European Annual High Yield and Leveraged Loan Report

EUROPEAN HIGH YIELD ASSOCIATION

2007

Publication Date: Winter 2008

The European High Yield Association, an affiliate of the Securities Industry and Financial Markets Association, is pleased to present the fourth issue of the *European Annual High Yield and Leveraged Loan Report*. The report analyses and presents aggregate information and trends related to the European leveraged finance marketplace. It incorporates both high-yield corporate bonds and leveraged loans, including issuance, credit quality and returns on investment. Unless otherwise noted, the data are through the fourth quarter of 2007.

European Leveraged Finance Ends the Year with a Thud as Volume Drops in the Second Half on Diminished Liquidity and Global Credit Market Uncertainty; Total 2007 Issuance Volume of €278.5 Billion Surpassed 2006

Highlights

- Greater investor risk sensitivity, heightened volatility, depressed and uncertain pricing and substantially reduced liquidity led to diminished market conditions in the European high-yield bond and leveraged loan markets in the second half of 2007.
- The outlook for 2008 issuance is subdued, certainly relative to the elevated growth rates through the first half of 2007. A *Financial News* survey, conducted in November 2007 in association with the European High Yield Association (EHYA), found that the majority of responding institutions expected issuance to be lower in 2008.
- Market conditions led to dramatic spread widening for high-yield bonds and leveraged loans with negative high-yield returns for the quarter and the year. Leveraged loan returns rebounded to positive territory in the fourth quarter but were well below the returns in the first half of 2007.
- Despite the weakened market tone, the underlying economic environment for European high-yield borrowers generally remains positive on above-trend economic growth.
- Credit quality metrics still appear solid based on historically low default rates and healthy balance sheets after the protracted period of corporate earnings growth. The prospect of moderating to slower economic expansion and reduced credit availability in 2008 increases the possibility of rising default rates later this year and a credit ratings slide. After an extended period in which issuers and sponsors dictated lending terms, investors were able to exert themselves as market conditions tightened.
- Leveraged finance issuance (combined leveraged loan and high-yield bond volume) declined to €125.7 billion in the second half compared to €152.8 billion in the first half; fourth quarter issuance dropped to €33.9 billion compared to €56.3 billion issuance over the same period in 2006. Total 2007 issuance was €278.5 billion compared to €254.2 billion in 2006.
- High-yield bond issuance totaled €40.9 billion in 2007 compared to €37.1 billion in 2006; the second half volume was only €5.4 billion compared to €35.5 billion in the first half; and fourth quarter issuance fell to €0.7 billion compared to €4.7 billion in the third quarter and €13.0 billion a year ago.

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Economic and Market Environment

Market Conditions

- The markets remain "tense" with a continuation of the reappraisal of risk and diminished liquidity. Credit repricing and increased investor risk aversion have led to wider spreads and rising borrowing costs.
- The credit turmoil started as a reaction to the downturn in the market for RMBS and CDOs backed by U.S. subprime residential mortgage loans but have since spread across global credit market sectors. The failures and retrenchments of several key European and U.S. investment funds focused on leveraged credit and with U.S. subprime exposure added to investor concern.
- Central banks, including the European Central Bank (ECB), infused liquidity to stem the deteriorating money credit market conditions and provide for greater market interbank funding stability. Money market rates started to decrease during the latter part of the quarter in response to central bank initiatives. For example, the three-month LIBOR rate was 3.33 percent as of 22 January, 151 basis points lower than a month earlier, subsequent to the U.S. Federal Reserve rate cut.
- Strong investor demand in the early part of the year gave way to significant investor trepidation on credit risk sensitivity and dramatically reduced market liquidity in the second half. CLO issuance has fallen, and hedge fund appetite has weakened. Traditional investor segments are expected to be important sources of renewed investor interest, eventually enhanced by the emergence of "opportunity" funds.
- The higher volatility raised investor risk sensitivity, and global credit risk repricing led to the European high-yield credit spread "blow out", with negative returns for both the quarter and the year. The appreciating Euro should boost Euro-denominated bond returns relative to U.S. dollar-denominated bonds.
- The European high-yield bond distressed ratio reached its highest level since 2003 in early January. The ratio is a measure of the percentage of high-yield bonds with spreads above 1,000 basis points. Historically, a substantial percentage of distressed bonds eventually default.

Economic Conditions

- The European economy is presently characterised by sound fundamentals, solid domestic demand and employment growth. Much of Europe maintains robust growth in investment, manufacturing, consumption, and exports. The full effect of the credit market conditions, however, has not been fully felt by the broader economy. The effect of rising borrowing costs from the credit correction on investing and spending comes with a substantial lag. Moody's Economy.com estimates a lag of at least six to 12 months depending on the investment cycle.
- The ECB estimated 2007 growth at an above-trend pace of 2.4 to 2.8 percent. ECB forecasts 1.5 to 2.5 percent growth in 2008 and 1.6 to 2.6 percent in 2009 based on the expectation of a resilient global economy. The forecasts have been revised slightly downward. There are downside risks to the growth outlook, including the effect of the financial market turmoil and European currency appreciation against the dollar.
- Controlling inflation remains an important ECB objective. High oil and food prices led to higher consumer prices in the fourth quarter. Rising labor costs and employment levels pose an additional price pressure.
- Business credit is expanding as banks are lending but at a premium. Rates have risen 200 basis points over the last two years. Despite ECB tightening over the last few years and volatile credit and money market conditions, credit aggregates are rising at a historically rapid rate, at 11.5 percent in the third quarter and a record-setting 12.3 percent growth in November. The rise can be attributed to firms taking on more risks because of healthy balance sheets to support debt service, historically low interest rates enabling higher leverage, and an increase in credit availability through the emergence of new financial instruments and vehicles including hedge funds, private equity, and securitisation.

- The most recent ECB lending survey indicated a net tightening of credit conditions, especially for large enterprises, due to a rise in the cost of funds, reduced tolerance of risk and effect of reduced access to securitisation on bank lending. Despite this tightening, conditions are not as tight as in 2003.
- Balancing the inflation and credit market considerations, the ECB in January decided to leave the target at 4.0 percent. The consensus view is that rates will be kept at the current level until the credit market turmoil works its way through the system.

