European Quarterly High Yield and Leveraged Loan Report

EUROPEAN HIGH YIELD ASSOCIATION

An Affiliate of SIFMA

First Quarter, 2009

The European High Yield Association (EHYA), an affiliate of the Securities Industry and Financial Markets Association, is pleased to present the ninth quarterly issue of the *European High Yield and Leveraged Loan Report*. The report analyses and presents aggregate information and trends related to the European leveraged finance and emerging market 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 is through the first quarter of 2009.

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Primary European Leveraged Credit Markets Quiet in First Quarter; Only One High Yield Bond Issue; Global Credit Market Conditions Remains Weak But Shows Signs of Improvement

Highlights

- Leveraged finance issuance, which includes leveraged loans and high yield bonds, declined to €6.3 billion in the first quarter of 2009 compared to €11.1 billion in the same period in 2008.
- High yield bond issuance of €0.3 billion on one deal was recorded in the first three months of 2009 compared to no issuance in all four quarters of 2008.
- Leveraged loan issuance was €6.0 billion in the first quarter compared to €11.1 in the same year-earlier period.
- There were no European emerging market bonds issued in both the first quarter of 2009 and the final quarter of 2008.[1]
- Investor risk sensitivity, subdued global investor demand, prospects for slower economic growth and uncertain pricing contributed to continued depressed market conditions in the European high yield bond and leveraged loan markets.
- European high yield bond and leveraged loan returns turned positive in the first quarter. The Merrill Lynch High Yield Index and the S&P LCD European Leveraged Loan Index returned 8.0 percent and 5.29 percent, respectively.
- The European leveraged loan pipeline backlog ended the quarter with €1.8 billion on bank books, well below the €31.6 billion recorded at the end of 2008, and less than the €38.6 billion a year ago. In the U.S., leveraged deals in the pipeline have also declined, falling to €1.1 billion at end-March from €12.1 billion at year-end.
- However, tightened financing conditions and lower-to-negative profit and economic growth trends continue to be potential downsides.
- Credit quality risk has risen further in the first quarter from a period of historically low default rates during which corporate issuers built up their financial positions in an environment of low borrowing costs.
- Elevated leverage levels and sharply reduced credit availability, along with a eurozone recession, add to the likelihood of significantly higher default rates over the year.

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[1] European emerging market bonds were introduced as a separate category in this report in the second quarter of 2008.

Market and Economic Environment

Market Conditions

- Credit markets remain largely frozen due to continued high levels of risk aversion, a weakened global economic outlook and minimal credit market liquidity.
- Although financing remained tight during the first quarter, conditions improved somewhat over the previous quarter, as reported in the European Central Bank (ECB) lender survey, with banks voicing concern about the economic outlook as well as the banking industry. According to the April 2009 ECB bank lending survey, banks slightly decreased net tightening of credit standards for loans to households for house purchase, consumer credit and other lending. Businesses credit standards remained tight, especially for large businesses, however overall credit standards improved compared to the previous quarter. Balance sheet constraints and cost of funds continue to be a concern for businesses, particularly for the larger firms. Business and household demand for loans stayed at low levels reflecting the weak economy, weak home market and declining consumer confidence.
- Beginning in the second half of 2008, central banks injected massive amounts of liquidity to ease the deteriorating credit market conditions and provide for greater market interbank funding stability. In addition, eurozone policy makers agreed on 12 October to temporarily guarantee bank refinancing and vowed to keep important banks from failing. Eurozone banks will have access to unlimited funds from the ECB until the end of 2009.
- The three-month LIBOR rate fell to 1.19 percent as of end-March from 1.43 percent at end-December, and fell further to 0.96 percent as of 7 May. The LIBOR-overnight indexed swap (OIS) spread tightened to 97 basis points at end-March from 121 basis points at end-December and tightened further to 75 basis points as of 7 May. The LIBOR-OIS spread, which measures the difference between the overnight index swap rate and the three-month LIBOR rate, averaged roughly 11 basis points over the ten years prior to 2008. The LIBOR-OIS spread is considered an indicator of both banks' willingness to lend to each other and concerns over liquidity. A wider spread implies funding is scarce.
- The euro fell against the U.S. dollar finishing the first quarter at 1.33 to the dollar compared with 1.40 at the end of the previous quarter.

