European Quarterly High Yield and Leveraged Loan Report

EUROPEAN HIGH YIELD ASSOCIATION

An Affiliate of SIFMA

Second Quarter, 2008

The European High Yield Association (EHYA), an affiliate of the Securities Industry and Financial Markets Association, is pleased to present the sixth quarterly issue of the *European High Yield and Emerging Market Leveraged Loan Report*. The report analyses and presents aggregate information and trends related to the European leveraged finance marketplace. It provides for both high yield corporate bonds and leveraged loans, new issuance, credit quality and returns on investment. Unless otherwise noted, the data are through the second quarter of 2008.

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Primary European Leveraged Credit Markets Slumber in the Summer with No High Yield Bond Issues in the Second Quarter; Performance Recovers Early, then Recedes

Highlights

- Leveraged finance issuance, which includes leveraged loans and high yield bonds, declined to €35.3 billion in the first half of 2008 compared to €221.7 billion over the same period in 2007.
- There were no recorded high yield bond deals in the second quarter and the first half of 2008 compared to issuance of €22.5 billion and €35.0 billion in the second quarter and first half of 2007. Leveraged loan issuance fell to €35.3 billion in the first half of 2008 compared to €187.7 in the same year-earlier period.
- European emerging market bond issuance, included as a separate category in this report for the first time, was €4.1 billion this quarter.
- Investor risk sensitivity, subdued global investor demand, prospects for slower economic growth and uncertain pricing contributed to continued depressed market conditions and sharply lower issuance volumes in the European high yield bond and leveraged loan markets.
- Market conditions are unlikely to improve substantially in the near term, and issuance levels are expected to remain below the peak levels experienced in the first half of last year.
- European leveraged credit pricing was volatile in the quarter and both high yield bond and leveraged loan returns turned positive in the second quarter from the first quarter's negative territory.
- There was a reduction in the substantial European leveraged loan pipeline backlog with €29 billion on bank books at the end of June compared to €34 billion at the start of the year. The number of leveraged deals in the pipeline has been much slower to reduce in Europe compared to in the US, where the backlog has been halved to €52 billion during the same period.
- European leveraged credit issuers continue to face a number of challenges including tightened financing conditions, lower profit and economic growth trends, and inflationary pressures arising from higher commodity prices.
- Credit quality risk is elevated from a period of historically low default rates during which corporate issuers built up their financial positions in an environment of low borrowing costs. The prospect of moderating-to-slower economic expansion, rising leverage levels and reduced credit availability adds to the possibility of rising default rates later this year.

Market and Economic Environment

Market Conditions

- Markets remain stressed with a continuation of the reappraisal of risk, global economic exposure to the US housing-led slowdown, and diminished credit market liquidity. Segments of the higher risk sectors of the European leveraged credit universe have been characterised as frozen.
- Financing conditions tightened during the second quarter as demonstrated by the heightened risk premium, with the European Central Bank (ECB) lender survey reporting tightened underwriting standards. According to the April 2008 ECB bank lending survey, banks will continue tightening their credit standards for loans to businesses and households. Investor risk appetite did seem to pick up as spreads began to narrow early in the second quarter but widened once again at the end of the quarter.
- Beginning in the second half of 2007, central banks have infused liquidity to ease the deteriorating credit market conditions and provide for greater market interbank funding stability. The ECB has been injecting additional three-month and six-month loans, but the interbank lending market is still characterised as tight. LIBOR (London Interbank Offered Rate) remains historically elevated, although rates appear to be stabilising. The three-month LIBOR rate was 2.81 percent as of 18 August, virtually unchanged from the previous month, however, the LIBOR-overnight indexed swap (OIS) spread widened to 78 basis points, the widest since early May. The LIBOR-OIS spread averaged roughly 11 basis points over the ten years prior to 2008.
- Reduced investor demand and resulting diminished liquidity has been further exacerbated by a pullback from newer investors such as hedge funds and collateralised loan obligations (CLOs). Euro-denominated CLO issuance has fallen to €2.3 billion in the second quarter of 2008 from €35.6 billion the second quarter of 2007.
- Credit demand appears to be slowing, initially from reduced merger and acquisition activity and more recently from capital expenditures relying more on internally generated funds.
- From end-December 2007 through mid-July 2008 the Euro trended upwards against the US dollar gaining some 11 percent, but has fallen 8 percent over the past month.

Economic Conditions

- The effect of tighter financing conditions on the real economy is expected to increase in coming months. According to Eurostat, eurozone GDP growth turned negative in the second quarter, down 0.2 percent from the first quarter, marking the first contraction since the launch of the euro. Growth had been resilient in previous periods due in part to emerging markets economic activity.
- Profit growth has held due largely to reasonably good macroeconomic growth and expense control. Corporate balance sheets have remained solid, but rising input and credit costs, as well as downside global economic risks, are likely to hold back investing and profit margins.
- The European economy has benefited from solid domestic demand, exports and employment growth with unemployment rates at 25-year lows. Higher energy and food prices are becoming a drag on consumer spending and recent surveys suggest a decline in consumer confidence levels. The ECB has commented that the survey results are consistent with moderating growth, and is projecting consumer spending growth in the range of 1.1 to 1.7 percent in 2008 compared to 1.6 percent in 2007.
- The ECB is forecasting slower economic growth in the range of 1.5 to 2.1 percent for full-year 2008 and 1.0 to 2.0 percent for 2009. A trough is expected in 2008 on a quarter-over-quarter basis due to the negative impact of tighter credit conditions and the effect of higher energy and food prices on consumption and investment.

