European Quarterly High Yield and Leveraged Loan Report

EUROPEAN HIGH YIELD ASSOCIATION

An Affiliate of SIFMA

The European High Yield Association, in conjunction with the Securities Industry and Financial Markets Association, is pleased to present the second issue of the *European Quarterly High Yield and Leveraged Loan Report*. Beginning with this issue, we are expanding coverage to encompass the leveraged loan market. Based on publicly available information, the report analyzes and presents aggregate information and trends related to the leveraged finance marketplace including both high yield corporate bonds and leveraged loans issued in the European marketplace or by European issuers. The report includes sections on issuance, credit quality and returns on investment. Unless otherwise noted, the data are through the second quarter of 2007.

Summer 2007

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European Leveraged Finance Has Blockbuster First Half with Combined Leveraged Loan and Bond Issuance Surpassing €150 Billion; Credit Quality Metrics Solid Despite Global Credit Market Repricing, Higher Risk Profile

Highlights

- Led by a global rise in risk consciousness, liquidity and pricing conditions in the European high-yield bond and leveraged loan markets took a downturn beginning in the second quarter of 2007. As the quarter progressed, investors began to question spread levels, and their appetites for new issues began to diminish.
- Since the end of the quarter, global credit markets have encountered more contraction, and bids have slowed dramatically. The recent "flight to quality" among credit investors has further reduced market liquidity and has increased the difficulty in funding some deals globally. Once conditions stabilise from the current disruption, the important question becomes the longer term commitment to high-yield products by new non-traditional investors.
- Before current market conditions set in, the pace of European leveraged finance (including leveraged loans, mezzanine financing and high yield bonds), increased in the first six months to an estimated €150.8 billion, 12.2 percent higher than the first half of 2006. Non-rated bond issuance could add as much as €2.1 billion to that total.
- Economic fundamentals in the European leveraged finance market remain favourable with sustained economic growth, higher corporate profits, business investment expansion and accommodative monetary policy, but with the expectation that economic growth will moderate as the cycle matures.
- Issuance levels in the first half were driven by balance sheet leveraging strategies, including M&A and especially LBO financing. However, a growing number of LBOs have just been postponed or canceled, including mega deals Chrysler and Alliance Boots, causing lenders to hold large amounts in commitments that may be difficult to sell into the secondary market without taking a discount. Goldman, Lehman, Bear Stearns and Morgan Stanley, for example, are said to be holding roughly $180 billion in commitments, although the amount that has already been syndicated to investors is not clear.
- Despite fundamental credit quality metrics that appear benign, lenders and investors are dictating stronger terms as conditions for new deals. The trends towards softer loan covenant packages and increased leverage has turned.
- European high yield bond and leveraged loan indices registered positive returns through the second quarter on a trailing twelve month basis. Global credit market repricing, especially in the high yield bond markets, trimmed gains late in the quarter, a trend that continued into July.

- Despite a relatively full calendar of high yield bond and leveraged loan transactions planned to support buyout activity, actual deal activity in the second half is likely to be lower.

Economic and Market Environment

Economic Trends

- The European high-yield market grew at a solid pace through much of the first half of the year, supported by sustained economic growth, higher corporate profits, business investment expansion, employment, consumer spending gains, and historically low interest rates.
- The April European Central Bank (ECB) bank loan survey found some credit standard easing, especially to larger enterprises. Internally generated cash flow from profit growth led to a degree of moderation in the demand for credit among corporate borrowers. M&A and corporate restructuring contributed significantly to loan demand, with fixed asset financing as an additional source of loan demand.
- The European macroeconomic growth outlook continues to be strong for 2007, although the consensus view is that the growth rate is expected to moderate from the above trend growth of 2.75 percent in 2006. The ECB is projecting 2.3 percent to 2.9 percent growth this year and 1.8 to 2.8 percent next year. The moderating pace of growth should ease inflationary pressures.
- Although "headline" inflationary data have moderated, central bank policies are sensitive to inflationary pressures from such sources as bottlenecks arising as the economy approaches full capacity on the supply side and rising consumer spending on the demand side. The Euro appreciation serves to ease inflationary pressures.
- The outlook will be affected by a rise in Euro-area real benchmark interest rates consistent with higher global yields. Based on a view of broad-based economic growth and an objective of anchoring inflationary expectations and promoting price stability, the ECB in June raised short-term interest rates for the eighth time in the current cycle to 4.0 percent, which is still considered accommodative.

Market Conditions

- The world credit markets, including the European high yield market, is currently undergoing a substantial repricing of credit risk, evidenced by significant spread-widening and a contraction of market liquidity.
- What started as a reaction to the downturn in the market for RMBS and CDOs backed by US subprime residential mortgage loans has quickly spread to other credit sectors in Europe and elsewhere. The failures and retrenchments of several key investment funds focused on leveraged credit has fueled investor concern.
- A number of recent new high yield bond issues have come to market at spread levels higher than initially anticipated. The leveraged loan market, which had been growing rapidly through the spring, has also contracted. "Covenant lite" loans, which had characterized much of the growth, have been largely abandoned by lenders and investors.
- Strong investor demand for high yield assets in the early part of the year has given way to significant investor trepidation.
- The rise in benchmark yields globally and higher volatility raised investor risk sensitivity and led to global credit risk repricing, leading to European high yield credit spread widening late in the quarter, giving back some of the year-over-year gains.