Economic Conditions

- The eurozone economy, which entered into a recession in 2008, contracted by 1.6 percent in the fourth quarter of 2008. Deteriorating economic conditions in Germany accounted for the bulk of the decline in economic activity. The European Commission predicted GDP would shrink by 4.0 percent in full-year 2009 and decline 0.1 percent in 2010. The International Monetary Fund forecast was more pessimistic with an outlook for contractions of 4.2 percent and 0.4 percent in 2009 and 2010, respectively.
- In the final quarter of 2008, 11 out of 16 countries in the eurozone recorded a decline in GDP growth. The Commission forecast that 11 out of the 16 eurozone countries would be in a recession in 2009.
- Eurozone unemployment rose for the ninth consecutive month to 8.9 percent in March, up from 8.7 percent in February. Unemployment is expected to reach 11.5 percent by 2010. Consumer confidence edged up to 67.2 in April from 64.7 in March. The eurozone's purchasing managers index, which measures the health of the manufacturing sector, increased to 36.7 in April from 33.9 in March. Although a reading below 50 indicates that the eurozone is in a recession, the rise in April may suggest that the worst of the downturn has passed.
- The ECB predicted that tight credit conditions will hamper growth for the rest of this year, but that the outlook for 2010 is fairly positive based on the decrease in commodity prices, enacted policies and rate cuts which should eventually restore confidence for businesses and consumers.

- The ECB has gradually lowered its target interest rate from 4.25 percent in October 2008 to 1.00 percent on 7 May. Following the rate cut, the President of the ECB, Jean-Claude Trichet, announced that the ECB will purchase €60 billion of euro-denominated covered bonds. The decision to only buy covered bonds was because the covered bond market has been hit the hardest. Issuance of covered bonds has been low since Lehman Brothers collapsed last September.
- Inflation in the eurozone was unchanged from March to April at 0.6 percent and is expected to move lower in the second quarter. The European Commission forecast inflation of 1.0 percent for full year 2009, which is below the ECB's target of 2.0 percent.
- European credit growth has been slowing with M3, the broadest measure of credit, declining to a seasonally adjusted annual growth rate of 5.9 percent at end-February, compared to 8.1 percent at the end of the fourth quarter of 2008 and 11.6 percent at end-December 2007.[2] The decline in M3 growth is attributable to deleveraging by firms in the financial sector as well as decreased lending activity to the private sector. Reduced contributions of short-term deposits was another reason why M3 growth declined in February 2009, the latest statistics available.

Issuance

- The primary market was virtually closed in the first quarter with total European high yield bond and leveraged credit issuance reaching only €6.3 billion for first quarter 2009.
- There was one €0.3 billion high yield bond issued in the first quarter, compared to no high yield issuance in all four quarters of 2008.[3] Fresenius, a BB-rated health care company that is based in the U.S. and has operations worldwide, issued the single high yield deal in the first quarter. Better rated, seasoned issuers such as Fresenius will be the first to return to the market as conditions improve.
- Based on Thomson Reuters' Loan Pricing Corporation (LPC) data, total European leveraged loan volume (including mezzanine financing) was €6.0 billion in the first three months of 2009, of which €5.9 billion was first lien loans and €0.1 billion was mezzanine.[4]
- The leading leveraged loan sectors were construction (€3.6 billion) and healthcare (€0.5 billion), according to Reuters' LPC.
- There were no European emerging market bonds issued in the fourth quarter of 2008 and the first quarter of 2009.[5]
- Market conditions wiped out the appetite for aggressive non-traditional deal structures. According to Fitch Ratings, there were no payment-in-kind (PIK) transactions for the third consecutive quarter.
- Market conditions considerably slowed leveraged buy-outs (LBO) and other acquisition debt financing, including private-equity sponsored deals. According to Reuters' LPC, in the first three months of 2009 leveraged loan LBO and recap volumes were €1.2 billion and €0.3 billion, respectively.
- Globally, there has been a large 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 U.S. backlog declined to €1.1 billion by end-March from €12.1 billion at the end of the

[2] 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).

[3] 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 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.

[4] 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.

[5] European emerging market bonds are defined as subinvestment grade 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. Further, due to differences in terms and documentation, Russian ruble-denominated issuance is excluded. The original 12 members of the European Union are France, Germany, Italy, Belgium, Netherlands, Luxembourg, Denmark, Ireland, United Kingdom, Greece, Spain and Portugal.

previous quarter and €78.0 billion at the end of the same year-earlier period. The European leveraged loan backlog declined to €1.8 billion at end-March compared to €31.6 billion in the previous quarter and €38.6 billion at end-March 2008.

