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# *European Quarterly High Yield Report*

## EUROPEAN HIGH YIELD ASSOCIATION

The European High Yield Association<sup>1</sup>, in conjunction with the Securities Industry and Financial Markets Association<sup>2</sup>, is pleased to introduce the inaugural issue of the *European Quarterly High Yield Report*. Based on publicly available information, the report analyses and presents aggregate information and trends related to high-yield corporate bonds issued in the European marketplace. The report includes sections on issuance, credit quality and returns on investment. Unless otherwise noted, the data are through the first quarter of 2007.

### **European High-Yield Corporate Bond Issuance Surges From Strong 2006 Pace to €12.7 Billion in the First Quarter of 2007, 78.9 Percent Higher than Last Year; More Floating Rate Notes; Sector Continues to Perform Well**

#### **Highlights**

- The pace of European high-yield bond issuance increased in the first quarter to an estimated €12.7 billion, 78.9 percent higher than the first quarter 2006 volume of €7.1 billion. High-yield issuance rose to €37.9 billion in full-year 2006.
- The European macroeconomic environment continues to be favourable for the high-yield market based on interest rates still at historically low levels despite recent European Central Bank (ECB) tightenings, Euro zone economic growth trends and corporate profitability.
- Issuance levels are being driven by balance sheet leveraging strategies, in particular, mergers and acquisition (M&A) and leveraged buyout (LBO) transaction financing.
- Sector performance remains positive and stable, boosted by high level of market liquidity, investor demand, risk tolerance, and current credit quality metrics. Rising leveraged transaction volume and increased global market volatility introduce a potential for heightened risk exposure over the longer term as the credit cycle matures.

#### **Economic and Market Environment**

##### Economic Trends

- Stronger economic growth, investment and consumer spending expansion, and higher profit levels have supported rising issuance volumes and improving credit quality trends in recent years.
- The European economic growth outlook will remain solid for 2007, but could moderate from the above-trend growth of 2.75 percent in 2006 (up from 1.5 percent in 2005). The outlook, especially in the manufacturing sector, will be affected by Euro currency appreciation and rising interest rates. The ECB has forecast 2007 growth in the 2.1 to 2.9 percent range.

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<sup>1</sup> The European High Yield Association (EHYA) is a trade association representing participants in the European high yield market. Membership is open to banks, investors, issuers, law firms, accounting firms and other participants in the European high yield market. The EHYA is an independent, self-funded forum of the Securities Industry and Financial Markets Association (SIFMA).

<sup>2</sup> SIFMA represents the industry which powers the global markets. Born on the merger between The Securities Industry Association and The Bond Market Association, SIFMA is the single powerful voice for strengthening markets and supporting investors – the world over.

- Inflation measures will remain within an acceptable range for policymakers through the early part of the year. The appreciating currency has helped to contain price levels. Price stability concerns include reduced excess capacity, anticipated wage pressures and money supply growth.
- The monetary tightening cycle is expected to be close to its completion. Based on the view of sustainable economic growth, the ECB in December raised rates for the seventh time to 3.75 percent, which is still considered to be accommodative.

### Market Conditions

- Over the past year, ample and rising liquidity, which has shown little sign of abating, characterizes the high-yield environment.
- A growing investor base, including non-bank and non-traditional investor classes, has fueled rapidly expanding European high-yield market liquidity. One example is the significant issuance growth of CDOs, some of which contain substantial corporate credit portfolios.
- Enhanced liquidity and investor demand has enabled high-yield issuance to be well absorbed by the marketplace. Despite the additional supply of European high-yield bonds, investor demand has driven up valuations and reduced credit spreads.
- The extended period of low volatility also boosted valuations over the last few years. The rise in volatility this year, however, has heightened investor sensitivity to credit issues in the wake of global financial market events such as the global equity sell off in February and subprime mortgage deterioration concerns in the US.
- The turmoil during the equity sell-off early in the year led to a flight to quality, which boosted the appetites of European investors for bonds generally. Market conditions have since stabilised.

