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Leveraged Finance:

As The European Market Heats Up, Recovery Prospects For Senior Secured Bondholders Cool

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Leveraged Finance:

As The European Market Heats Up, Recovery Prospects For Senior Secured Bondholders Cool

(Editor's Note: This is the first edition of a new quarterly leveraged finance report, in which we examine current market developments. This quarter we examine the capital structures of rated European speculative-grade companies that have recently issued debt.)

Europe's capital markets responded with enthusiasm to the European Central Bank's (ECB's) cuts in key policy interest rates and unconventional measures in early June to combat deflationary pressures and boost bank lending. The iTraxx Crossover index, which is a proxy for speculative-grade credit risk, tightened to its lowest level since the global financial crisis of 2007-2009. Pricing for high-yield debt has already tightened in the past year and a half, with the average yield for 'B' rated companies compressing to 6.1% in the six months to June 6, 2014, from 8.3% at the end of 2012. For 'BB' rated companies, yields have fallen to 4.4% from 5.7% over the same period, according to S&P Capital IQ LCD data.

Until now, credit quality for speculative-grade companies (that is, those rated 'BB+' and lower) has held firm amid broadly stable credit conditions in Europe. However, thanks to the ECB's actions, the low interest rate environment is set to continue for the foreseeable future, which will only exacerbate investors' search for yield. In Standard & Poor's Ratings Services' opinion, this supply-demand imbalance could continue to lead to excessively borrower-friendly lending standards and more highly leveraged transactions, something we are already starting to observe. Indeed, leverage multiples on transactions in Europe have been steadily increasing since 2009.

Overview

- Leverage multiples for all European transactions were 5.1x in the first quarter of 2014, rising above the 10-year average (4.8x) for the first time since 2008.
- New (post financial crisis) transaction structures, particularly those using senior secured bonds and super senior revolving credit facilities, are now competing with more traditional debt structures, which include senior secured loans with subordinated mezzanine or bonds.
- However, the new structures have reduced potential recoveries for senior secured bondholders, who are replacing the more traditional senior secured loanholders. Recovery ratings for all senior secured bonds have fallen to between '3' (50%-70% recovery of principal) and '4' (30%-50%), compared with '3' in 2010 and '2' (70%-90%) in 2009.
- Covenant-lite transactions, which dominate the U.S. leveraged loan market, have yet to take off in Europe. However, we are starting to see these deals emerge here.

Transaction Structures Take A New Turn

When the high-yield bond market first boomed in Europe following the global financial crisis of 2007-2009, we

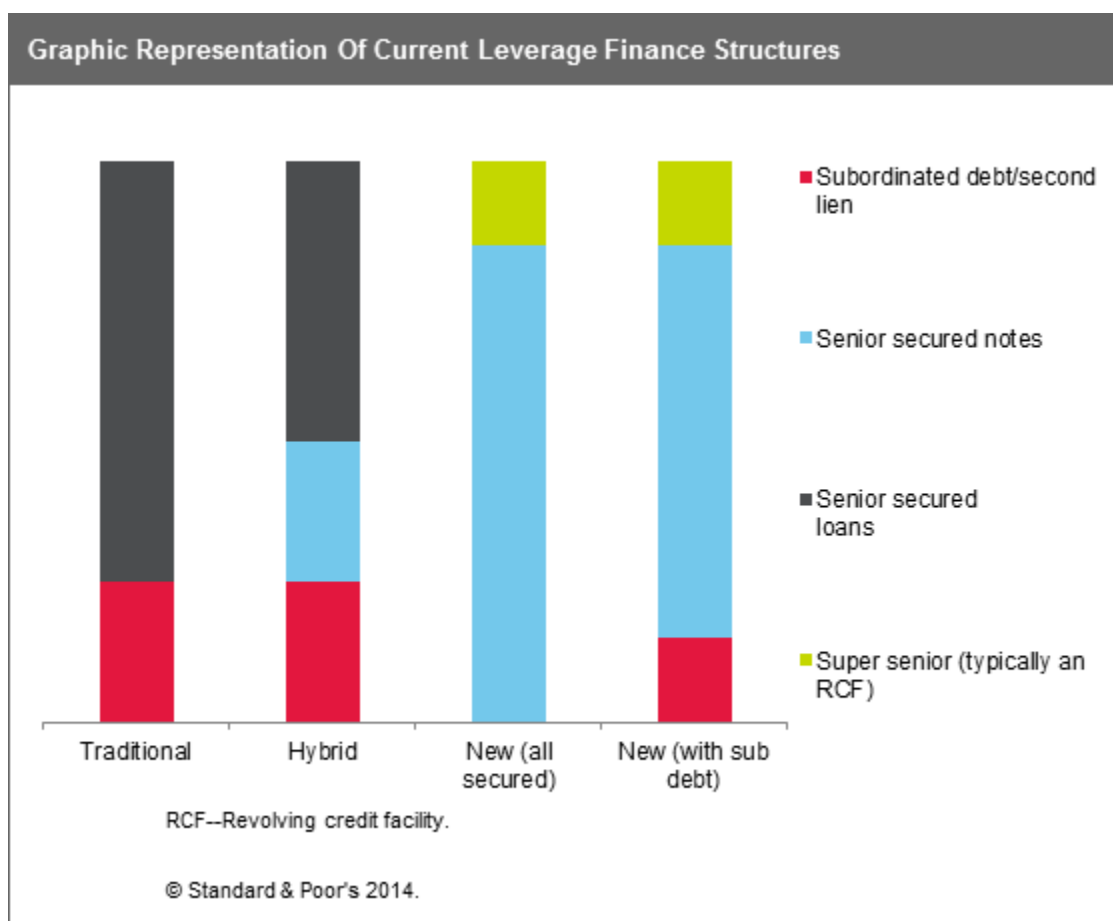
observed a new phenomenon: the use of secured bond financing to refinance existing bank debt. Before the crisis, leveraged buyouts (LBOs), the predominant form of speculative-grade financing in Europe, were usually financed with senior secured loans and subordinated debt in the form of mezzanine financing. From 2000, high-yield bonds were increasingly used to fund the subordinated portion, although mezzanine finance remained dominant.