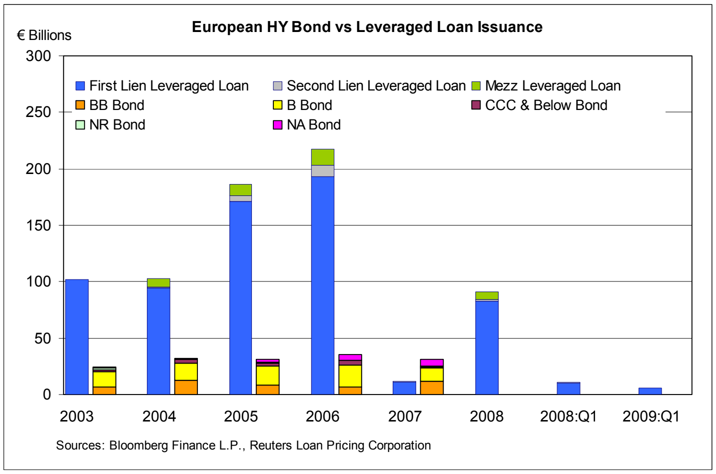
Credit Quality

- According to S&P Global Fixed Income Research, year-to-date through 23 April 2009, 92 companies defaulted compared to 23 defaults in the same year-earlier period. Although U.S. issuers account for the majority of the increase in the global default rate in the first quarter of 2009, most macroeconomic indicators in Europe are showing weakness, which should push default rates higher in the second and third quarters of 2009. In addition, weaker profits and limited access to the credit markets are putting downward pressure on credit quality.
- The S&P Global Fixed Income Research European speculative-grade default rate was 4.08 percent for the twelve months ending in March 2009, well above the year-end 2008 default rate of 2.54 percent, but considerably less than the first quarter U.S. speculative-grade default rate of 5.42 percent. S&P Global Fixed Income Research reported 14 European high-yield upgrades and 145 downgrades in the first quarter, compared to 13 upgrades and 151 downgrades in the prior quarter and 17 upgrades and 35 downgrades in the first quarter of 2008. S&P expects credit spreads to remain elevated, reflecting investor uncertainty and increasing default rates over the next couple quarters.
- Fitch Ratings reported that the European mezzanine loan default rate was 2.46 percent, or 5.85 percent when adjusted for "distressed" restructurings, below the recent peak in 2003. These numbers are based on the last twelve months' defaulted volumes of €2 billion on 16 defaulted issuers.
- European high-yield bond recoveries were between 11 and 30 percent with an average around 20 percent for the twelve months ending 31 March, 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 both the "BB" and "B" rated issuer share of the European high-yield or speculative-grade market decreased in the first quarter.
- Leverage ratios, as reported by Fitch, used as a measure of credit risk, have increased over the last several years and increased in the first quarter of 2009. In the first quarter the median senior leverage ratio of Fitch-rated shadow credits was 4.8 times and the median total leverage was 6.1 times. The corresponding median leverage ratios in the previous quarter were 3.9 times for senior and 5.5 times for total.

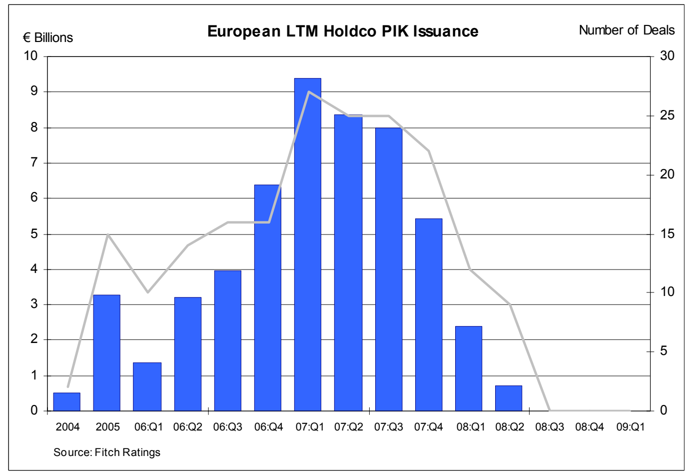
Relative Value

- European high-yield sector returns were positive and spreads tightened in the first quarter. Based on the Merrill Lynch High Yield Index, the total market return was 8.0 percent for the first quarter 2009 compared to -22.7 percent in the previous quarter. At the end of the quarter, the Merrill Lynch High Yield Index reported a 1,993 basis-point credit spread, 211 basis points tighter than at the end of the previous quarter, but 1,228 basis points wider than the same year-earlier period. Similarly, the spread in the credit derivatives market as measured by the iTraxx Cross-over Index (iTRAXX.EU.XO) was 944 basis points, 83 basis points tighter than at the end of the fourth quarter of 2008, but 367 bps wider than at the end of first quarter 2008.
- The leveraged-loan index return also turned positive for the first quarter. The S&P LCD European Leveraged Loan Index (ELLI-Total Return) was 5.29 percent for the first quarter compared to a loss of 23.69 percent in the third quarter and a loss of 8.56 percent in the first quarter of 2008.
- High yield bonds in the U.S. and European markets have recorded total returns of 20 percent this year, compared with a 2 percent return for investment grade bonds, according to Deutsche Bank.