Issuance

- As a result of a strong first half of the year, the leveraged finance 2007 volume totaled €278.5 billion, 9.6 percent higher than 2006. The volume slowed in the fourth quarter to €33.9 billion compared to €91.8 billion in the third quarter and €56.3 billion in the fourth quarter of 2006.
- High-yield bond issuance[1] volume totaled €40.9 billion in 2007, 10.2 percent higher than 2006. Second half issuance was much lower totaling €5.4 billion, compared to €35.5 billion in the first half of the year. Fourth quarter high-yield volume was €0.7 billion, compared to €4.7 billion in the third quarter and €13.0 billion in the fourth quarter of 2006. Based on Reuters Loan Pricing Corporation data, total European leveraged loan[2] volume (including mezzanine financing) was €237.6 billion in 2007 compared to €217.1 billion in 2006, of which €8.0 billion were mezzanine and €9.7 billion were second lien loans. Fourth quarter volume totaled €33.2 billion (€0.3 billion mezzanine) compared to €87.1 billion (€1.7 billion mezzanine) in the third quarter. Second half leveraged loan issuance was slightly higher rated at €120.3 billion from €117.3 billion in the first half of 2007.
- Unrated bonds[3] totaled €7.2 billion in 2007, compared to €6.1 billion in 2006. On a quarter-over-quarter basis, fourth quarter unrated bond issuance fell to €0.5 billion, down from €1.1 billion in the third quarter. Unrated bond volume in the first half of the year was €5.6 billion compared to €1.6 billion in the second half of 2007.
- Market conditions dramatically reduced the appetite for aggressive non-traditional deal structures. Once popular "covenant-lite" deals have virtually disappeared from the market. According to Fitch Ratings, on a 12-month trailing basis, issuance of payment-in-kind (PIK) transactions was €5.4 billion on 22 deals in 2007, compared to €6.4 billion in 2006, with this trend coming to a halt in the second half as credit risk repriced. Fourth quarter PIK volume was only €89.0 million on two deals which came to market in the fourth quarter but were structured earlier in the year.
- Standard & Poor's (S&P) "BB"-rated bond issuance totaled €17.1 billion, "B" totaled €15.2 billion and "CCC & Below" totaled €1.4 billion in 2007. "BB" issuance accounted for 41.8 percent of total 2007 issuance and 44.4 percent of issuance in the second half of the year. The industrial sector accounted for the largest high-yield volume in 2007 totaling €2.7 billion and 49.1 percent of total high-yield issuance.
- In 2007, the sectors with the most leveraged loan borrowing were general manufacturing (€29.5 billion), media (€27.1 billion), telecom (€16.3 billion) and healthcare (€16.3 billion) sectors, according to Reuters Loan Pricing Corporation.
- M&A and LBO transactions, including private equity sponsored deals, have led bond and loan issuance volume growth in recent years. LBO transactions, however, were much more difficult and expensive to finance in the second half of the year, and thus volumes slowed appreciably. Combined, LBO (42.0 percent) and recap (39.0 percent) accounted for 80.9 percent of leveraged loan volume in 2007, according to Reuters Loan Pricing.

[1] High-yield bond transactions are defined as transactions with an S&P rating equal to or less than BB+, a Moody rating equal to or less than Ba1, or a Fitch rating equal to or less than BB+. Includes all European issuers and all international issuers that issue in a European currency. CDs, general term notes and split-junk rated transactions are excluded. ABS, federal credit agency, supranational agency, sub-sovereign, and sovereign debt transactions are excluded. Transactions without a manager, non-underwritten transactions, self funded ineligible transactions, and transactions that are not rank eligible (due to submission guidelines) are excluded.
[3] Leveraged loans include first lien and second lien loans generally with below-investment grade ratings or spreads of at least 150 basis points and mezzanine loans.
[3] Unrated are defined as all bonds that either are not rated or for which the rating is "not available," according to Bloomberg.

- The fixed-rate share of high-yield bond issuance rose to €27.8 billion in 2007 (67.8 percent of total issuance), up from €25.9 billion (69.8 percent) during 2006. Floating rate issuance rose to €13.2 billion (32.2 percent of total issuance) from €11.2 billion (69.9 percent of total issuance) in the same period of 2006. During the first half of the year, fixed-rate issuance accounted for 67.0 percent and floating rate accounted for 33.0 percent compared to 72.2 percent fixed rate and 27.8 percent floating rate in the second half, perhaps reflecting shifts in the shape of the yield curve and volatility at the short end of the curve.
- There remains a substantial backlog of leveraged finance deals. Globally, there has been reduction in the deal calendar as some deals closed under revised terms and others were removed from the calendar.

Credit Quality

- Credit fundamentals still look solid, even taking into account the repricing of risk, as issuers strengthened their balances sheet during the protracted period of profit growth. However, the expectation is for some pick-up in defaults in 2008, as access to credit markets for refinancing existing debt becomes more restricted and the rate of economic growth in anticipated to moderate.
- As of the end of 2007, the Standard & Poor's (S&P) Global Fixed Income Research default rate was 0.95 percent, virtually unchanged from November, and lower than 1.42 percent in October and 1.57 percent at the end of 2006. However, S&P expects default rates to rise especially in the second half of 2008, but remain below the longer-term average default rate. In the EHYA-*Financial News* survey, the average forecast was a 4.7 percent default rate at the end of 2008. S&P also expects downward pressure on ratings as a result of slower economic growth, an appreciated Euro currency reducing profit margins and tighter credit market conditions. S&P reported 29 European high-yield upgrades and 27 downgrades for full-year 2007, but there were six more downgrades than upgrades in the second half of the year.
- Fitch Ratings reports that the mezzanine loan default rates are well below the peak in 2003 at 0.7 percent for 2007. There were five defaulted deals with an aggregate value of €194.6 million during the year.
- High-yield bond recoveries rose from 11 percent in 2001 to 49 percent in 2006 before declining to 39 percent at the end of 2007, as calculated by Fitch Ratings. The recovery rate was unchanged between the third and fourth quarter. Recovery rates are approximated by dividing the price of defaulted bond issues one month after default by the bond volume before default.
- Trends in the investment rating composition over recent years confirm the potential for increased risk exposure as the European leveraged finance markets expand. S&P noted credit market deepening, risk appetite and reduced intermediation has led to a gradual shift to high-yield ("speculative-grade") ratings but the average rating was still investment grade. The rating shift is due to origination rather than migration of ratings. S&P Loan Commentary and Data reported a relative decline over the last two years in the leveraged loan rating mix of "BB" rated issuers, and S&P Global Fixed Income Research reported that the "BB" rated issuer share of the European high-yield or speculative-grade market has declined while the "B" rated share has increased over the last three years.
- As a measure of credit exposure as we enter a more subdued economic environment, Fitch reports increased leverage ratios over the last several years. In the fourth quarter, the median senior leverage was 5.1 times (a full-year 2007 median of 5.2 times) and total leverage of 6.7 times EBITDA (a full-year 2007 average of 6.3 times). The increase in the second half of the year in the total leverage ratio would appear to be surprising in view of the reduced volume of leveraged syndications. The Fitch calculations are based on the shadow-rated transactions, which include older shadow-rated vintage deals that were updated during the quarter and new transactions. Most of the new transactions would have been arranged in the first half of the year prior to the onset of the credit market turmoil and thus more representative of the syndication market at its peak.

