

Leveraged Finance:

Is History Repeating Itself In The European High-Yield Market?

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We Believe That Investor Understanding Is Vital For Market Development

Are memories in the capital markets getting shorter? The global markets have just experienced one of the worst liquidity and credit dislocations since the Great Depression yet it appears that in some cases investors are not exercising sufficient discipline in regard to speculative-grade debt transactions. If so, the market may be at risk of repeating past mistakes. Standard & Poor's Ratings Services believes that there is no replacement for fundamental credit analysis and that investors are best served by understanding the nature and risks of their investments, including their probability of default and the recovery potential for speculative-grade debt in case the worst happens, in order to determine whether the pricing on offer is commensurate with the risk. We believe investor understanding is vital if the European high-yield bond market is to develop into a mature and liquid capital market, with a stable infrastructure for pricing and trading risk.

However, amid calls for market discipline, not least from banking chiefs, the reality appears somewhat different. Standard & Poor's believes that the lack of returns in money markets and investment-grade bonds may be prompting new investors to enter the European high-yield market, compressing spreads as volumes remain low. This market data may suggest that investors may not fully be factoring credit risk into their investment decisions, given the tight pricing of new issuance and the reemergence of creditor-unfriendly transaction terms.

In July 2009, Standard & Poor's predicted that refinancing needs would drive European companies toward the high-yield bond market because traditional sources of leveraged funding--bank loans and collateralized loan obligation proceeds--have not been as readily available as in the past (see "Refinancing Needs Drive Leveraged Companies In Europe Toward The High-Yield Bond Market," published July 29, 2009, on Ratings Direct). Although 74% of all issuance in the European leveraged finance market in the third quarter of 2009 came from high-yield bonds, according to Standard & Poor's Leveraged Commentary and Data (LCD), volumes still remain relatively low, compared with the period before the market dislocation. In 2006 there was just over €30 billion of issuance, which fell to zero in 2008. For 2009 year-to-date, according to data from Standard & Poor's and Dealogic, high-yield borrowers have issued €17 billion in bonds, close to the €19 billion borrowed in 2007 before the market came to a halt in the middle of the year, (see chart 1).

There has been strong demand for these high-yield volumes, as shown by recent heavily oversubscribed transactions, such as HeidelbergCement AG's (B+/Positive/B) €2.5 billion bond offering and Germany's Evonik Industries' (not rated) €750 million 7% notes. Both bonds trade above par in the secondary market, like investment-grade bonds, according to LCD. Of the 11 issues priced since July for which we have data, nine traded up in the aftermarket and seven were trading above par as of October 20, 2009. This strong demand is also evident in the tightening of the iTraxx crossover index (series 4), which was trading at 279 basis points on Oct. 15, 2009. The last time the series was trading at this level was in June 2008, before the bankruptcy of Lehman Brothers (see chart 2).