- The ECB raised its target rate to 4.25 percent in early July on inflationary concerns as it strives to balance the multiple objectives of supporting credit market stability and liquidity on the one hand and managing inflation and inflationary expectations on the other.
- The ECB expects higher labor costs and tighter profit margins reflective of GDP growth moderation. Inflation growth had been relatively moderate thus far but has begun to pick up in food and energy. Higher commodity prices increased ECB inflation forecast to the 3.2 to 3.6 percent range for 2008. Other identified inflationary concerns include indirect taxes and wages.
- According to the ECB, despite the credit market conditions, there is still robust credit availability to nonfinancial borrowers. Financial institution lending has been growing as deposits have been expanding more rapidly than debt securities issuance.
- European credit expansion remains robust with M3, the broadest measure of credit, growing at a seasonally adjusted annual rate of 9.5 percent at end-June, compared to 9.9 percent at end-March and 11.5 percent at end-December 2007.[1] The rise is somewhat exaggerated as it reflects a preference for shorter term assets, attributable to the flat yield curve and reduced demand for higher credit risk assets in the current volatile credit market environment. There has also been growth in assets held by financial institutions that is, in part, explained by banks retaining a higher portion of securitised pools.

Issuance

- The primary market was virtually closed for much of the second quarter. Total European high yield bond and leveraged credit issuance was €35.3 billion in the first half of 2008 compared to €221.7 billion in the same period a year ago.
- There were no high yield bond issues in the first and second quarters of 2008 compared to €22.5 billion in the second quarter of 2007 and €35.0 billion in the second half of 2007 as a whole.[2] Based on Reuters' Loan Pricing Corporation (LPC) data, total European leveraged loan volume (including mezzanine financing) was €35.3 billion in the first half of 2008, of which €7.0 billion was mezzanine and €8.1 billion second lien loans, compared to €187.7 billion in the first half of 2007.[3]
- For the first time in this report, European emerging market bond issuance data are provided and reported separately. European emerging market bonds are defined as corporate bonds with a minimum issue size of €75.0 million issued by issuers with a European country of risk outside of the original twelve members of the European Union.[4] Further, due to differences in terms and documentation, Russian ruble-denominated issuance is excluded. There were €4.1 billion in European emerging market bonds issued in the second quarter.
- Market conditions, to a large extent, wiped out the appetite for aggressive non-traditional deal structures. According to Fitch Ratings there were no payment-in-kind (PIK) transactions in the second quarter.
- In the first half of 2008, the leading leveraged loan sectors were real estate (€5.3 billion), healthcare (€3.1 billion) and general manufacturing (€1.5 billion), according to Reuters' LPC.

[1] M3 includes physical currency, demand deposits, time-related deposits, savings deposits, non-institutional money-market funds, large time deposits, institutional money market funds, and repurchase agreements (see http://www.ecb.int/home/html/index.en.html).

[2] 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 second lien and second lien loans generally with below-investment grade ratings or spreads of at least 150 basis points and mezzanine loans.

[4] The original 12 members of the European Union are France, Germany, Italy, Belgium, Netherlands, Luxembourg, Denmark, Ireland, United Kingdom, Greece, Spain and Portugal.

- Market conditions dramatically slowed leveraged buy-outs (LBO) and other acquisition debt financing, including private equity sponsored deals. Leveraged loan LBO (€21.8 billion) and recap (€3.0 billion) volumes declined precipitously in the first half of 2008 compared to the first half of 2007, falling 69.0 percent and 94.5 percent respectively, according to Reuters' LPC.
- Globally, there has been a reduction in the leveraged loan deal calendar as some deals closed under revised terms and others were removed from the calendar. According to S&P Leveraged Commentary and Data LCD, the US backlog declined to €51.6 billion by end-June from €106.3 billion at the end of 2007. The European leveraged loan backlog decline has been slower, with roughly €28.7 billion held by banks at mid-year compared to €33.9 billion at the end of last year.

