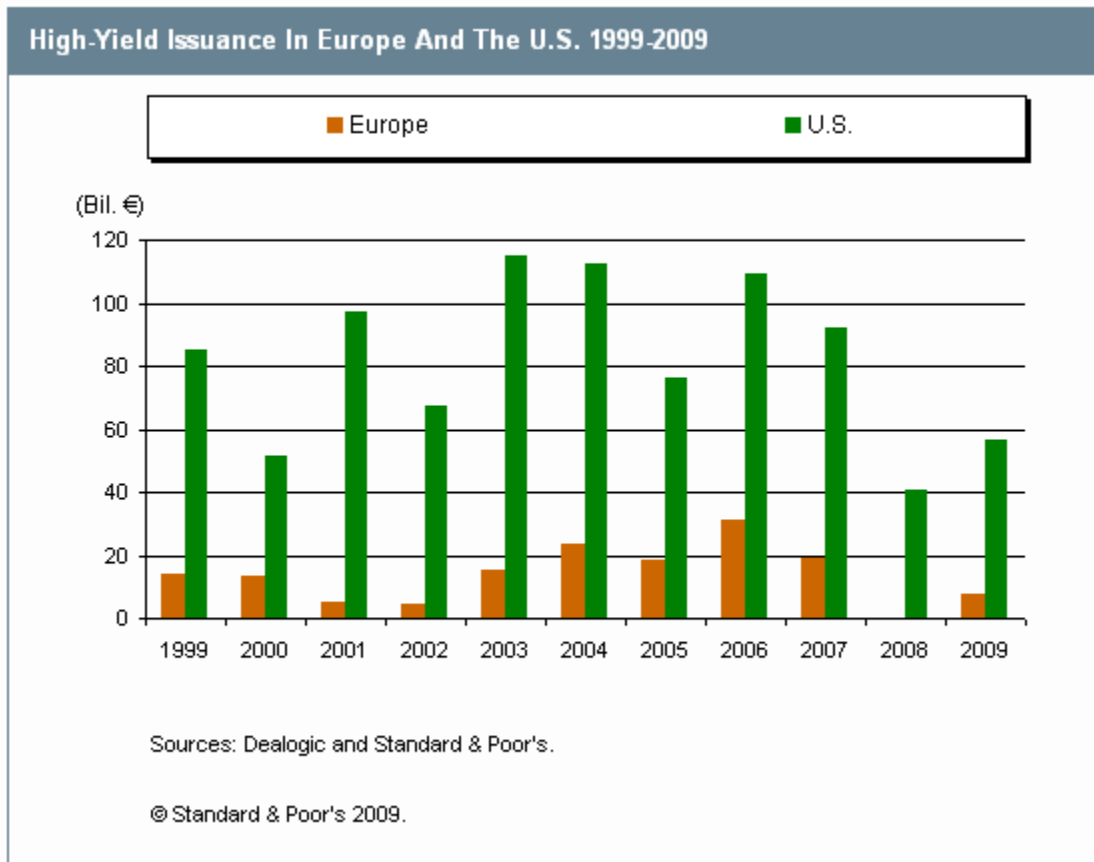
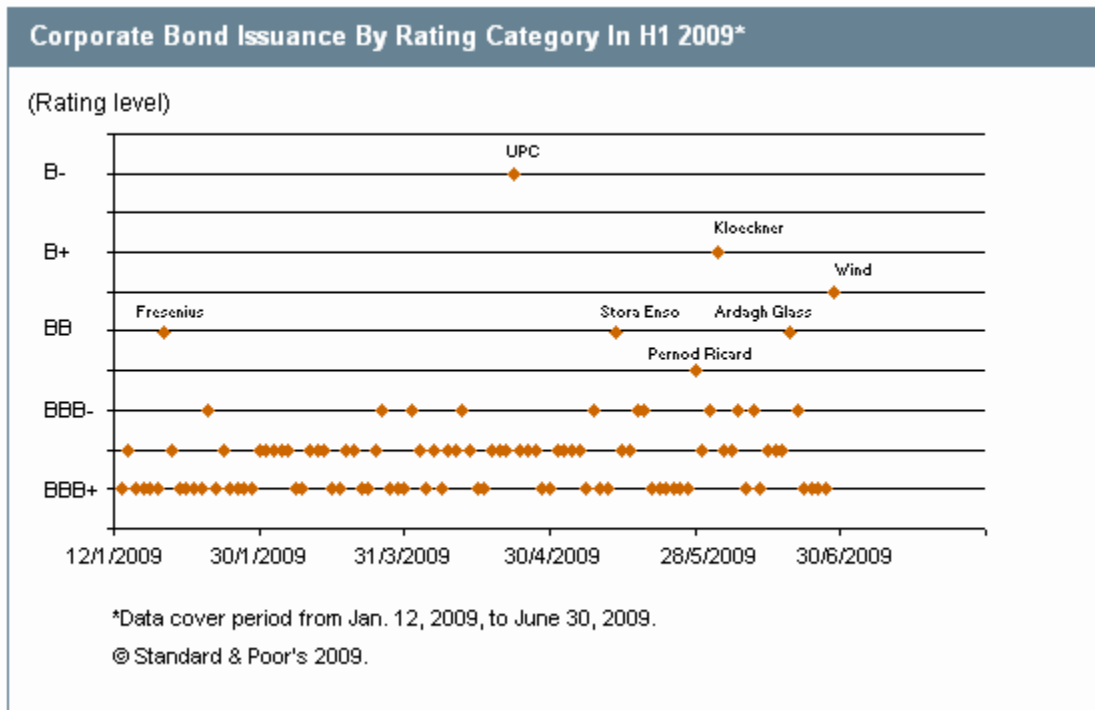


