Europe
Special Report

European High-Yield Issuance and Default Review: New Dawn

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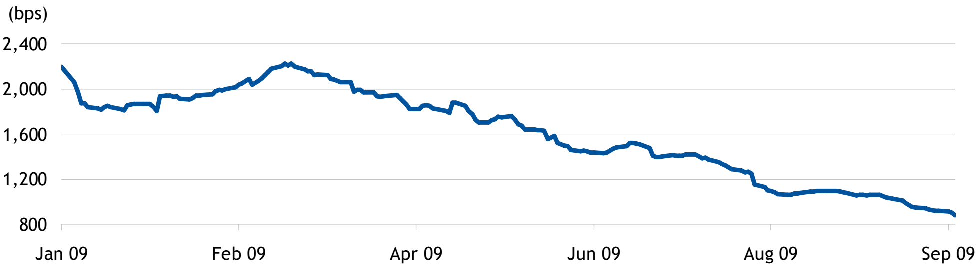
Executive Summary

After 18 months of minimal primary market activity since the onset of the credit crisis in summer 2007, European high-yield corporate bond issuance has reached EUR20bn thus far in 2009, and is poised to rise further. The dramatic return of risk appetite, and the corresponding demand for the refinancing of near-term (principally bank) debt maturities among European "fallen angels" and legacy high-yield borrowers, suggests that the high-yield product may be on the precipice of its long-awaited arrival as a corporate financing instrument and an asset class of choice for European borrowers and investors.

Notwithstanding rising default volumes and poor recoveries for legacy high-yield bonds issued in 2004 to 2007, the product stands ready to provide one of the few solutions to speculative-grade European corporate borrowers heretofore overly reliant on private bank and structured credit alternatives that may no longer offer reliable volumes.

Chart 1: European High Yield Spread Development

Ave. daily hy spread to worst (Jan 09 until Oct 09)



Source: Bloomberg, Merrill

Since the beginning of 2009, the ongoing combination of historically low policy rates and ongoing banking system deleveraging has directed yield-seeking investors and corporate treasurers attempting to diversify away from or replace legacy lending arrangements toward corporate bonds. European investment-grade corporate bond issuance reached EUR236bn equivalent in H109, compared with EUR100.3bn equivalent during H108, as corporate treasurers paid historically high spreads to replace maturing bank lines and enhance liquidity profiles, while investors seeking income were forced out along the curve in terms of duration and credit quality in the light of record low government bond yields.

The same dynamics that drove large high-quality investment-grade borrowers to issue bonds in early 2009 slowly extended to European high-yield; with Fresenius in February 2009, followed by Virgin Media in June and, later, Wind Telecommunications in July, among others. Again, despite high spreads and coupons in relation to their credit quality, these issuers re-opened a dormant European high-yield market and set the template for further issuance. The market is specifically open to quality, well-known legacy high-yield credits in defensive sectors, as well as fallen angels that benefitted from plausible deleveraging stories involving asset sales and relationship bank support in underwriting complementary equity rights issues.

The corroborative effects of tightening secondary market spreads, successful recapitalisations, restored confidence in the financial system, and corresponding stabilisation in economic and business conditions, all appear set to carry on — such that European high-yield issuers and investors will eagerly embrace the product as part of economic and financial system recovery. Moreover, the heavy-volume arrival of new industries into the high-yield market — such as Pernod Ricard and Peugeot — demonstrates the potential for European high-yield to develop the similar reach and maturity that characterises its US counterpart.

European high-yield has developed from a niche provider of growth capital to alternative telecom issuers in the late 1990s, to large volume solutions for fallen angel and large leveraged buyouts in the mid-2000s, towards a long-term source of patient capital for Europe's legion of unrated industrial champions.

The challenge now appears to be maintaining current (October 2009) momentum such that spreads tighten further so as to coax reluctant privately held and privately financed borrowers — such as the large number of legacy European leveraged buyout and "Mittelstand" borrowers — to tap investor demand and boost high-yield issuance yet further. Given the legacy leverage levels on leveraged buyouts, and relatively distant refinancing pressures, it is unlikely that financial sponsors will take advantage of the market's current appetite, as they will remain content to wait for further improvement in business and capital market conditions before locking in high coupons inherent in high-yield bonds. Likewise, Mittelstand borrowers are long accustomed to cheap, flexible bank credit at modest spreads, and may find the price and the terms of credit in the high-yield bond market — and, indeed, the wholesale changes in reporting and disclosure — too cumbersome in the near term.