Another pre-crisis trend was the increasing use of institutional investment alongside traditional bank funding, mostly in the form of collateralized loan obligations (CLOs). But post-crisis, as the market began to recover, banks were no longer able to support the market as before and new CLOs were unable to price. So bond investors stepped in with senior secured financing, leading to hybrid transaction structures (see table 1 and chart 1). But the liquidity available in the senior secured market eventually allowed borrowers to refinance their entire senior structure, which we've termed a new capital structure in contrast with the more traditional pre-crisis structure. These new structures now compete with traditional structures in Europe, being used on 21 transactions so far in 2014, compared with 30 traditional structures and nine hybrid structures. (We've excluded seven structures from the dataset in this study because we consider them to be bespoke structures for certain types of companies or situations).

Table 1

Standard & Poor's Definitions Of Leverage Finance Structures	
Traditional	Combination of senior secured loan debt and subordinated debt (either high yield notes; mezzanine or second lien loans).
Hybrid	Introduction of senior secured notes ranking pari passu with senior secured loans within the traditional structure framework.
New	Priority bank facilities (e.g. super senior revolving credit facility) with the majority of funding provided through a combination of secured and/or unsecured notes.

Chart 1



Senior Secured Debt Does Not Always Mean Better-Than-Average Recoveries

These structural changes in leveraged finance funding have resulted in changes to our recovery expectations. We assign recovery ratings indicating expected recovery post-default to speculative-grade companies on a scale between '1+' (see table 2), indicating our expectation of full recovery, to '6', indicating our expectation of negligible recovery. (For more information, see "Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt," published Aug. 10, 2009, on RatingsDirect).

Table 2

Recovery Rating Scale And Issue Rating Criteria			
For issuers with a speculative-grade corporate credit rating			
Recovery rating	Recovery description	Recovery expectations*	Issue rating notches relative to corporate credit rating
1+	Highest expectation, full recovery	100%¶	+3 notches
1	Very high recovery	90%-100%	+2 notches
2	Substantial recovery	70%-90%	+1 notch
3	Meaningful recovery	50%-70%	0 notches

Table 2

Recovery Rating Scale And Issue Rating Criteria (cont.)			
4	Average recovery	30%-50%	0 notches
5	Modest recovery	10%-30%	-1 notch
6	Negligible recovery	0%-10%	-2 notches

*Recovery of principal plus accrued but unpaid interest at the time of default. ¶¶Very high confidence of full recovery resulting from significant overcollateralization or strong structural features.

When senior secured bonds started to replace existing bank debt in 2009-2010, we typically assigned a recovery rating of '2' (70%-90% recovery of principal), leading to an average of 2.4 across seven issuers with such structures in 2009. But by 2010, we were assigning debt with a "senior secured" nomenclature a recovery rating of '3' (50%-70% recovery), with an average of 3.1 across 18 issuers. So far in 2014, the recovery rating average has fallen further to 3.6 across 30 transactions (including new and hybrid structures). For hybrid structures alone, meanwhile, our expected recoveries are much higher--at an actual recovery rating average of 3 for nine transactions so far in 2014. Nevertheless, this is still lower than the average recorded in 2009.

We see two reasons for the consistent slide in recovery expectations. First, companies are using bonds in a different way. In 2009 and 2010, firms mainly used senior secured bond debt to refinance existing senior secured loan debt on a pari passu basis. Over the past 12 months, however, the more common use of senior secured debt issuance is to refinance entire debt structures--typically with a super priority revolving credit facility (RCF) ranking ahead of the new senior secured debt. So far in 2014, 21 European companies with speculative-grade public ratings or private credit estimates issuing debt have adopted this structure. This compares with seven companies in 2010 and three in 2009.