Credit Quality

- There are signs of increased credit risk exposure following an extended period of strengthened balance sheets and low default rates boosted by a protracted period of profit growth. Additional defaults are expected later in 2008, as access to credit markets for refinancing existing debt becomes more restricted and profit growth and margins moderate.
- The S&P Global Fixed Income Research default rate was reported as zero for the twelve months ending in June but is expected to rise during the course of 2008 and into 2009. According to S&P, default rates have been held back by limited refunding requirements and structural concessions that averted defaults. S&P Global Fixed Income Research reported 37 European high-yield upgrades and 57 downgrades in the second quarter, compared to 18 upgrades and 35 downgrades in the first quarter and 54 upgrades and 19 downgrades in the second quarter a year ago. S&P expects downward pressure on ratings as a result of slower economic growth, an appreciated Euro, reduced profit margins and tighter credit market conditions.
- Fitch Ratings reported that the mezzanine loan default rates were 0.25 percent, or 0.68 percent when adjusted for "distressed" restructurings, well below the peak in 2003. These numbers are based on last twelve months defaulted volumes of €74.2 million or one defaulted issuer.
- High-yield bond recoveries were between 51 and 70 percent for the twelve months ending 30 June, as calculated by Fitch Ratings. Recovery rates are approximated by dividing the price of defaulted bond issues one month after default by the bond volume before default.
- S&P Global Fixed Income Research reported that the "BB" rated issuer share of the European high-yield or speculative-grade market declined while the "B" rated share has increased over the last five years. The movement towards the decline in the leveraged credit rating mix in Europe has recently slowed amid the credit market turbulence, increased investor risk sensitivity and some reversal in the disintermediation trend. The "BB" rated share of the European high yield has increased slightly over the past year, and S&P LCD reported a relative increase in "BB" rated loans in the second quarter.
- Leverage ratios as reported by Fitch, which are used as a measure of credit risk, have increased over the last several years but declined over the past quarter as financing terms have tightened. The median senior leverage ratio of Fitch-rated shadow credits in the second quarter was 3.9 times and the median total leverage was 4.9 times. The corresponding median leverage ratios in the first quarter were 4.8 times for senior and 6.9 times for total.

Relative Value

- European high-yield sector returns turned positive for the quarter. Based on the Merrill Lynch High Yield Index, the total market return was 1.67 percent for the second quarter 2008. Although there were gains early in the quarter, the high-yield index turned negative for the month of June and remained in negative territory in July. At the end of the quarter, the Merrill Lynch High Yield Index reported a 733 basis-point credit spread, having widened by 242 basis points since the beginning of the year, but 32 basis points below the level at the end of the first quarter. Similarly, the spread in the credit derivatives market as measured by the iTraxx Cross-over Index (iTRAXX.EU.XO) was 519 basis points, 180 bps wider than at the end of fourth quarter 2007, but 58 basis points tighter than at the end of the first quarter.
- The leveraged-loan index return was also positive for the second quarter. The S&P LCD European Leveraged Loan Index (ELLI-Total Return) was 5.29 percent for the second quarter compared to -8.56 percent in the first quarter and 1.50 percent in the second quarter of 2007. S&P LCD reported a wider primary weighted-average institutional loan spread of 339 basis points in the second quarter compared to 320 basis points at the end of the first quarter.

European High Yield Report - Issuance Volume

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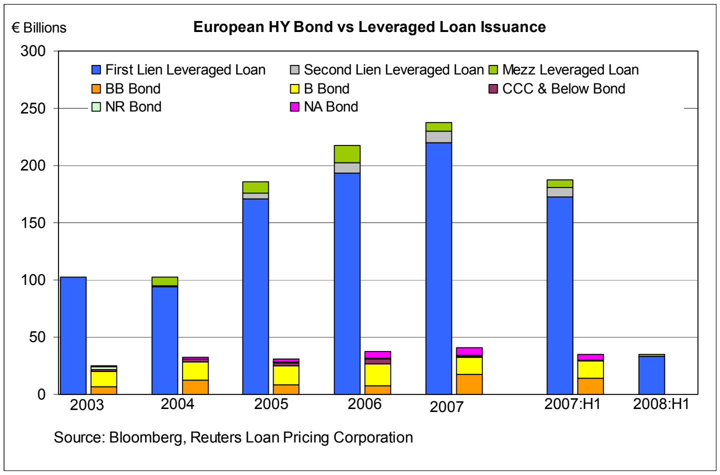

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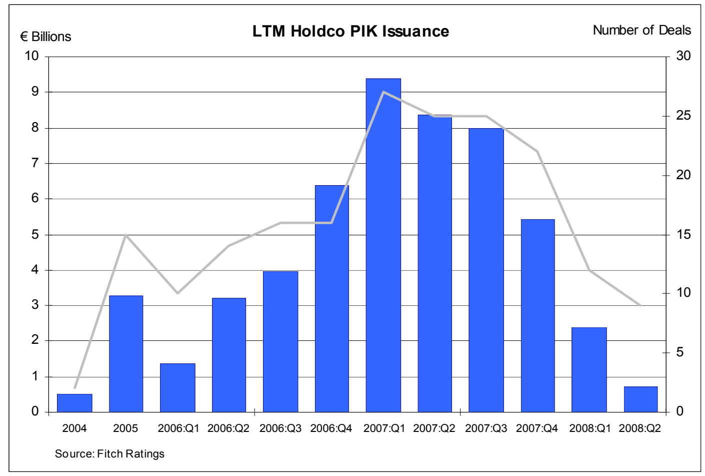

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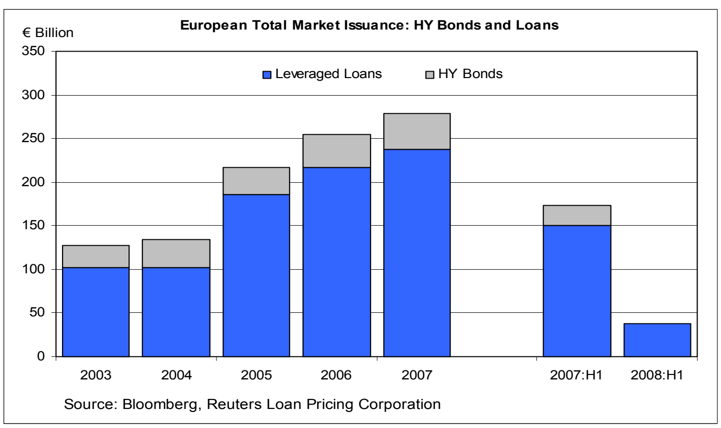