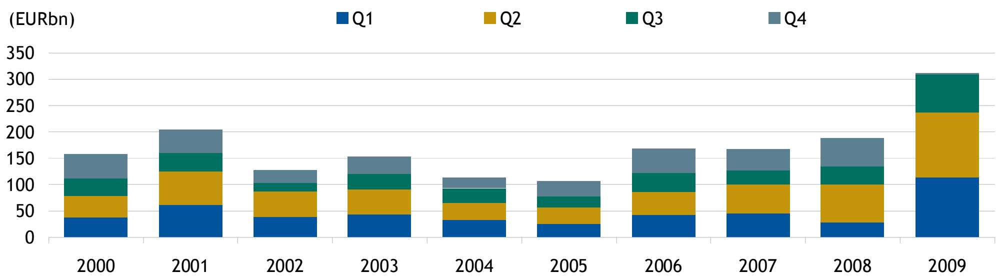
European High-Yield in 2009

New Issuance in 2009 Ending the Trough

In addition to the favourable policy environment that helped stabilise financial system concerns, new issuance in corporate bonds — both broadly, and in European high-yield in particularly — is supported by evidence of global economic recovery, outlined by Fitch's sovereign group in its *Global Economic Outlook* dated 1 October 2009. What began as defensive borrowing to reduce reliance on deleveraging banks, has turned into opportunistic financing in the light of economic recovery.

Chart 2: European Investment Grade Issuance

2000 - end September 2009 by quarter

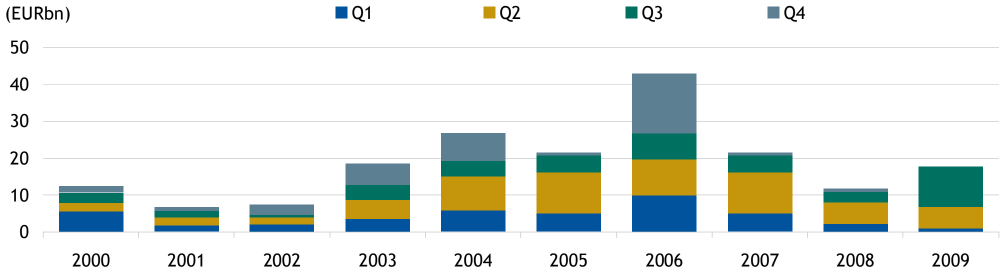


Source: Dealogic

At the start of 2009, the corporate bond market for investment-grade issuers ushered in the capital market revival with a record monthly volume of EUR56.6bn in January, led by French utility companies EDF, GDF Suez and German utility EON, as well as German carmaker Volkswagen, each of which contributed with multi-billion offerings to yet another record issuance of EUR236bn during H109.

The European corporate high-yield market was almost dormant through 2008, although issuance volume continued in banking & finance and emerging markets. However, given the rapid supply of investment-grade-rated issues at historically attractive spreads in early 2009, the migration carried on down the credit curve to a few well-known high-yield issuers — including 'BB' rated German healthcare company Fresenius, which managed to successfully place a total EUR648m equivalent of bonds at a yield of 10.5% that included a USD500m tranche for its larger and more liquid US investor base.

Chart 3: European High Yield Issuance
2000 - end September 2009 by quarter



Source: Dealogic

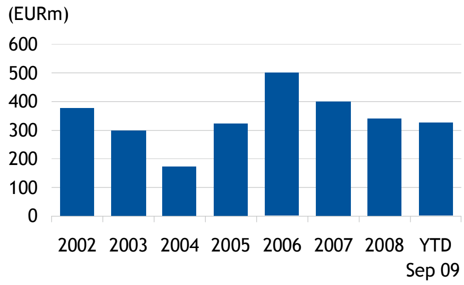
Fresenius was followed by UK telecom Virgin Media's total EUR1.15bn equivalent in June and a tap issue in July, used to prepay senior debt and reduce its 2012 maturities. By July 2009, as the Q209 reporting season signalled more stability and rising risk appetite, high-yield issuance substantially picked up:

- 'BB+' rated French car maker Peugeot sold a five-year EUR750m bond tranche that led to a record high EUR10.8bn total of high-yield issuance during Q309 alone
- 'BB-' rated Italian telecoms operator Wind Telecomunicazioni made a USD2bn and EUR1.25bn offering to refinance EUR2bn PIK loans and execute EUR700m in dividends
- 'B+' rated Danish business services company ISS issued EUR525m five-year senior notes to fund a tender for up to EUR500m of existing euro medium-term notes due 2010
- Following its three-year EUR1.25bn offering at 9% in July, 'BB+' rated Italian carmaker Fiat SpA managed to take advantage of improved market sentiment and place an otherwise identical five-year EUR1.25bn bond at 7.625% only two months later, in September 2009.

European High-Yield Investors Returning to Risk?

Fitch notes that high-yield issuers during the first nine months of 2009 displayed either proven and defensible business models predominately in the telecoms, healthcare, food, energy and utilities sectors, eg Wind Telecomunicazioni, Virgin Media, Fresenius; or were fallen angels in the high-speculative-grade ratings category ('BB' range), eg car makers Fiat, Renault and Peugeot. Unlike the US market, where most issuers are publicly registered and widely followed, there has been little market demand for low-

Chart 4: Average EHY Issuance Size
By issuer



Source: Bloomberg, Fitch

single-'B' rated issuers. Moreover, with the exception of Wind's eight-year non-call-4 that had an initial yield of 12.25%-12.5%, most new high-yield issues came with a tenor of 5-7 years and non-call features of two years, and a yield of 9%-9.5% at the outset.

Most recently, in October 2009, 'B' rated Heidelberger Cement (HC) placed three euro tranches totalling EUR2.5bn to help refinance its most pressing near-term maturities. Fitch considered that, in combination with an accompanying rights issue and asset disposal programme, the deleveraging of the balance sheet, and extension of the maturity profile in case of a successful placement, would result in HC's IDR being upgraded by up to two notches (see Fitch's rating action *Fitch Places Heidelberg Cement's 'B' IDR on Rating Watch Positive*, dated 12 October 2009). Moreover, the size of the issuance could mark a crossroads for the European high-yield market, and characterises investors' appetite for riskier high-yield at lower yields than witnessed at the onset of the market recovery.

A Maturing European High-Yield Market

The composition of the European high-yield market has substantially diversified from the telecom- and cable-dominated market at the time of the last default peak in 2002. Today's market is almost three times larger and more diversified, with telecom and cable only accounting for approximately 10% versus around half of the market in 2002 — although TMT is still the largest-single non-financial sector, along with automotive. Recent arrivals from global drinks group Pernod Ricard and European auto original equipment manufacturers (OEMs) Renault, Peugeot and Fiat, add further to the reach of the European high-yield universe.