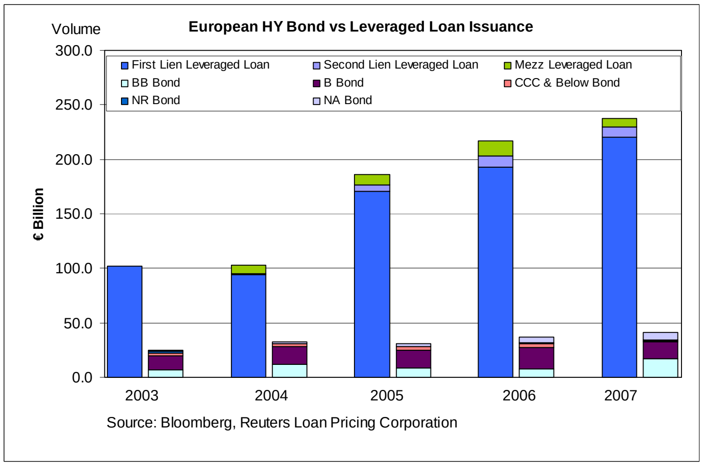
Relative Value

- European high-yield sector returns were negative for the quarter and full year 2007, and spreads dramatically widened on illiquidity, credit repricing and credit market volatility. Based on the Merrill Lynch High Yield Index, total market return was -2.32 percent for the fourth quarter and -1.99 percent for the year. At the end of the fourth quarter, the Merrill Lynch High Yield Index reported a 491 basis-point credit spread, having widened by more than 250 basis points during the year. There was spread widening in the credit derivatives market as measured by the iTraxx Cross-over Index (iTRAXX.EU.XO) to 339 basis points, 120 basis points wider than at the beginning of the year. Both the cash and derivatives indices tightened modestly, by less than ten basis points, in December. As of 18 January, the spread widened further early in 2008 to 438 basis points for the iTraxx Cross-over Index and 610 basis points for the Merrill Lynch Cash Index.
- The leveraged-loan index turned positive after a negative return third quarter. The S&P LCD European Leveraged Loan Index (ELLI-Total Return) was +0.32 percent for the fourth quarter (1.12 percent Euro-only) compared to -3.70 in the third quarter and +1.63 percent in the fourth quarter of 2006. The sum of the four quarterly returns totaled -0.47 percent (+1.08 percent Euro-only) for 2007. S&P LCD reported a wider primary weighted-average institutional loan spread of 305 basis points at the end of 2007 and 276 basis points at 30 September compared to 254 basis points on 30 June.

- To download issuance data, please click on the attached link below.

Download Data.
Microsoft Excel

1


European HY Bond vs Leveraged Loan Issuance
Volume
€ Billion
First Lien Leveraged Loan
Second Lien Leveraged Loan
Mezz Leveraged Loan
BB Bond
B Bond
CCC & Below Bond
NR Bond
NA Bond
300.0
250.0
200.0
150.0
100.0
50.0
0.0
2003
2004
2005
2006
2007
Source: Bloomberg, Reuters Loan Pricing Corporation

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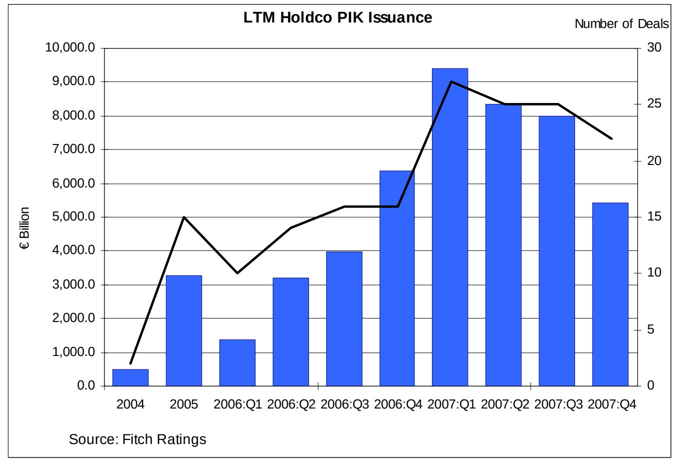
LTM Holdco PIK Issuance
Number of Deals
€ Billion
10,000.0
9,000.0
8,000.0
7,000.0
6,000.0
5,000.0
4,000.0
3,000.0
2,000.0
1,000.0
0.0
30
25
20
15
10
5
0
2004
2005
2006:Q1
2006:Q2
2006:Q3
2006:Q4
2007:Q1
2007:Q2
2007:Q3
2007:Q4
Source: Fitch Ratings

