

Leveraged Finance:

High-Yield Debt Offers European Issuers Potential Financing Options And Flexibility: 2010 Could Be A Record Year For Issuance

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High-Yield Debt Offers European Issuers Potential Financing Options And Flexibility: 2010 Could Be A Record Year For Issuance

The scale of the rebound in European high-yield issuance toward the end of 2009 surprised the market and demand for high-yield bonds has remained strong in 2010. As of April 14, the volume of Western European high-yield debt issuance so far this year has reached approximately €11.7 billion, compared with €36.7 billion in the whole of 2009. In our view, such issuance offers potential financing options and flexibility for speculative-grade issuers (those rated 'BB+' and below) and Standard & Poor's Ratings Services believes that 2010 could be a record year for high-yield issuance in Europe.

High-Yield Bond Market Has Several Potential Attractions For Issuers

The loan market is much less accessible for leveraged borrowers than previously, so such issuers have been attracted to the potential for a greater pool of liquidity provided by the high-yield bond market. Given the relatively higher funding cost of most bank finance and what we understand are often typical limitations on the banks lending for longer than three years--particularly to borrowers rated 'BBB' and below--the high-yield market currently appears competitive in comparison. In addition, and perhaps with the greatest long-term potential for the market, the high-yield bond market may offer an attractive opportunity for debut corporate issuers to lock-in fixed rates and longer maturities for term debt funding. We have observed that this has been one way that companies that previously have been wholly reliant on the private bank market for funding have had the opportunity to expand and diversify their funding sources. We have also observed that at this stage of the economic recovery investors are buying high-yield bonds that have various degrees of security, including at a level that sits alongside senior bank debt. They have also shown an apparent preference for longer-duration, higher-yielding credit instruments.

The Proceeds Of High-Yield Issues Have Been Used For A Variety Of Purposes

There is a fairly wide variety of reasons typically cited for issuing high-yield bonds, although refinancing bank loans and extending the profile of debt maturities are the most prevalent. However, high-yield issuance is also playing a role following bankruptcy or restructuring, and we are even starting to see the proceeds of high-yield issues being channeled to shareholders as dividends, reminiscent of the leveraged finance market back in 2007. In this article, we examine features of the current market through examples of companies that have used high-yield debt to extend maturities, eliminate a portion of refinancing risk, for bankruptcy exit financing, and for dividend recapitalizations.

Companies Use The High-Yield Bond Market To Extend Maturities

The first--and most common--way in which we have seen companies use the high-yield bond market is to extend debt maturities. Often this is being done through a senior secured bond which repays senior secured bank loans. In

2010 so far, frequent issuers Virgin Media Inc. (B+/Stable/--), Liberty Global Inc. (B+/Watch Neg/--) and SEAT PagineGialle SpA (B/Negative/--) all took advantage of this market to refinance existing bank debt, issuing new senior secured bonds to repay a portion of their senior secured bank facilities. However, some companies are using publicly rated senior secured bonds to completely refinance all their existing senior secured term debt--typically private loans. This group comprises a growing number of smaller first-time issuers such as French life science company Novasep Holding S.A.S. (B/Positive/--). In December 2009, the company sold a two-tranche cross-border transaction raising six-year senior secured bonds for €270 million and \$150 million that repaid all its senior bank debt and its outstanding second-lien and mezzanine debt. The cost of funding (9.625% coupon plus upfront fees) is currently higher than the cost of the previous senior bank debt (EURIBOR plus 237.5 basis points {bps} for term loan B and EURIBOR plus 287.5 bps for term loan C). While the company benefits from being able to generate sustainable free cash flow, this refinancing has further improved its financial flexibility through replacing maintenance covenants with incurrence-based covenants.

However, we believe that when companies replace or layer-in new debt onto their balance sheet, an analysis of the details can offer insights. For instance, a senior secured bond seldom means that the bonds share exactly the same rights and security as a senior secured loan, even where they are labeled as ranking pari passu.

In the case of Novasep, for example, our analysis suggested that the security package for the senior secured bonds was, in our view, relatively weak. Specifically, we understand that the security is limited to pledges over only two of the four main intellectual properties of the group as well as share pledges from the subsidiaries guaranteeing the bonds. In addition, the company retains some flexibility to raise additional debt sharing the same level of security subject to an incurrence test for senior leverage.