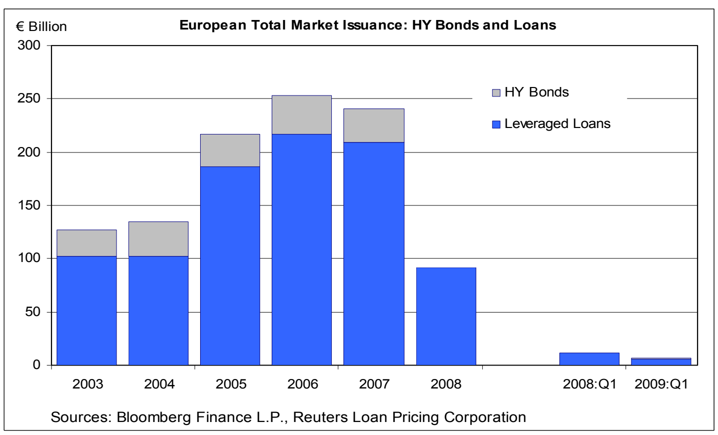
1


European HY Bond vs Leveraged Loan Issuance
€ Billions
First Lien Leveraged Loan
Second Lien Leveraged Loan
Mezz Leveraged Loan
BB Bond
B Bond
CCC & Below Bond
NR Bond
NA Bond
2003
2004
2005
2006
2007
2008
2008:Q1
2009:Q1
Sources: Bloomberg Finance L.P., Reuters Loan Pricing Corporation

2


European LTM Holdco PIK Issuance
€ Billions
Number of Deals
Source: Fitch Ratings

3


European Total Market Issuance: HY Bonds and Loans
€ Billion
HY Bonds
Leveraged Loans
Sources: Bloomberg Finance L.P., Reuters Loan Pricing Corporation

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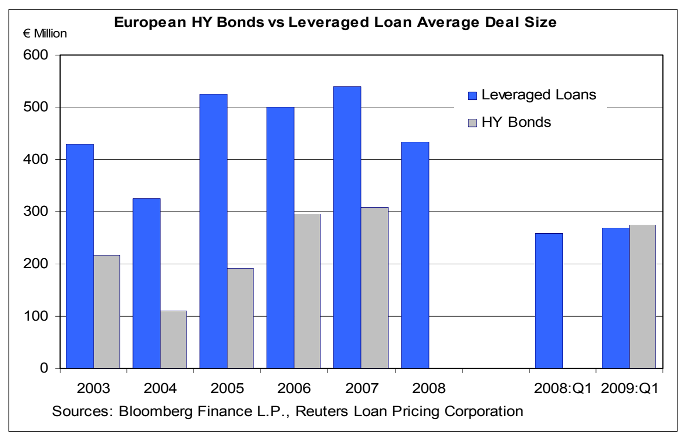
European HY Bonds vs Leveraged Loan Average Deal Size
€ Million
Leveraged Loans
HY Bonds
Sources: Bloomberg Finance L.P., Reuters Loan Pricing Corporation

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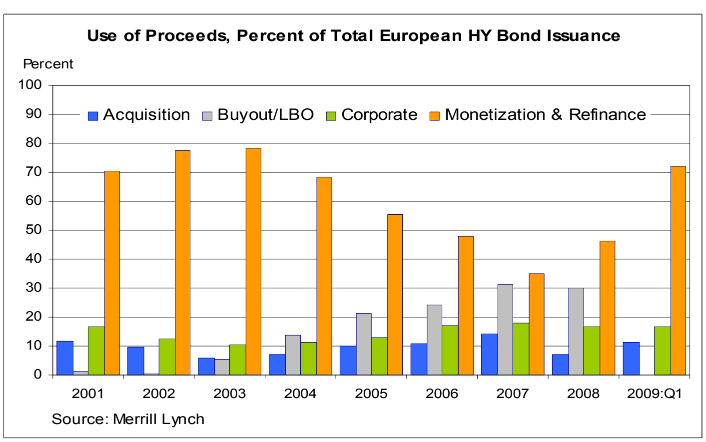
Use of Proceeds, Percent of Total European HY Bond Issuance
Percent
Acquisition
Buyout/LBO
Corporate
Monetization & Refinance
Source: Merrill Lynch