Chart 2



Bank Funding Market And CLOs Offer No Relief

Bank financing opportunities have dropped away for companies in Europe across the credit spectrum. But the absence of bank financing for speculative-grade companies could be of particularly concern in the near future as refinancing risk looms. On past experience, bank lending, particularly among regional banks that have close links with local companies, tends to dominate speculative-grade financing in Europe. For those companies going through an LBO, the syndicated loan market traditionally provides the funding. And for the subordinated part of the capital structure in an LBO, mezzanine funds typically act as the main funding source.

From 2001-2007, CLOs and hedge funds introduced an element of diversity into the LBO and leveraged finance market in Europe, via both European-based issuers and funds and the entry of U.S. CLO and hedge fund businesses. Despite this influx of new capital, the leveraged finance market in Europe did not in our view become truly diversified, largely because a broader range of institutional capital—particularly those funds that do not use leverage, such as mutual funds—did not enter the market. By contrast, in the U.S. there are a wide variety of mutual funds that also invest in the leverage finance market due, we believe, to what is regarded as its greater transparency.

Refinancing Risk Set To Rise In 2013-2014

Approximately 90% of financing transactions in the European leveraged finance market consist of LBO deals, most of which are not publicly rated. The majority of these transactions were structured in 2006 and 2007 with tenors between seven years and nine years, which means that refinancing risk will increase substantially in 2013 and 2014, according to data from Dealogic and Standard & Poor's (see chart 3). These transactions were based on structures

that assumed a high level of EBITDA growth because of the necessity to provide for material deleveraging. This was necessary to attract investors, as the debt multiples on these transactions were high due to high purchase price multiples. However, that growth has not typically materialized, making deleveraging in many cases impossible.

Earlier this year, we undertook a survey among our portfolio of publicly rated companies to establish borrowers' refinancing needs over the next five years. The results of our survey confirm that refinancing risk will increase substantially in 2013 (see chart 4).