Selection of the 20 Largest European High-Yield Issuers Year-to-Date 2009

	Issuer	Sector	Country	Issuance currency	Equiv. (EURbn)	Tenor years	Coupon	Yield	Date	Rating[a]
1	Wind	Telecom	Italy	USD	1.4	8	11.75	12.2	13 Jul	B+
	Wind	Telecom	Italy	EUR	1.25	8	11.75	12.05	13 Jul	B+
2	Heidelberg C.	Building & Materials	Germany	EUR	1.0	5	7.5	7.88	14 Oct	B+
	Heidelberg C.	Building & Materials	Germany	EUR	1.0	7	8	8	14 Oct	B+
	Heidelberg C.	Building & Materials	Germany	EUR	0.5	10	8.5	9	14 Oct	B+
3	Fiat	Automobile	Italy	EUR	1.25	3	9	9.05	28 Jul	BB+
	Fiat	Automobile	Italy	EUR	1.25	5	7.63	7.66	15 Sep	BB+
4	Dt. Lufthansa	Transportation	Germany	EUR	0.85	5	6.75	6.78	24 Mar	BB+
	Dt. Lufthansa	Transportation	Germany	EUR	0.75	7	6.5	6.53	7 Jul	BB+
5	Haniel	Consumer Products	Germany	EUR	1.0	5	6.75	7	15 Oct	BB+
6	Pernod Ricard	Food & Beverage	France	EUR	0.8	5.5	7	7	15 Jun	BB+
7	Renault	Automobile	France	EUR	0.75	5	6	6.13	29 Sep	BB
8	Virgin Media	Telecom	UK	USD	0.54	7	9.5	9.94	3 Jun	B+
	Virgin Media	Telecom	UK	EUR	0.18	7	9.5	9.94	3 Jun	B+
	Virgin Media	Telecom	UK	USD	0.43	7	9.5	9.94	3 Jun	B+
9	Peugeot	Automobile	France	EUR	0.75	5	8.375	8.46	15 Jul	BB+
10	ISS	Business Services	Denmark	EUR	0.53	5	11	11	15 Jul	NR
11	Elan	Healthcare	Ireland	USD	0.43	7	8.75	9	29 Sep	B
12	Fresenius	Healthcare	Germany	USD	0.37	6.5	9	-	15 Jan	BB
	Fresenius	Healthcare	Germany	EUR	0.28	6.5	8.75	10.62	15 Jan	BB
	Fresenius	Healthcare	Germany	EUR	0.15	9	5.5	-	3 Jun	BB
13	Mobile Tele Systems	Telecom	Russia	RUB	0.34	5	16.75	16.75	19 May	BB
	Mobile Tele Systems	Telecom	Russia	RUB	0.34	7	14.25	14.25	28 Jul	BB
14	Severstal	Metals & Mining	Russia	RUB	0.3	3	14	14	22 Sep	BB-
15	Ardagh Glass	Consumer Products	Ireland	EUR	0.3	7	9.25	9.43	26 Jun	BB-
16	UPC Holding	Computer & Electr.	Neth.	EUR	0.18	9	9.75	-	23 Apr	B
	UPC Holding	Computer & Electr.	Neth.	EUR	0.06	9	9.75	-	23 Apr	B
	UPC Holding	Computer & Electr.	Neth.	EUR	0.15	9	9.75	-	21 May	B
17	UPC Holding	Computer & Electr.	Neth.	USD	0.29	9	9.88	11.08	29 May	B-
18	Petroplus	Oil & Gas	Switz.	USD	0.28	10	9.38	9.63	9 Sep	B+
19	Stora Enso	Forest & Paper	Finland	EUR	0.23	5.5	5.13	12.25	14 May	BB
20	Ceva	Transportation	Netherl.	USD	0.16	7	11.63	12.25	30 Sep	CCC

[a] Indicates composite instrument rating
Source: Dealogic, Bloomberg, Fitch

Following the 2002 default cycle, high-yield survived in the interim as a source of fallen angel financing in 2003 and 2004, as well as the only source of subordinated debt in large volumes that accompanied jumbo leveraged buyouts from 2005 to 2006. Despite a decline in large volume transactions during the last market peak in H107, high-yield issuance depended on an increased proportion of senior secured floating-rate notes with little prepayment protection — as a viable alternative to record volumes in senior secured loans. The abrupt turn in credit market conditions in H207 meant that high-yield issuance was effectively closed. Despite an ongoing low-default environment for the fifth consecutive year, there was minimal corporate high-yield issuance during 2008 and through to Q109, as the credit crisis prevailed and nominal issuance was only sustained by credit-linked notes and loan participation notes issued by financial institutions in relation to emerging market transactions.

Fitch's European High-Yield Default Index

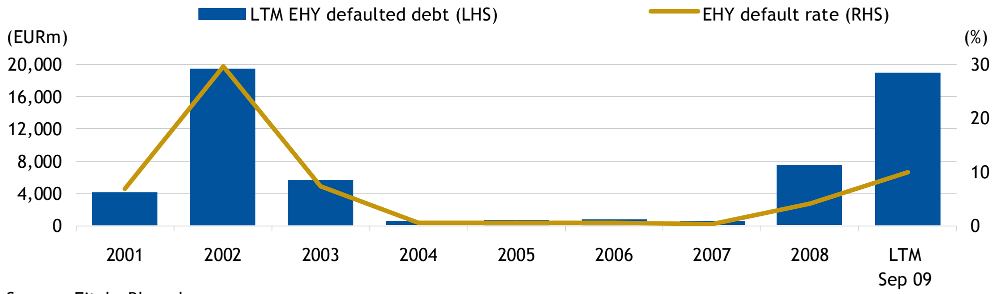
- Based on the non-investment-grade, non-convertible, speculative-grade Eurobond market, also including non-European-based issuers. Includes issuance by corporates as well as by financial institutions in relation to emerging markets
- Includes issues rated (by Fitch, or at least one of the two major rating agencies)
- Uses a composite rating of the other two major rating agencies by using the lower of the two on a single-notch difference, and the average for all other notch differentials, which are then compared with the Fitch rating using the same methodology
- Defaults include missed coupons or principal payments after the passing of a 30-day grace period and distressed exchanges, unless there is a bankruptcy filing — in which case defaults are immediate