Second, the quantum of senior secured debt relative to the entire capital structure has increased as a result of refinancing, which affects expected recoveries post-default, particularly where stressed valuations are low. When we strip out the hybrid structures, the recovery rating average for senior secured bonds is even lower at nearly '4' (30%-50% recovery), with the average being 3.8.

Overall, we are assigning an increasing number of '4' recovery ratings to structures with sizable senior secured bond tranches. These debt tranches, although often secured, are subordinated to priority RCFs or other secured financing sources such as factoring facilities, all providing working capital.

As recovery ratings move lower, so do numerical recovery values, so we see potential for these ratings to shift even lower, to the '5' category. For recent issuers Deoleo and Soho House Group Ltd. we see recovery prospects at the low end of the 30%-50% range in the '4' recovery rating category. That said, there have been only a couple of exceptional occasions over the past 18 months where we've assigned a recovery rating of '5' (10%-30% recovery of principal) to senior secured debt instruments.

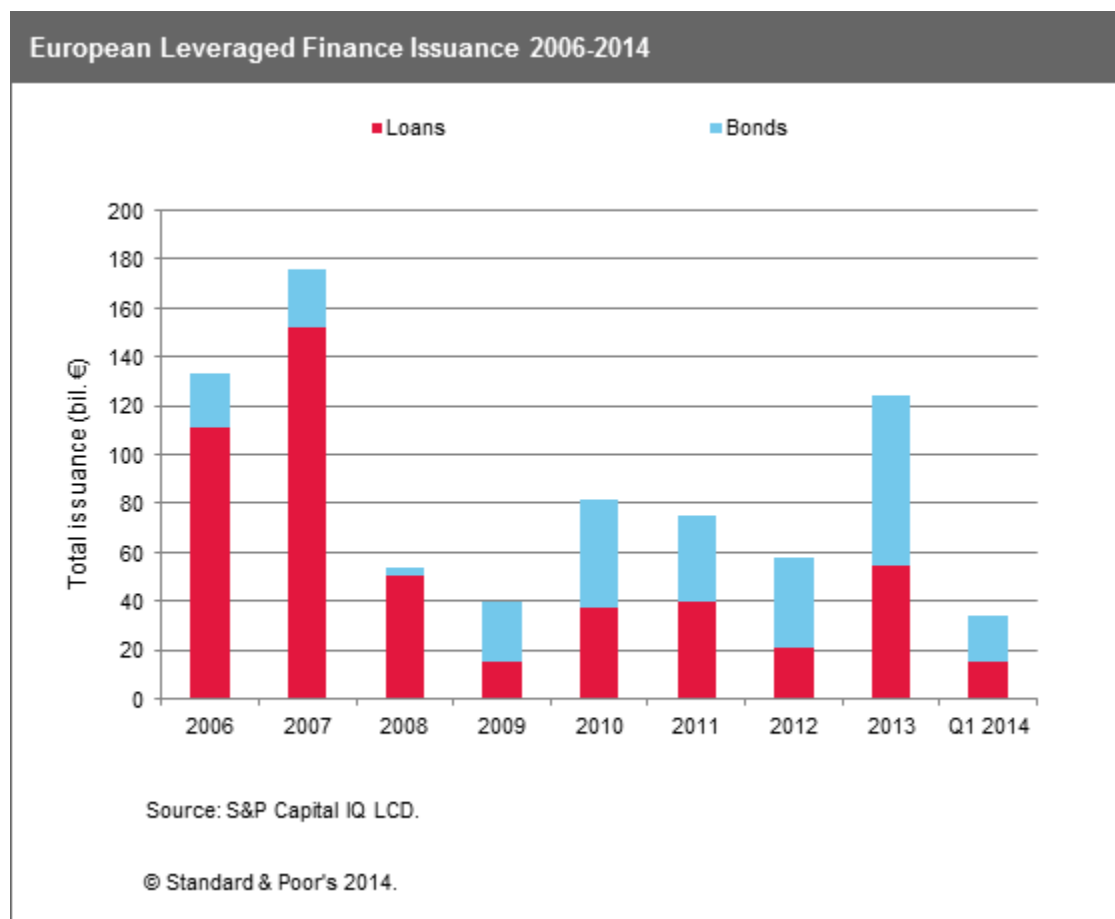
We've started to examine the structures that have been through actual defaults in our empirical data study, which looks at evidence on actual recoveries. We have data on only two cases where the structures included super senior RCFs and senior secured notes and lenders of the RCFs received full recovery. The mean and median recoveries for the senior secured notes, however, were 39% and 37%, respectively, reflecting an actual recovery rating of '4'. For more details on our empirical recovery experience, see "European First-Lien Recovery Rates Remain Strong As

Issuance Volumes Near 2006 Level," published June 18, 2014.

Demand Exceeds Supply Despite Rebound In Issuance

To the end of the first quarter of 2014, the mix of bond to loan financings in the European leveraged finance market held steady from last year at 56% of all leveraged finance activity, according to data from S&P Capital IQ LCD (see chart 2). But loan issuance returned in 2013, in part, due to the return of the CLO market, which lends floating-rate loan debt. Such a development contrasts sharply with the situation in 2009-2012, when publicly rated CLO issuance reached a hiatus.

