High-yield flies high

CHETAN MODI LOOKS AT WHAT'S BEHIND THE POSITIVE MOMENTUM IN THE EUROPEAN HIGH-YIELD BOND MARKET AND WHETHER IT CAN CONTINUE.

Since the credit shock that occurred after the Lehman bankruptcy in 2008, Moody's default studies have seen a relatively benign global default environment. This stable credit and default environment largely reflects the positive impact of government stimulus programmes together with historically low interest rates (see Figure 1).

Another factor contributing to the low default rate has been the willingness of high-yield bond markets in the US and Europe to refinance companies in an environment where funding from banks has been more difficult to obtain. Throughout this year, these markets have remained open despite the uncertainties caused by the Japanese earthquake, the ongoing turmoil in the MENA region and the high level of oil prices.

RECORD LEVELS OF EUROPEAN HIGH-YIELD BOND ISSUANCE

In fact, so far this year the European high-yield bond market has been financing progressively riskier credits. This increased investor appetite for risk has largely reflected investors' search for yield in a low interest-rate environment, which has also resulted in yields falling for similar-rated credits. Moody's has rated a number of Caa bonds (14% of the total in the first half of the year), as well as pay-in-kind instruments that are sometimes judged as indicating top-of-the-market sentiment. Financial metrics for new issuers have also become more stretched. As an example, Moody's adjusted opening debt/EBITDA for new issuers rose by over one turn in the past year to over five times.

A positive outcome of this dynamic has been a deepening of the European high-yield market, with increased supply from companies in a broad range of industries being matched on the demand side with the establishment of new dedicated high-yield funds.

We expect that funding from banks will remain more constrained going forward than has historically been the case, given the impact of new regulations that will, among other things, require them to hold more capital. The structured credit market that helped fund much of the leveraged buy-out (LBO) boom in the middle of the past decade is also noticeably absent in Europe at the moment, again reflecting the impact of new regulations as well as the changed economics of those transactions.

European companies have therefore been flocking to the high-yield bond market, mainly to refinance their bank debt. High-yield issuance in EMEA amounted to a record $65bn in 2010, and issuance in the first half of 2011 was $58bn.

About one-third of this debt was issued by companies tapping the market for the first time. Many corporate treasurers who have historically relied solely on the bank market are recognising the risk management benefits of diversifying their sources of debt funding. High-yield bonds also provide greater flexibility of covenants compared to bank funding, notably the lack of financial maintenance covenants, but also in terms of general business operations. The addition of high-yield bonds to a company's debt structure, with long-term fixed rate funding, also helps in derisking. The market itself has been responsive to investor concerns about rising interest rates through the return of floating-rate notes, and also to concerns of some companies about redemption terms by providing additional non-call flexibility.

CONTINUED LOW DEFAULT RATES SUBJECT TO EVENT RISK

Although our expectation is that near-term default rates will remain

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low, there are various factors that could cause a potentially material deviation from the base case forecast.

One factor is the potential for increased interest rates. In its recent annual report, the Bank of International Settlements commented on the various dangers of maintaining the current level of interest rates, which are zero or negative in the UK, the US and the euro zone. The European Central Bank appears to be particularly focused on this, with two rises already this year promoted by concerns over inflation, despite the potential impact on growth and the disparities in economic performance of the euro zone economies. Rising rates will negatively impact those companies that currently find it difficult to generate free cashflow despite the very low rates they currently enjoy, and this may prompt some of those companies to engage in a full debt restructuring.

Although the high-yield market has largely shrugged off the various global events this year, it is currently experiencing a pause as investors watch developments in the Greek/European sovereign debt crisis. Despite the support package announced for Greece, it remains unclear how and when the euro zone crisis will ultimately end. We have also placed the ratings of the US government under review for downgrade. Should these sovereign credit issues be resolved to allow a return of market stability, we would expect high levels of high-yield bond issuance to resume. However, a disorderly outcome on either the euro zone or US sovereign situation could result in a further jolt to the economies of the developed world.