High-Yield Defaults and Restructurings

Rise in European High-Yield Defaults

Chart 5: European High Yield Default Rate and Volume Increases

2001 - LTM Sep 2009

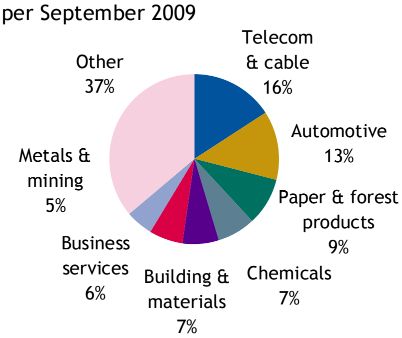


Source: Fitch, Bloomberg

The year 2009 marked the end of a low-default environment that lasted for five years, as the last 12 months (LTM) number of defaulted issuers almost tripled to 26 — from nine at year-end 2008 (YE08). LTM default volumes increased to a new peak of EUR19bn or 10.1% of the outstanding market, a third of which was contributed by LBO issuers, and up from EUR7.5bn or 4.1% at YE08. This is close to the peak default volume of EUR19.4bn in relation to the predominantly defaulted telecom and cable issuers in 2002, when the default rate was close to 30% (as a result of the smaller market outstanding).

Chart 6: European High Yield Market by Sector (Excluding Non Financial)

As per September 2009



Other includes: Broadcasting & media, Food & beverage, Utilities, Cable, Healthcare, Real estate, Transportation, Leisure, Energy, Industrial, Computer, Gaming, Retail

Source: Bloomberg

2009 Defaults and the Face of High-Yield Restructurings

In the aftermath of the credit crisis, European high-yield investors have been faced with an increased number of distressed situations that differ widely in their outcome — including comprehensive operational and balance sheet restructurings, debt write-offs, minor refinancing exercises, or simply maturity extensions. Debt buybacks, increasingly used by borrowers to ease their debt service by taking advantage of their debt trading substantially below par value, include opportunistic debt purchases exercised by LBO borrowers such as Cognis and TDC. In addition, the agency took action on coercive debt exchanges (CDEs), which Fitch considers as default, such as UAB Bite Lietuva which the agency downgraded to 'RD' on 20 March 2009 following the confirmation of the settlement of purchase of over 90% of Bite's subordinated notes (Fitch's published a criteria report on 3 March 2009, entitled *Coercive Debt Exchange Criteria*, available on www.fitchresearch.com).

The average time to default accelerated to 3.3 years, down from 3.8 years at YE08, and 4.4 years at YE05, the low point in the current default cycle. In the largest default to date, LyondellBasell defaulted only one year after the leveraged takeover of US chemical Lyondell by Netherlands-based chemical producer Basell.

Selected List of European High-Yield Defaults Year-to-Date 2009

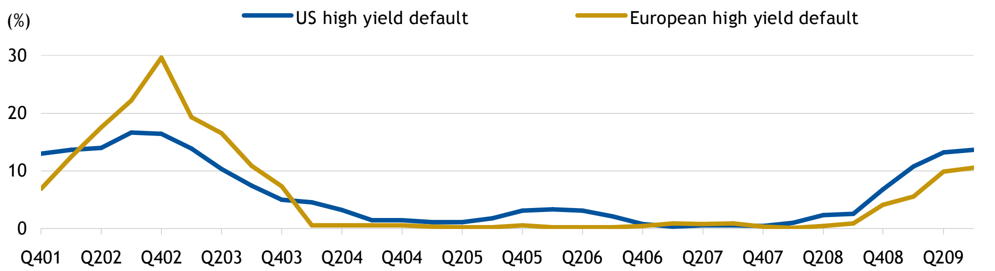
Credit	Fitch sector	Country	Debt volume (EURbn)	Date	Reason
NXP	Computer & Electronics	Netherlands	4.0	April 2009	Debt exchange
Lyondell Basell	Chemical	Netherlands	1.0	February 2009	Payment default
Countrywide	Real Estate	UK	0.9	February 2009	Debt for equity
Sensata	Computer & Electronics	Netherlands	0.8	March 2009	Debt exchange
Ceva	Transportation	Netherlands	0.5	July 2009	Debt exchange
Treofan	Chemical	Germany	0.1	July 2009	Bond for equity
Bite [a]	Telecom	Lithuania	0.1	March 2009	Debt exchange