Chart 2



Appetite for speculative-grade credit has been so strong of late that supply has not kept up with demand, largely because many companies have already refinanced their debt and mergers and acquisitions (M&A) issuance has not yet returned. That said, supply may be returning because M&A activity in 2014 has almost caught up with that for the whole of 2013. Nevertheless, the general lack of debt supply has resulted in ever-tighter pricing for new issuance of both loans and bonds. In May this year, for example, ball-bearing manufacturer Schaeffler AG, rated 'BB-', was able to reduce its average cost of funding to about 3.5%, compared with 8% previously. Putting pricing for speculative-grade

companies in context, bond yields for 'B' and 'BB' rated entities are 5.3% and 3.2% on June 17, well below their 6.9% and 5.3% lows before the crisis at the end of 2006, according to the Bank of America Merrill Lynch Bond Index (see chart 3). Spreads on leveraged loans have not yet hit pre-crisis levels (see chart 4), however, the cost to borrowers when taking into account EURIBOR, has declined from 4.3% in mid-2007 to 0.7% at the end of the first quarter.

Chart 3

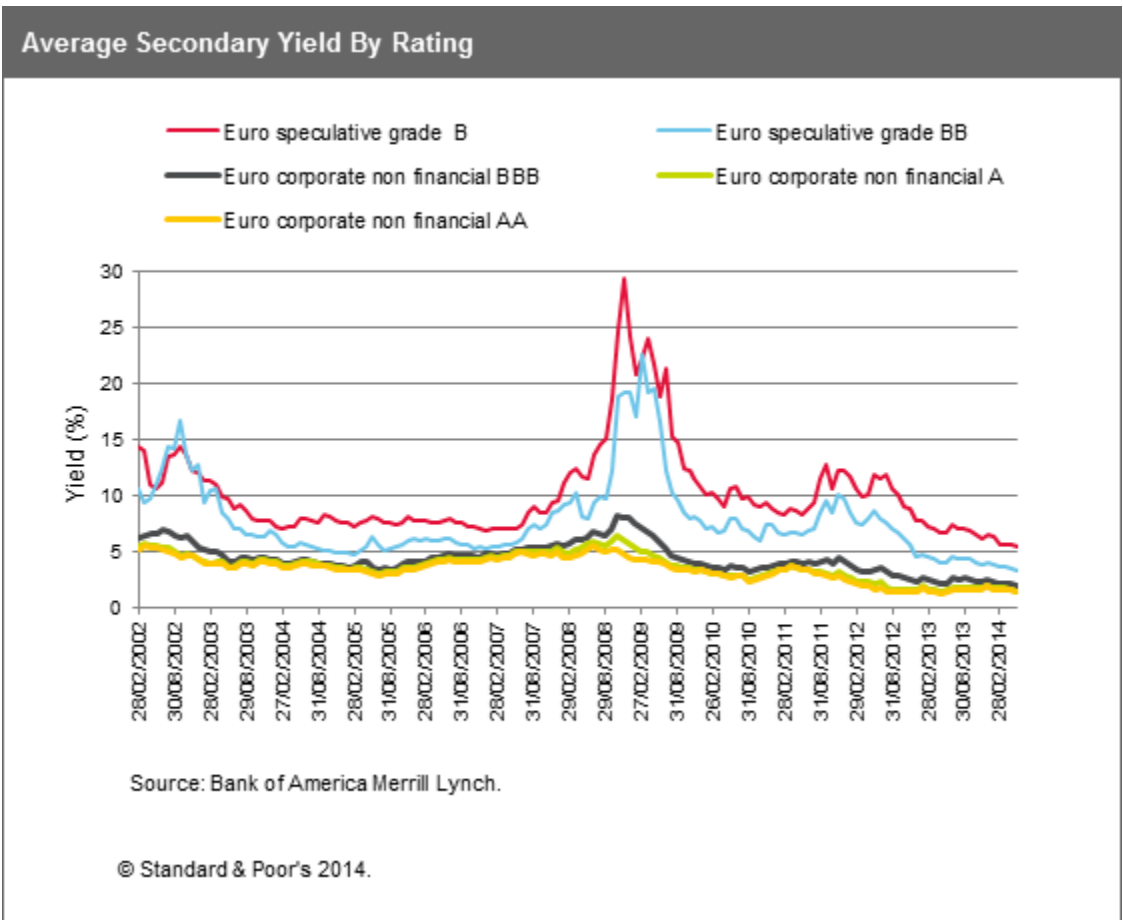
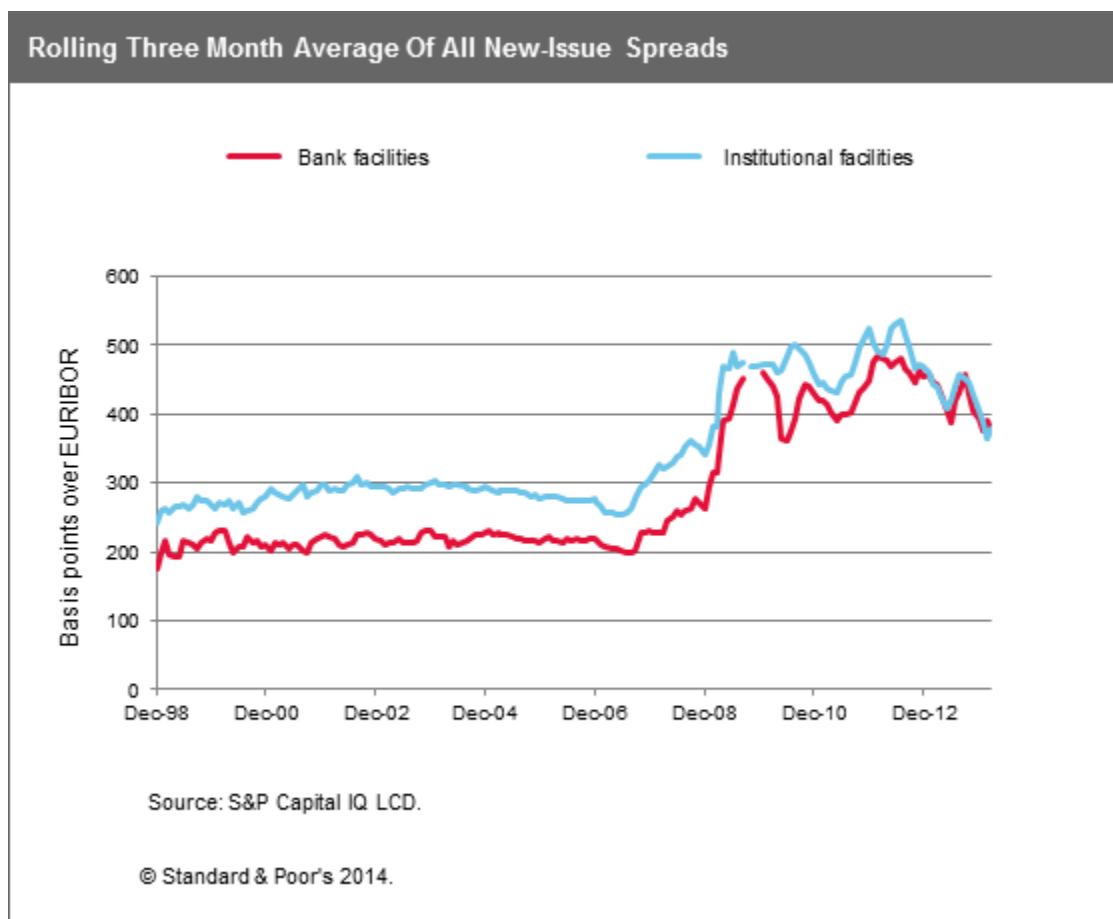