### **Issuance**

- First quarter high-yield bond issuance volume was €12.7 billion, 78.3 percent higher than the first quarter of 2006. European total leveraged loan volume issuance was €5.9 billion in the first quarter, of which €4.5 billion were mezzanine and €2.7 billion were second lien loans.
- Standard & Poor's (S&P) "BB"-rated bond issuance totaled €7.0 billion, "B" was €4.8 billion and "CCC & Below" was €0.1 billion for the quarter.
- The industrial sector accounted for €5.2 billion in issuance during the first quarter, more than 40 percent of total first quarter high yield issuance.
- LBO and M&A transactions have driven issuance volume growth in recent years. Based on Merrill Lynch data, approximately 41.1 percent of high yield bond proceeds were used to finance LBO/M&A deals in 2006 (the most recent data available), compared to 34.9 percent in 2005 and 10 percent in 2001. Acquisitions and LBOs are similarly driving loan volume. Based on Reuters Loan Pricing Corporation data, approximately 42.7 percent of first lien loan proceeds were used to finance LBO/M&A deals in 2006, compared to 29.2 percent in 2005 and 18.6 percent 2004.
- The fixed rate share of total issuance rose to €10.0 billion in the first quarter (78.7 percent of total issuance), up from €6.8 billion (95.3 percent) in the first quarter of 2006. Floating rate issuance rose to €2.7 billion (21.3 percent of total first quarter issuance) from €0.3 billion (4.7 percent) in the first quarter of 2006.
- As a measure of the market's development and capacity to absorb new supply, first quarter "BB"-rated issuance totaled 3.6 percent of the total "BB" outstanding volume in the marketplace, "B" issuance totaled 9.3 percent of total outstanding, and "CCC" and non-rated issuance was 1.2 percent of total outstanding based on Merrill Lynch data.

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### **Credit Quality**

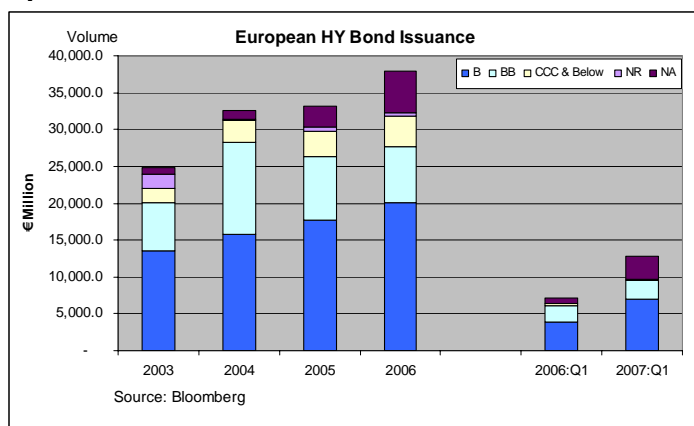
- Credit fundamentals remain solid, with the prospect of a pick-up in defaults and gradual re-pricing of risk possible over the next year.
- Noting a continuation of benign rating trends and a high level of liquidity, S&P Global Fixed Income Research commented on the presence of risk exposure from relaxed bond covenants and leveraged financial structures when the credit cycle turns. The rating agency has also indicated that relaxed covenants help contain reported default levels. As of the end of March 2007, the 12-month trailing European speculative grade default rate rose slightly to 2.30 percent.
- Consistent with the current credit environment, recoveries have picked up from 11 percent in 2001 to 45 percent in 2006 and 39 percent in the first quarter, as calculated by Fitch Ratings. Recoveries are defined as an approximation by dividing the current price of defaulted bond issues one month after default by the amount of bond volume before default.