[a] Rated by Fitch
Source: Bloomberg, Fitch

Will European High-Yield Defaults Follow the US Market?

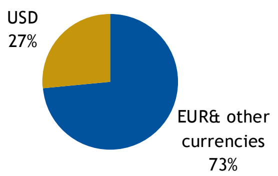
Since 2003, European and US default rates have remained similarly low, while more recently Europe's default rate (10.1% at end-September 2009) followed the increasing US rate (13.6% at end-September 2009) with an approximate six-month delay.

Chart 7: LTM Default Rates: European High Yield vs US High Yield
2001 until LTM Sep 2009



Source: Fitch, Bloomberg

Chart 8: EHY Issuance by Currency
YTD Sep 09

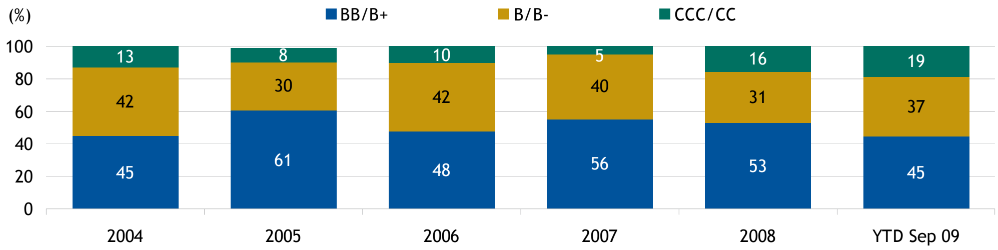


Source: Dealogic, Fitch

By end-September 2009, the European high-yield market had grown to approximately one-third of the corresponding US market volume, up from merely a fraction at its inception in the mid-1990s. Approximately 27% of the outstanding European high-yield market and 2009 year-to-date issuance has been denominated in US dollars, which demonstrates the continued importance of the US investor base. However, unlike the cable and telecom dominated years, which led to a more pronounced default peak in 2001-02 in Europe than in the US, today's market also displays greater sector diversity, more similar to its US counterpart.

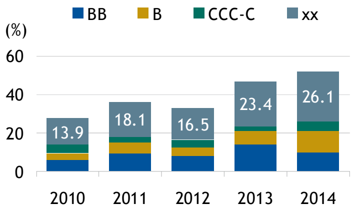
About 30% of the US high-yield market carries an instrument ratings of "CCC and below"' as of September 2009, compared with its European counterpart whose "CCC and below"' rated instrument share increased to 19% by end-September 2009 from only 5% at YE07, indicative of the increased default risk. However, the observed rapid deterioration in credit quality slowed down notably during 2009, as reflected in the improved — yet still negative — upgrade/downgrade ratio: 1:33 (Q109), 1:26 (Q209) and 1:7 (Q309).

Chart 9: EHY Universe by Instrument Rating Group (% of Volume)
2000 - end September 2009