Issuance

- High yield bond issuance[1] volume totaled €33.5 billion through the first half of 2007, 81.1 percent higher than the first half of 2006. Based on Reuters Loan Pricing Corporation data, total European leveraged loan[2] volume (including mezzanine financing) was €117.3 billion in the first half, of which €5.9 billion were mezzanine and €5.9 second lien loans. Combined, leveraged finance volume was slightly over €150 billion, 12.2 percent higher than year-to-date 2006. Including unrated bonds, the year-to- date high yield bond total through the second quarter could be as high as €35.6 billion.[3]
- According to Fitch Ratings, on a 12-month trailing basis, issuance of payment-in-kind (PIK) transactions rose to €8.4 billion in the second quarter of 2007, up from €3.2 billion in the second quarter of 2006, although this trend is subsiding as credit risk is repriced.
- Standard & Poor's (S&P) "BB"-rated bond issuance totaled €12.5 billion, "B" was €14.2 billion and "CCC & Below" was €0.9 billion for the second quarter. The industrial sector accounted for €16.0 billion in issuance during the first six months, nearly 50 percent of total high yield issuance.
- Through the first half of the year, the largest volume leveraged loan industry sectors were in the media and utilities industries, which totaled €19.9 billion and €10.7 billion, respectively, according to Reuters Loan Pricing Corporation.
- Through the second quarter, "BB"-rated issuance totaled 9.8 percent of the total "BB" outstanding volume in the marketplace, "B" issuance totaled 21.4 percent of total outstanding, and "CCC" and non-rated issuance was 15.7 percent of total outstanding. Despite the substantial first half volume growth, high yield issuance in the first half of 2007 as a percentage of outstanding was only slightly above the historic median, 14.7 percent to 15.2 percent, based on Merrill Lynch data.
- M&A and LBO transactions, including private equity sponsored deals, have led bond and loan issuance volume growth in recent years. Based on Merrill Lynch data, approximately 16.7 percent of high yield bond proceeds were used to finance M&A/LBO deals through May, compared to 43.2 percent in 2006 and 1.7 percent in 2001. Refinancing, which includes refinancing of LBO deals, accounted for an additional 39.8 percent of high yield bond financing. Combined, LBO (51.7 percent) and recap (37.6 percent) accounted for 89.3 percent of leveraged loan volume in the first half of 2007, according to Reuters Loan Pricing.
- The fixed rate share of high yield bond issuance rose to €23.6 billion in the first six months of 2007 (70.6 percent of total issuance), up from €13.2 billion (71.2 percent) in the first half of 2006. Floating rate issuance rose to €9.8 billion (29.4 percent of total issuance) from €5.3 billion (28.8 percent) in the first half of 2006.
- Issuer and sponsor demand for financing remains strong with a substantial forward calendar of leveraged finance transactions. Market participants are conscious of the potential effect that significant issuance growth and the forward calendar can have on pricing (i.e. the effect of a "supply overhang"). As a measure of the market's development and capacity to absorb new supply,

[1] 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+. 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).

[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] Unrated rated bonds are defined as all bonds that either are not rated or for which the rating is "not available," according to Bloomberg.

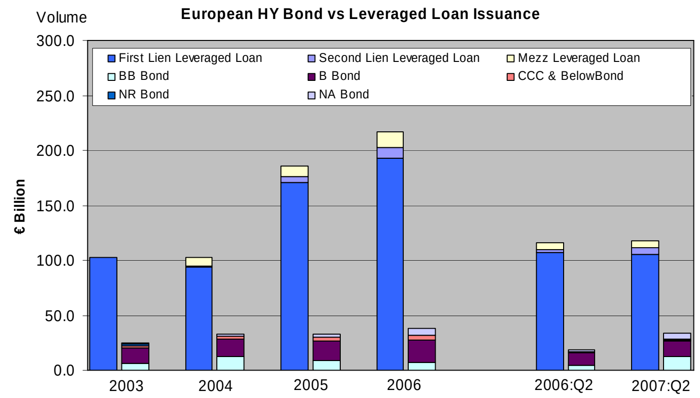
Credit Quality

- Credit fundamentals remain solid, even taking into account the late-second quarter repricing of risk. However, there are indications that some pick-up in defaults could occur later in the year.
- 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 June 2007, the S&P 12-month trailing European speculative-grade default rate rose slightly to 2.33 percent. S&P high yield bond downgrade to upgrade ratio has declined over the last several years, including 2007 year-to-date.
- Fitch Ratings reports a similar trend in mezzanine loan default rates well below the peak in 2003 but rising from last year's cyclical low to 2.1 percent as of the second quarter.
- High yield bond recoveries have picked up from 11 percent in 2001 to 49 percent in 2006 before declining to 37 percent in the first half of the year, 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.
- Trends in the investment rating composition over recent years confirm the potential for increased risk exposure as the European leveraged finance markets expand. S&P LCD reports a steady decline over the last two years in the leveraged loan rating mix to 7.4 percent "BB" rated, 79.0 percent "B" rated and the balance unrated as of the second quarter, and S&P Global Fixed Income Research reports that, over the last three years, the "BB" rated issuer share of the European high yield or speculative-grade market has declined while the "B" rated share has increased.
- As a measure of credit exposure, Fitch reports a jump in leverage ratios over the last several years, although with some signs of moderating this year. In the second quarter, the median senior leverage went up to 5.2 and total leverage was at 6.0 times EBITDA.

Relative Value

- According to both iBoxx and Merrill Lynch indices, European high yield sector returns were positive for the second quarter and over the last three years, but negative for the year as of late July. The global credit repricing, which began late in the quarter and continued into the third quarter, lowered gains year-to-date and year-over year. Based on the Merrill Lynch High Yield Index, the second quarter return was 0.26 percent. As of July 25, the year-to-date return was -0.2 percent and year-over-year return was 5.7 percent. As of July 25, the Merrill Lynch High Yield Index was reporting a 288 basis point spread, 84 basis point wider than one month earlier. The credit spread was 70 basis points wider year-to-date and 15 basis points tighter on a year-over-year basis. The recent spread widening in the credit derivatives market has been more dramatic as measured by iTraxx cross-over index (iTraxx.EU.XO).
- The leveraged loan index is also showing positive returns through the second quarter. The S&P LCD European Leveraged Loan Index - ELLI-Total Return - was 1.5 percent (6 percent annualized) for the second quarter compared to 1.41 percent in the first quarter and 1.56 percent in the second quarter of 2006. S&P LCD reports a substantial spread tightening of the primary weighted-average institutional loan spread to 253 basis points as of the second quarter.