### **Relative Value**

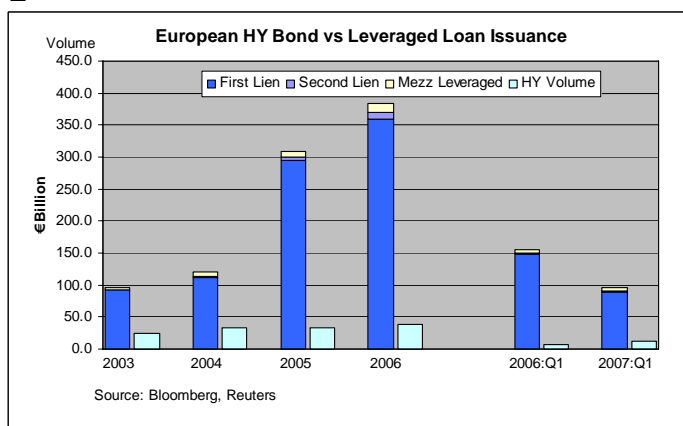
- According to both iBoxx and Merrill Lynch indices, European high-yield sector returns were positive for the quarter and over the last three years, reflecting the current stable credit metrics, liquidity and investor demand.

## European High Yield Report Issuance Volume<sup>3</sup>

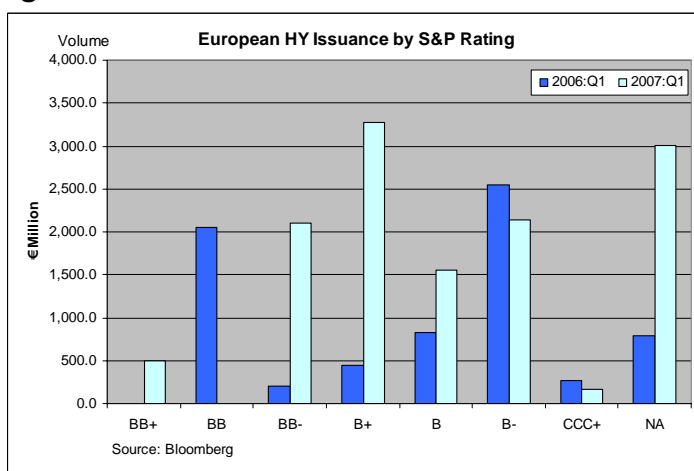
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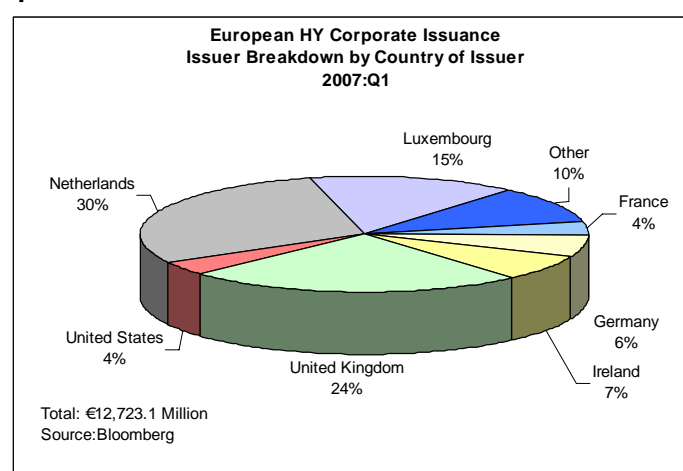
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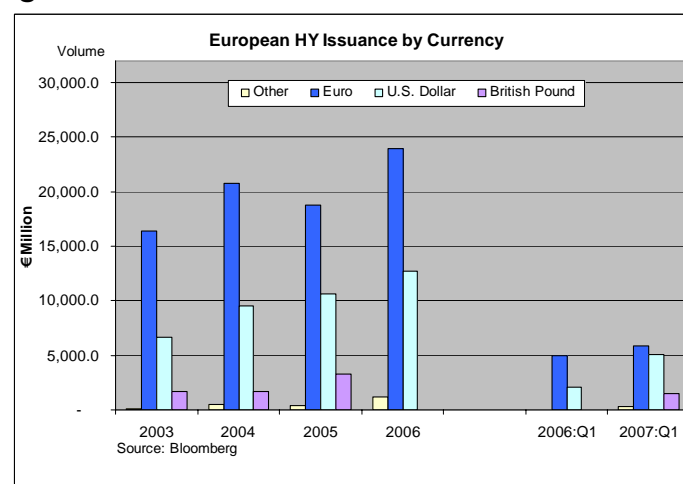
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### 2007:Q1 Long-Term European HY Issuance By Industry Sector