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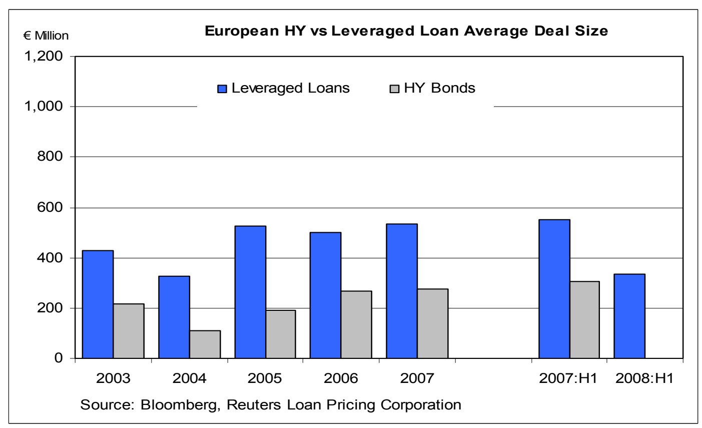

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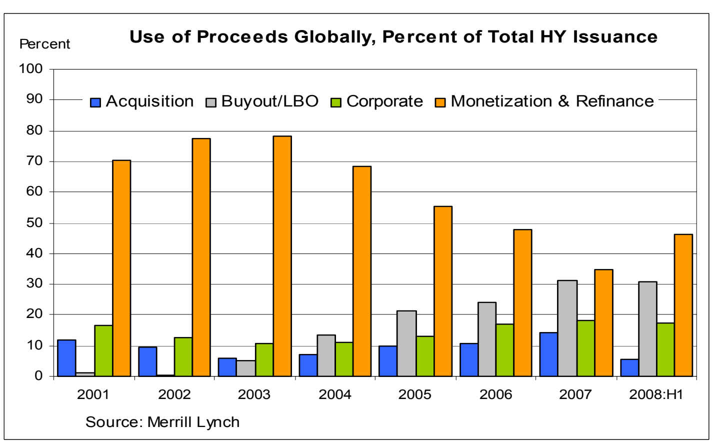

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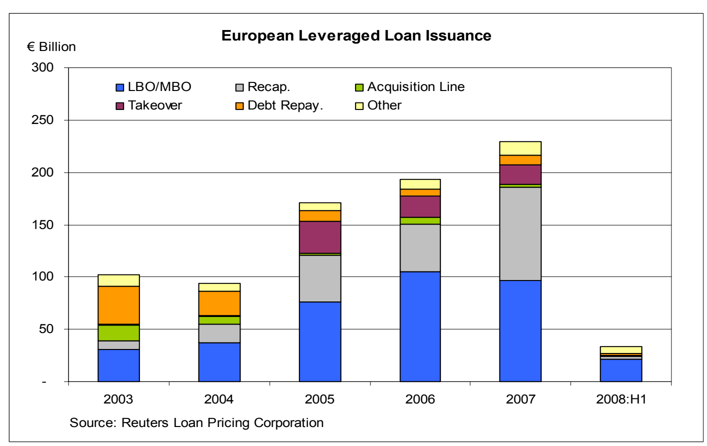

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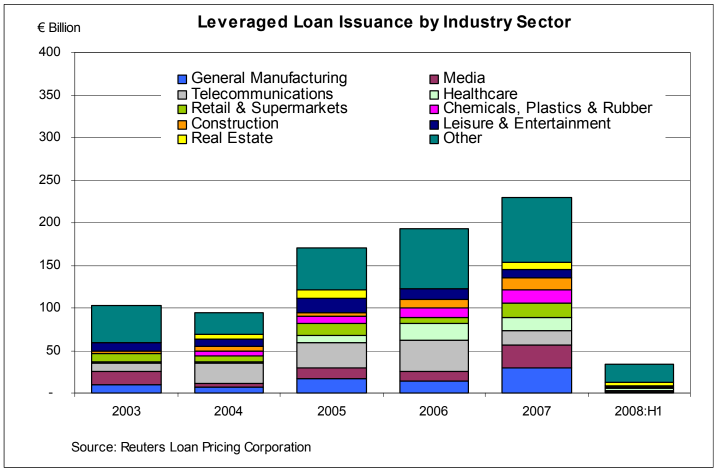

Leveraged Loan Issuance by Industry Sector
€ Billion
General Manufacturing
Telecommunications
Retail & Supermarkets
Construction
Real Estate
Media
Healthcare
Chemicals, Plastics & Rubber
Leisure & Entertainment
Other
2003
2004
2005
2006
2007
2008:H1
Source: Reuters Loan Pricing Corporation