Chart 4



Sponsored Transactions Exhibit More Sober Leverage Than In The U.S.

The general lack of supply is allowing an increasing number of lower-rated companies to tap the market, and for debt-to-EBITDA multiples for specific European transactions to stretch higher in the past few years. We've seen the amount of issuance from both 'BB' and 'B' companies in the European high-yield market grow substantially in 2013 (see chart 5). At the same time, total debt-to-EBITDA multiples in Europe have for the first time since 2008 risen above the 10-year average (see chart 6). When we compare this data to that for the U.S. market, we observe that the trend in the two regions of a steady climb in leverage is similar.

However, we also split the data by transaction type--sponsored private equity transactions versus non-sponsored corporate transactions. We found that for sponsored transactions sold to European investors, debt-to-EBITDA multiples remain lower than for those sold into the U.S. (see chart 7). We believe this is because the European leveraged finance market is still slightly more borrower-friendly than it is across the Atlantic. Furthermore, such conditions are the reverse of those seen between 2004 and 2008, when debt multiples on sponsored European transactions were higher than in the U.S. due to institutional funding flooding into the European leveraged finance market for the first time. But the spike in defaults from this cycle, which peaked in the third quarter of 2009, injected

some sobriety into the market--perhaps more so than in the U.S. because it was the first real credit cycle in Europe in this market. Since that time, debt-to-EBTIDA levels in Europe have remained more measured, particularly in relation to the U.S. market.