Sector	S&P BB Rating	S&P B Rating	S&P CCC Rating	S&P NA Rating
Banking	326.9	471.8	54.2	1,563.3
Finance		2,598.0		460.5
Industrial	1,775.0	3,295.4	110.0	
Special Purpose	495.7	592.1		980.2
<b>Industry Total</b>	<b>2,597.6</b>	<b>6,957.3</b>	<b>164.2</b>	<b>3,004.0</b>

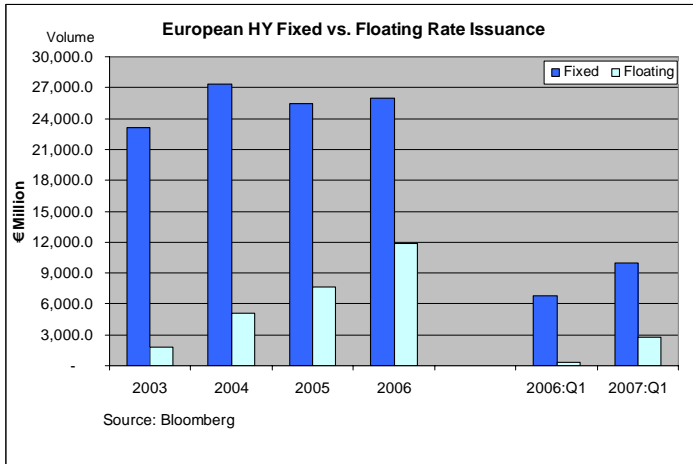
Through March 31, 2007  
Source: Bloomberg

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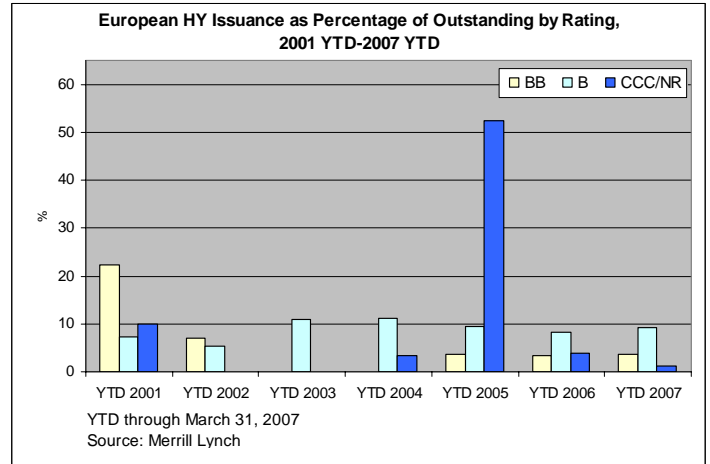


<sup>3</sup> High-Yield Corporate Debt is defined as transactions with an S&P rating equal to or less than BB+, a Moody rating equal to or less than Ba1, or a Fitch rating equal to or less than BB+. CDs, General term notes and split-junk rated transactions are excluded. Includes all European issuers and all international issuers that issue in a European currency. Excludes ABS, federal credit agency, supranational agency, sub-sovereign, and sovereign debt transactions. Excludes transactions without a manager, non-underwritten transactions, self funded ineligible transactions, transactions that are not rank eligible (due to submission guidelines).