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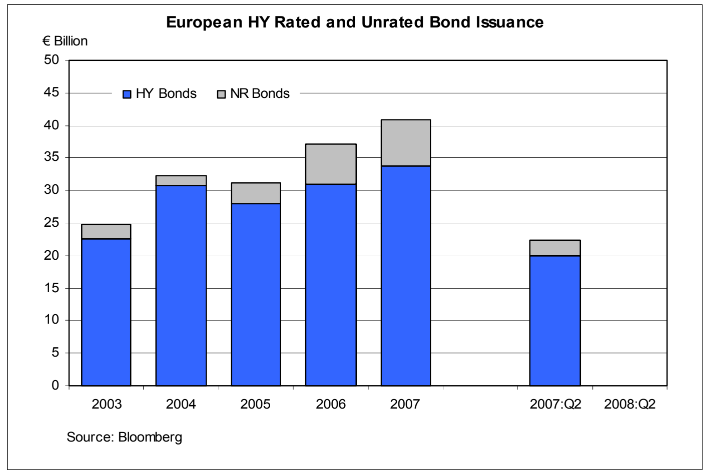

European HY Rated and Unrated Bond Issuance
€ Billion
HY Bonds
NR Bonds
2003
2004
2005
2006
2007
2007:Q2
2008:Q2
Source: Bloomberg

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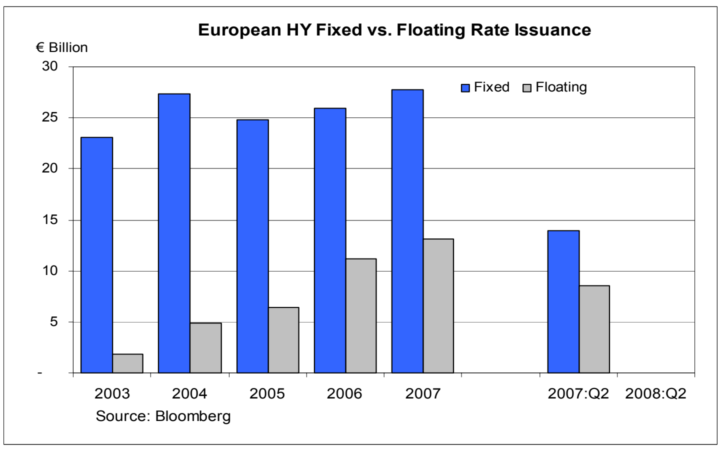

European HY Fixed vs. Floating Rate Issuance
€ Billion
Fixed
Floating
2003
2004
2005
2006
2007
2007:Q2
2008:Q2
Source: Bloomberg

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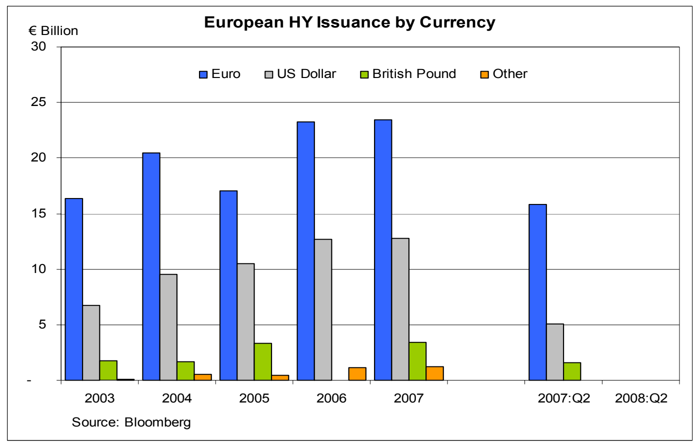

European HY Issuance by Currency
€ Billion
Euro
US Dollar
British Pound
Other
2003
2004
2005
2006
2007
2007:Q2
2008:Q2
Source: Bloomberg

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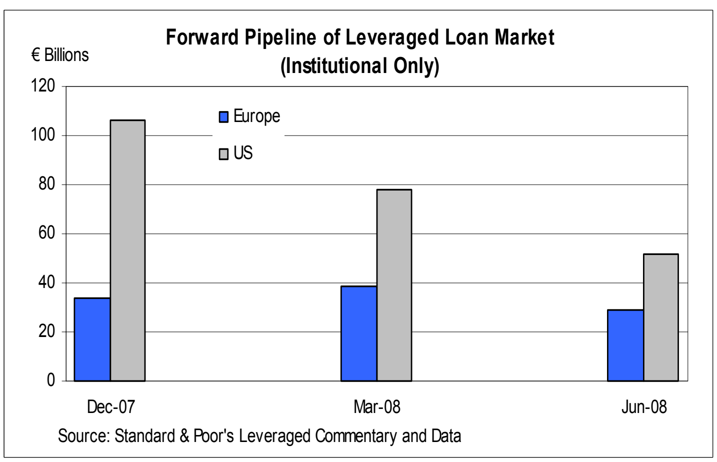

Forward Pipeline of Leveraged Loan Market
(Institutional Only)
€ Billions
Europe
US
Dec-07
Mar-08
Jun-08
Source: Standard & Poor's Leveraged Commentary and Data