Chart 5

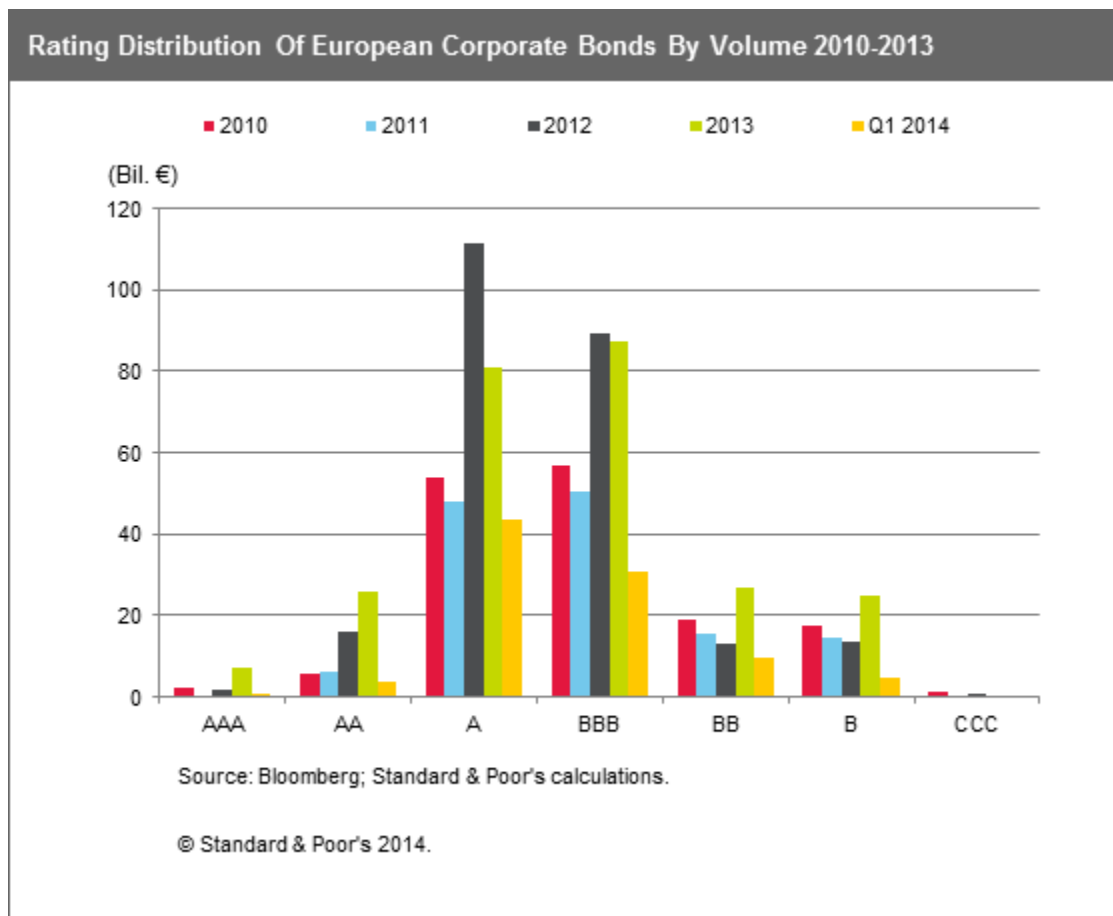


Chart 6

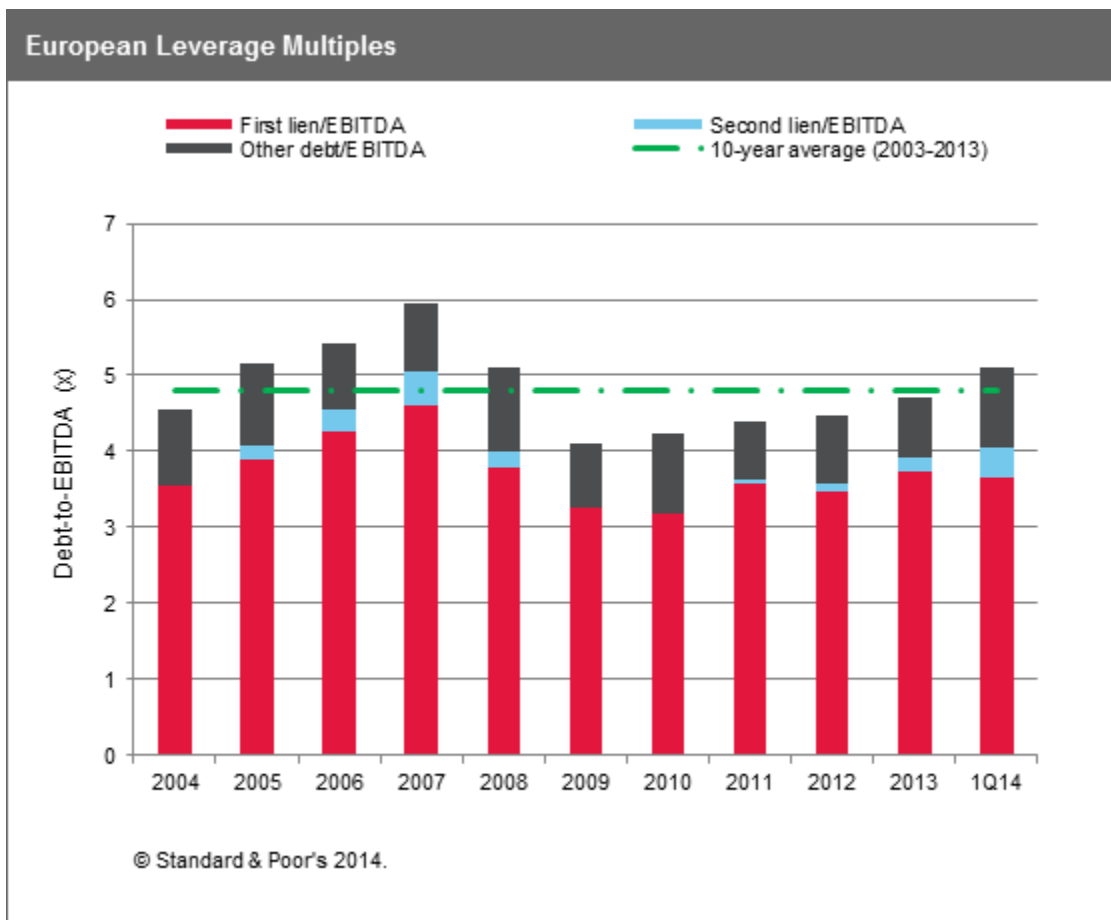
