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THE PAST YEAR HAS SEEN THE BOND MARKET HUNGRY FOR PAPER, ALLOWING ISSUERS TO BENEFIT FROM LOWER SPREADS THAN MIGHT BE EXPECTED FROM IMPROVING CREDIT QUALITY ALONE. **BARBARA RIDPATH,** EUROPEAN HEAD OF STANDARD & POOR'S RATINGS SERVICES, LOOKS AT ISSUER PROSPECTS FOR THE REST OF 2005 AND QUESTIONS WHETHER THIS CAN BE SUSTAINED.

Towards the end of 2004, total non-governmental issuance into the Eurobond market had risen only 10% in dollar terms on the previous year – compared with an increase of 24% in 2003. This relative contraction together with the composition of 2004 issuance reveals several trends that are combining to dictate pricing. What may be apparent is that high investor appetite and limited supply is further challenging credit quality as a main driver of spreads. Whereas credit quality is by nature a medium to long term consideration, the shorter term buy-or-hold priorities of investors – including the need for investors to report their assets on a mark-to-market basis – may now be causing a negative mismatch between pricing and medium term default risk.

Furthermore, as both buy- and sell-side liquidity has tended towards more speculative grade paper – which now accounts for around 25% of rated issues outstanding, and a higher percentage of new issuance – the effect of ratings actions on market pricing is becoming correspondingly more of a risk. Added to this potential source of pricing volatility is the effect of ever increasing debt: EBITDA ratios in the leveraged loan market.

The outlook, therefore, may be one in which narrow pricing spreads cannot be sustained without improvement in credit quality and corporate profitability. But with such improvements largely limited to the UK and the wider risk-picture still cloudy, spreads may ultimately have to widen in order to accommodate default risk – especially in high yield.

CREDIT QUALITY AND RATINGS VOLATILITY Why, then, the relatively slim issuance in 2004? First, corporates largely 'pre-funded' in 2003 in anticipation of higher rates, which did not come. In the face of largely stable rates, there was not much reason for further capital raising in 2004, especially in the absence of any increase in demand that would encourage new investment in productive capacity. Second, European corporate profitability has rebounded strongly. This, together with a relatively weak continental economy, relatively low needs for capacity expansion and a relatively weak environment for mergers and acquisition activity have limited companies' need for new funds.

One growth sector was financial institutions, however, where issuance rose by 27.5% mainly to fund the growth in consumer credit – although industrial issuance fell by almost the same percentage. Indeed, overall net issuance after redemptions was negative for short-dated maturing euro-denominated bonds in 2004 – the first time this has been the case since the beginning of the euro five years ago. Moreover, until the end of 2004, there was a

Executive summary

- Low Eurobond issuance through 2004, the trend towards speculative grade paper and increasing debt:EBITDA ratios in the leveraged loan market all indicate that spreads may have to widen in the future.
- Lower ratings are being driven by the addition of newer ratings for smaller companies in Western Europe and the increase in lower rated debt in general.
- Despite some optimistic indicators for the rest of 2005 Standard & Poor's is not bullish about the credit markets and does not expect sustained credit quality improvements.

THE OUTLOOK, THEREFORE, MAY BE ONE IN WHICH NARROW PRICING SPREADS CANNOT BE SUSTAINED WITHOUT IMPROVEMENT IN CREDIT QUALITY AND CORPORATE PROFITABILITY.

relatively weak supply of longer-dated bonds. This situation has changed in early 2005, with issuers taking advantage of low rates to issue long-dated paper, much sought after by pension fund investors.

In terms of credit quality, the overall 'downgrade ratio' for Western Europe in 2004 was 1 – meaning an equal number of upgrades and downgrades. But this conceals deeper variability in credit quality, both regionally and in terms of the credit cycle. For instance, when we factor in Eastern Europe, the overall downgrade ratio for Europe falls to .76 – indicating that Eastern Europe's credit quality is improving more rapidly than that of Western Europe. By contrast, when we remove financials and services from the Western European picture, the remaining industrial corporates give a less impressive showing – a downgrade ratio of 1.36. This is largely attributable to downgrades among Nordic and German issuers, and is potentially discouraging given that industrials are generally taken to be a barometer of credit quality by investors. The best performance, by contrast, was in Southern Europe – largely driven by upgrades among financial institutions in Spain, Portugal, France and Italy.

An overall downgrade ratio for industrial corporates of 1.36 is nonetheless a substantial improvement on the respective figure for 2003, which was 4.1. Indeed, the speed with which ratings deteriorated and then improved over this last cycle is quite remarkable, and warrants explanation. It would appear that this ratings volatility is due to firms now becoming accustomed to lower average ratings, which, according to Standard & Poor's rating default and transitions studies, are more subject to adjustment in either direction.