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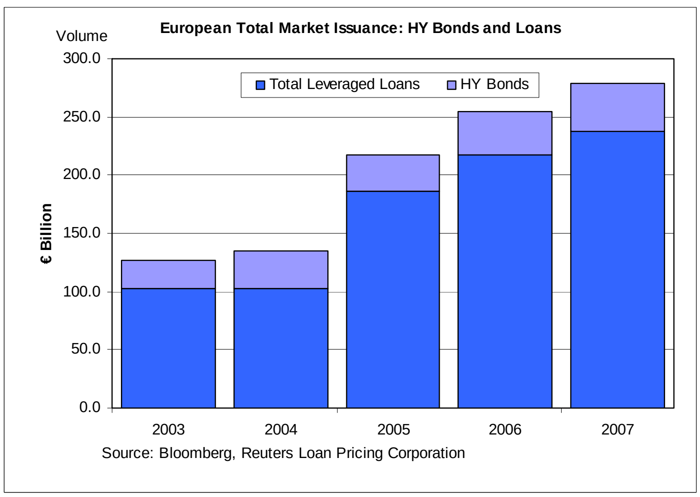
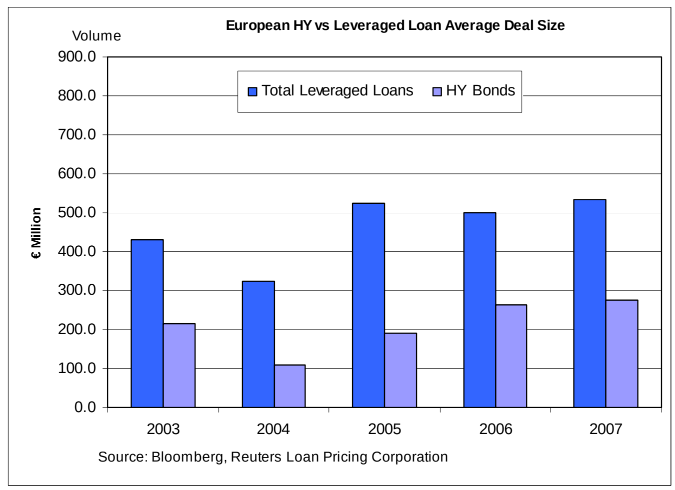

European Total Market Issuance: HY Bonds and Loans
Volume
€ Billion
Total Leveraged Loans
HY Bonds
300.0
250.0
200.0
150.0
100.0
50.0
0.0
2003
2004
2005
2006
2007
Source: Bloomberg, Reuters Loan Pricing Corporation

4


European HY vs Leveraged Loan Average Deal Size
Volume
€ Million
Total Leveraged Loans
HY Bonds
900.0
800.0
700.0
600.0
500.0
400.0
300.0
200.0
100.0
0.0
2003
2004
2005
2006
2007
Source: Bloomberg, Reuters Loan Pricing Corporation

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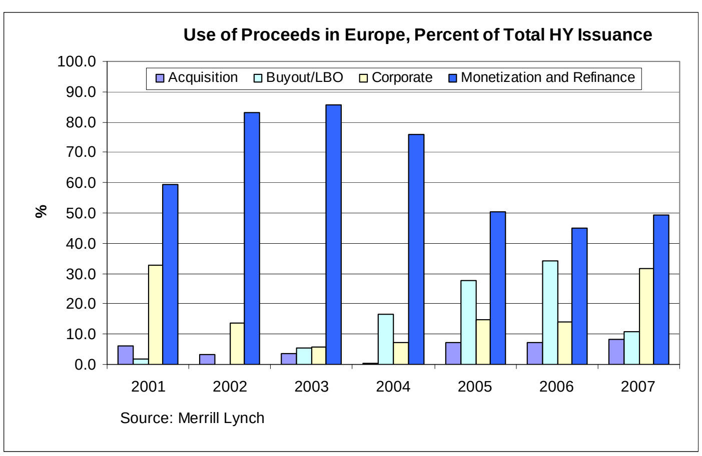
Use of Proceeds in Europe, Percent of Total HY Issuance
%
Acquisition
Buyout/LBO
Corporate
Monetization and Refinance
100.0
90.0
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
2001
2002
2003
2004
2005
2006
2007
Source: Merrill Lynch

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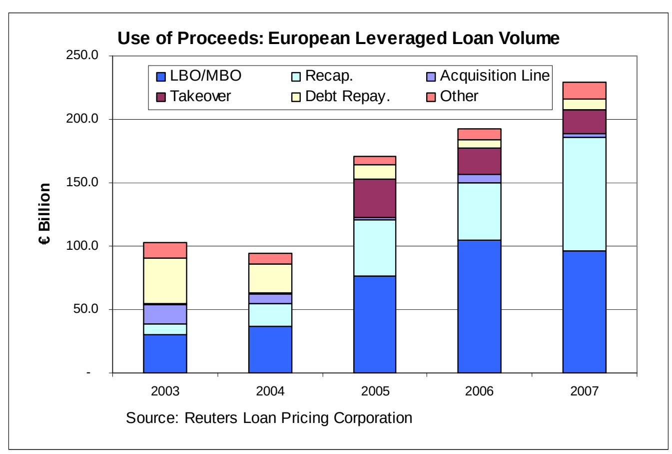
Use of Proceeds: European Leveraged Loan Volume
€ Billion
LBO/MBO
Recap.
Acquisition Line
Takeover
Debt Repay.
Other
250.0
200.0
150.0
100.0
50.0
-
2003
2004
2005
2006
2007
Source: Reuters Loan Pricing Corporation

7

2007 Long-Term European HY Issuance
By Industry Sector
(in € Millions)

Sector	S&P BB Rating	S&P B Rating	S&P CCC Rating	S&P NR Rating	S&P NA Rating
Banking	711.4	736.5	54.2		3,115.8
Finance	2,964.6	4,686.6	250.5		1,478.7
Industrial	10,052.7	8,252.4	892.3	275.0	584.6
Special Purpose	2,671.9	1,509.1	223.8		1,713.8
Utility	745.1				
Industry Total	**17,145.7**	**15,184.6**	**1,420.8**	**275.0**	**6,892.9**