1



Source: Bloomberg, Reuters Loan Pricing Corporation

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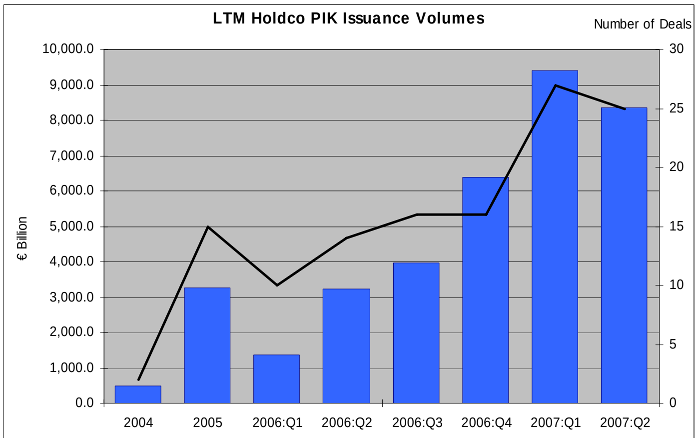

Source: Fitch Ratings

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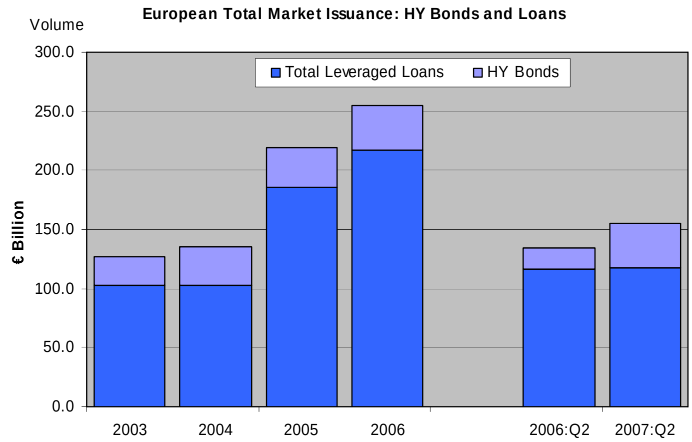

Source: Bloomberg, Reuters Loan Pricing Corporation

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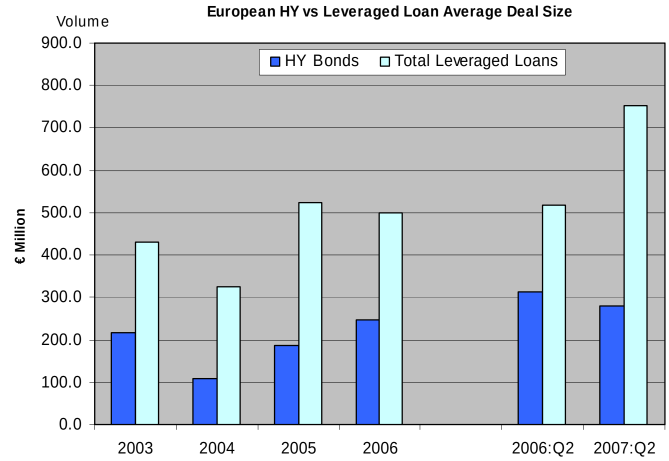

Source: Thomson Financial, Bloomberg

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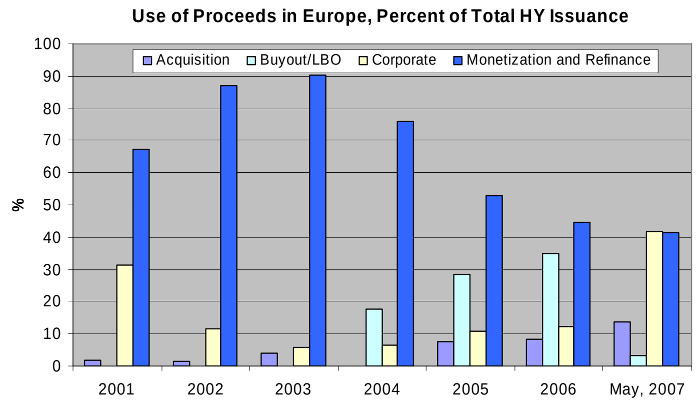

Source: Merrill Lynch

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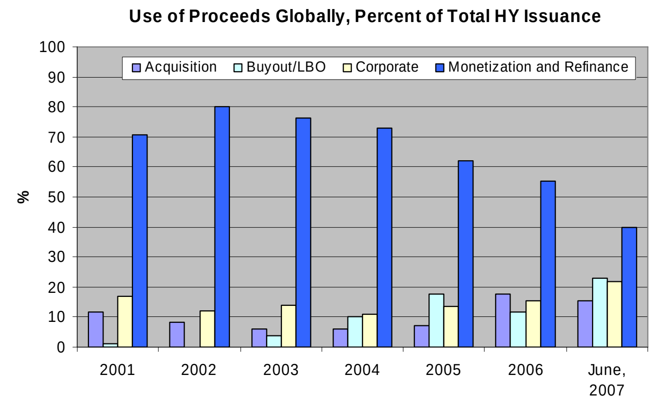