SPECULATIVE GROWTH Lower ratings can be accounted for in two ways. Firstly, there is the fact of newer ratings being added for smaller companies as the Western European debt markets mature. The greatest growth in ratings has been in the UK, Germany and Eastern Europe, each of which market produced more than 15 new corporate ratings in 2004. Whilst in the UK this can be accounted for by smaller companies seeking bond or leveraged finance, the beginnings of disintermediation from banks to capital markets has led to the demand for ratings in Germany. New corporate and insurance company ratings dominated in these markets – with the exception of Eastern Europe, where new ratings were mostly for banks and corporates.

The second driver of lower ratings is, of course, an increase in lower-rated debt from corporates as a whole, with the median new rating among industrial issues BB- at the end of 2004. Despite this, median rating among all European corporates is now BBB+, and this is higher than the BBB median in 2002. The median rating in North America, the economy of which tends to prefigure developments in Europe, hovers in the lower BB range. But this is a function of American investors' relative comfort levels with leverage and the rating of start-ups earlier in their lives. As such, we would not expect European issuers to follow this example fully.

The median rating in Europe is instead likely to stay within the BBB category, i.e. no lower than BBB-, for two reasons. First, this is a rate that effectively balances the risks and returns for both equity holders and debt holders. Second, investors on the whole remain marginally more conservative in Europe than North America.

But it is nonetheless clear from Standard & Poor's Ratings Transition and Default studies that ratings on the edge of investment grade move more frequently than those at higher levels, as these financial positions are less stable and more susceptible to changes in economic conditions. This may go a long way toward explaining the high downgrade ratios of 2001-2003 among corporates and the strong correction currently underway – and the attendant volatility in spreads.

Speculative grade ratings now account for almost 25% of Standard & Poor's bond ratings in the European region. But this data is skewed in that 35% of corporate ratings and a full 93% of Central and Eastern European corporate ratings are speculative grade (the latter at least in part due to country risk in some markets). Also, corporate ratings tend to be lower than banks and insurers in any case. There are two reasons for this. First and foremost, credit quality is important to the ability of financial services to continue to generate business, which is less the case among corporate issuers. Second, regulatory supervision requires certain minimum standards to exist among all regulated financial institutions. However, it is important to recognise that high yield issuance still represents under 5% of total volume of transactions for European issuers.

But given the increased interest in speculative grade debt, it is worth asking whether this is a sea change in investor appetite, a function of a low absolute interest rate environment and a low spread environment, or just another cyclical phenomenon (with the market currently being at the frothy end of the up-side of the cycle). Speculative grade bond growth was accompanied by strong speculative grade loan growth, where volumes are being driven by leveraged buy-outs and secondary buyouts. Within the leveraged loan market, key credit measures are moving to a level of aggressiveness in gearing and coverage that approach the peak levels of 1998. There is little or no room for any economic correction without credit repercussions for these transactions. Some of them

REGULATORY SUPERVISION REQUIRES CERTAIN MINIMUM STANDARDS TO EXIST AMONG ALL REGULATED FINANCIAL INSTITUTIONS.

are now relying on unrealistically high levels of growth in corporate profitability to be able to reduce debt. This in turn has significant implications for recovery value on this debt, in the event of default.

Another element of demand for corporate assets is structured finance, where speculative grade bonds and leveraged loans form the asset base for collateralised bond obligations (CBOs) and collateralised loan obligations (CLOs) – together known as collateralised debt obligations (CDOs). Standard & Poor's has rated $22.5 billion of debt issued in such transactions, which gives some indication of the appetite for assets to fill them. High demand together with lower issuance is also putting pressure on spreads for these assets.

FUTURE OUTLOOK Based on this picture, there are somewhat conflicting signals for the remainder of 2005. On the one hand, the number of issuers on negative outlooks or CreditWatches are at the lowest levels they have been since 1994 – 15.5% of all Western European ratings at the close of 2004. But within industrials sector alone in Europe, the numbers are slightly more pessimistic – over 18% – despite this being a substantial improvement on the 27% figure in 2003. And these figures compare favourably with the global data, which shows negative outlooks or CreditWatches at 21% this year (as opposed 26% in 2003).

This sounds quite optimistic. But given that positive outlooks are significantly fewer – only 6.4% in Western Europe against a global total of 7.6% – the flat downgrade ratio mentioned at the outset may not be sustained. If you add the skewing of speculative grade ratings towards the lower end of the scale, along with aggressive leverage and coverage levels in the leveraged loan market, a faster than average transition of these credits to default is possible – especially in the case of changes in the economic environment.

Standard & Poor's is not, therefore, bullish about the credit markets, nor do we see a tremendous upside in ratings. Many traditionally conservative corporate issuers are now happy to manage their business on the cusp of investment grade. They are actively managing their ratings to try to optimise value for all their stakeholders, and therefore we do not expect significant further de-leveraging. Moreover, it is only a matter of time before cash accumulated is either returned to shareholders or invested in expensive acquisitions. Add to this the fact that the European economic outlook (outside the UK) remains lacklustre at best, and Standard & Poor's does not expect the rate of credit quality improvements to be sustained into 2005.

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