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Leveraged Finance:

Refinancing Risk Remains The Main Threat To The Credit Quality Of European Speculative-Grade Companies

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For European speculative-grade companies (those rated 'BB+' and below) refinancing risk looms large in the next few years, despite the fact that over the past year such companies have repaid about €12 billion of bank debt with speculative-grade bonds. This is mainly because the 2008 market dislocation affected the banking system in Europe so dramatically. According to economic research from Standard & Poor's Ratings Services (see "European Economic Forecast: The Two-Track Recovery Stretches On" published June 3, 2010, and "The Bad News Is The Good News Isn't Good Enough" published Sept. 14, 2009, on RatingsDirect), banks that typically lend to nonfinancial companies are still using some of the liquidity central banks have provided to them to buy bonds, repair their balance sheets, or redeposit at the European Central Bank (ECB), rather than lending to the private sector. This has been of particular concern for speculative-grade companies in Europe because they have typically relied heavily on the bank lending market for funding, unlike in the U.S., where the capital markets play a much larger role.

In recent weeks, a robust speculative-grade bond market in Europe has suddenly stalled. Before the market uncertainty stemming from the state of the fiscal situations in Greece, Spain, and Portugal, the speculative-grade market had begun to make a dent in the refinancing risk that such companies in Europe have been facing. In the four months to the end of April 2010, European companies issued €19 billion in speculative-grade bonds, not far behind the €24.5 billion for the whole of 2009, according to Standard & Poor's Leveraged Commentary & Data (LCD). Of these totals, €12.4 billion specifically went to refinance a portion of those companies' bank debt in the dollar and euro speculative-grade bond markets, according to calculations from Standard & Poor's Ratings Services (see table at end of article).

However, the story is far from over. There remains a substantial amount of refinancing needs from leveraged buyouts (LBOs). The bulk of this comes due in 2014 and 2015, as many of the companies were financed at the peak of the bull market in 2006 and 2007, mostly with maturities of seven to nine years. Standard & Poor's European Leveraged Loan Index (ELLI) shows €37 billion coming due in 2014 and €49 billion in 2015. However, these amounts are limited to the debt held by institutional investors in those transactions and to facilities that are components of the ELLI. Nevertheless, we believe that an index best represents the amount of refinancing risk that companies face because it takes into account debt paid down as a result of mandatory prepayments, refinancings, and recapitalizations, and debt written off as a result of defaults and restructurings.

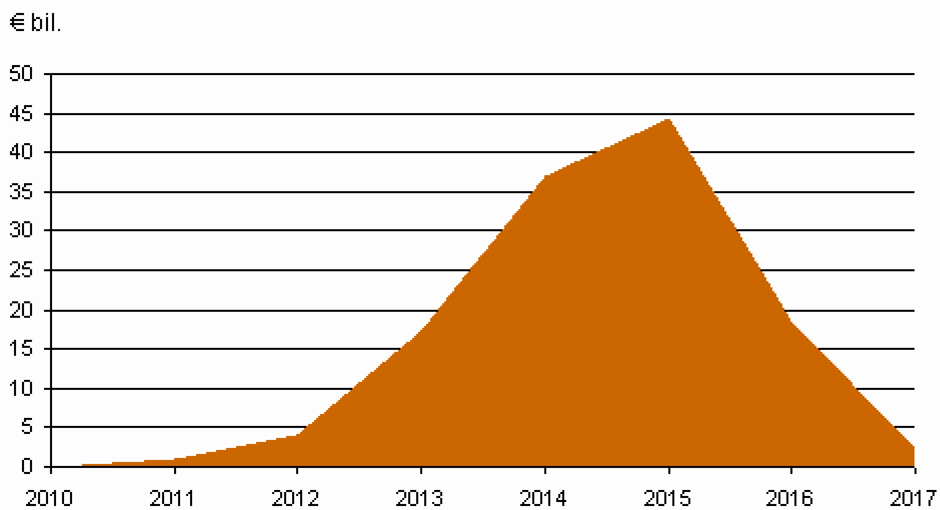
This "wall of refinancing" from LBOs means that European speculative-grade companies still have some way to go to refinance their debt. Standard & Poor's forecasts gradual GDP growth in the near term, with a rebound in manufacturing output in the eurozone, although consumers will likely remain reluctant to spend, capping potential growth. Without a strong economic recovery that enables companies that are facing refinancing risk to generate sustainable free cash flow, or an equity injection from shareholders to pay down balance-sheet debt, it is most likely that companies will need to write down a portion of their debt to achieve more sustainable capital structures. This supports our view that default rates will stay well above the 4% average reported over the course of this cycle in the

European leveraged finance market, reaching 8.7% by the end of the year.

