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EUROPEAN HIGH YIELD: KEEP ON KEEPIN' ON

Spurred by an improved global macroeconomic environment, the European High Yield ("HY") market had a strong performance in the second half of 2019. The current HY rally is poised to continue through the first half of 2020 supported by continued macroeconomic and near-term political certainty in Europe. Against this favourable economic and political backdrop, trends seen in the second half of 2019 are likely to persist, such as the prevalence of HY refinancing deals (including loan-to-bond and bond-to-bond), US companies opportunistically accessing the European HY market and the continuous evolution of HY covenant terms. This year is also likely to see an increase in HY-financed M&A mandates, a growing share of the global HY market represented by Emerging Markets issuers and a sustained focus on ESG by HY investors alongside continued financing competition from direct lenders.

2019: YEAR IN REVIEW

The European HY market in 2019 was characterised by a sustained fall in average coupons and a rally of corporate refinancing in the last half of the year.

Despite a sluggish start to 2019, primarily due to macroeconomic uncertainty surrounding interest rates, a slowdown in a number of European economies and political uncertainty stemming from both the on-going trade tensions between America and China and the Brexit negotiations, 2019 recorded the second-largest volume of HY issuances for the decade at €74.1 billion, up from €63.5 billion in 2018. This deal volume principally followed the US Federal Reserve's change in interest rates during summer 2019 and the EU's corresponding decision to resume quantitative easing ("QE"). These regulatory decisions resulted in record-low yields for HY bonds including Dufry's €750million 2.00% Senior Notes issued in November 2019 and the largest quarterly volume of deals in the fourth quarter for two years.

Refinancings were the largest component of the 2019 European HY market, significantly outpacing M&A driven activity. At roughly 37.5% of 2019's overall volume (compared to 30% in 2018), issuances by BB-rated issuers, such as

Key issues

- The second half of 2019 saw a large volume of corporate refinancing alongside record-low coupons. This trend has continued into the first half of 2020.
- With continued macroeconomic and near-term political certainty, the 2020 European HY market has already opened demonstrating a strong early performance.
- The European HY market in 2020 is expected to see (a) continued HY refinancing deals (including loan-to-bond and bond-to-bond) (b) strategic accessing of the market by reverse Yankee issuers; (c) a growing share of the global HY market represented by Emerging Market issuers; (d) the continued evolution of covenant terms by sponsors; (e) continued competition of the HY product with TLB lenders and direct lenders; and (f) a sustained focus on ESG by HY investors.
- While there is sustained confidence in the market for the first half of 2020, greater uncertainty exists for the second half of 2020 as markets are expected to slow ahead of the US presidential election as well as likely growing concerns over whether a UK-EU trade deal can be reached by the end of 2020.

OCI's $1.4 billion senior secured notes issued in October 2019, accounted for a larger share of total debt placements in 2019 and the greatest allotment for this rating in Europe since 2005. This was largely due to unprecedented spread compression together with the European market's significant number of BB issuers. In conjunction with higher volumes of BB issuances, 2019 also saw improved investor returns. This trend was echoed in the US market where according to the S&P US Issued High Yield Corporate Bond Index, returns for BB bonds outperformed both B and CCC bonds, at 15.2% (compared to 9.64% for CCC and 14.4% for B). The overall asset class in the US provided a double-digit return throughout the year, at more than 14%, after closing 2018 in the red.

2020: LOOKING FORWARD

The European HY market at the start of 2020 is in a markedly stronger position than it was at the start of 2019 as evidenced by €4.15 billion of issuances during the first two weeks of 2020 alone. Whereas the last few months of 2018 saw a secondary sell-off, a waning primary and concerns about slowing global economic growth, the final quarter of 2019 saw €26.2 billion of overall European HY issuances (compared to €6.9 billion in 2018 and €9.4 billion in the first quarter of 2019).

The US Federal Reserve's change in interest rates last summer played an important role in the HY rally experienced during the second half of 2019. This change undoubtedly stimulated the US economy as well as the global economy as a whole and simultaneously enabled a number of central banks globally to begin easing monetary policy, including, in some cases, returning to open market purchases and QE, without weakening their exchange rates against the US dollar. This catalysed a move by investors to re-allocate investments to fixed rate debt products (such as HY bonds) from floating rate products. Combined with further QE in Europe as well as in Japan, the global economy in 2020 appears poised to enjoy the benefits of economic growth and worldwide monetary easing which has led to lowering interest rates and a resultant hunt for yield among investors.