Chart 3

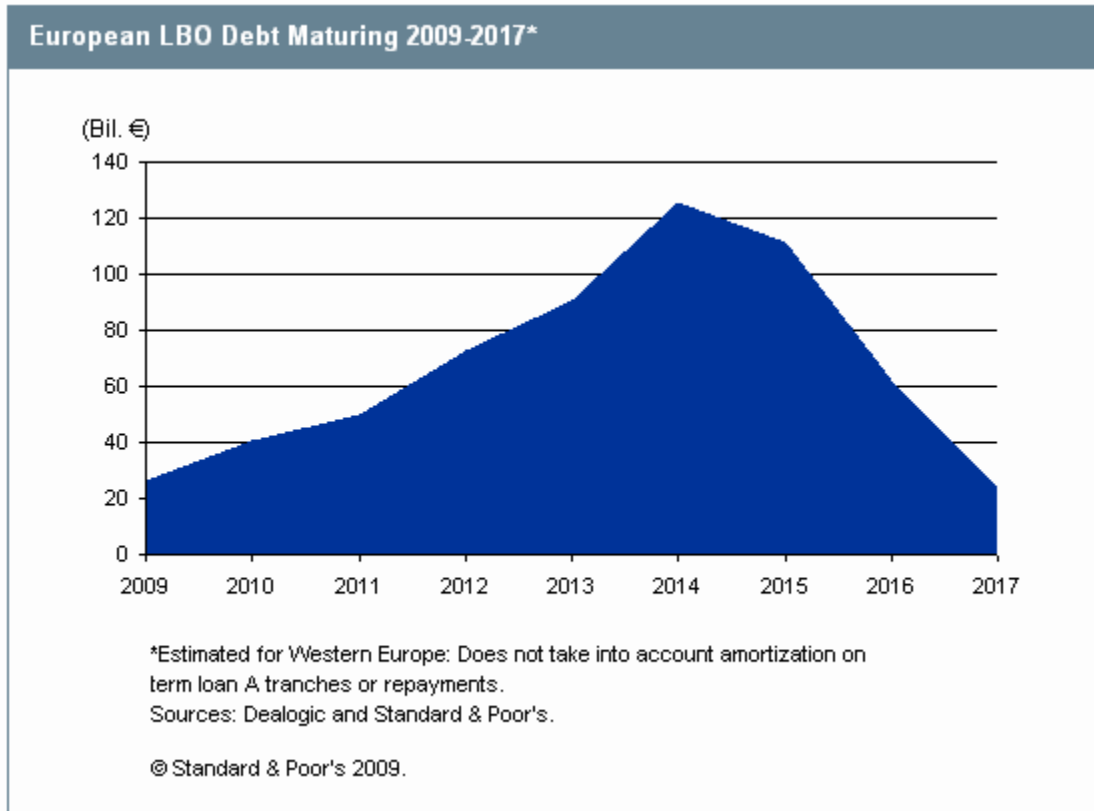
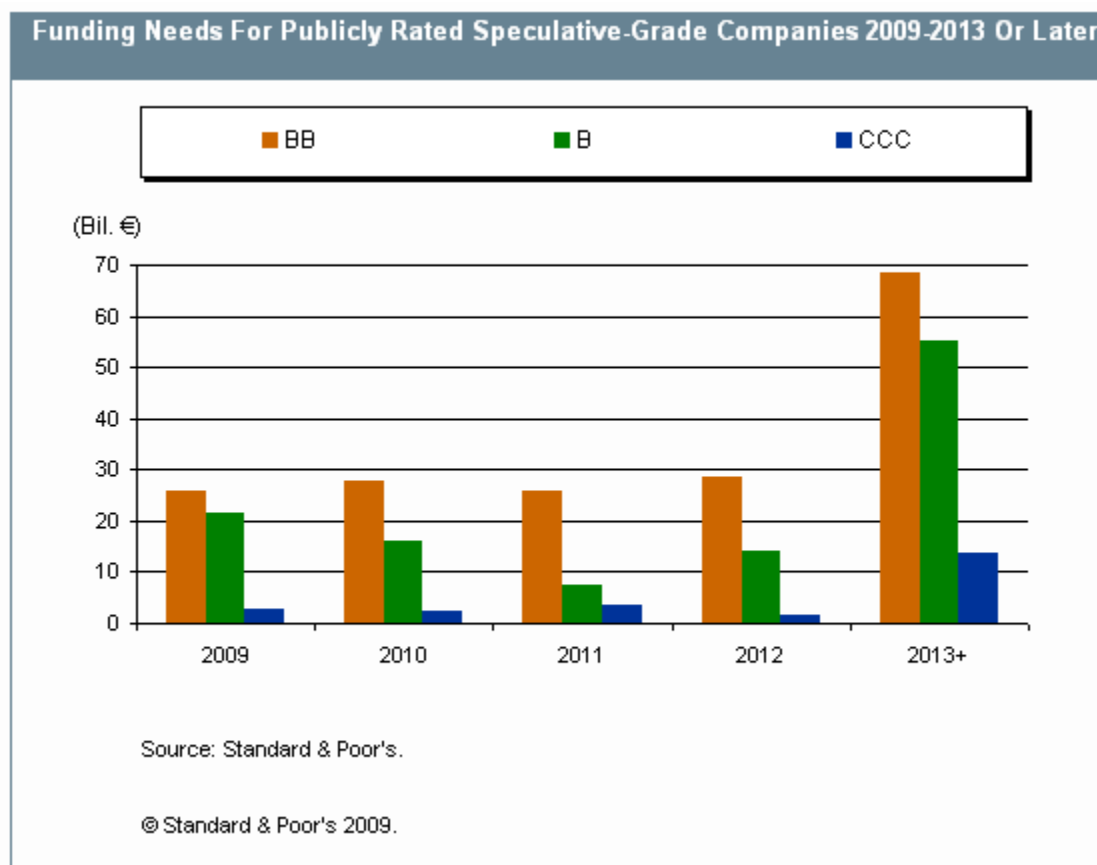