The interaction between the various lender classes is detailed in the intercreditor agreement and, in our view, it has a direct bearing on the value of the security package supporting these types of high-yield instruments and therefore on the recovery potential for investors if the company ever becomes distressed. We assigned a recovery rating of '4' to Novasep's bonds, reflecting our estimate of average (30%-50%) recovery potential in the event of a payment default, even though the bonds are labeled as senior secured debt. For further discussion of this topic, see "Senior Secured Bonds Are The New Face of Speculative-Grade Issuance In Europe: What Are The Risks?" published March 4, 2010 on RatingsDirect.

On March 18, 2010, the U.K.-based Ineos group (which includes Ineos Group Holdings PLC and Ineos Holdings Ltd. {both CCC+/Developing/--}) announced a lenders' consent process with the aim of refinancing part of its amortizing bank debt with a longer-maturity senior bond/term loan and increased covenant headroom; this was approved today. When the original announcement occurred, Standard & Poor's affirmed its 'CCC+' rating on the company and revised the outlook to developing from negative to reflect our view of the uncertain outcome of the proposal to refinance existing debt, including the €0.7 billion 2011 repayment obligation, and the proposal to obtain lender consent on improved covenant headroom. At the time, we stated that if Ineos were able to reach agreement to extend the maturity of its debt, eliminate the requirement for making amortization payments, and reset its covenant headroom, this would likely be positive from a credit perspective, albeit at the cost of an estimated €40 million-€50 million increase in cash interest payments in addition to the transaction expenses.

LyondellBasell To Exit Bankruptcy With Help Of High-Yield Bond

We have observed that companies have also used high-yield bonds to assist in exiting from a restructuring or insolvency process, for example Hungary-based fixed-line telecommunications operator Invitel Holdings A/S (B/Stable/--) and Netherlands-based LyondellBasell AF S.C.A. (not rated).

First, following a selective default on Nov. 4, 2010, due to the completion of a distressed tender offer for three bonds at substantial discounts to par, Invitel completed a successful refinancing by issuing €345 million seven-year senior secured notes. The proceeds were used to repay outstanding senior facilities and second-lien debt, as well as the company's outstanding 2012 notes. Following this refinancing, we understand that Invitel has only minor debt repayment requirements until 2012. In our view, this transaction extended Invitel's debt maturity profile, improved its liquidity position, and removed restrictive financial covenants in favor of incurrence-only tests. This development, which we viewed as positive from a credit perspective, provided support for our upgrade of the corporate credit rating on the company and other group members to 'B'.

Netherlands-based petrochemicals producer LyondellBasell filed for Chapter 11 in January 2009, and has recently taken steps to refinance existing debt ahead of its imminent emergence from Chapter 11. The dual-tranche \$2.25billion/€375 million 7.5-year senior secured bonds were sold in late March at the same time as a \$500 million, six-year senior secured term loan and a \$1.75 billion asset-based revolving credit facility (RCF) due 2014. The company has announced that the proceeds of the new debt will be used to replace and repay existing debt, including the company's debtor-in-possession credit facilities and an existing European securitization facility and certain related payments. LyondellBasell has not yet emerged from Chapter 11 and is not rated by Standard & Poor's.

Despite these two cases, we believe that most companies, including those that were targets of leveraged buy-outs (LBOs) and have completed a restructuring, remain reliant on the loan market as opposed to the bond market. We have seen that this often reflects the lengthy and complex negotiations between stakeholders to finalize a consensual restructuring, and in many cases the need for additional RCFs to support working capital. However, in our view, the continued reliance on the loan market also stems from the relatively high proportion of companies emerging from insolvency or restructuring that remain over-leveraged. High-yield investors may be wary of repaying existing lenders when the credit profile of a restructured company remains very weak. Of course, to the extent that these restructured companies improve their operating performance, we believe that it is more likely that the high-yield market can offer a potential refinancing route.

Matalan Completes Dividend Recapitalization

A less-welcome development from a credit perspective, and one that is currently more prevalent in the U.S. market than in Europe, is the return of the dividend recapitalization. Recaps of LBOs became frequent toward the peak of the 2005-2007 boom. These transactions enable owners to pay themselves a dividend, not through cash from operations, but from added leverage, in the form of bonds or bank loans. Private equity sponsors, in particular, made particular use of this strategy, which essentially decreased the risk of their portfolio equity investments, boosting their near-term equity returns at the expense of the credit quality of the companies themselves.