Source: Merrill Lynch

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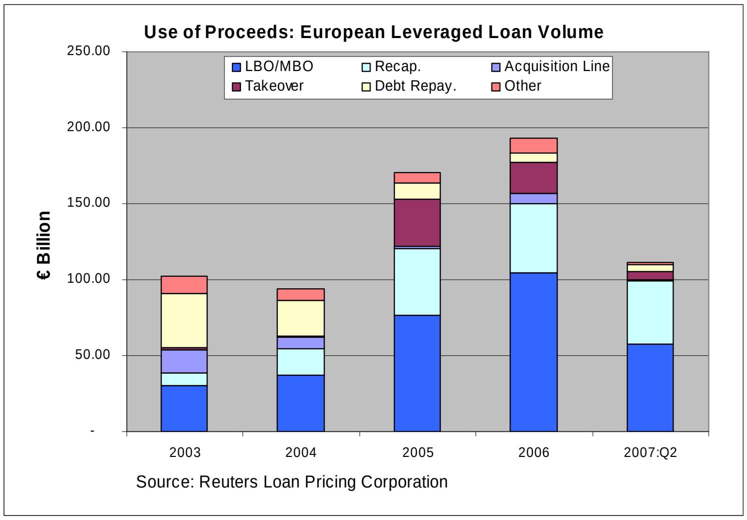

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2007:Q2 Long-Term European HY Issuance
By Industry Sector

Sector	S&P BB Rating	S&P B Rating	S&P CCC Rating	S&P NR Rating	S&P NA Rating
Banking	685.6	695.4	54.2		2,707.8
Finance	1,773.1	4,684.7	250.6		908.6
Industrial	7,011.3	7,752.9	550.0	275.0	404.2
Special Purpose	2,322.1	1,041.0			1,613.2
Utility	745.3				
Industry Total	**12,537.4**	**14,174.0**	**854.8**	**275.0**	**5,633.8**

Through June 30, 2007
Source: Bloomberg

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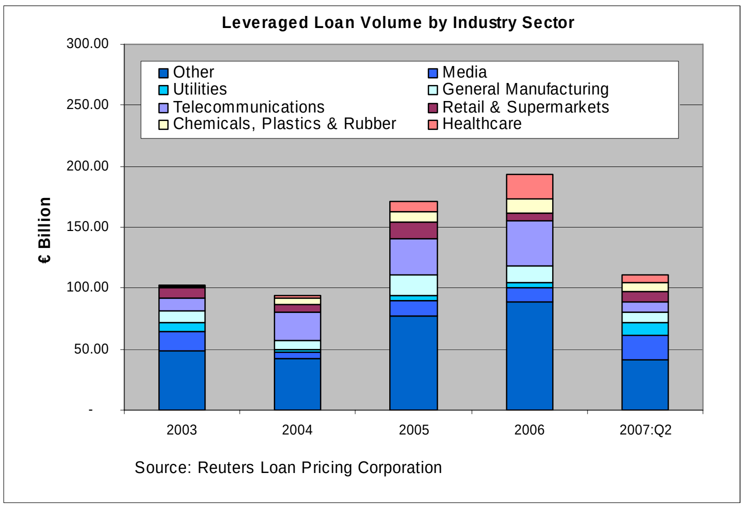

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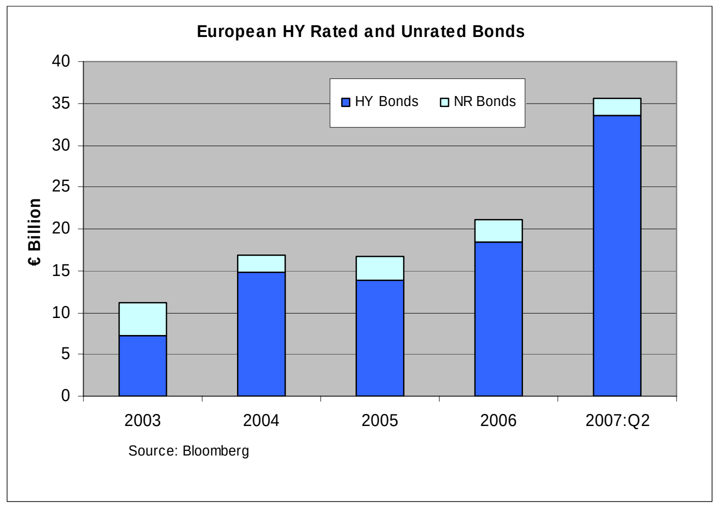

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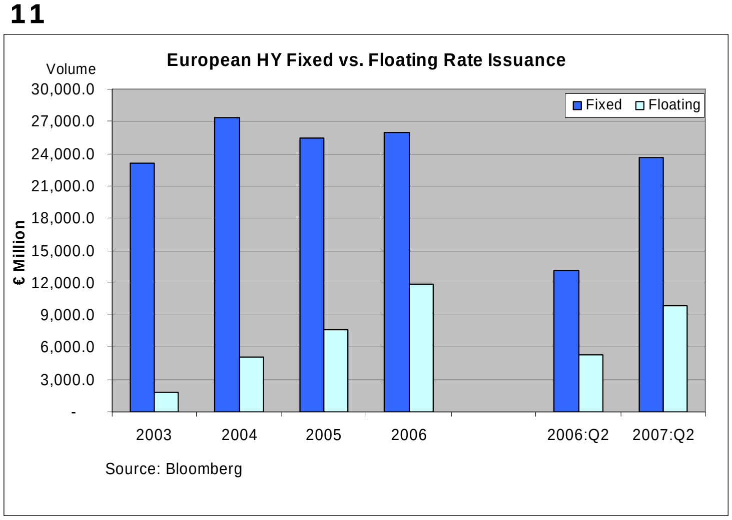