Through December 31, 2007
Source: Bloomberg

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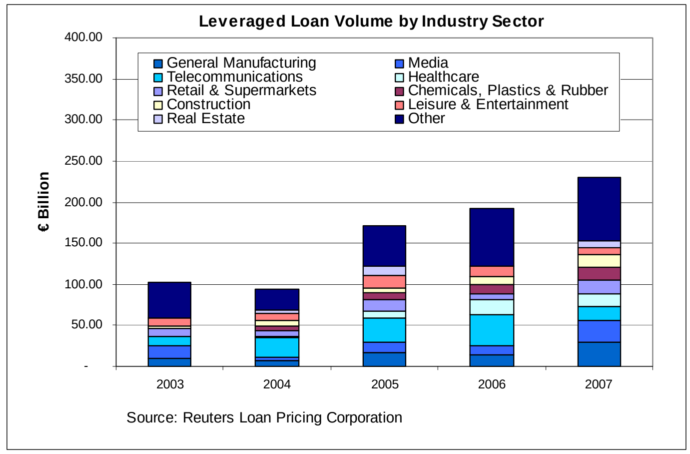

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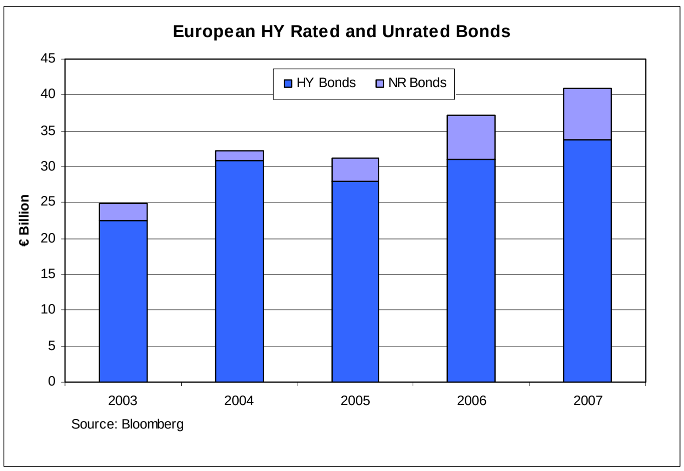

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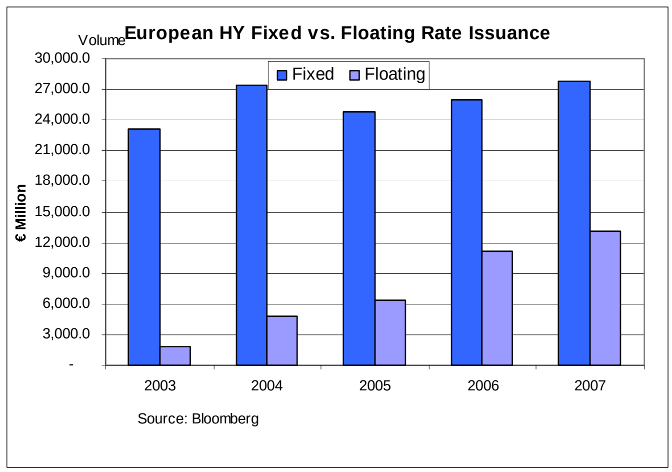

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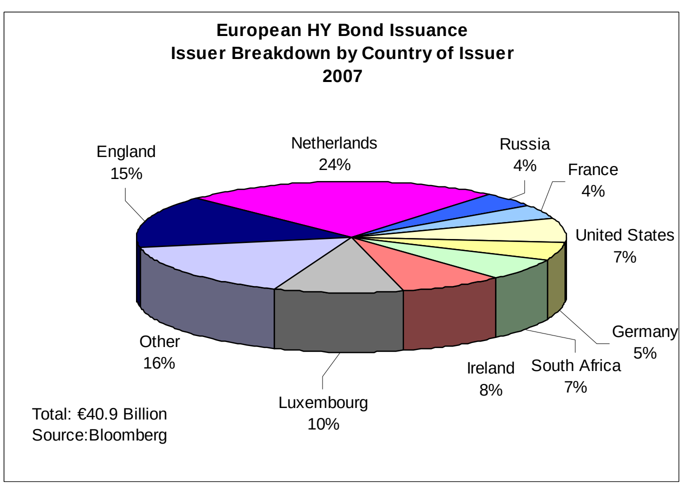

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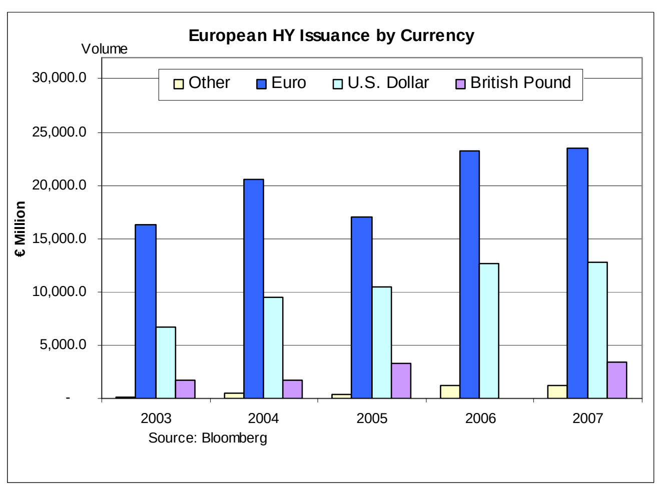

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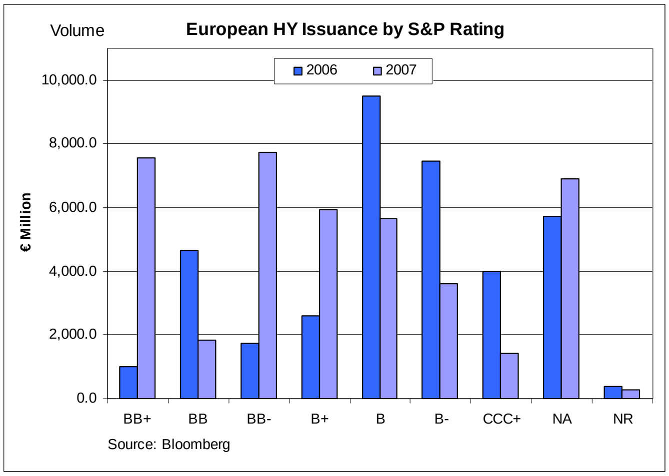

