EUROPEAN HIGH YIELD: LOOKING BACK TO LOOK FORWARD

Overview

In this article we provide a summary of the key themes seen in the European High Yield (HY) market during 2018 in the context of the wider European leveraged finance market and provide our views on the current position of that market. From there, we then look forward to consider what we may see in the European HY market during 2019.

2018: Year in Review

2018 was marked by several notable bond transactions in the European HY market despite a significant reduction in volumes. Equally important, however, were the notable trends of a growing diversity of issuers tapping the market and a buy-side becoming increasingly more active and involved in the dialogue.

Moreover, the European leveraged finance market has continued to evolve; 2018 saw the establishment of a clear alignment of documentary terms across European HY and the European leveraged loan market. This alignment represents a critical development as issuers/borrowers in the European leveraged finance market now have a wider range of options to borrow funds and can focus principally on commercial terms and the execution process of a transaction as the differentiating factors when determining optimum financing for a credit.

Alongside this alignment, some of the larger European LBO transactions, such as the TDC take-private financing, have signalled the return to a more traditional financing structure of secured bank debt with a subordinated HY note sitting above the bank debt, a structure commonly used in the US leveraged finance market, as well as being the standard European leveraged financing structure prior to the 2008 global financial crisis. What could then be viewed as a return to normal provides important options for investors in the European market across both secured debt and subordinated debt instruments and may also trigger further developments including potentially longer-dated HY instruments with relatively shorter non-call periods (e.g., 10-year notes with three-year non-call periods) that could represent an attractive financing source for infrastructure credits and businesses looking to lock in fixed rate long-term debt in a rising interest rate environment.

2018 European High Yield Volumes

2018 started where 2017 left off and through June 2018 new issue supply was close to tracking 2017's volume. However, with the headwinds of global financial market instability and Brexit uncertainty appearing in July, 2018 ended with the full year volume considerably lower than 2017 and represented one of the smallest years in volume terms since 2013.

While volumes were significantly down on 2017, a closer look at 2017 reveals that approximately one-third of the transactions were refinancings. In contrast, 2018 had fewer refinancings and, instead, was largely driven by new paper coming into the market to fund leveraged buy-out (LBO) transactions.

The increase in popularity of the European leveraged loan market (which out-performed the European HY market in terms of volume, flexibility and cost) represents the most significant development of the year. Indeed, for LBOs alone in 2018, the European leveraged loan market raised over €65 billion of supply, which represents more than the total new issuance volume in the bond market. However, despite this out-performance, HY importantly featured on several significant deals, typically as the subordinated instrument, allowing issuers to maximize price, leverage and investor base. For example, the TDC take-private financing that completed in June 2018 saw approximately €1.4 billion of notes above the approximately €3.9 billion of loan tranches.

How did we get here? Looking Back

Today's competition for market share between European HY and leveraged loans principally stems back to the global financial crisis and the resultant growth of non-bank lending in Europe. The arrival of debt funds and other alternative sources of finance dramatically changed the European market. Pre-financial crisis, a high proportion of leveraged lending was bank-financed with HY featuring as subordinated debt. Post-crisis, and following the imposition of new regulatory guidelines (e.g., Basel III, etc.), European banks were disincentivized and became reluctant to lend, which created an opportunity for HY (as well as the US loan market). As the market was open and offered a number of attractive features, HY was regularly utilized as a senior ranking instrument in the European markets.

Accordingly, the financial crisis created an environment that allowed HY to proliferate rapidly, which was augmented due to the flexibility it offered issuers, including bullet maturities and less restrictive covenants than traditional European bank debt. This correlated with the requirements of private equity (PE) sponsors desiring debt funding that provided the optimum flexibility to re-invest cash flows rather than service debt. As such, the growth of European HY (along with some participation from the US loan market) created a broad debt market in Europe with no financial maintenance covenants.

This success of European HY led the loan market to refine and tailor its product to win back market share and the result has been a convergence of the European loan and HY markets with both products seemingly trying to outdo each other in terms of covenant flexibility. While historically containing financial maintenance covenants and amortized payments, many European leveraged loans have now adopted the same HY and US leveraged loan practices, including bullet maturities with minimum amortization and incurrence covenants, while, importantly, maintaining the ability for borrowers to repay the loan at any time without penalty before its maturity date (a feature that contrasts favorably to HY, which still includes call protection). This convergence between the European HY and loan markets means that there is now a narrower difference between the products, leaving borrowers to focus on specific market-driven areas of difference such as pricing expectations and liquidity for specific credits, transaction types and structures, which, in turn, provides the opportunity for a more dynamic and liquid market.

What Facilitated the Change in the European Leveraged Loan Market?

Driven by the search for yield in a low interest rate environment, increased competition amongst the investor base and pressure on institutional investors to diversify and ensure profitability of their portfolios (including from Solvency II and other regulatory regimes), investors have looked to higher-risk products such as leveraged loans. This has resulted in an increased convergence in the investor base between HY and leveraged loans, the reduction of capital supplied by traditional banks (although relative to the US market, Europe is still significantly overbanked) and the resultant dominance of institutional investors, managers of Collateralized Loan Obligations (CLOs) and hedge funds.