Chart 1

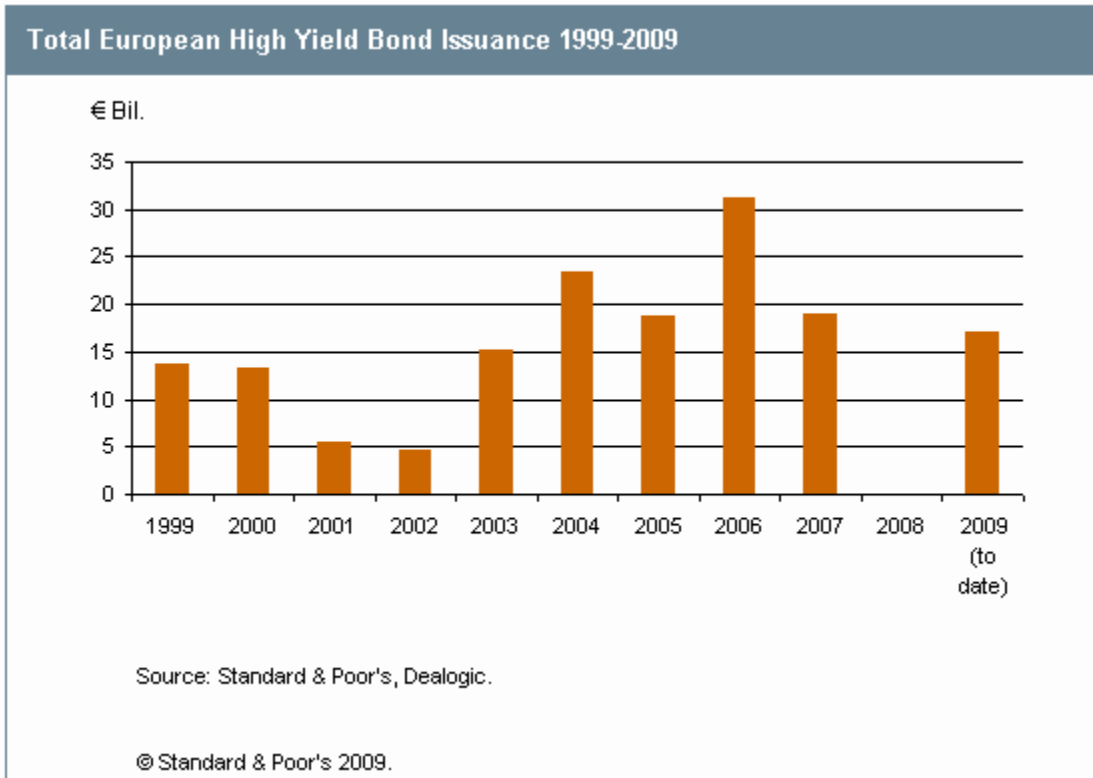
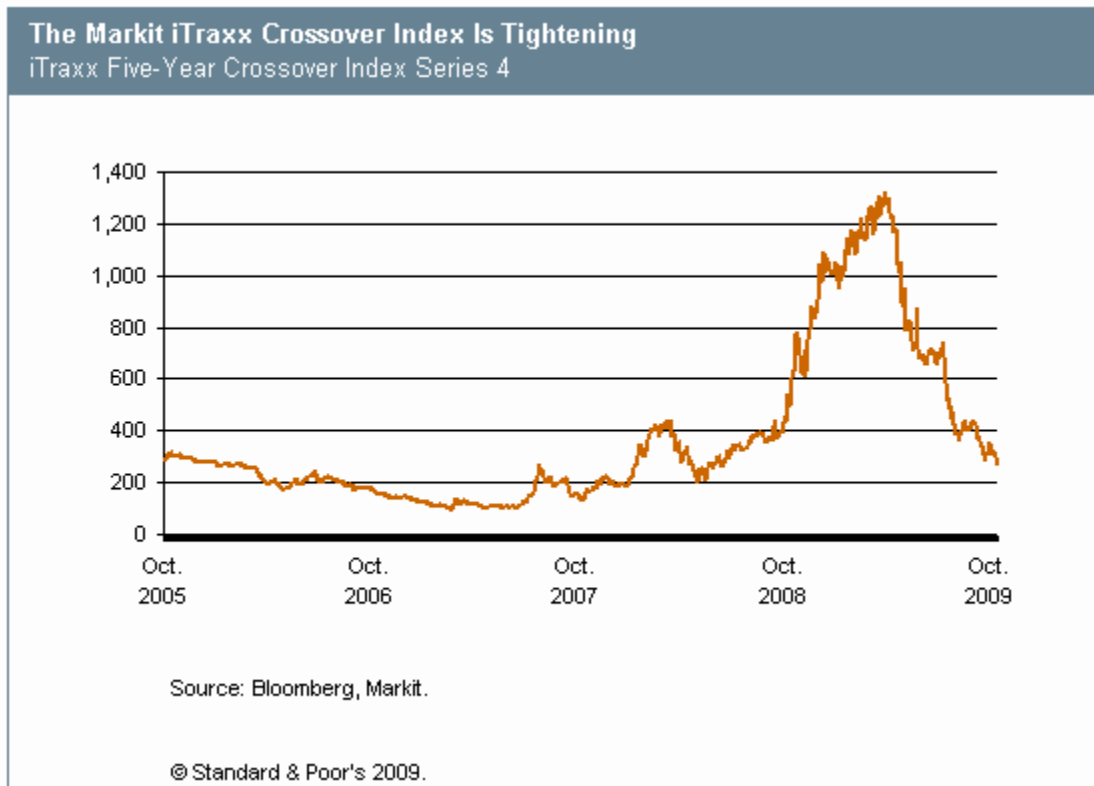