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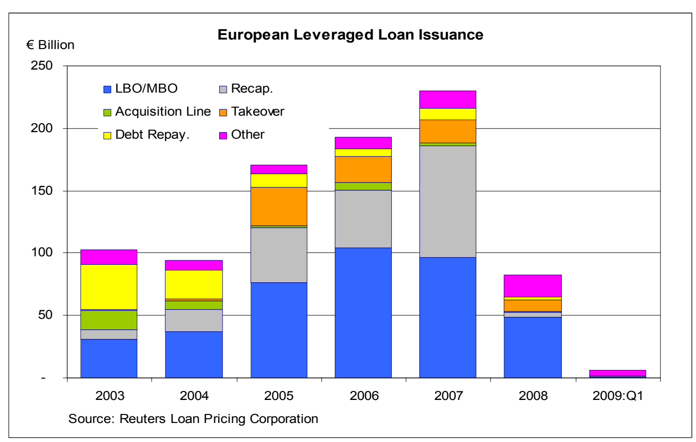
European Leveraged Loan Issuance
€ Billion
LBO/MBO
Recap.
Acquisition Line
Takeover
Debt Repay.
Other
Source: Reuters Loan Pricing Corporation

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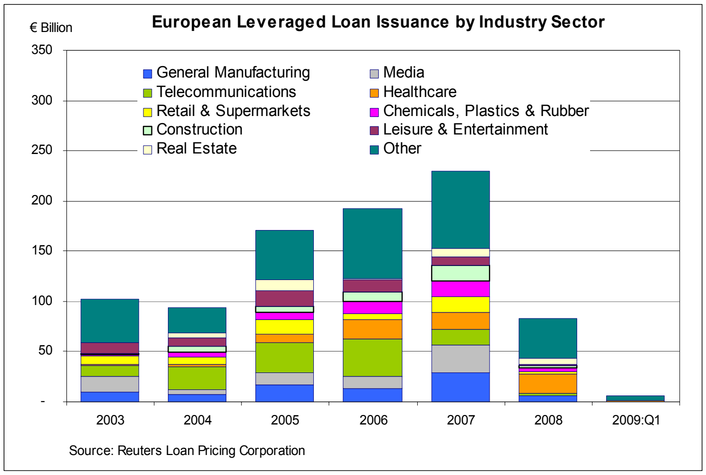
European Leveraged Loan Issuance by Industry Sector
€ Billion
350
300
250
200
150
100
50
-
General Manufacturing
Telecommunications
Retail & Supermarkets
Construction
Real Estate
Media
Healthcare
Chemicals, Plastics & Rubber
Leisure & Entertainment
Other
2003
2004
2005
2006
2007
2008
2009:Q1
Source: Reuters Loan Pricing Corporation

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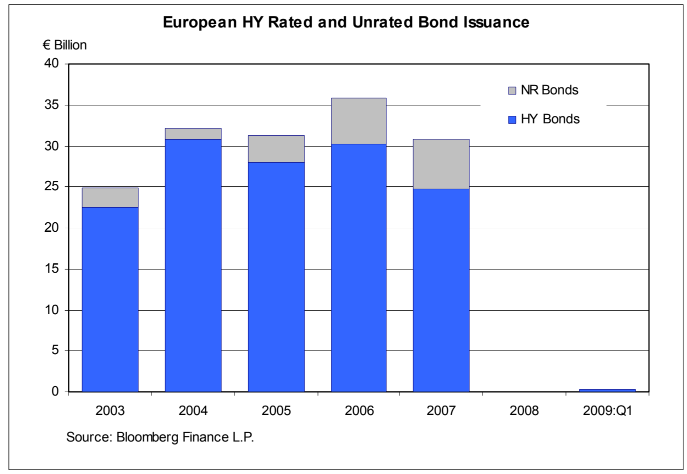
European HY Rated and Unrated Bond Issuance
€ Billion
40
35
30
25
20
15
10
5
0
NR Bonds
HY Bonds
2003
2004
2005
2006
2007
2008
2009:Q1
Source: Bloomberg Finance L.P.

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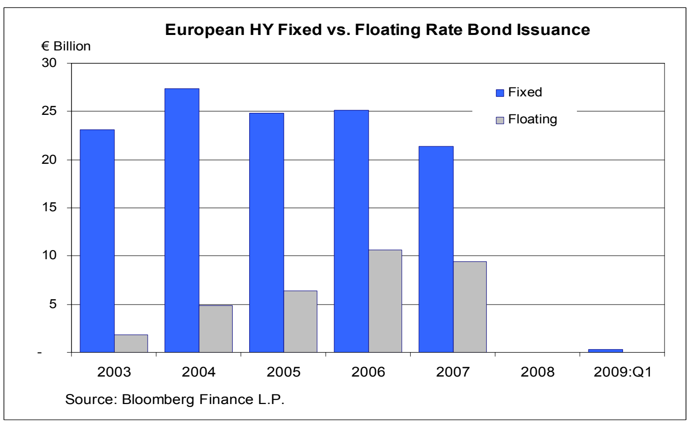
European HY Fixed vs. Floating Rate Bond Issuance
€ Billion
30
25
20
15
10
5
-
Fixed
Floating
2003
2004
2005
2006
2007
2008
2009:Q1
Source: Bloomberg Finance L.P.