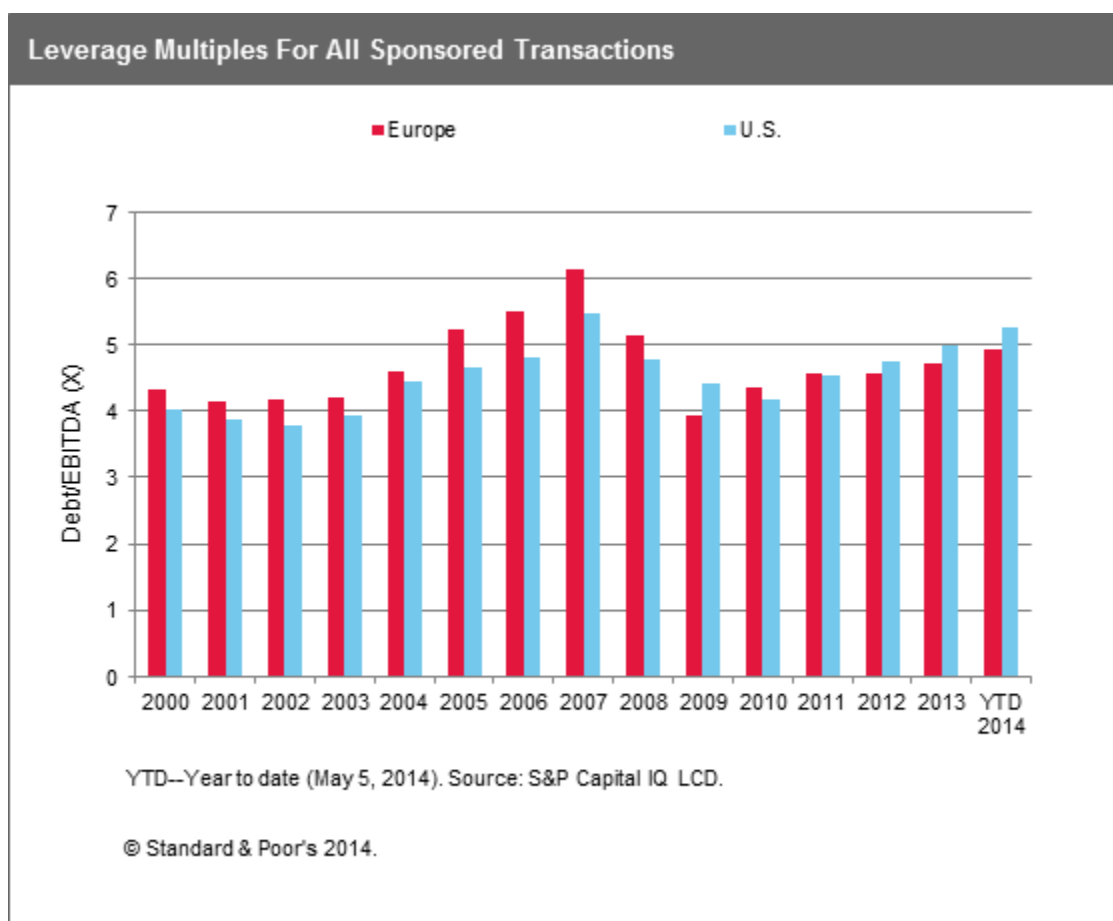
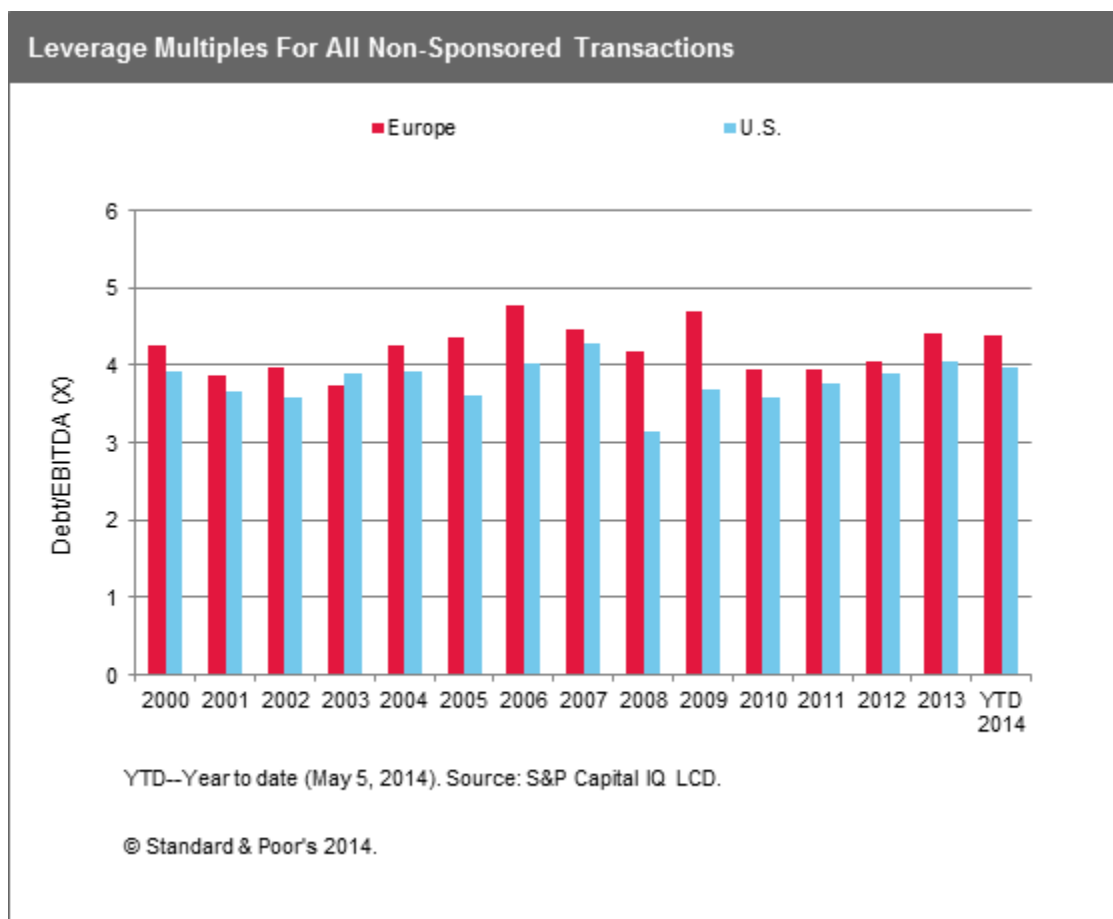