Source: Bloomberg, Fitch

Chart 10: EHY Maturities
By instrument



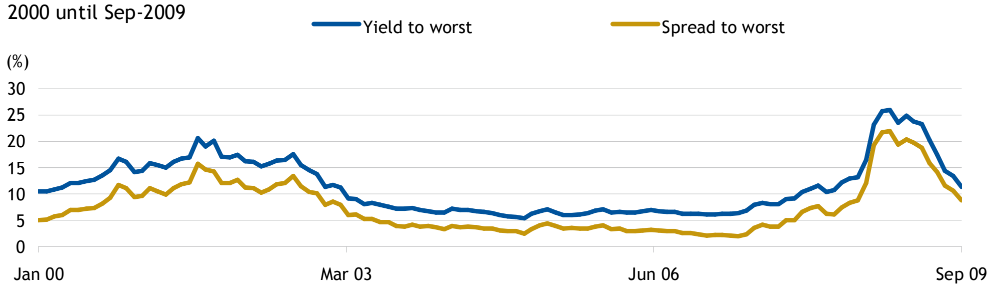
Source: Bloomberg, Fitch

Over 40% of the current high-yield universe will mature over the next five years in both the European and US market. However, only 6% of European high-yield bonds are in need of refinancing during 2010 — including 2% that are currently rated 'CCC' and below, compared with 3% and 1.5%, respectively, in the US market, limiting the risk of further substantial default rate hikes as a result of failed refinancings during 2010, all provided the global economy continues to recover.

Wanted: More Issuers!

Particularly in light of the recent ebb in issuance and secondary market spread tightening toward historical averages in investment-grade, both institutional and retail investor demand is focused on reaching further down the credit quality spectrum — such that, like its US high-yield counterpart enjoying the same dynamics, European high-yield can offer a refinancing solution for almost any borrower. Whereas the most recent issuance of five-, seven- and 10-year notes at yields of 7.875%, 8.5% and 9%, respectively, for Heidelberg Cement (a borrower widely considered distressed only six months ago) represents the latest and most convincing testament to appetite of investor demand, the prevailing challenge remains finding primary market issuers to satisfy such demand.

Chart 11 - European High Yield: Yield to Worst/Spread to Worst Development
2000 until Sep-2009



Source: Bloomberg, Merrill

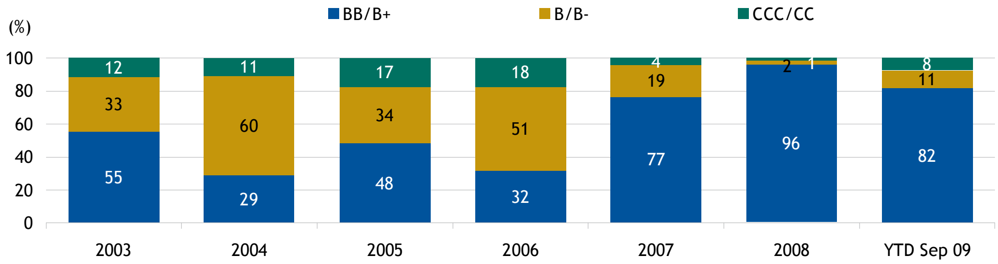
As noted, most issuers year-to-date have been 'BB' rated or "crossover" credits in the eyes of investors. They are generally characterised either as large fallen angels with public equity listings that have benefitted from complementary balance-sheet-enhancing equity rights issues, or well-known legacy credits with proven business models in the eyes of institutional high-yield investors. These issuers have also taken a pragmatic approach, in so far as 2009 high-yield coupons, in light of financial system volatility, are notably higher in comparison to coupons during peak of the market in 2006-7. That said, in the context of a full market cycle, high-yield coupons — while presently high compared with 2004-2007 — are in line with the 10-year average.

Moreover, much of the issuance to date in 2009 for large-volume borrowers such as Heidelberg, Evonik, Fiat, Peugot and Pernod continues to be presented in the form of Eurobonds as opposed to the US-oriented European high-yield indenture. Borrowing via Eurobonds allows issuers to maintain bi-annual reporting and disclosure practices in line with their equity listings, and maintains investment-grade-style covenant flexibility. In the absence of traditional, US-style covenant packages, many of these have coupon step-up clauses in the event of downward rating migration, or benefit from upstream guarantees that fall away in the event of upgrade to investment-grade.

The Eurobond format allows borrowers to access European retail investors, actively seeking yield in well-known, recognised branded borrowers. It also allows fallen angel issuers to maintain pari passu ranking with legacy investment-grade issues that remain on balance sheet. The number of borrowers eligible for traditional investment-grade investors to reach into "crossover" speculative-grade territory in search of yield or satisfy the retail investor demand for well-recognised national brands, may become more limited.

Consequently, bankers will look to the large number of privately held and privately financed borrowers in the EUR 400bn leveraged credit market, or among Europe's unlisted and unrated Mittelstand that must address refinancing pressures due to withdrawing bank credit. Unlike the US, where even 'CCC' rated issuers are accepting 12+% coupons in the effort to extend maturities and allow for potential credit improvement in tandem with economic recovery, Europe has yet to witness widespread 'CCC' issuance, with the noted exception of 'CCC' rated Dutch transportation group Ceva Logistic.