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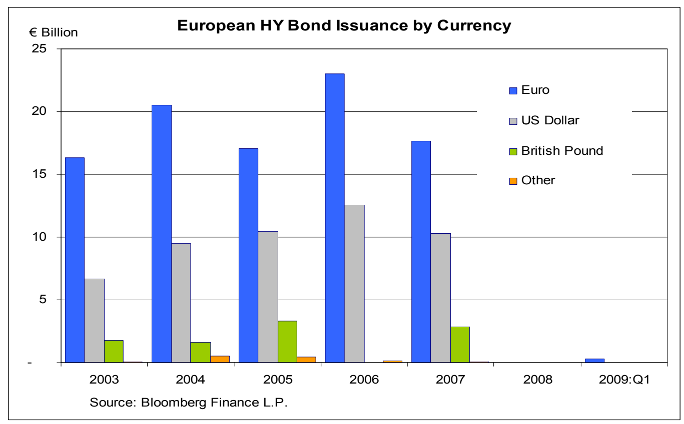
European HY Bond Issuance by Currency
€ Billion
25
20
15
10
5
-
Euro
US Dollar
British Pound
Other
2003
2004
2005
2006
2007
2008
2009:Q1
Source: Bloomberg Finance L.P.

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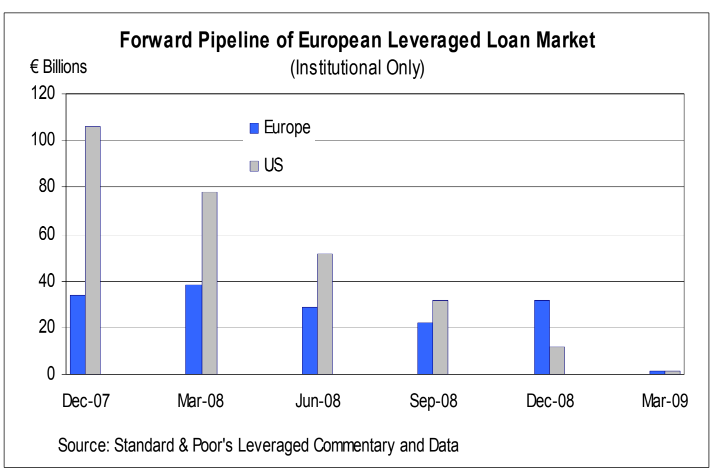
Forward Pipeline of European Leveraged Loan Market
(Institutional Only)
€ Billions
120
100
80
60
40
20
0
Europe
US
Dec-07
Mar-08
Jun-08
Sep-08
Dec-08
Mar-09
Source: Standard & Poor's Leveraged Commentary and Data

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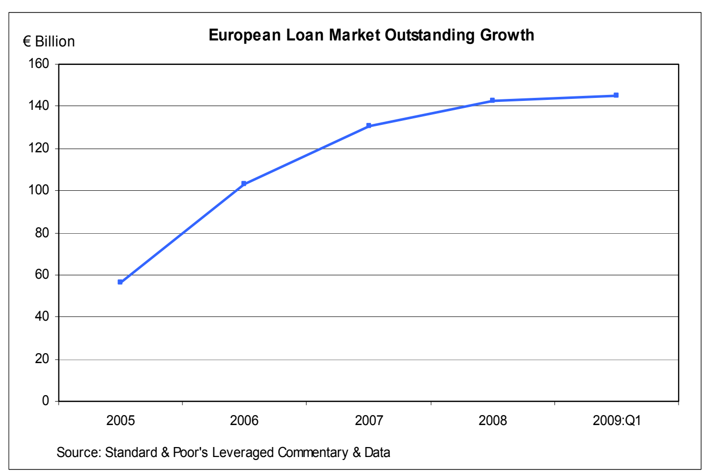
European Loan Market Outstanding Growth
€ Billion
160
140
120
100
80
60
40
20
0
2005
2006
2007
2008
2009:Q1
Source: Standard & Poor's Leveraged Commentary & Data