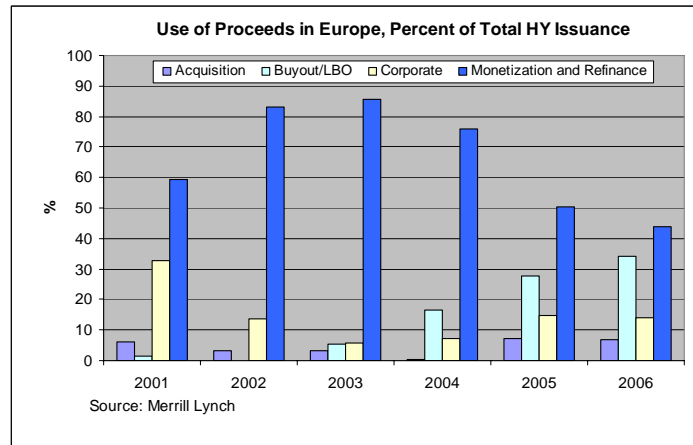
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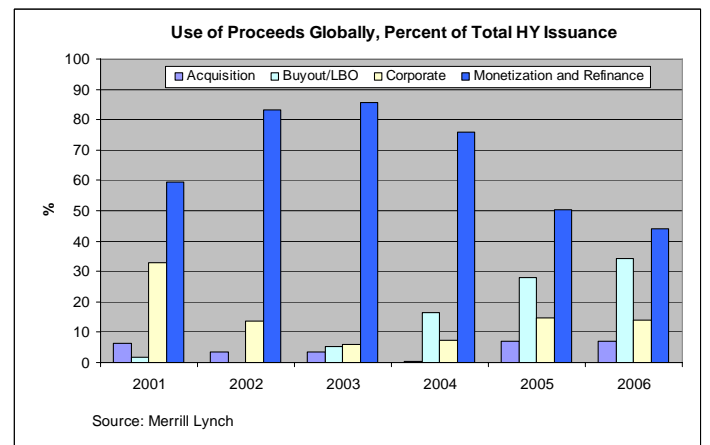
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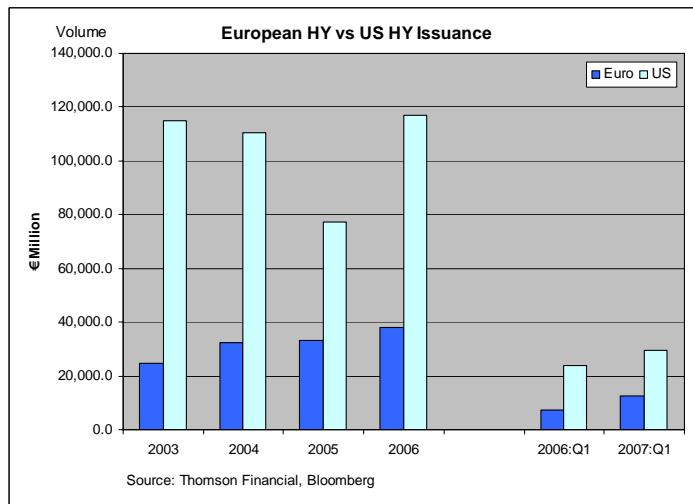
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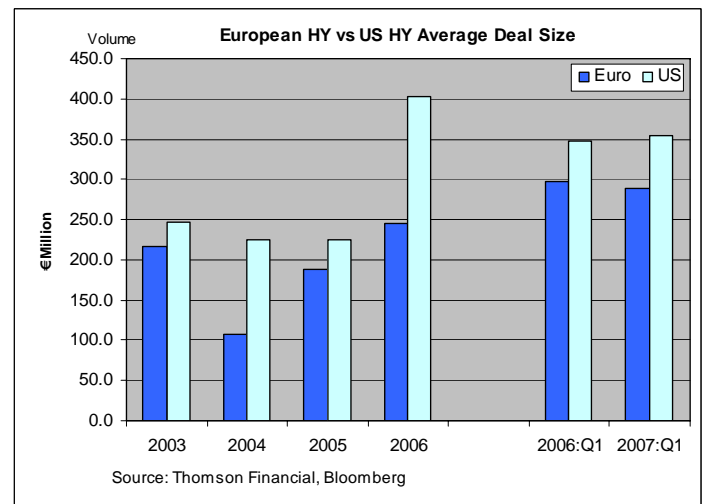
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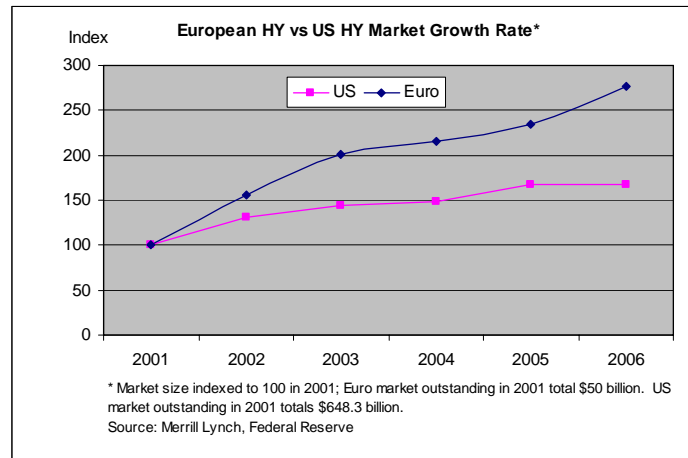