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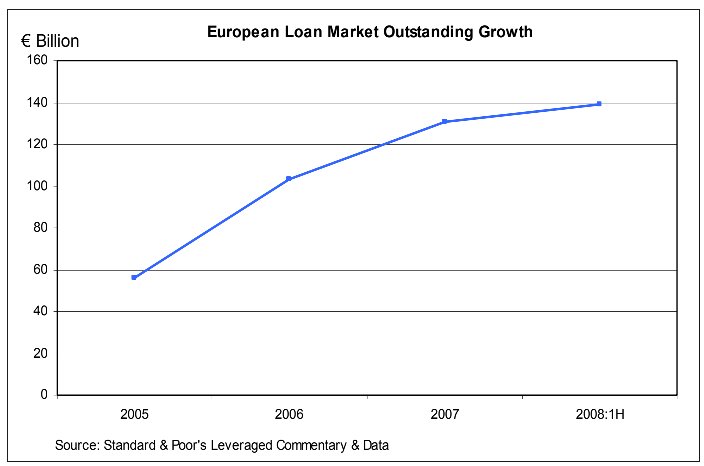

European Loan Market Outstanding Growth
€ Billion
2005
2006
2007
2008:1H
Source: Standard & Poor's Leveraged Commentary & Data

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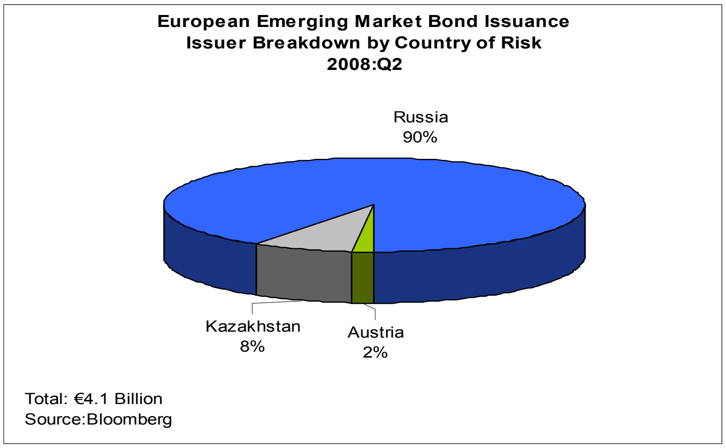

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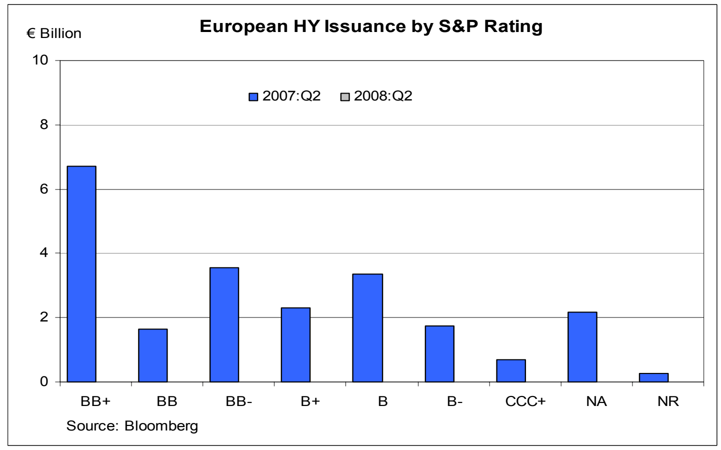

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European Emerging Market Bond Issuance 2008:Q2

Company Name	Issue Date	Maturity Date	Coupon Rate	Amount Issued (€)	Country of Risk	S&P Rating
STRABAG SE	18/06/2008	18/06/2013	5.750%	75,000,000	Austria	BB+
HSBK EUROPE BV	16/04/2008	16/10/2013	9.250%	313,550,000	Kazakhstan	BB+
AK BARS BANK	19/06/2008	20/06/2011	9.250%	193,500,000	Russia	N.A.
ALFA MTN INVEST LTD	24/06/2008	24/06/2013	9.250%	256,920,000	Russia	BBe
EVRAZ GROUP SA	27/05/2008	24/04/2013	8.875%	159,325,000	Russia	BB-e
EVRAZ GROUP SA	24/04/2008	24/04/2013	8.875%	828,880,000	Russia	BB-
EVRAZ GROUP SA	24/04/2008	24/04/2018	9.500%	446,320,000	Russia	BB-
HCFB LLC	20/06/2008	20/06/2011	11.000%	320,350,000	Russia	B+
TRANSCREDITBANK	23/06/2008	25/06/2011	9.000%	225,540,000	Russia	BB
VIMPELCOM	30/04/2008	30/04/2013	8.375%	640,100,000	Russia	BB+
VIMPELCOM	30/04/2008	30/04/2018	9.125%	640,100,000	Russia	BB+

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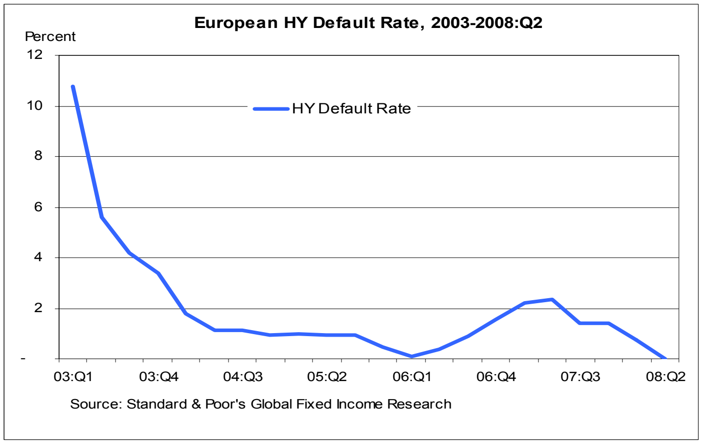