LBOs Pose Significant Refinancing Risk From 2012 Onward

Approximately 90% of the legacy financing transactions in the European leveraged finance market from 2003-2007 consist of LBO transactions, most of which are not publicly rated. The majority of these transactions were structured in 2006 and 2007 with tenors of between seven and nine years (see chart). This means that refinancing risk in Western Europe will increase substantially starting in 2012.

Outstanding Maturity Profile Of European Leveraged Buyouts



Source: Standard & Poor's European Leveraged Loan Index

Most transactions of that vintage 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 because the debt multiples on these transactions were high due to increasing purchase-price multiples. However, for the most part, the assumed EBITDA growth has not materialized, making deleveraging from internal cash flow difficult to achieve in the time horizon set out in the original offering memoranda.

Some lenders are still looking to improve the economics of existing loans by amending covenants in the near term. However, we fully expect debt restructurings to gather pace. We have already seen that banks are becoming more demanding in situations where companies are facing stress, including requiring that buyout firms implement asset-disposal programs as part of restructuring negotiations. Therefore, even assuming gradual improvements in the economic outlook, we believe that the steady pace of consensual restructurings will likely continue for several more years, keeping the default rate above the 4% average reported in Europe this cycle (see "Year-End 2009 European Speculative-Grade Default Rate Falls From Third-Quarter 2009 Peak," published April 9, 2010).

Bank Refinancing Has Been Scarce ...

The lack of ready bank investors is severely restricting European leveraged loan volumes in 2010, as it did throughout 2009. According to LCD, only €15.4 billion was borrowed in 2009, and a single borrower, HeidelbergCement AG (BB-/Stable/B), raised €8.0 billion of that as part of its refinancing plan. (However, it later partially refinanced the loans in the bond market.) Issuance has started to increase incrementally in 2010, with €9 billion issued in the first quarter, compared with €1 billion in the same quarter in 2009. However, the volume of leveraged loans is still low compared with amounts in 2005-2007 or with speculative-grade bond issuance in the same period.

Bank lending, particularly among regional banks that have close links with midsize local companies, has historically dominated speculative-grade financing in Europe. However, from 2001 to 2007, collateralized loan obligations (CLOs) and hedge funds presented other options to the LBO and leveraged finance market, through both European-based issuers and funds and the entry of U.S. CLO and hedge-fund businesses into the region. 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 from those funds that do not use leverage, such as mutual funds--did not enter the market. Hence, the fall in CLO and bank lending has severely affected leveraged loan issuance.

Arbitrage CLO volume dropped to zero in the first quarter of 2010 from €400 million in 2009, just over €11.2 billion in 2008, and €32.2 billion in 2007, according to LCD. It is not yet clear how much of a role CLOs will play in the future funding of European speculative-grade companies. Issuance has not yet rebounded because the cost of capital for these structured vehicles has increased substantially to an all-in funding cost of 331.7 basis points (bps) for 'AAA'-rated paper for the six months to the end of the first quarter 2010 from a low of 23 bps at the end of the first half of 2007, according to LCD.

Banks, meanwhile, face uncertainty over additional capital requirements that could continue to impair their lending, while companies have been willing to pay higher spread premiums on the bond markets to raise their liquidity buffers. These two trends combined are likely, in our opinion, to result in long-term disintermediation changes in Europe, similar to what has happened in the U.S. For example, in the U.S. loans provide 40% of companies' overall debt compared with 90% in Europe, according to ECB data.