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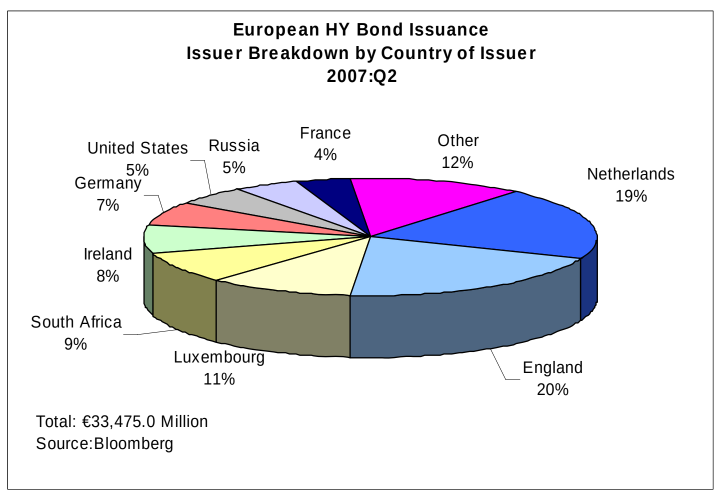

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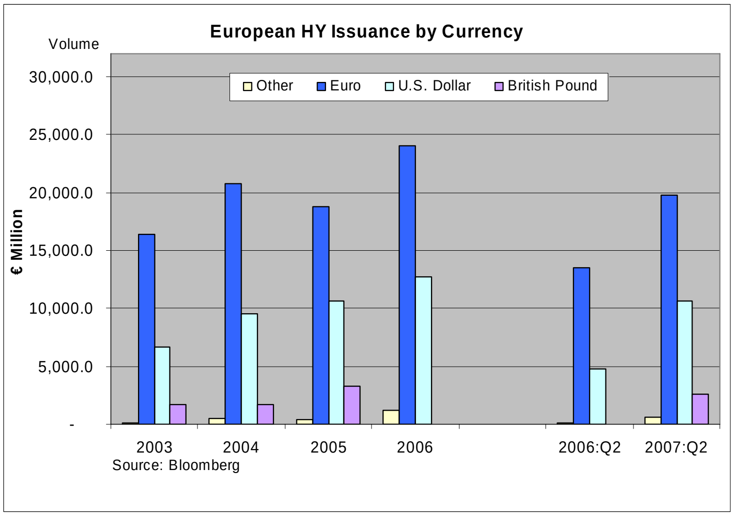

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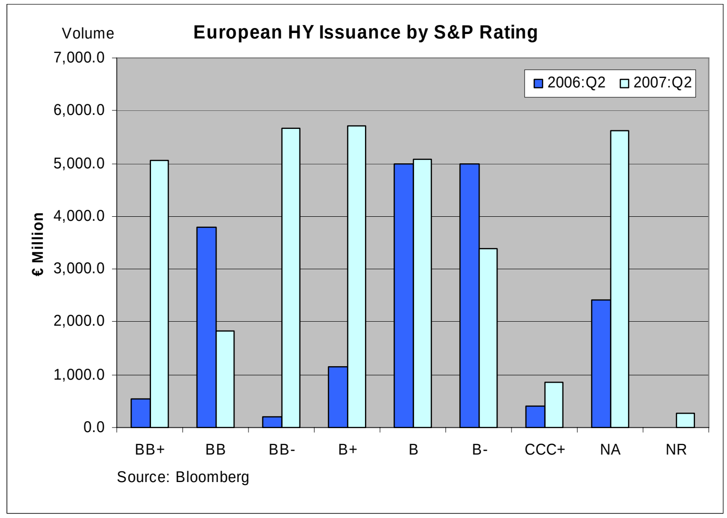

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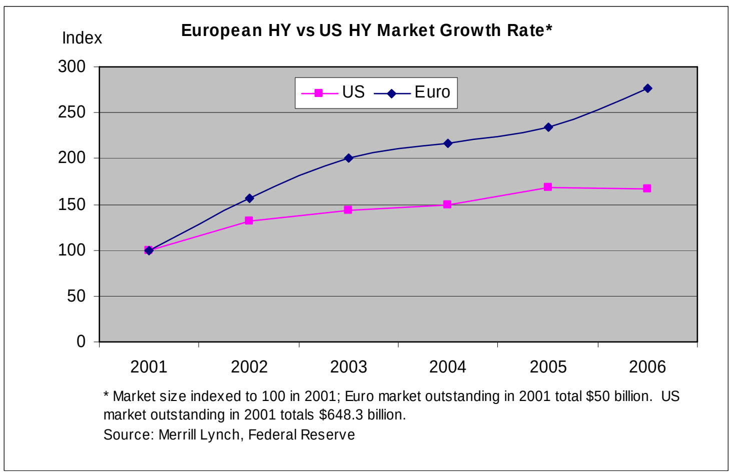

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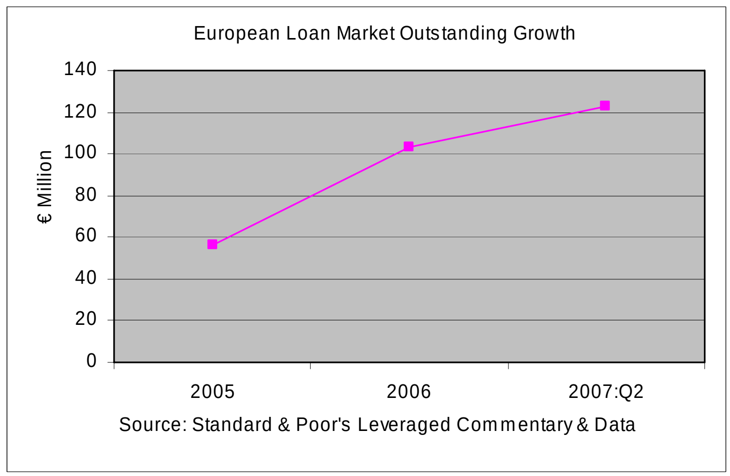