Chart 4



Amend-And-Extend Exercises Gain Traction In Europe

In the U.S. market, which we view as having a much deeper institutional funding base, as well as more liquidity and transparency, private equity-sponsored companies have been asking their lenders for amendments which include an extension of maturities. Called an amend-and-extend exercise, this strategy aims to extend existing maturities, albeit at a price and with amended loan terms. For example, we understand that chemicals company Rockwood Specialties Group Inc. (B+/Stable/--) extended some of its loans for a fee of 200 basis points, increasing the loan margins by 250 basis points and adding a LIBOR floor into the transaction, according to Standard & Poor's Leveraged Commentary & Data (LCD). Other changes made to give lenders comfort include a \$1 billion cap on the company's ability to raise incremental senior unsecured debt.

The trend appears to be spreading across Europe, although so far mainly through cross-border transactions, and only those companies with public ratings. Such companies include The Nielsen Co. B.V. (B/Stable/--), SunGard Data Systems Inc. (B+/Stable/--), and HCA Inc. (B+/Stable/--). Furthermore, Smurfit Kappa Group PLC (BB-/Stable/--), received approval from lenders to extend a portion of its current €600 million revolving credit facility (RCF) by one year, to December 2013. Similarly, UPC Holding B.V. (UPC; B+/Positive/--) asked investors to roll their exposure into new tranches of existing term loans to extend its maturities, although we understand the exchange offer was not called an amend-and-extend exercise because an amendment was not required according to the documentation. UPC

issued \$400 million in senior unsecured notes, nine-year noncallable for the five years, alongside the extension.

Another strategy we observe in Europe is to negotiate forward-starting loans. Borrowers pay a fee for this structure, as refinancing risk is alleviated, even though interest is not paid until the loan is actually put into place. We understand that this tool has been in common use among investment-grade borrowers since earlier this year, but is now being taken up by speculative-grade borrowers as well. For example, Dutch plastic pipes manufacturer Wavin U.K. (Holdings) Ltd. (not rated) has reached agreement with its lenders on a recapitalization package, which includes a €475 million forward-start facility, according to Standard & Poor's LCD. When its current facility, which has been reduced to €500 million from €750 million, matures in 2011, it will be extended to April 2013 with a new €475 million facility. Typically, we observe that borrowers will sign their transactions between 18 months and two years before they mature, and then extend their debt for no longer than two years.

Some Lenders See Their Recovery Prospects Improve

However, another option in Europe available for refinancing is the high-yield bond market. Publicly rated companies that already access this market have started the first wave of refinancings. These include Compagnie Generale de Geophysique - Veritas (CGG-Veritas; BB/Stable/--), Virgin Media Inc. (VMI; B+/Stable/--), Ardagh Glass Group PLC (B+/Stable/--), UPC, and Wind Telecomunicazioni SpA (Wind; BB-/Stable/--). A complete list is shown in table 1.

We believe these companies use the high-yield market not only to extend their maturities, but in certain cases to issue high-yield debt to pay down more senior debt, thereby improving recovery prospects for existing senior lenders.

For example, Virgin Media issued a total of \$1 billion equivalent seven-year senior unsecured notes in May 2009, with the intent to repay priority debt and alleviate the pressure of its amortization schedule. Payments are due in 2010 and 2011. As a direct consequence, we raised the issue ratings on the unsecured notes to 'B' from 'B-'. Our decision was based on the fact that the new bond ranks equally with the existing unsecured notes. Furthermore, in our view, the new issuance results in a lower projected amount of senior secured priority debt at the point of default, as well as slightly lower gross leverage, due to some debt being repaid from cash on Virgin Media's balance sheet.