Global fundamentals are also cause for cautious optimism. The International Monetary Fund anticipates a rebound in global gross domestic product growth in 2020, with emerging markets in particular already performing better than in 2019 in part due to China's anticipated fiscal stimulus and the expectation that the US economy will continue to grow at a steady pace that neither reduces risk appetite out of emerging-market assets nor erodes confidence in the global environment driving investments away from them. Moreover, the expectation of a near term global recession appears to have receded with an accompanying improvement in market sentiment. There is also hope that with the upcoming US presidential election there may be some easing of US-China trade tensions (recently signalled with the signing of Phase 1 of the US-China trade agreement) which will likely engender further macroeconomic stability to the financial markets.

This favourable macroeconomic backdrop and low interest rate environment is likely to create further refinancing opportunities and spur HY issuance. Analysts believe that investors looking for yield and opportunistic borrowers will front-load issuances to lock-in the benefits of the current environment particularly in light of potential macroeconomic turbulence in the second half of the year stemming from the upcoming US presidential election and concerns around the likelihood of reaching an EU-UK trade deal by the end of 2020, this was witnessed by the surge of issuance in the first two weeks of the year.

Pricing is central to this trend in the global HY market which in turn is directly impacted by the amount of funds deployed in the HY market. During 2019 the market saw a strong net inflow into HY bonds (+ $17.5 billion at September 2019), compared to a net outflow in 2018 - $45.7 billion). As a result, measured on a three-month basis ended on December 6, 2019, the fall in average new-issue yields, which hit record lows of 2.98% for BB and 4.33% for B indicates that demand from borrowers will continue. Such low yields will likely entice more loan borrowers to opportunistically refinance in the fixed rate bond market and make HY bonds more competitive on pricing compared to floating rate leveraged loans.

Corporate Refinancing

Bond-to-Bond Refinancing

European bond-to-bond HY refinancing in 2019 saw the largest-ever volume of this measure, at €25 billion (just surpassing 2017's €24.6 billion). Although there is an estimated €110 billion of bonds callable in 2020, it is unclear whether 2020 can replicate 2019's volume. Although yields are at record lows, the significant number of refinancings in 2019 has front run a number of possible refinancings in 2020. The crop of potential 2020 refinancings are largely 2017 issued bonds that are coming out of their non-call, and as 2017 saw similar competitive new-issue coupons as 2019, the incentive on pricing may be reduced but extending the maturity profile will be attractive and provide clear advantages for issuers. In addition, there are often potential benefits such as improving covenant flexibility.

Loan-to-Bond Refinancing

Refinancing bank debt with HY bonds has increased with deals such as OCI and Berry Global, coming in at €12.15 billion in 2019 (the fourth-largest volume this decade and more than doubles 2018 volumes). While some market observers have argued that the loan-to-bond refinancing trend has been driven by a desire for more flexible covenants the move is increasingly price-driven as seen in the clear pricing arbitrage in the BB rated space. For these borrowers, coupons are on a downward trend, so there will either be refinancing opportunities into a bond or repricing opportunities within the loan itself. However, for private equity ("PE") sponsors, the life-cycle of the underlying investment in the portfolio company may also play a role here. For example, sponsors seeking to exit their investment in the short term may, in the absence of favourable portability terms, eschew the option of refinancing into a fixed rate bond so as not to bind themselves to a longer non-call period than would be included in a loan, despite otherwise attractive pricing opportunities. It is therefore reasonable to expect that the loan-to-bond refinancing trend will continue in 2020, but for PE sponsors it will remain subject to an investors' investment life-cycle in the credit. Notwithstanding the foregoing, if the market rallies and bond spreads tighten there will be more loan-to-bond refinancings, as seen during the first few weeks of 2020 where low funding costs continue to drive borrowers such as Techem, Ineos Styrolution, Stena International and Victoria to refinance into bonds.