Chart 7



As we would normally expect, debt multiples for non-sponsored corporate transactions remain lower than those of sponsored LBO transactions (see chart 8). But the U.S. companies in this dataset are more conservative in terms of leverage. We believe this is due to the fact that in the U.S. there is a well-developed market for non-sponsored leveraged transactions, typically coming from larger, higher-rated credits with lower leverage. By contrast, in Europe, this corporate market is still developing, so it is difficult to compare the two.

Chart 8



Covenant-Lite Loans Creep In On Cross-Border Transactions

In addition to borrowers lower down the credit spectrum tapping the capital markets, and leverage creeping higher, we observe a trend toward weaker credit protection, in the form of covenant-lite loans. In our view, these loans may challenge lenders when the credit cycle turns. We also note that the liberal use of senior secured bonds in European speculative-grade borrowers' capital structures of late replicates a covenant-lite loan structure, since by their nature such bonds are "covenant lite" in that they lack maintenance covenants.

Covenant-lite loans have been a recognizable feature of the leveraged finance landscape in the U.S. in 2013 and 2014. So far in 2014, there have been three European covenant-lite loans syndicated in Europe including Deoleo, S.A. Prior to these three transactions, the elimination of covenants on loan tranches was limited to those deals syndicated into both the European and U.S. dollar-denominated market or the U.S. market alone.

One example of a European borrower that has syndicated a U.S. dollar-denominated covenant-lite loan is Unit4 (AI Avocado B.V.). These structures typically have a so-called "springing" covenant on the RCF only, tested only when utilization is above a specified percentage (typically 25%-35%). We consider that these transactions fall into the

covenant-lite category since there are no standard maintenance covenants tested on a regular basis and the springing covenants have substantial headroom.

All Signs Point To More Aggressively Structured Transactions

For now, we expect companies to continue to take advantage of the demand and supply imbalance to seek advantageous pricing and liquidity from both European and U.S. investors. The degree of this imbalance will influence the structure of transactions in terms of recovery prospects, leverage, and the lack of covenants. However, in the low interest rate environment, and with current market conditions, all signs point one way--toward more aggressive capital structures.

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Related Criteria And Research

Related criteria:

- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009

Related research:

- European First-Lien Recovery Rates Remain Strong As Issuance Volumes Near 2006 Level, June 18, 2014
- Inside Credit: Leveraged Credit Conditions In Europe Become Increasingly Stretched As Investor Demand Outstrips Supply, April 10, 2014

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