Standard & Poor's believes that these types of transactions can potentially erode a company's credit quality and expose debt providers to a high level of asymmetric risk. By that, we mean that if a company's operational

performance is strong, the burden of additional debt can, in our view, act to cap any improvement in credit quality. If the company's operational performance deteriorates, in a negative scenario lenders could become impaired. Higher floating interest rates in a period of rising interest rates could also potentially exacerbate this risk.

Although we are just emerging from recession in Europe, we have seen that companies have already started to undertake dividend recaps. Following its cancelled IPO in late March, Matalan Finance Ltd. (not rated; a subsidiary of Missouri TopCo Ltd. {B+/Stable/--}) issued a high-yield bond and used the proceeds to pay a dividend to the major shareholder. Matalan Finance Ltd. sold a £225 million senior unsecured bond (rated 'B'), which was priced at the low end of initial guidance and traded up in the aftermarket due to strong demand. The bond financing was conducted alongside a loan refinancing of a £250 million six-year term loan and £50 million RCF (both rated 'BB').

Bond investors appeared comfortable with allowing the company to pay the dividend because of its relatively low headline leverage and its ability to generate free cash flow. We estimate the company's unadjusted net debt is approximately 2.2x EBITDA. However, after adjusting for operating lease commitments, the leverage ratio rises to 4.5x-5.0x, which we view as commensurate with an "aggressive" financial risk profile. This, together with our assessment of the company's business risk profile as "weak" was a factor in our final assessment of the corporate credit rating of 'B+' on Missouri TopCo.

However, we view Matalan's ability to generate free cash flow--which we estimate at approximately £50 million-£70 million a year over the next three years, and which we understand the company plans to use for debt reduction--as supportive of the current rating on Missouri TopCo Ltd. In our view, the company has also given itself some additional flexibility with its senior lenders. We understand that the senior loan documents include borrower-friendly equity cure rights that can be used up to three times during the life of the facility. Furthermore, we also understand that the company is permitted to conduct debt buybacks from surplus cash flows or share issue proceeds, subject to compliance with the specified tendering processes.

In terms of the recovery analysis supporting our ratings on both of the senior loans as well as the unsecured notes, the outcome of our analysis reflected our assessment of the security package and our view of the priority ranking of any payments that may be made after a default event. Matalan Finance Ltd.'s £225 million senior unsecured notes were assigned a recovery rating of '5' and an issue rating of 'B', one notch below the corporate credit rating on Missouri TopCo, reflecting our estimate of modest (10%-30%) recovery potential in the event of a payment default.

This contrasts with our recovery rating of '1' on the senior secured debt, reflecting our estimate of very high (90%-100%) recovery potential. These £300 million of instruments benefit from what we see as a relatively strong security package and the relatively favorable insolvency regime in the U.K. The security package includes share pledges and asset security granted by holding companies as well as from subsidiaries Matalan Ltd., Matalan Retail Ltd., Matalan Travel Ltd., and Wolsey Ltd. (all not rated), entities which we understand collectively account for almost all of the group's revenues, assets, and EBITDA. We understand that the loan documentation includes provisions for senior lenders to individually waive their rights to receive amortization payments, although we do not factor this into our analysis.

We Expect The Increased Level Of High-Yield Issuance To Continue In 2010

Given the strong start to the year in the European high-yield market, we anticipate that 2010 could be a record year of issuance in Europe. An increasing number of companies are seeking consent to refinance senior bank debt with senior secured bonds. Also, some companies are reported to be interested in undertaking dividend recapitalizations.

In addition, we have observed that there are companies that are planning to use the high-yield market to refinance following an IPO. However, we believe that the number of LBOs paying down debt from the equity proceeds of an IPO has been quite limited to date. Whether a change of control through an IPO triggers a refinancing following an IPO typically varies case by case and can often depend on the size of the equity stake sold. Given the relatively low cost of existing senior debt found on the balance sheet of many companies and the current low level of floating interest rates, we believe that many companies will try to avoid refinancing if they can.

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