While some financings are expected to be diverted from the loan market by way of loan-to-bond refinancings and a potential increase in the overall volume of HY bond issuances this year, leveraged loans and TLBs in particular are likely to remain competitive against HY bonds. Indeed, some borrowers, including PE sponsor owned credits or highly acquisitive businesses may prefer TLBs over bonds notwithstanding HY's competitive price position due to the speed of TLB execution and flexible prepayment features. However, the HY market offers a deeper investor pool and pricing and market conditions can lend a similarly strong rationale for borrowers to refinance into bonds. Refinancing into bonds allows investors to take advantage of low yields and/or protect themselves against declining markets by replacing floating rate loans with fixed rate bonds. Additionally, HY bonds offer further advantages in countries such as Italy where they are a structurally favoured product over bank financing and the cost and time invested in the Rule 144A due diligence and disclosure process can also be seen as a future cost-saving investment and good preparation for a borrower contemplating an IPO in the future (or, conversely, for an existing listed company as the basis for a quickly executable transaction).

Acquisition Finance

One area where the 2020 HY market may likely see significant activity is in the acquisition finance space considering the €11.7 billion volume in 2019 was the lowest level for the last three years and represented a significant decline from 2018's €21.1 billion. In addition to deals committed in 2019 that will be executed in 2020, the line-up for M&A deals in 2020 is building and HY bonds should remain competitive against, or attractive in combination with, TLBs in particular owing to their current pricing position, deep and liquid capital market, flexibility around leverage levels, ability to be issued as unsecured debt as well as more easily finance cyclical credits. Moreover, PE's dry powder stood at almost $2 trillion globally at the end of 2019, creating significant pressure to deploy some of this capital during 2020 and alongside this the investment cycle of portfolio companies acquired between 2014 and 2016 may be coming to an end, prompting a potential suite of pass-the-parcel transactions.

Direct Lending

Direct lending continued to grow in 2019 with a number of leveraged borrowers turning to the direct lending market for leveraged financing. For example, Premium Credit, a UK-based finance company, recently redeemed in full of its outstanding HY bonds conditional upon a new privately financed credit facility. In addition, the £1.0 billion refinancing of British telecoms company Daisy Group ("Daisy") in the first quarter of 2019 with Ares Management Limited ("Ares"), represents one of the largest ever private direct financings in Europe. While Ares first provided junior capital in 2014 to support the take-private of Daisy, and since then has been involved in a number of add-on financings for Daisy, this £1.0 billion financing is a significant step up and illustrates the size of deal that can now be financed by direct lenders. Competition from direct lending market with the European HY market is likely to continue in 2020.

Reverse Yankees

The European HY bond market in 2020 is likely to see a continued trend in "reverse Yankee" HY issuances. Reverse Yankees in the European HY market refer to US companies issuing bonds denominated predominately in euro. While originally this market was driven by competitive pricing dynamics between the dollar and euro markets, the €1.1 billion issuance of senior notes by Netflix in October 2019 evinces a growing trend of US companies with significant European operations seeking to issue euro debt in order to better balance their financial profile through natural hedges. This strategy coupled with current low European borrowing costs, where in the euro zone in particular interest rates are at minus 0.5% and the average yield on corporate euro-denominated bonds has fallen to 0.48% (compared to 1.86% in the United States and 2.83% at the start of 2019) will likely see this trend continue in 2020.

Emerging Markets

Over the last decade HY issuances out of Eastern Europe, Africa and the Middle East have, along with Far-East Asia and Latin America, become a standalone asset class and a new focus area for investors. In 2019, emerging markets ("EM") HY bond issuances accounted for 23% of global HY issuance, compared to 16% for European HY issuances.

With yields on government bonds and other safer asset classes set to remain low, investors are likely to increasingly seek higher-yielding alternatives in riskier markets such as Eastern Europe, Africa and the Middle East ("EMEA"). In 2019, companies in developing nations sold a record $118 billion of HY bonds, a total that has more than doubled from five years previously. EMEA, in particular, recorded a number of high profile EM issuances with Nigeria-based telecom infrastructure company, IHS Nigeria, placing $1.3 billion of senior notes. Alongside this, the EM market presents borrowers and investors with non-traditional opportunities, such as the sale by Arabian Centres Company, a Saudi mall operator, of an innovative $500 million sukuk with HY-style covenants, as part of a wider $1.9 billion refinancing package. Momentum in EM issuances is likely to continue in 2020.