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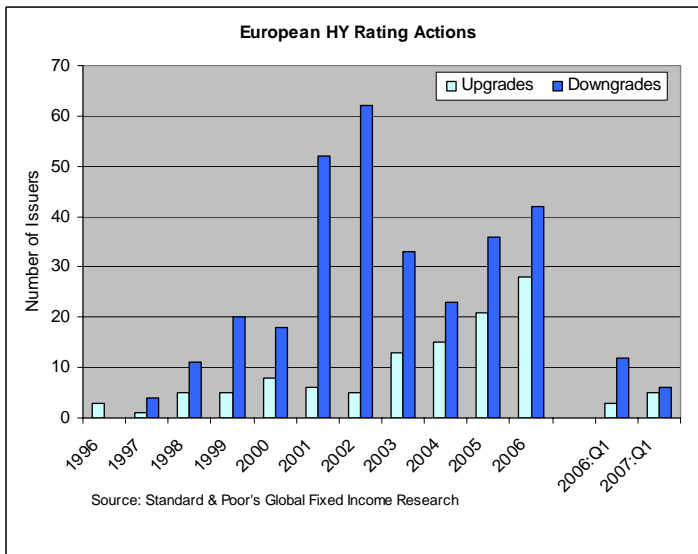
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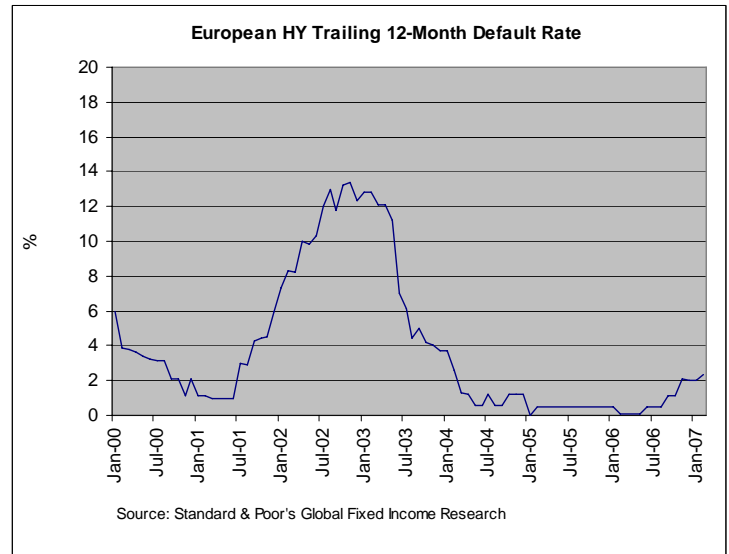