... But The Speculative-Grade Bond Market Has Offered Some Assistance

The speculative-grade bond market, however, has been a relative success story in 2009 and 2010 for companies in Europe. Before the recent market uncertainty, the volume of Western European speculative-grade debt issuance reached approximately €19.0 billion by April 30, 2010, compared with €24.5 billion in the whole of 2009. In our view, such issuance has offered potential financing options and improved financial flexibility for speculative-grade issuers.

There is a fairly wide variety of reasons for issuing speculative-grade bonds, although refinancing bank loans and extending the profile of debt maturities are the most prevalent. Often this occurs through a senior secured bond that repays senior secured bank loans. In 2010 so far, frequent issuers Virgin Media Inc. (B+/Positive/--), Liberty Global Inc. (B+/Positive/--) and SEAT PagineGialle SpA (B/Negative/--) have all taken advantage of this market to refinance existing bank debt, issuing new senior secured bonds to repay a portion of their senior secured bank facilities. (For a complete list of issuers from 2009 to 2010, see table 1.)

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 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.

Companies have even started using the speculative-grade bond market to refinance mezzanine loans--the more traditional financing that private equity buyers use to fund the subordinated portion of LBO targets' capital structures. In April, Netherlands-based cable operator Ziggo Bond Co. B.V. (Ziggo: B+/Stable/--) issued €1.2 billion of senior secured notes to refinance its mezzanine debt, which is worth €1.18 billion. (For further details, see "Ziggo Bond Co. B.V. Recovery Rating Profile," published April 23, 2010, on RatingsDirect.)

Despite refinancing in the speculative-grade market, we still consider that highly leveraged financial risk profiles constrain many of these companies. In Ziggo's case, although the proposed notes' indenture restricts dividend payments made by Ziggo, we consider that the company's ultimate ownership by private equity sponsors makes the stability of its equity uncertain. In particular, we calculate an adjusted leverage ratio including shareholder loans sitting at Zesko BV, an indirect holding company above Ziggo and outside the restricted group. These loans (€1.9 billion at year-end 2009) are outside the restricted obligor group. They are also non-cash-paying, structurally subordinated, and not cross-defaulted with the restricted obligor group's debt. But, given that they mature between mid-2015 and early 2016, we cannot rule out that their refinancing could, to a degree, affect Ziggo's credit quality.

Refinancing Of European Speculative-Grade Companies Is Likely To Be Complex

Corporate credit has been a "sweet spot" in Europe as investors at this stage of the economic recovery have been buying longer-duration, higher-yielding credit instruments for the past six months. But it is not yet clear how long the current market disruption, which began in April, will last.

The extent of the economic recovery--and the amount of cash that speculative-grade companies are able to generate for deleveraging--will play a big role in determining how much debt companies will need to refinance from 2012 onward. Another part of the equation will be the level of willingness of new or existing investors to invest new equity into companies.

Any such equity injections would likely be positive for companies in Europe because they would, in our view, restore confidence in the growth potential of highly leveraged European companies.

Table 1

Standard & Poor's-Rated Speculative-Grade Bonds Used To Refinance Bank Debt In Europe, 2009-2010