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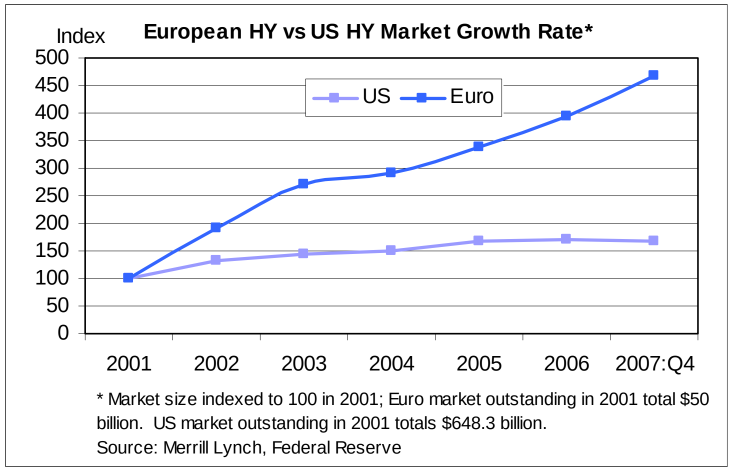

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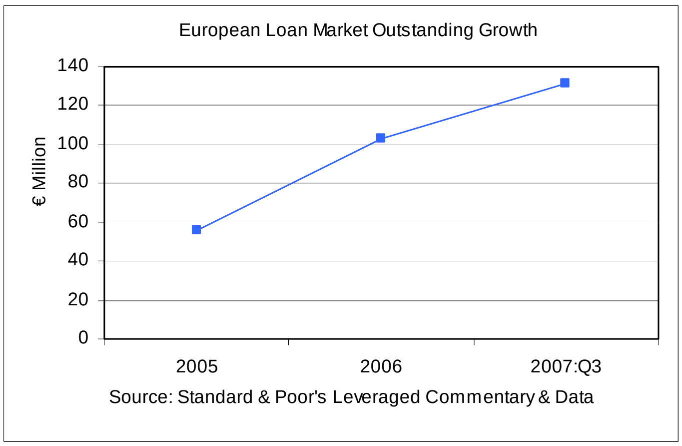

European High Yield Report - Credit Quality

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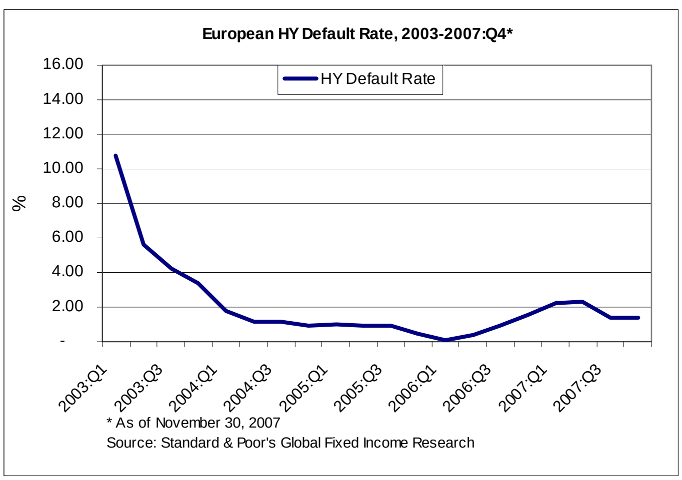

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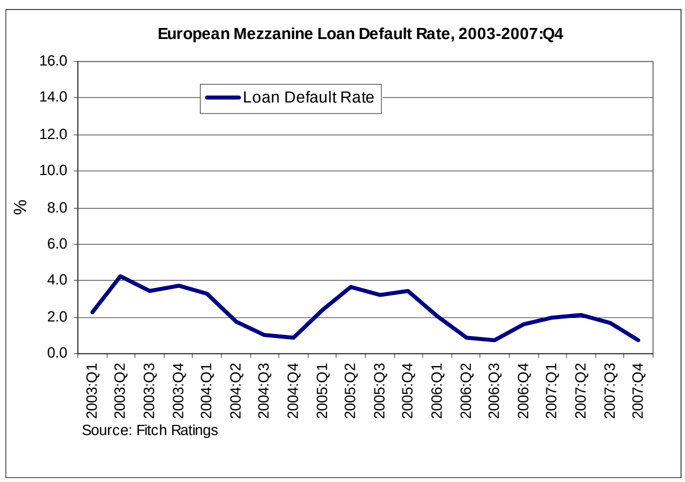

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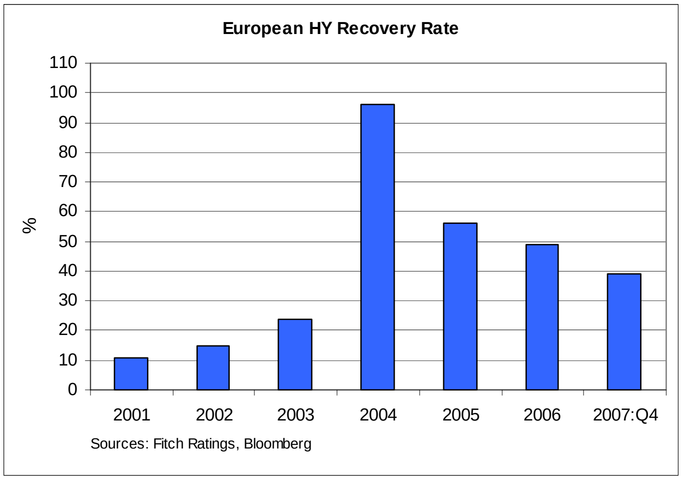