CGG-Veritas, meanwhile, issued seven-year senior unsecured notes at the beginning of June to repay senior secured debt, extending the maturity profile of the company. In our view, overall recovery prospects are hardly affected, since debt levels remain the same. As a result, only minor changes were made to our previous default scenario.

However, Wind's recent subordinated issuance will be used to pay down lower-ranking, payment-in-kind (PIK) securities. The new debt is being issued at the same level as existing subordinated high-yield debt and is assigned the same recovery rating of '4' (meaning an expected recovery of 30%-50%). As a result of this transaction, the default in our hypothetical default scenario extends past the original date of 2011. This should improve recoveries because the amount of senior secured debt ranking ahead of the notes should be less than previously assumed due to the payment of the scheduled amortizations. However, it is our opinion that this positive rating driver would be more than offset by a higher amount of subordinated debt outstanding at the point of default.

Speculative-Grade European Corporates' High-Yield Bond Issues May 1, 2009, to July 15, 2009

Speculative-Grade European Corporates' High-Yield Bond Issues May 1, 2009, to July 15, 2009 (cont.)

Issuer	Ranking	Size	Date	Term (years)	Maturity	Corporate credit rating*	Issue rating*	Recovery rating*	Recovery prospects (%)	Coupon† (%)	Price‡ (par value)
Stora Enso Oyj	Senior unsecured	€232 mil.	May 15, 2009	5	June 23, 2014	BB/Negative/B	BB	3	50-70	5.13	74.09
UPC Holding B.V.	Senior unsecured	\$400 mil.	May 21, 2009	9	April 15, 2018	B+/Positive/--	B-	6	0-10	9.88	92.427
UPC Holding B.V.§	Senior unsecured	€400 mil.	May 21, 2009	9	April 15, 2018	B+/Positive/--	B-	6	0-10	9.75	89.174
Pernod Ricard S.A.	Unsecured	€800 mil.	May 28, 2009	7	Jan. 15, 2015	BB+/Negative/--	BB+	3	50-70	7.00	99.882
Virgin Media Inc.	Senior unsecured	\$750 mil.	May 29, 2009	7	Aug. 15, 2016	B+/Stable/--	B-***	6	0-10**	9.50	95.574
Virgin Media Inc.	Senior unsecured	€180 mil.	May 29, 2009	7	Aug. 15, 2016	B+/Stable/--	B-***	6	0-10**	9.50	95.574
Compagnie Generale de Geophysique - Veritas	Senior unsecured	\$300 mil.	June 2, 2009	7	May 15, 2016	BB/Negative/--	BB	3	50-70	9.50	96.95
Fresenius Finance B.V.	Senior unsecured	€125 mil.	June 3, 2009	7	Jan 31, 2016	N/A	BB	3	50-70	5.50	92
IFCO Systems N.V.	Senior secured	€200 mil.	June 5, 2009	7	June 30, 2016	BB-/Negative/--	BB-	4	30-50	10.00	95.75
Ardagh Glass Group PLC	Senior secured	€300 mil.	June 19, 2009	7	July 1, 2016	B+/Stable/--	BB	1	90-100	9.25	98.116
Wind Telecomunicazioni SpA	Senior unsecured	€1.2 bil.	July 1, 2009	8	July 15, 2017	BB-/Stable/--	BB-	4	30-50	11.75	96.271
Wind Telecomunicazioni SpA	Senior unsecured	\$2.0 bil.	July 1, 2009	8	July 15, 2017	BB-/Stable/--	BB-	4	30-50	11.75	97.492
Virgin Media Inc. (add-on)	Senior unsecured	\$600 mil.	July 16, 2009	7	Aug. 15, 2016	B+/Stable/--	B	5	10-30	9.50	98.662
ISS Global A/S¶¶	Senior unsecured	€525 mil.	July 16, 2009	5	June 15, 2014	BB-/Stable/--	B	6	0-10	11.00	100

*On July 24, 2009. †According to Standard & Poor's Leveraged Commentary & Data. §Added into the euro tap issue due to strong demand. **On July 16, 2009, the issue and recovery ratings on Virgin Media were raised to 'B' and '5', respectively, from 'B-' and '6'. ¶¶Notes issued by special purpose vehicle ISS Financing PLC. N/A--Not applicable.