Chart 2



Some of the recent high-yield issuance is unrated (see table below). Anecdotal evidence suggests that much of the demand for unrated deals comes from private banks and other relatively new players to the credit market in Europe (many institutional investors are not able to invest in unrated transactions). These investors, like many others in the market, appear to be moving down the credit curve in the search for yield. One recent unrated transaction was a €500 million five-and-a half-year offering for food and retail sector holding company Rallye, which was priced at a yield of 8.5%, referenced against recent 'BB' rated transactions, according to International Financing Review magazine.

Given what we now know about what happened in 2007-2008, we believe that investors might want to consider the benefits of maintaining discipline in structuring, pricing, and distributing high-yield bond transactions.

Some Structures Give More Protection Than Others

We believe the quality of the security package is one of the most important considerations when analyzing the downside risks pertaining to a potential future default. For example, in September 2009, Standard & Poor's rated the \$210 million senior secured notes issued by The Netherlands-based logistics group CEVA Group PLC (CCC+/Stable/--) two notches below the existing debt due to a perceived weakness in the security package. Although these notes have the same guarantee structure and security as the company's existing senior secured credit facilities, we assigned a recovery rating of '5' (indicating our expectation of 10%-30% recovery in the event of a default) to the new notes, compared with '2' (70%-90% recovery) on the existing bank facilities, reflecting our assessment of

the new notes only having a second-ranking claim on a noncomprehensive security package. The recovery ratings assume that the security available to the secured debtholders of the existing bank facilities is taken from the assets and share pledges of entities that generate about 60% of CEVA's EBITDA. Since these assets do not give full coverage to the senior first-lien lenders, the new secured lenders would need to share the limited residual value (which comes from the unpledged assets) on a pari passu basis with the existing secured lenders, the second-lien lenders and the unsecured noteholders.

This is in contrast with other senior secured bonds that have been issued in recent months by speculative-grade companies. An example of this is Ardagh Glass Holdings Ltd. (B+/Stable/--), which in June 2009 issued €300 million of senior secured notes due 2016 to extend its maturities. The company used the proceeds to repay a portion of its senior secured debt due 2014 and also repay its revolving credit facility due 2014. The new bond ranks pari passu with the existing senior debt, with, in our view, immaterial differences in the security package.

Additionally, we see some variation between the covenant packages for investors in senior secured bonds and those of the bank lenders at the same ranking. Although these creditors may rank pari passu, if the senior lenders have maintenance covenants while the high-yield bond investors have financial incurrence covenants and there is a covenant breach, the bond investors will sit beside the loan investors in a passive position, since they have no actual power to negotiate new terms. Therefore, unlike bondholders, the bank investors would be in a position to negotiate better terms for themselves to reflect the increased risk.

Debt issued at the holding company level is another related risk, due to structural subordination. Generally, investors are better protected if debt is issued at the operating company level rather than at the holding company level. This is because such debt is closer to the physical assets of the company, usually giving the debtholders of the operating company a stronger claim on those assets, compared with creditors holding debt of the holding company. An example of a recent issue by a holding company is that by unrated Evonik Industries. Its operating company is Evonik Degussa GmbH (BB/Stable/B), which holds the chemical operations of the wider Evonik group.