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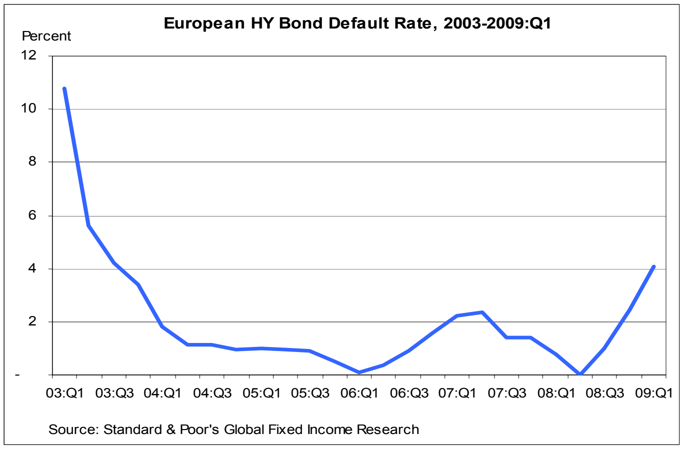

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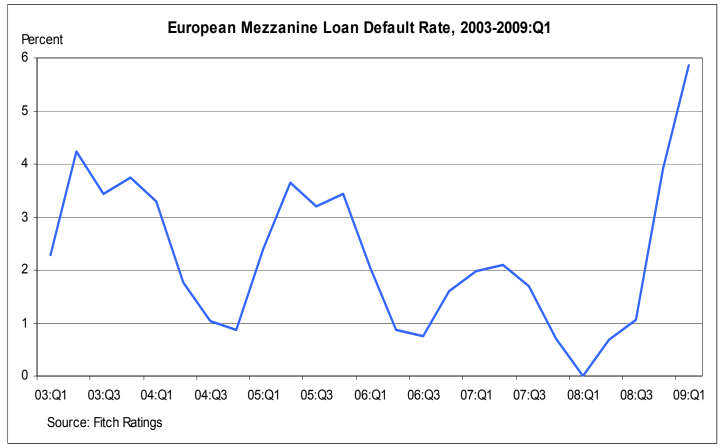

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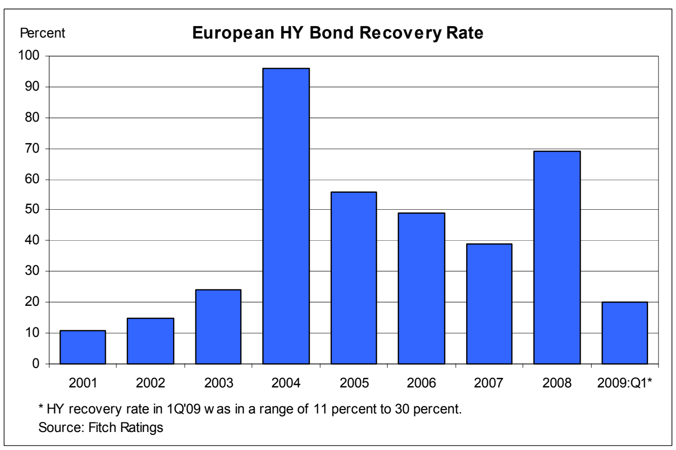

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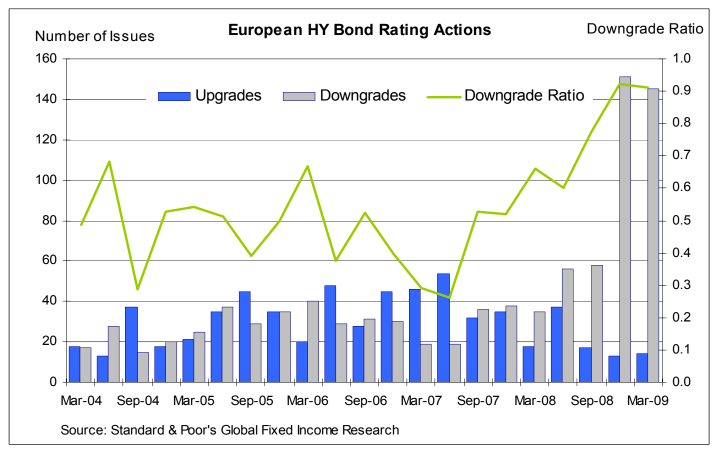

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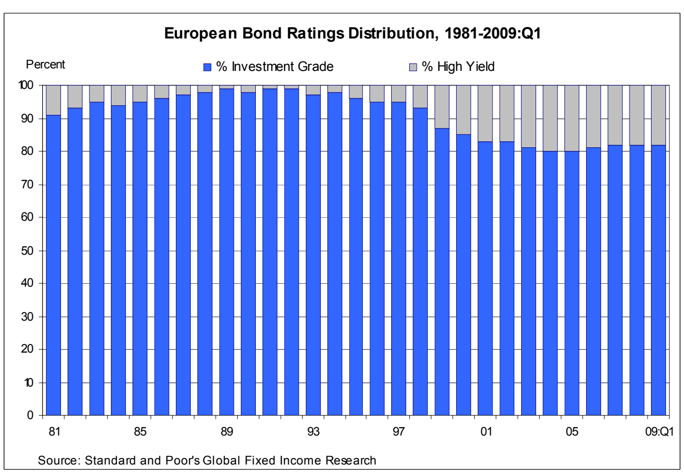