The More Highly Rated Issuers Are Opening Up Europe's High-Yield Market

For companies that have never used the bond market, the pricing may be much higher than they have seen before--especially compared with cheap funding available from banks and CLO funds in recent years. There are also

the limits of noncallable debt, compared with the more flexible mezzanine market (mezzanine debt can typically be repaid at any time) to take into account. In our view, issuers may feel that there is still time for conditions to improve because refinancing risk does not become material until 2013 or 2014. On LBO transactions, some sponsors may prefer to wait to avoid higher priced, longer dated debt and hope that the initial public offering (IPO) market may open up or a sale to trade or private equity may be possible. Also, some transactions may require sponsors to contribute new equity before tapping the market, because the companies seeking refinancing may be too highly leveraged.

To date, high-yield transactions have been mostly limited to credits rated 'BB' or at the upper end of the 'B' category. Among the latter are Ardagh Glass, which, in our view, currently has a comparatively strong liquidity position, and Virgin Media and UPC, both of which have sustained cash-generative operating performance. Virgin Media and UPC also include large, dollar-denominated components in their financing that target U.S. investors, whose appetite covers a wide range of credit profiles.

Need for funds can outweigh privacy considerations

We also understand that some lower-rated (and unrated) borrowers may be considering issuing in the high-yield market. This could prove to be a real challenge for those borrowers and their private equity owners used to keeping information private and lending syndicates tight. However, if market conditions remain as they are at present, with the banks and the CLO market offering greatly reduced funding, the benefits may outweigh the costs.

The opportunity to tap the high-yield market as a source for senior secured debt is not unprecedented. Ardagh Glass, for example, issued €300 million of senior secured notes due 2016 to extend its maturities. It used the proceeds to repay a portion of senior secured debt due 2014 and also repay its RCF due 2014. The new bond debt ranks pari passu with the existing senior debt, with, in our view, immaterial differences in the security package. In addition, we understand that Smurfit Kappa is seeking an amendment from lenders that would allow it to issue a bond to refinance a portion of its senior secured debt facilities. The company would prepay €100 million of senior bank debt at par, to be applied pro rata against existing term loans. The amendment also includes a request to increase covenant headroom, and, as mentioned previously, a request to extend the maturity on its €600 million RCF.

Refinancing senior secured bank debt with senior secured bond debt may involve more than just issuing subordinated bonds and repaying senior debt. This is because it generally requires lender approval (unless the company is making a full repayment) and could meet resistance if the new lenders are ranked pari passu. However, we believe existing lenders will often feel more comfortable as long as the new debt has a longer tenor--meaning the existing debt would mature first.

IFCO Systems N.V. (BB-/Stable/--), the Netherlands-based provider of reusable plastic containers, adopted a similar strategy, although it refinanced already publicly issued senior notes. We understand that the new €200 million notes due 2016 were issued in order to repay an existing €110 million senior secured bond issued by IFCO and provide additional liquidity. As a consequence, we revised our outlook on IFCO to stable from negative because of the resulting improvement in the company's liquidity position, which in our view provides satisfactory headroom at this rating level to cover potential trading underperformance and/or volatility in working capital movements.

Are Newcomers Ready To Tap The Market?

In our view, the contrast between the European and U.S. high-yield bond markets has never been more apparent than in the current economic downturn. Although companies in North America are suffering from similar funding constraints, we believe that even those companies rated 'B' have some access to funds to lengthen their maturities and reduce their exposure to refinancing risk. The wider, more liquid U.S. leveraged finance market offers extensions as well as high-yield bond financing alongside bank and CLO funding.

However, in our view, Europe is starting to follow the U.S.'s lead. Publicly rated credits are tapping the high-yield bond market to improve their liquidity and reduce refinancing risk by repaying secured debt with new unsecured issuance. What's more, their interest is extending to issuing secured debt in the bond market to repay existing secured debt. Amend-and-extend exercises also appear to be coming available for those publicly rated companies. Companies that traditionally have shied away from the public market may not be far behind in our view.

We have already started to see larger speculative-grade issuers at the higher end of the credit spectrum tap the high-yield bond market. If economic conditions stabilize or improve, and traditional funding sources remain unavailable, we may see high-yield issuance grow from companies that are lower down the credit rating spectrum.

Additional Contact:

Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

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