Covenant Evolution

A key feature of the 2019 European HY market was an increase in dialogue with the buy-side investors that was characterized by a small but growing number of deals having their terms amended ahead of pricing to address roadshow investor feedback. This dialogue has helped the European HY market focus on key investor protections and a more disciplined approach has been taken to credits in the market. At the same time, however, covenants have continued to evolve principally driven by top tier PE sponsors and developments in the TLB market which continues to influence HY covenants, with a number of developments including:

- *Debt incurrence using Restricted Payment capacity*: A provision that allows an issuer to increase leverage by using capacity earned under the Restricted Payments build-up basket (Power Solutions, TAP, Merlin Entertainment).
- *Restricted Payments Build-Up Basket Floor*: Establishing a zero floor in the Restricted Payments build-up basket for negative CNI or any Restricted Payments that count against the build-up basket (Merlin Entertainment, Kantar).
- *Removal of the Restricted Payments Build-Up Basket leverage test*: The removal of the requirement for the issuer to comply with a ratio debt incurrence test (either fixed charge coverage ratio or consolidated leverage ratio) before utilizing Restricted Payments capacity (Merlin Entertainment).

- *Restricted Payments with waived Asset Sale Offer proceeds*: A provision that has allowed issuers to increase the Restricted Payment build-up basket capacity with asset sale proceeds that have been waived by bondholders (Kantar).
- *Disapplication of Default provisions for Restricted Payments:* A number of 2019 deals have eliminated the no Default or Event of Default condition when making Restricted Payments as well as disapplying it from the Restricted Payments build-up basket (Power Solutions, Grifols).
- *Leverage-based testing for Asset Sale proceeds:* A number of deals now feature a leverage-based grid for Asset Sale excess proceeds such that the amount of excess proceeds to be used for an Asset Sale Offer can be reduced on the basis of a leverage test (Kantar, Merlin Entertainment, Cirsa, Power Solutions).
- *Anti-Net Short Provision:* This controversial provision in the 2019 European HY market, which evolved from the Windstream litigation in the US and subsequent adoption in the US HY market, disenfranchises bondholders who are net short on the issuer from the voting provisions in the indenture (Merlin Entertainment).
- *Events of Default – two year sunset:* Alongside the above net short provision, this feature imposes a two-year limitation on when a default notice may be given to the issuer from bondholders after the issuer has taken a publicly reported action (Inmarsat, OCI).

Further evolution of terms will likely remain a feature in 2020, especially terms originating in the US HY market or the TLB market, as top-tier sponsors alongside high performing repeat issuers continue **to** push for more flexibility and related covenant evolution. However, alongside this, investors are likely to continue to check basket limits and ratio capacities specifically, enforcing some bright lines and pushing back if the issuer's industry, jurisdiction or credit quality is considered risky or transaction momentum is against the issuer.

Continued focus on ESG

Environmental, Social and Governance ("ESG") factors are likely to increasingly become a feature in the European HY market in 2020 and beyond as investors continue to focus on whether their capital is contributing to a more sustainable future (see "*From junk bonds to just bonds - the increasing importance of ESG financing in European high yield*"). While historically there has been substantial focus on green financing products that raise funds for projects with direct environmental benefits, investors are also looking to issuers' broader ESG credentials as part of their commitment to sustainable investing. The capital markets have responded to this with a wide range of financial products to meet these demands and HY issuers have also begun designing products that conform with popular green principles, such as Getlink SE's green bond to finance clean transportation and energy efficient products. While these deals are predominantly limited to Regulation S only transactions (non-US distribution) involving BB or greater retail issuers, with at least $3 trillion of institutional assets now tracking ESG scores and over $1 trillion ESG bonds expected to be issued in 2020, investors search for yield in the current macroeconomic environment means we are likely to see an increased volume of HY issuers tap the ESG compliant sector of the HY market.

CONCLUSION

Good fundamentals underpinned by global economic growth, near-term political stability and loose monetary policy point to an overall positive year for the European HY market, with most activity expected to be seen during the first half of 2020. A number themes from 2019 are likely to continue into 2020, supplemented by new trends including an increase in HY-financed M&A activity, reverse Yankee bonds, EM HY issuances, investor focus on ESG and greater competition among HY, TLB and direct finance providers. In navigating the 2020 European HY market, companies, PE sponsors and investment banks are likely to build upon the momentum experienced in the second half of 2019 in order to keep on keepin' on.

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