European High Yield Report – Credit Quality

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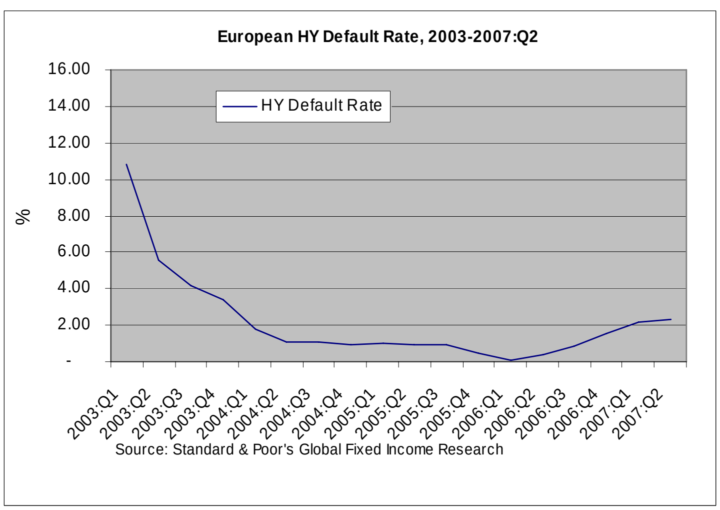

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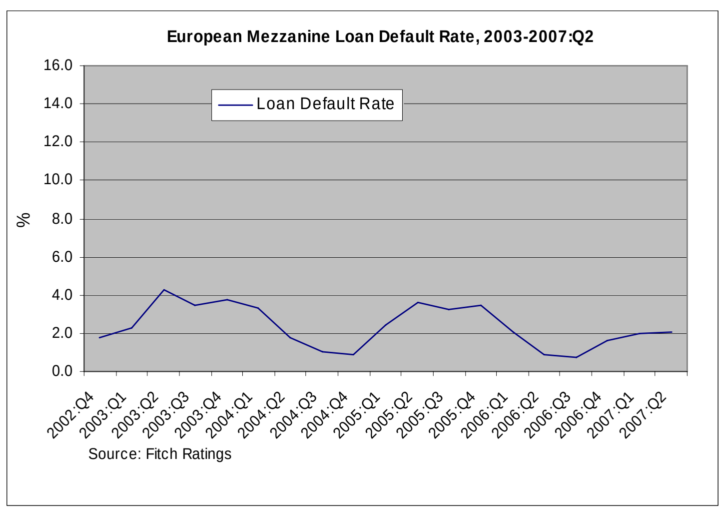

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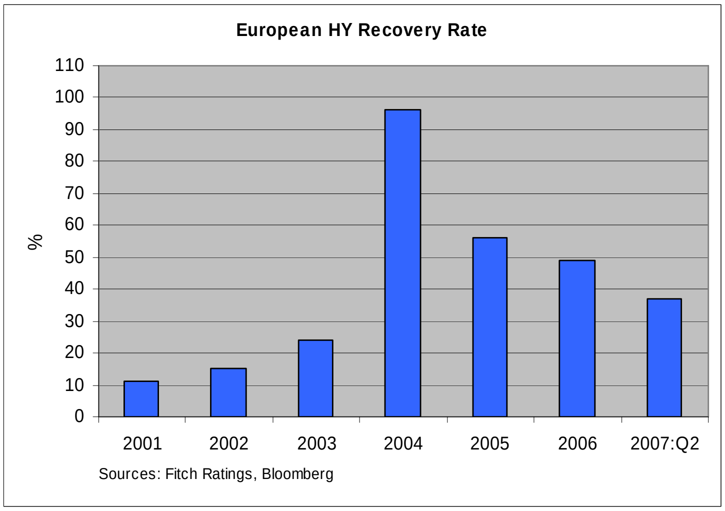

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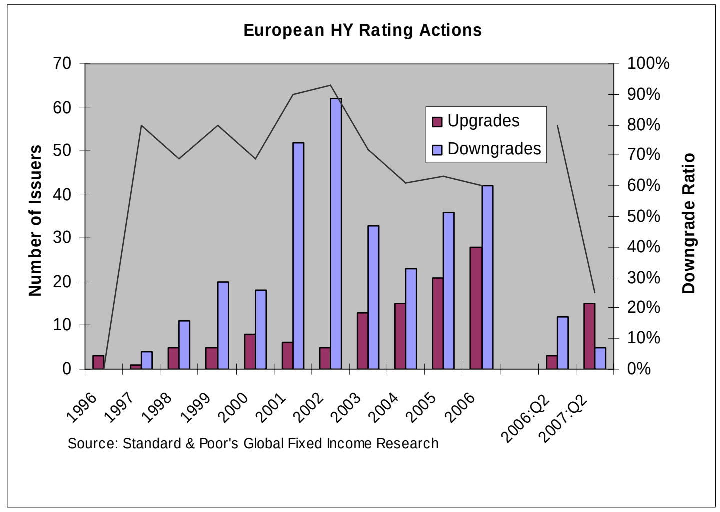

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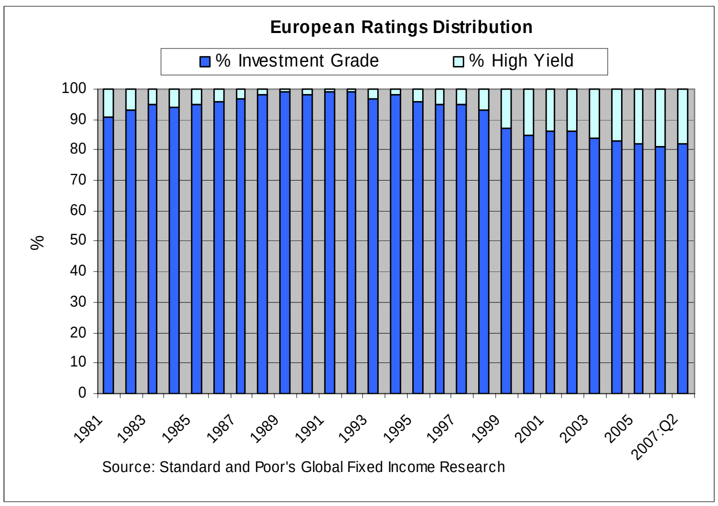