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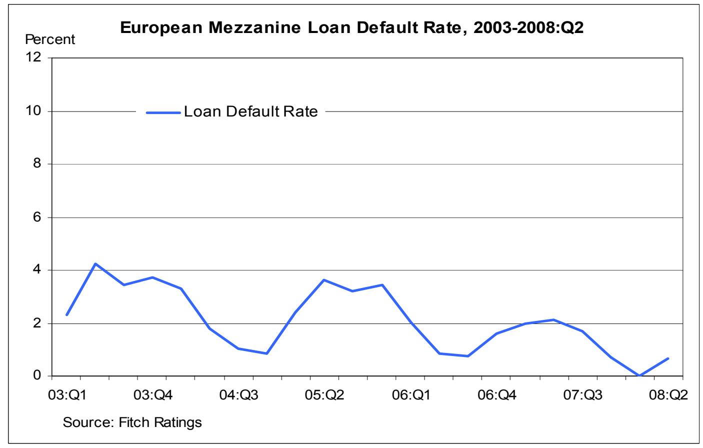

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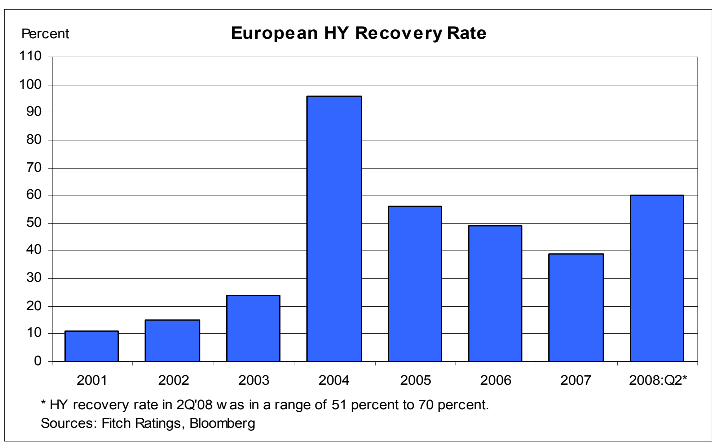

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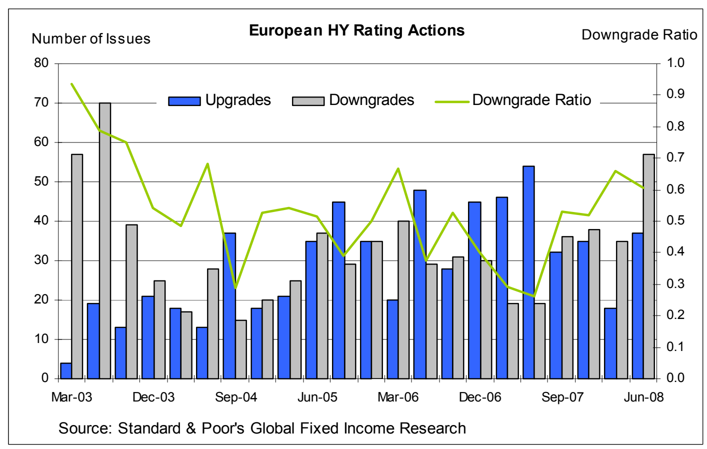

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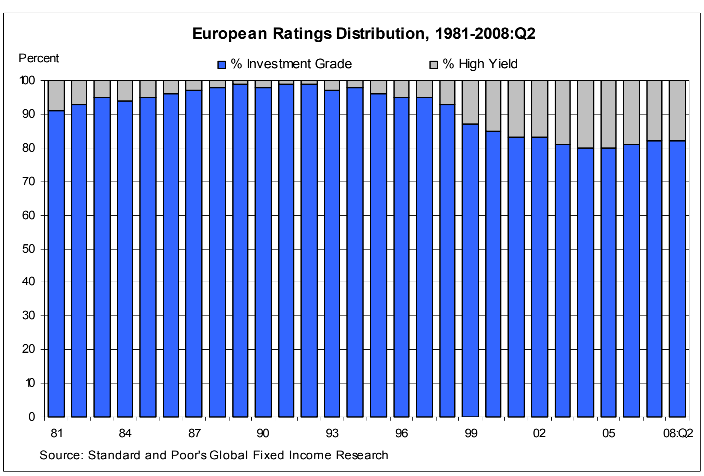

21

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%	0.0%
2007	8.4%	77.7%	13.1%	0.9%
2008:H1	14.8%	69.5%	14.1%	1.6%