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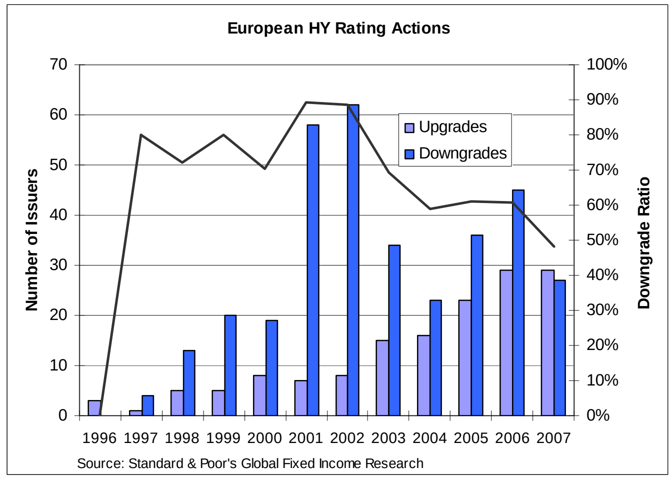

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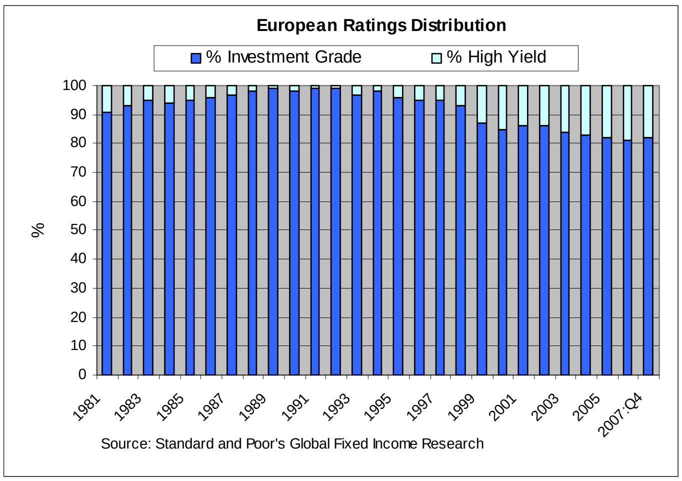

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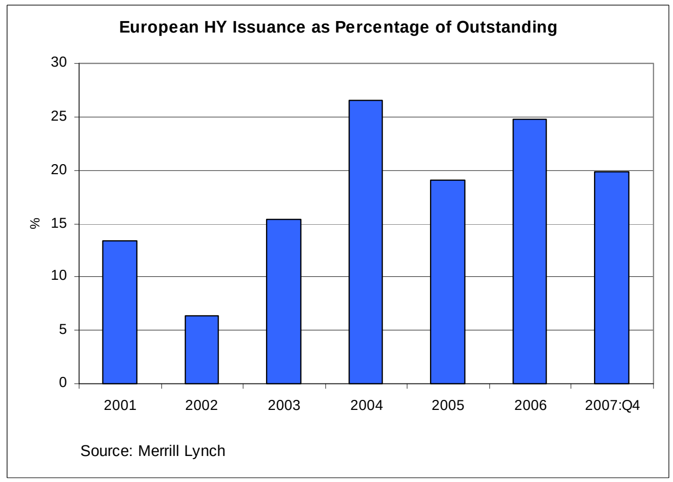

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S&P European Leveraged Loan Index

Ratings Diversification

	S&P BB Rating	S&P B Rating	S&P NR Rating	Other
2005	15.5%	74.5%	9.7%	0.3%
2006	9.3%	77.9%	12.9%	-0.1%
2007:Q4	8.4%	77.7%	13.1%	0.8%

Source: Standard & Poor's Leveraged Commentary and Data

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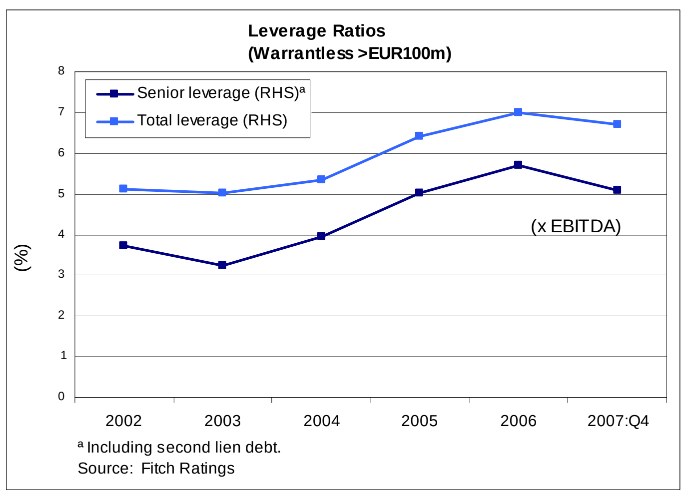

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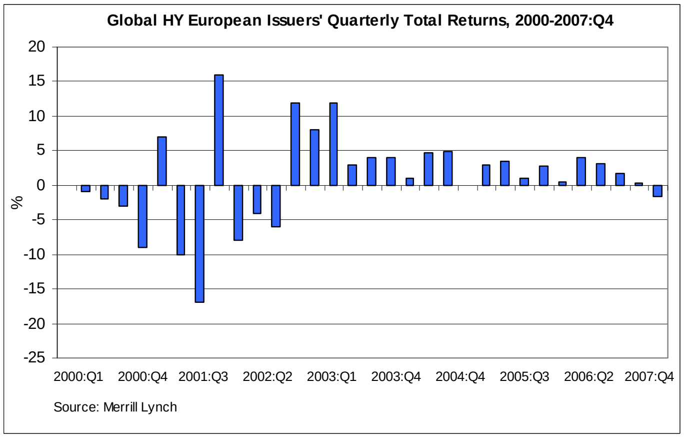
Global HY European Issuers' Quarterly Total Returns, 2000-2007:Q4
%
20
15
10
5
0
-5
-10
-15
-20
-25
2000:Q1
2000:Q4
2001:Q3
2002:Q2
2003:Q1
2003:Q4
2004:Q4
2005:Q3
2006:Q2
2007:Q4
Source: Merrill Lynch