Chart 12: European High Yield Issuance by Instrument Rating Group
In % of volume



Source: Bloomberg, Fitch

Don't Rely on Leveraged Buyout Credits … Yet

As discussed at length in the agency's latest *European Leveraged Credit Market Review*, published in tandem with this report and available at www.fitchratings.com, the problem for leveraged credits remains their legacy leverage. Not only are median total leverage levels for Fitch's approximately 270 privately rated leveraged credits rated 'CCC' and above still near 7x EBITDA, the legacy debt remains historically cheap on both a spread and absolute basis — as it was arranged at the peak of the previous cycle. Why would a financial sponsor refinance cheap, flexible bank debt with more expensive high-yield coupons and associated prepayment penalties and covenant restrictions? Indeed, sponsors are compelled to wait well into 2010 and even into 2011 in anticipation of more spread tightening in the high-yield market, a complementary revival of senior debt markets, and further deleveraging portfolio companies before considering the high-yield option. Fitch anticipates that sponsors are more likely to pursue equity-oriented exits as they develop, rather than extend maturities.

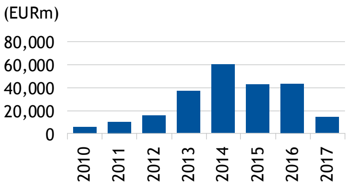
European High-Yield Issuers and LBO Borrowers Targeting Public Offerings/IPOs in 2010

Company	Sector	Country	Sponsor	HY/private debt
Acromas (AA Saga)	Insurance	UK	CDC, CVC, Permira	Private
Amadeus	Business Services	Spain	BC Partners/Cinven	Private
Baratt	Buildings & Materials	UK	Public	HY
Brenntag	Transportation	USA/Germany	BC Partners	Private
Heidelberger Cement	Buildings & Materials	Germany	Merkle	HY
Iglo Birds Eye	Food	UK	Permira	Private
Medica France	Healthcare	France	Healthcare	Private
Merlin Tussauds	Gaming, Lodging & Leisure	UK	Blackstone-Kirkbi-DIC	Private
Mivisa	Packaging	Spain	CVC	Private
New Look	Retail	UK	Apax, Permira	Private
Orangina	Food		Charterhouse	Private
Petroplus	Oil & Refining	Switzerland	Carlyle	HY
Pets at Home	Retail	UK	Bridgepoint	Private
Phoenix	Pharma	Germany	Merkle	HY
Ruhrgas	Utilities	Germany	CVC	Private
TDC	Telecom	Denmark	Apax, Permira, Blackstone	HT
Travelport	Business Services	US		HY
United Biscuits	Food	UK	Blackstone/PAI	Private
Unity Media	Cable	UK	Apollo , Blackstone	HY
Yell	Broadcasting & Media	UK	Public	Private
		Total debt volume over EUR50bn		

Source: Fitch

Chart 13: European LBO Maturities

Volume of scheduled senior debt amortisations



Source: Fitch rated leveraged loans

Likewise, the demand for high-yield solutions among privately held industrial and cooperative companies in Europe will likely remain anaemic. Not only are these borrowers used to cheap, flexible bank loans, most are unprepared for the kind of disclosure and reporting requirements and restrictive covenant packages typical of US-style, European high-yield indentures. Without a public listing, IFRS accounts and a well-recognised brand among institutional and retail investors, Europe's "hidden" champions would be forced to meet stringent dedicated high-yield investor terms and conditions. Moreover, while European regional banks continue to be constrained, they are nonetheless rolling over credit to mid-size corporates, albeit at higher spreads. The corporate management would therefore have to undertake a substantial investment project or acquisition in order to pursue high-yield as a financing option.

Notwithstanding these constraints, there remains widespread sentiment that European companies must diversify their funding sources and, in particular, reduce their reliance on traditional bank lending relationships. Herein lies the longer-term outlook for European high-yield. Likewise, it is Fitch's view that only the most robust business models in the European leveraged credit market will deleverage to the point where an equity market solution makes sense for financial sponsors. The others will have to address maturing senior and subordinated debt volumes in the hundreds of millions of euros. Where else are they going to come up with that?