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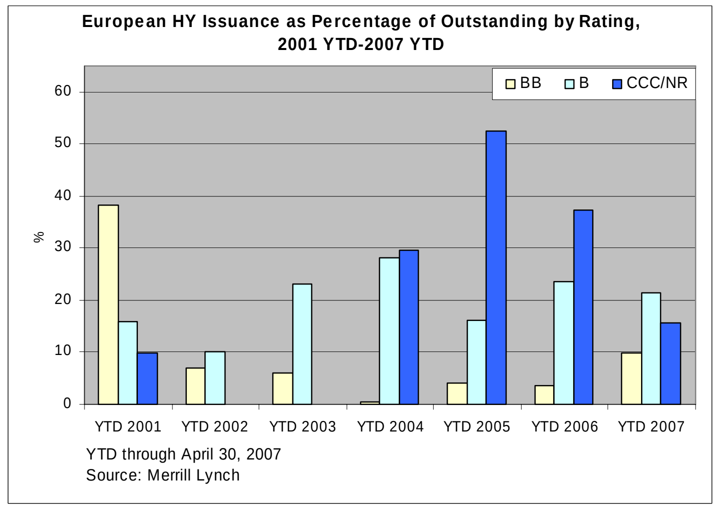

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2005-2007:Q2 Leveraged Loan Rating Mix
By Rating

	S&P BB Rating	S&P B Rating	S&P NR Rating	Other
2005	15.5%	74.5%	9.7%	0.3%
2006	9.6%	77.5%	12.9%	0.0%
2007:Q2	7.4%	79.0%	12.7%	0.9%

Source: Standard & Poor's Leveraged Commentary and Data

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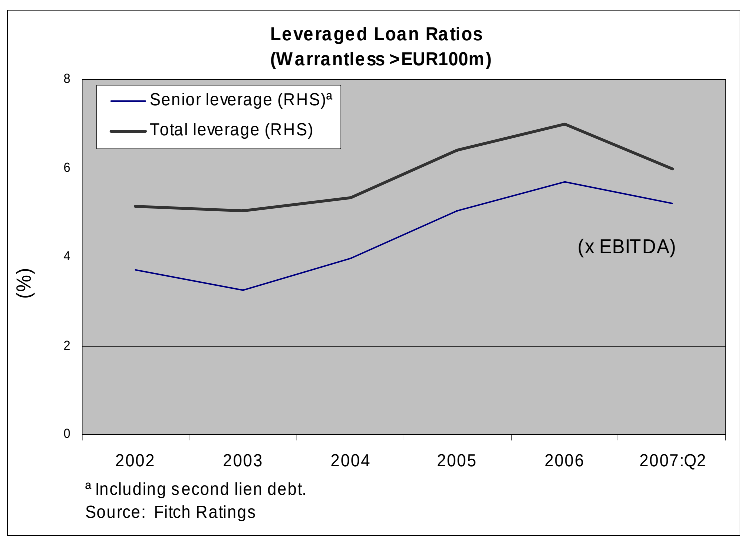

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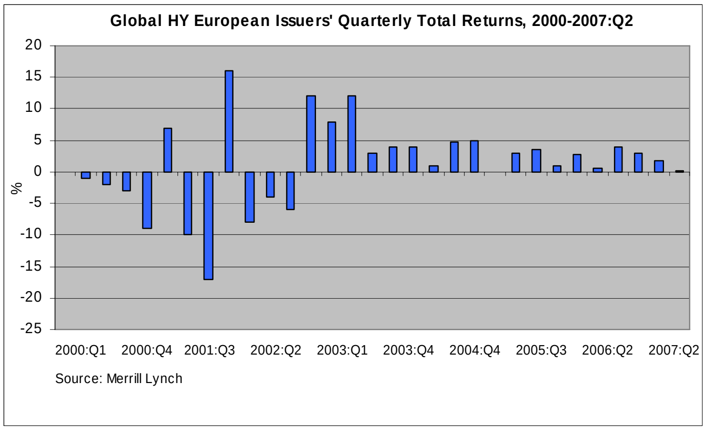
Global HY European Issuers' Quarterly Total Returns, 2000-2007:Q2
%
20
15
10
5
0
-5
-10
-15
-20
-25
2000:Q1 2000:Q4 2001:Q3 2002:Q2 2003:Q1 2003:Q4 2004:Q4 2005:Q3 2006:Q2 2007:Q2
Source: Merrill Lynch

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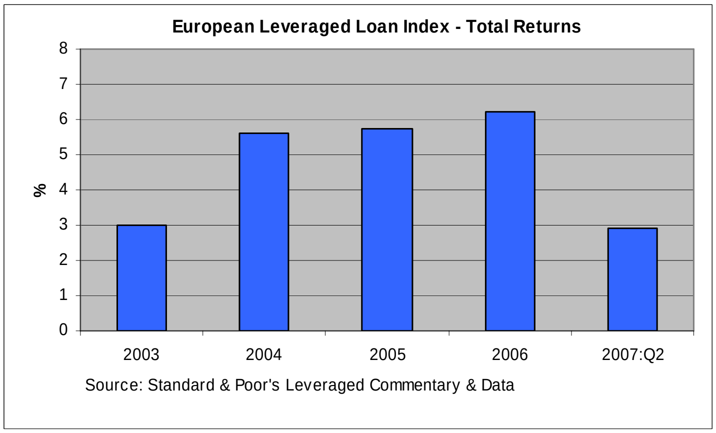
European Leveraged Loan Index - Total Returns
%
8
7
6
5
4
3
2
1
0
2003 2004 2005 2006 2007:Q2
Source: Standard & Poor's Leveraged Commentary & Data