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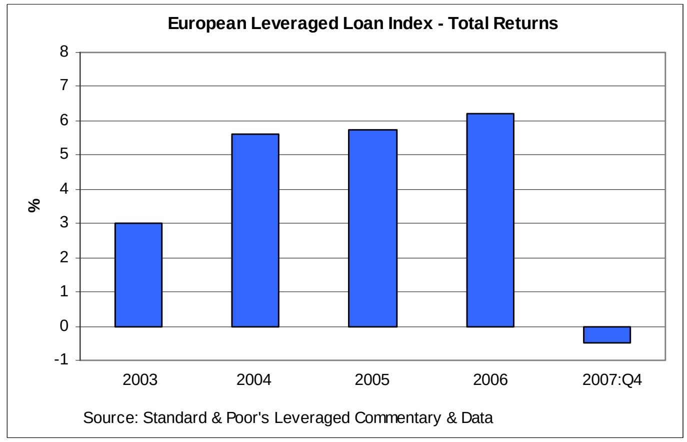
European Leveraged Loan Index - Total Returns
%
8
7
6
5
4
3
2
1
0
-1
2003
2004
2005
2006
2007:Q4
Source: Standard & Poor's Leveraged Commentary & Data

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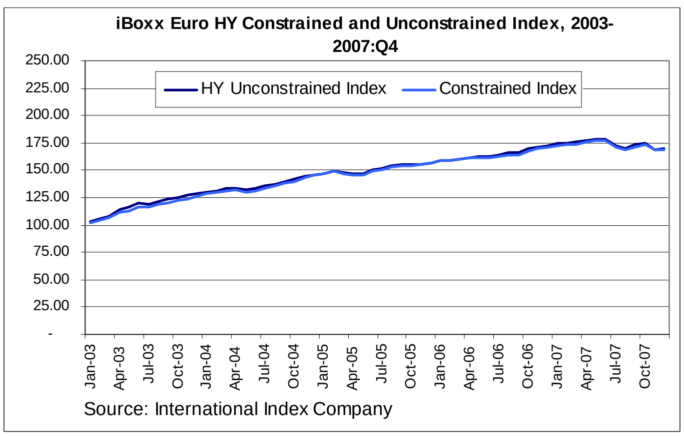
iBoxx Euro HY Constrained and Unconstrained Index, 2003-2007:Q4
HY Unconstrained Index
Constrained Index
250.00
225.00
200.00
175.00
150.00
125.00
100.00
75.00
50.00
25.00
-
Jan-03
Apr-03
Jul-03
Oct-03
Jan-04
Apr-04
Jul-04
Oct-04
Jan-05
Apr-05
Jul-05
Oct-05
Jan-06
Apr-06
Jul-06
Oct-06
Jan-07
Apr-07
Jul-07
Oct-07
Source: International Index Company

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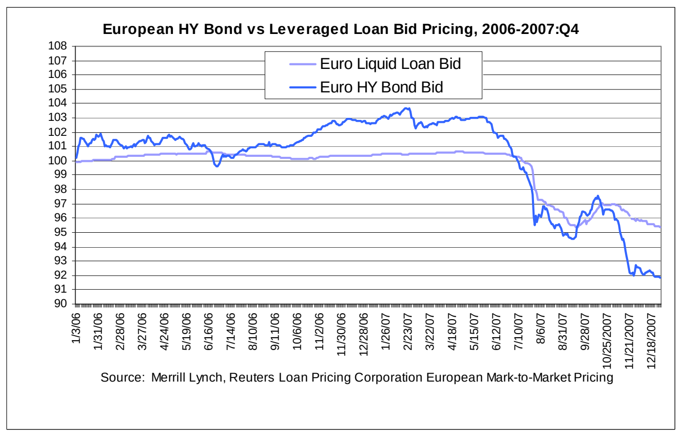
European HY Bond vs Leveraged Loan Bid Pricing, 2006-2007:Q4
Euro Liquid Loan Bid
Euro HY Bond Bid
108
107
106
105
104
103
102
101
100
99
98
97
96
95
94
93
92
91
90
1/3/06
1/31/06
2/28/06
3/27/06
4/24/06
5/19/06
6/16/06
7/14/06
8/10/06
9/11/06
10/6/06
11/2/06
11/30/06
12/28/06
1/26/07
2/23/07
3/22/07
4/18/07
5/15/07
6/12/07
7/10/07
8/6/07
8/31/07
9/28/07
10/25/2007
11/21/2007
12/18/2007
Source: Merrill Lynch, Reuters Loan Pricing Corporation European Mark-to-Market Pricing

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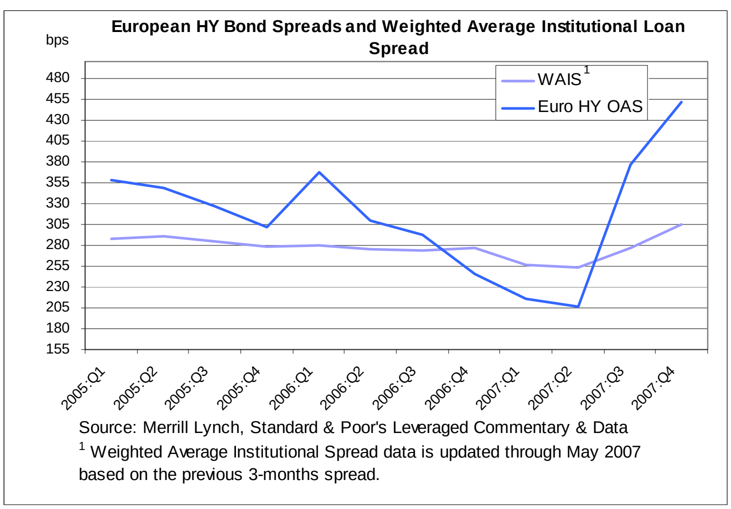
European HY Bond Spreads and Weighted Average Institutional Loan Spread
bps
WAIS[1]
Euro HY OAS
480
455
430
405
380
355
330
305
280
255
230
205
180
155
2005:Q1
2005:Q2
2005:Q3
2005:Q4
2006:Q1
2006:Q2
2006:Q3
2006:Q4
2007:Q1
2007:Q2
2007:Q3
2007:Q4
Source: Merrill Lynch, Standard & Poor's Leveraged Commentary & Data
[1] Weighted Average Institutional Spread data is updated through May 2007 based on the previous 3-months spread.