Today, institutional investors (including managers of CLOs) dominate the European leveraged finance market, and this has allowed the loan origination process to move from a “lend and hold” model, in which the arranging banks made and held the loans to maturity, to an “originate and sell” model in which the arranging banks syndicated the loans to public investors, the latter being much preferred by international investment banks. Whereas the “lend and hold” model was facilitated by banks that were staffed with teams capable of monitoring covenant compliance on an on-going basis, institutional investors generally do not have the same resources and, therefore, HY-style incurrence covenants, rather than traditional bank financial maintenance covenants, better suit the nature of this investor base.

This syndicated loan demand, which has become dominated by CLOs, has established a system that repackages and distributes non-investment grade debt primarily to buyers seeking investment grade-rated paper with outsized yield. Moreover, while CLOs have come to dominate the loan market, since 2015 CLOs have been prohibited from investing in HY by the US Dodd Frank Wall Street Reform and Consumer Protection Act. The result of this is that the European leveraged loan market has never had a stronger investor base. By contrast, while the HY market shares a similar institutional investor base, including both mutual funds and pension funds, no securitization market comparable to CLOs currently exists for HY.

Finally, PE sponsors have also had an influence in this development. The convergence of investor base and terms between European leveraged loans and HY has been of great benefit because, with the pricing spreads tightening between loans and HY, PE sponsors are now able to focus principally on commercial terms and the execution process as the differentiating factors when determining optimum financing.

Diversification of Issuer and Issuance Type

While several industries that typically access the European HY market, such as retail and basic industry, had a challenging year, 2018 saw a significant increase in participation in the European HY market by cross-over credit issuers (typically BB+ rated issuers), such as the offering by Baltic-based retailer Maxima Grupe, companies operating in the infrastructure space, including the offering by Getlink, and strong performances by companies in the healthcare and telecom industries.

This growing diversity reflects the current depth and long-term strength of the European HY market. Looking at infrastructure, while in Europe this sector has typically been financed by the bank market (in contrast to the US infrastructure market, a large portion of which is bond-financed), the depth and maturity of the European HY market is now allowing it to become an increasingly popular choice for large infrastructure operators. Moreover, issuances by cross-over credits represent a "fallen angel" phenomenon that is unique to the HY market and significantly drives issuer diversity because no comparable dynamic exists in the loan universe as investment grade borrowers rarely issue syndicated loans. In Europe in particular, a large portion of the investment grade market consists of issuers with BBB ratings. As such, any downgrades could significantly increase the size of the European HY market and represent a significant opportunity for HY investors, especially as a number of existing investment grade investors may be prohibited from holding sub-investment grade debt.

Alongside this, due to the large difference between US dollar and euro interest rates, the European HY market also continued to see US companies with euro requirements issuing bonds (Reverse Yankee Bonds). This represents a continuation of a theme from 2017 (and will remain a theme given the differing monetary policies between the US and Europe) and provides important investor diversification for US companies while also taking advantage of the pricing differential between the European and US markets. In addition, the European market has also embraced new types of HY bonds such as green financing bonds, including Getlink's offering of one of the first European green HY bonds in September.

Finally, tied to the resurgence of the European leveraged loan market and related jumbo LBO activity, the European HY market has seen a significant increase in volumes of subordinated HY debt issuance (Senior Notes), such as the offering by TDC. These bonds have typically been issued in the context of large LBOs where a slug of subordinated HY debt has both facilitated leverage levels and maximized investor demand. Noting that this takes its cue from the US leveraged finance market (where the HY bond is typically a subordinated instrument in the capital structure) and is consistent with the pre-financial crisis European leveraged finance market, we may now be seeing a return to normal, with large leveraged deals financed by secured bank debt and senior unsecured and sometimes subordinated HY notes.

Increasing Buy-Side Dialogue

2018 was also marked by increased buy-side investor dialogue with a significant number of deals having their terms flexed ahead of pricing. While it is commonly seen in the European leveraged loan market, the adjustment of terms in the European HY market has traditionally been significantly less prevalent than it was during 2018. This constructive engagement not only indicates a growing discipline among the buy-side for HY credits, but a sign that covenants may increasingly begin to follow the risk of a credit as opposed to the underlying market dynamics. Indeed, deals including Recordati, Cirsa, TDC, Nexi Capital and Fedrigoni, amongst others, all tightened their terms ahead of pricing. The various changes included, for example, a tightening of the restricted payments covenant, especially with regard to leverage-based restricted payments; the removal of the 10% at 103 call feature during the bond's non-call period; amendments to the synergy features in the definition of EBITDA (including a reduction in time horizons and limiting such synergies to an overall cap); and the removal of the bond's portability feature or the tightening of the terms by which portability can be used. Furthermore, increased buy-side dialogue is also reflected by the HY division of the Association for Financial Markets in Europe (AFME), which has established a relationship with the recently formed European Leveraged Finance Alliance Investor Group.