## European High Yield Report – Credit Quality

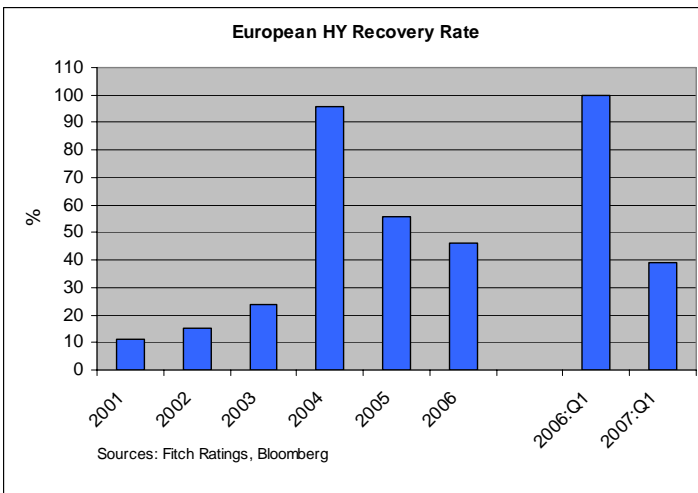
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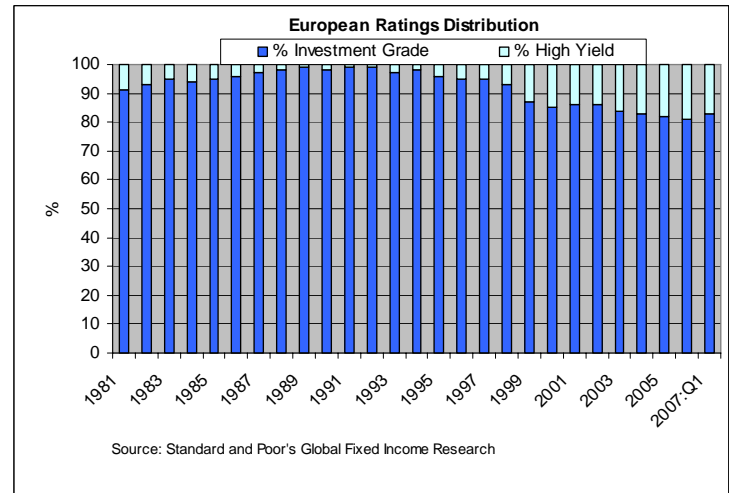
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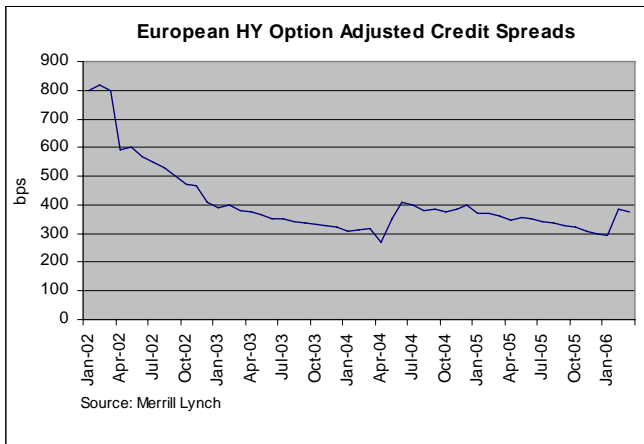
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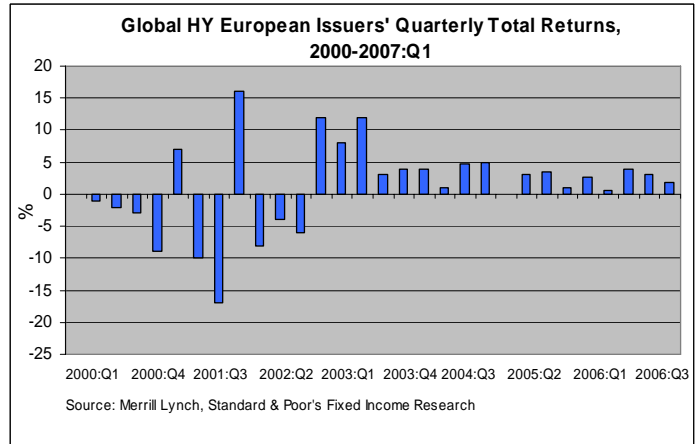
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