Issuer	Ranking	Size (mil.)	Date	Term (years)	Maturity	Corporate credit rating	Issue rating	Recovery rating/Recovery prospects (%)	Coupon (%)	Price (par value)
2009										
Pernod Ricard S.A.	Unsecured	€800	May 28	7	Jan. 15, 2015	BB+/Stable/B	BB+	3 (50-70)	7.0	99.882
Virgin Media Inc.*	Senior unsecured	$750	May 29	7	Aug. 15, 2016	BB-/Positive/--	B	6 (0-10)	9.5	95.574
Virgin Media Inc.*	Senior unsecured	€180	May 29	7	Aug. 15, 2016	BB-/Positive/--	B	6 (0-10)	9.5	95.574
Compagnie Generale de Geophysique - Veritas	Senior unsecured	$350	June 2	7	May 15, 2016	BB-/Stable/--	BB	3 (50-70)	9.5	96.95
Ardagh Glass Group PLC¶	Senior secured	€300	June 19	7	Jul. 1, 2016	B+/Negative/--	BB	1 (90-100)	9.25	98.116
Sappi Ltd.§	Senior secured	€350	July 29	5	Aug. 1, 2014	BB-/Stable/B	BB	2 (70-90)	11.75	95.066
Sappi Ltd.§	Senior secured	$300	July 29	5	Aug. 1, 2015	BB-/Stable/B	BB	2 (70-90)	12.0	95.095
Pregis Corp.	Second-priority senior secured	€125	Sept. 24	4	April 15, 2013	B/Stable/--	B+	2 (70-90)	EURIBOR + 500 bps	94.0
Smurfit Kappa Funding PLC**	Senior secured	€500	Nov. 12	8	Nov. 15, 2017	BB-/Stable/--	BB	2 (70-90)	7.25	98.52
Smurfit Kappa Funding PLC**	Senior secured	€500	Nov. 12	10	Nov. 15, 2019	BB-/Stable/--	BB	2 (70-90)	7.75	99.15
Piaggio & C. SpA	Senior unsecured	€150	Dec. 1	7	Dec. 1, 2016	BB/Negative/--	BB	3 (50-70)	7.0	100.0
Rexel S.A.	Senior unsecured	€575	Dec. 11	7	Dec. 15, 2006	B+/Stable/B	B+	4 (30-50)	8.25	100.0
Expro Holdings U.K. 3 Ltd.	Senior secured	$1,400	Dec. 15	7	Dec. 14, 2016	B/Negative/--	B+	2 (70-90)	8.5	96.207
Novasep Holding S.A.S	Senior secured	€270	Dec. 15	7	Dec. 16, 2016	B/Positive/--	B	4 (30-50)	9.625	98.765
Novasep Holding S.A.S	Senior secured	$150	Dec. 15	7	Dec. 16, 2017	B/Positive/--	B	4 (30-50)	9.75	97.555
2010										
Fresenius Medical Care (FMC)¶¶	Unsecured	€250	Jan. 13	6	July 15, 2016	BB/Positive/--	BB+	2 (70-90)	5.5	98.66
Virgin Media Inc.*	First-lien secured (144A)	$1,000	Jan. 13	8	Jan. 15, 2018	BB-/Positive/--	BB	1 (90-100)	6.5	98.488
Virgin Media Inc.*	First-lien secured (144A)	£875	Jan. 13	8	Jan. 15, 2019	BB-/Positive/--	BB	1 (90-100)	7.25	98.503
Liberty Global Inc.§§	Senior secured	€500	Jan. 13	10	Jan. 15, 2020	B+/Positive/--	B+	3 (50-70)	7.63	99.138
SEAT PagineGialle SpA	Senior secured	€550	Jan. 22	7	Jan. 31, 2017	B/Negative/--	B+	2 (70-90)	10.5	97.59
Fage Dairy Industry S.A.***	Senior unsecured	£150	Jan. 26	10	Feb. 1, 2020	B-/Stable/--	B-	N/A	9.875	93.278
Cable & Wireless Communications PLC¶¶¶	Senior secured	$500	Feb. 9	7	Feb. 15, 2017	BB/Stable/B	BB	N/A	7.75	100.0

Table 1

Standard & Poor's-Rated Speculative-Grade Bonds Used To Refinance Bank Debt In Europe, 2009-2010 (cont.)										
Pernod Ricard S.A.	Unsecured	€1,200	March 11	6	March 18, 2016	BB+/Stable/B	BB+	3 (50-70)	4.875	99.741
Ziggo Bond Co. B.V.	Senior unsecured	€1,200	April 27	8	May 15, 2018	B+/Stable/--	B	5 (10-30)	8.0	99.271

All ratings as of June 15, 2010. *Issued by Virgin Media Secured Finance PLC. ¶Issued by Ardagh Glass Finance PLC. §Issued by PE Paper Escrow GmbH, guaranteed by Sappi Ltd. **Issued by Smurfit Kappa Acquisitions. ¶¶Issued by: Fresenius Medical Care Finance VI S.A. §§Issued by UPCB Finance Ltd. ***Jointly and severally issued by Fage USA Dairy Industry Inc. ¶¶¶Issued by Cable & Wireless Communications PLC subsidiary, Sable International Finance Ltd. N/A--Not applicable.

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