Source: Standard & Poor's Leveraged Commentary and Data

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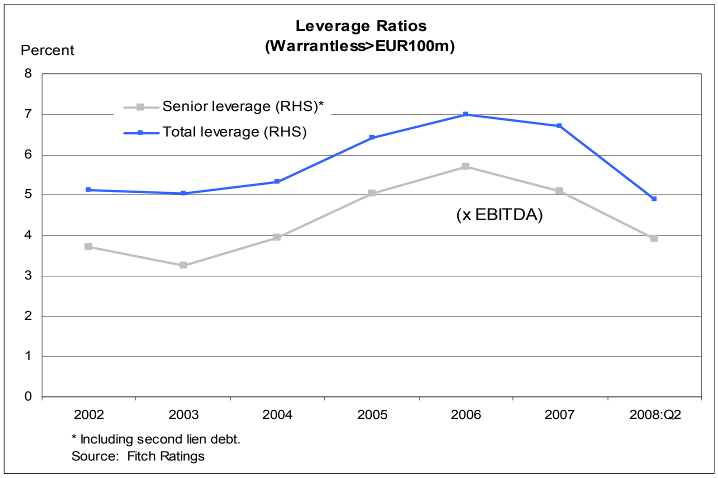

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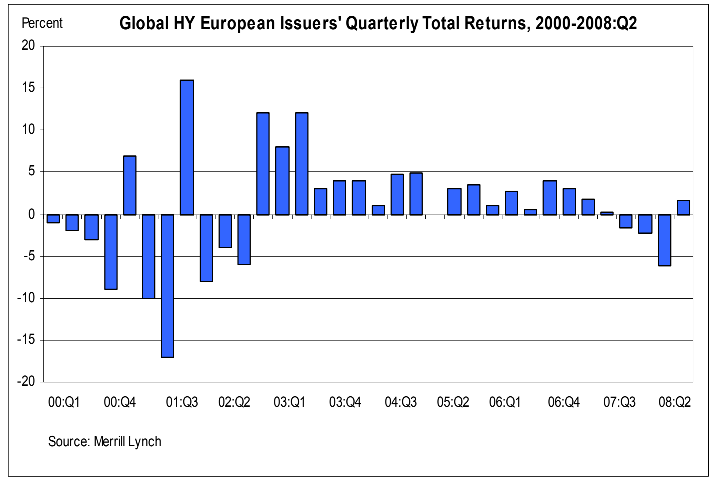

European High Yield Report - Relative Value

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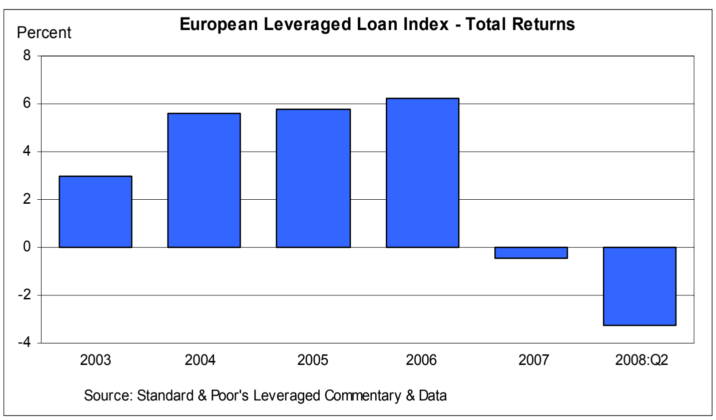

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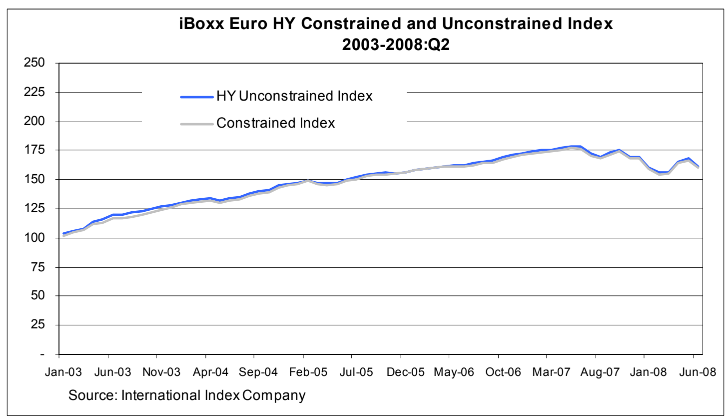

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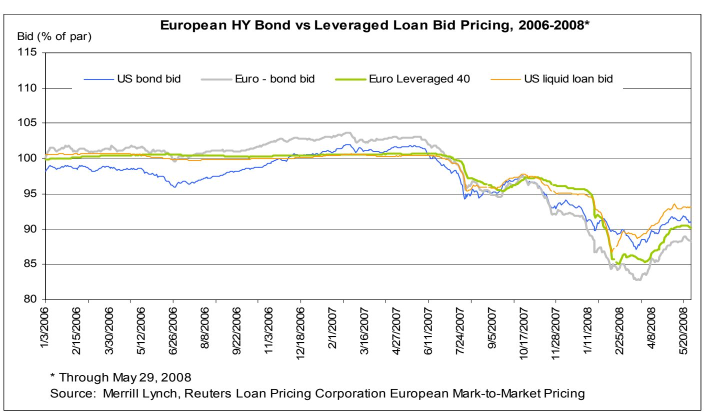

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