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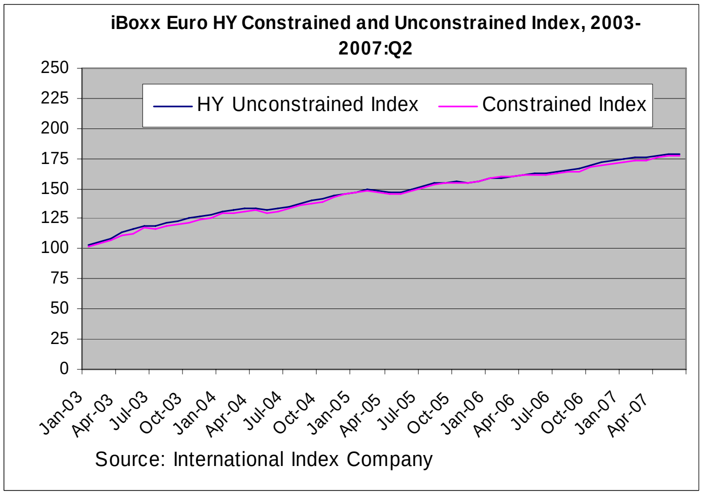
iBoxx Euro HY Constrained and Unconstrained Index, 2003-2007:Q2
HY Unconstrained Index
Constrained Index
250
225
200
175
150
125
100
75
50
25
0
Jan-03 Apr-03 Jul-03 Oct-03 Jan-04 Apr-04 Jul-04 Oct-04 Jan-05 Apr-05 Jul-05 Oct-05 Jan-06 Apr-06 Jul-06 Oct-06 Jan-07 Apr-07
Source: International Index Company

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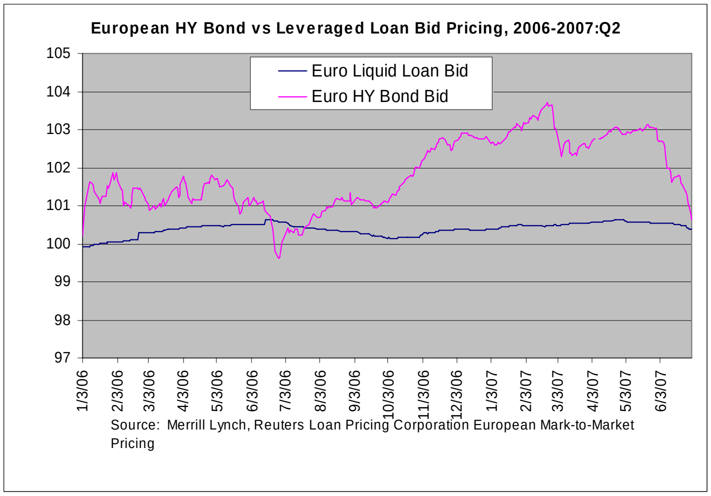
European HY Bond vs Leveraged Loan Bid Pricing, 2006-2007:Q2
Euro Liquid Loan Bid
Euro HY Bond Bid
105
104
103
102
101
100
99
98
97
1/3/06 2/3/06 3/3/06 4/3/06 5/3/06 6/3/06 7/3/06 8/3/06 9/3/06 10/3/06 11/3/06 12/3/06 1/3/07 2/3/07 3/3/07 4/3/07 5/3/07 6/3/07
Source: Merrill Lynch, Reuters Loan Pricing Corporation European Mark-to-Market Pricing

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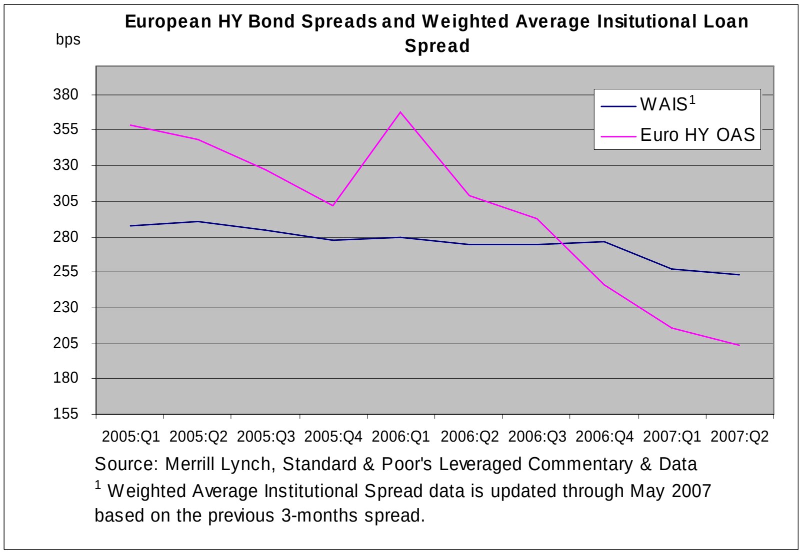
European HY Bond Spreads and Weighted Average Insitutional Loan Spread
bps
WAIS¹
Euro HY OAS
380
355
330
305
280
255
230
205
180
155
2005:Q1 2005:Q2 2005:Q3 2005:Q4 2006:Q1 2006:Q2 2006:Q3 2006:Q4 2007:Q1 2007:Q2
Source: Merrill Lynch, Standard & Poor's Leveraged Commentary & Data
[1] Weighted Average Institutional Spread data is updated through May 2007 based on the previous 3-months spread.