2019: Looking Forward

With the CLO-driven European leveraged loan market continuing to offer significant competition to, as well as a complementary option alongside, the European HY market and on-going global and European uncertainty, it is generally believed that European HY issuance volumes in 2019 will remain broadly in line with the levels seen in 2018, in particular if defaults remain low and global growth is still evident. Nonetheless, while significant risks to growth remain (e.g., global trade wars, Brexit, Italy), clarity around some of these factors should emerge and this could help unlock HY issuance.

However, with average new issue yields back to 2016 levels and potentially going wider as the European Central Bank's (ECB) quantitative easing (QE) programme ends, alongside an expectation that the ECB will raise rates for the first time in eight years during 2019, the potential economic benefits of an early refinancing are reduced – noting also that a large portion of issuers made hay while the sun shone during 2017 and H1 2018, meaning there already remain fewer refinancing candidates. Those who are late to the party will likely see noticeably higher coupons for HY bonds, due not only to the increases in market rates but also because many are more challenging credits. It should be noted, however, that those increasing coupons are more of a return to normal, as the historically low rates of the last decade have been the result of an external stimulus to the market that cannot continue indefinitely. Those who have been in the HY market for a longer period of time will recall the pre-stimulus days that generated the market's "High Yield" moniker.

Notwithstanding the foregoing, the diversity of issuers is likely to grow, and many expect a large volume of HY to be driven by BB-rated corporates as well as cross-over credits, Italian businesses and subordinated tranches in large LBO transactions. There is little doubt that we will continue to see industry-specific issuances as well as issuers looking to tap the capital markets in advance of an IPO (the HY offering process can act as a first foray into the international capital markets, and the IPO process is able to leverage selected portions of the HY offering memorandum including risk factors, the business description and the Management's Discussion and Analysis of Results of Operations).

Italy is likely to remain effectively HY-centric with loans requiring a fronting bank structure that creates substantial settlement delays. Moreover, concerns over the Italian economy, as well as its banks' appetite to lend, could create further opportunities for the HY market. Alongside this, the European HY market is likely to remain a fruitful source of supply for Reverse Yankee Bonds as US companies with euro needs lock in cheaper coupons than the US market can currently offer. However, these transactions will also need to compete against the price differential between offering in dollars and then swapping into euros, which has previously been cheaper in absolute terms for US companies, if slightly riskier.

While looking at recent developments in the European leveraged market, there is also the potential that we could see similar creativity and adaptation from the European HY market during 2019. For example, 2019 may see the greater use of floating rate notes, which offer reduced non-call features, or there could be issuances of fixed rate HY notes with reduced call protection. Alternatively, we could see the use of multiple tranches of bonds with different maturities to ensure flexibility to redeem some debt or a perhaps return to longer-dated bonds as issuers look to lock interest rates in a rising rate environment but with a shorter (but more common) non-call period (e.g., 10-year notes with three-year non-call periods).

What is clear though is that with the emergence of significant competition from the European leveraged loan market, in particular with regard to LBOs, we will likely see a return to a more traditional financing structure of secured bank debt with a subordinated HY note sitting above. Again, those with longer memories will recall this as the standard European HY structure prior to the financial crisis. In addition, with stock prices currently significantly depressed, public companies may represent attractive targets for PE sponsors and this may further support LBO volumes and be particularly attractive in the Public-to-Private M&A space.

Nonetheless, it is likely that scope will remain for all four principal debt financing capital structures (i.e., a secured credit facility and senior (subordinated) notes; senior secured notes and a super senior revolving credit facility (RCF), term loans (including first and second lien structures) and an RCF; and senior secured notes alongside senior secured credit facilities) depending on the dynamics of a particular transaction.

The trend of increased buy-side interaction is likely to remain, especially with the buy-side's increased selectivity, and therefore dialogue between sell-side and buy-side is likely to increase. Alongside this, 2019 will likely also see increased competition from private lenders. As market rates increase, the delta between the target rates those lenders seek and those of the market reduce, making private deals a more viable alternative.

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In Conclusion

The European leveraged finance market continues to evolve and now offers a number of alternative and complementary debt financing options. With over three decades of new issue history across three economic downturns, the European HY and wider leveraged finance market has grown, seasoned and matured. In many cases, issuers, borrowers and investors who initially approached the European HY and later the European leveraged loan market as alternative and competing products can now maintain a secular view across these financing products. Ultimately, issuers, borrowers and investors know the argument between the products now comes down to relative value in the context of a specific transaction, which is likely to continue to develop and change throughout 2019. This signals a positive evolution in the European leveraged finance markets and while in the short term one market could offer benefits over the other, at the end of the day, there is a constant ebb and flow across the products and there will likely be further development and evolution in 2019, which is good for everyone.

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