A third factor that may cause the default rate to increase over the medium term is the so-called refinancing wall. Although views on the seriousness of this vary, it is certain that many European companies need to refinance debt in the face of a maturity wall that peaks in 2014.

Although the chart in Figure 2 – which focuses on the unrated European LBO universe, and is therefore only a segment of the overall picture – shows that some progress has been made in reducing the refinancing burden of such companies, the challenges remain formidable for maturities through 2015.

Much of this debt is of LBOs with capital structures that reflect the easy availability of bank and CLO (collateralised loan obligation) debt during the 2005-2007 boom. A number of such companies remain stressed through excess indebtedness. In particular, there is a concentration in 2014 of such companies, which we believe will not be able to tap the high-yield market and will default through an inability to refinance (either a full debt restructuring, or involuntary "amend-and-extend" if lenders remain reluctant to take write-downs).

We have observed that many companies – both new and existing issuers in the high-yield market – are aware of this refinancing wall. Indeed, much of the refinancing that has been undertaken so far this year has been pre-emptive, as companies look to extend their maturities ahead of a possible rush to market ahead of the maturity peak.

Figure 1: Interest rates from 1999

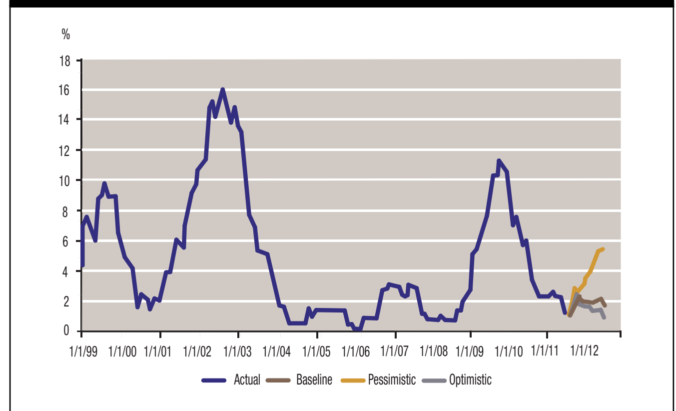
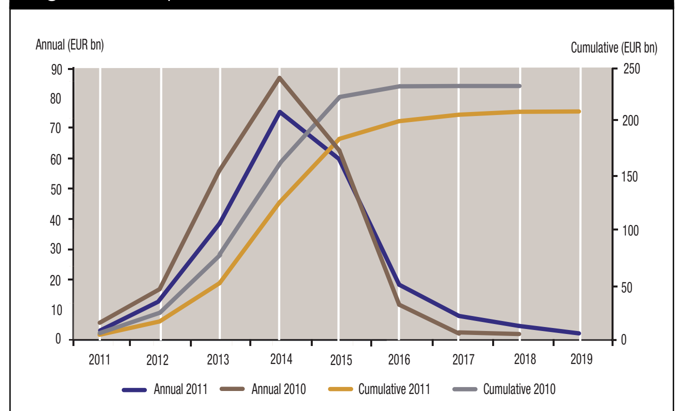


Figure 2: European unrated LBO debt maturities



GROWTH – AND UNCERTAINTY – LIES AHEAD It appears that the global financial outlook will remain highly uncertain over the medium term. The outcome of the problems caused by sovereign credit risk, particularly in the euro zone world, remains a key "known unknown". Companies no longer have the luxury – insofar as they ever did – of passive management of liquidity and refinancing risk. Our liquidity surveys among our rated universe have indicated positive trends over the past couple of years, as companies have learned from the crisis the fundamental importance of good liquidity management to ensure survival at times of turmoil.

For the reasons set out here, we believe the European high-yield market will continue to grow in the medium term as bank disintermediation proceeds. However, it is more important than ever that companies maintain flexibility to access different sources of funding, and plan their liquidity requirements with stress assumptions of a possible lack of external funding for extended periods.

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