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S&P European Leveraged Loan Index

Ratings Diversification

	BB Rating	B Rating	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	13.4%	66.0%	15.3%	5.3%
2009:Q1	11.4%	62.3%	16.2%	10.1%

Source: Standard & Poor's Leveraged Commentary and Data

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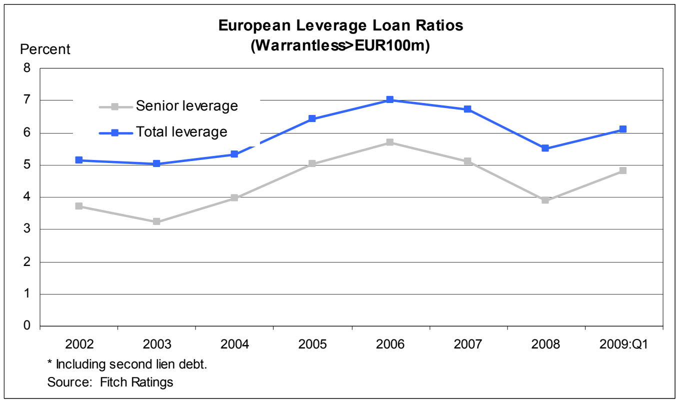

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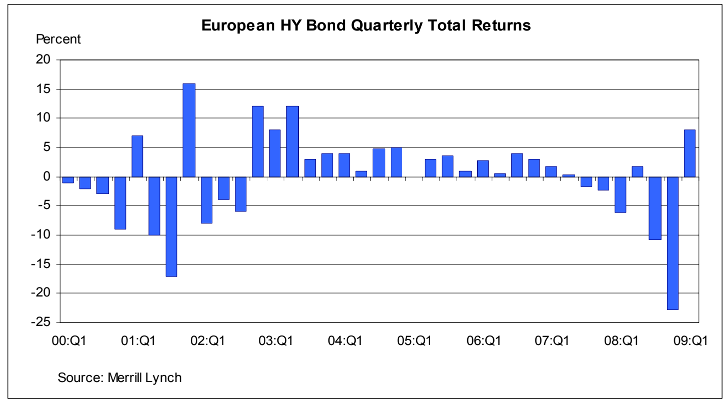

European High Yield Report - Relative Value

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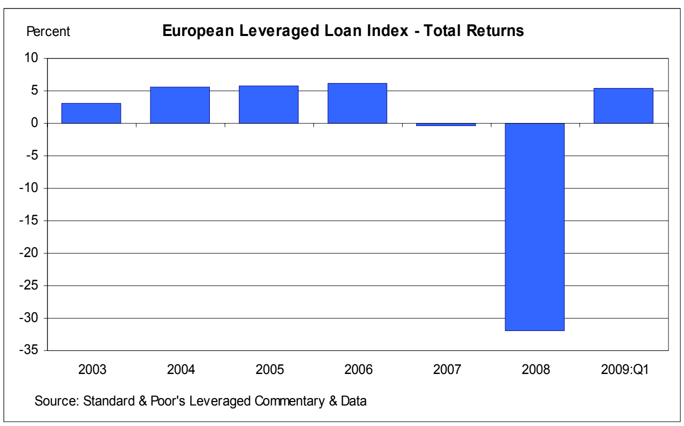

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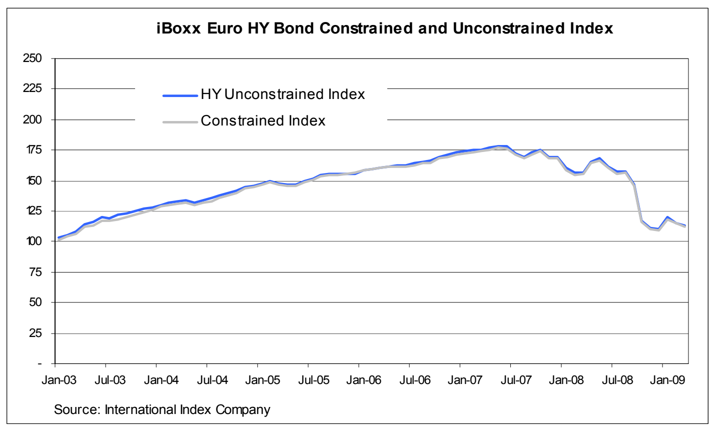

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