Bond Covenants Are Not Always Effective For High-Yield Debt

We observe that bond covenants have not been particularly strong for unsecured high-yield debt. In fact, their generally weak nature may often mean it is quite feasible for companies to raise additional debt with a higher priority ranking. For example, many investors in unsecured bonds will rely on negative pledge language. However, Standard & Poor's recovery rating analysis factors in the potential for unsecured bank lenders to take and perfect security, despite the existence of a negative pledge on the path to default. This would put the unsecured high-yield bond lenders, who originally ranked pari passu, in a markedly inferior position, resulting in the risk of very substantial dilution of recovery prospects in the event of a payment default.

This is what happened in the case of HeidelbergCement AG. When we assigned a recovery rating of '5' to the senior unsecured bonds in November 2008, we assumed that prior to default, based on stronger documentation for the acquisition loan, HeidelbergCement would be able to renegotiate its acquisition loan terms with lenders. Accordingly, we assumed that the acquisition loan would be extended and could be senior or secured at the point of default. In July 2009, HeidelbergCement issued new €8.7 billion syndicated bank facilities benefiting from extensive share pledges and guarantees, which we believed effectively subordinated the claims of existing bondholders.

Should Investors Be Looking At Rigorous Risk Assessment?

In order to foster the development of a robust, sophisticated, and liquid capital market for high-yield issuers in Europe following the recent credit dislocation, we believe that certain minimum market standards to support a disciplined approach to risk assessment would benefit investors. However, because of an extremely competitive market for new issues, we observe that financial intermediaries are incentivized to accept only minimal disclosure standards on borrowers in the capital market--as long as those intermediaries are not putting their own capital at risk for the duration of the transaction. This means that, in the absence of regulatory intervention, it is up to the end-investors to exercise caution and demand protection.

Speculative-Grade European Corporates' High-Yield Bond Issues July 1, 2009-Oct. 11, 2009

Issuer	Size	Date	Term (years)	Corporate credit rating*	Issue rating*	Recovery rating*	Recovery prospects (%)	Coupon (%) [¶]	Price (par value) [¶]
Wind Telecomunicazioni SpA	€1.2 bil.	July 1	8	BB-/Stable/--	BB-	4	30%-50%	11.75	96.271
Wind Telecomunicazioni SpA	\$2.0 bil.	July 1	8	BB-/Stable/--	BB-	4	30%-50%	11.75	97.492
Virgin Media (add-on)	\$600 mil.	July 16	7	B+/Stable/--	B	5	10%-30%	9.50	98.662
ISS Global A/S\$	€525 mil.	July 16	5	BB-/Stable/--	B	6	0%-10%	11.00	100.00
Fraport AG	€800 mil.	September 1	10	N.A.	N.A.	N.A.	N.A.	5.25	99.83
Fiat Finance & Trade Ltd.	€1.2 bil.	September 8	5	BB+/Neg/B	BB+	3	50%-70%	7.63	99.498
Rallye SA	€500 mil.	September 18	7	N.A.	N.A.	N.A.	N.A.	7.63	99.605
Central European Media Enterprises Ltd.	€240 mil.	September 23	7	B/Negative/--	B	N.A.	N.A.	11.63	102.75
Lagardere	€1.0 bil.	September 24	5	N.A.	N.A.	N.A.	N.A.	4.88	99.74
Wendel	€300 mil.	September 28	5	BB/Negative/B	N.A.	N.A.	N.A.	4.88	85.04
Renault S.A.	€750 mil.	September 29	5	BB/Stable/B	BB	3	50%-70%	6.00	99.475
Evonik Industries AG	€750 mil.	October 6	5	N.A.	N.A.	N.A.	N.A.	7.00	99.489
Gruppo Campari	€350 mil.	October 8	7	N.A.	N.A.	N.A.	N.A.	5.38	99.43

*Standard & Poor's Ratings Services' ratings. [¶]Bloomberg and Standard & Poor's Leveraged Commentary & Data. \$On July 16, 2009, we raised the issue ratings to 'B' from 'B-' and the recovery rating to 5 (10%-30% recovery). N.A.--Not applicable.

Related Research

"Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt," Aug. 10, 2009.

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