RISK AND THE REFINANCING RUSH

THE CREDIT QUALITY OF FIRST-TIME SPECULATIVE-GRADE ISSUERS IN EMEA IS CONTINUING TO FALL, SAYS TOBIAS WAGNER

European high-yield markets have evolved significantly over recent years, reaching a record issuance of $63bn in the first half of 2013 after a total of $70bn in 2012. Bond markets have rapidly become a key source of funding for speculative-grade corporates in Europe as a result of low interest rates, bank disintermediation and investors' search for yield. The mix of corporates seeking a rating in the European high-yield space is diverse, representing various industries and countries, although France, Germany and the UK remain strongly represented. Refinancings are the main reason for accessing bond markets, often to take advantage of market conditions, and leveraged buyouts (LBOs) are the most active among first-time issuers.

At the same time, the observed credit quality of issuers is weakening – not only among existing and repeat bond issuers as shown by downgrades exceeding upgrades for a number of quarters, but also among first-time issuers at ratings assignment. In a recent study, we analysed the initial financial projections of 175 first-time rated corporate issuers in Europe, the Middle East and Africa (EMEA) over January 2010 to March 2013 and found that initial leverage, measured as debt/EBITDA, has increased considerably year-on-year from an average of 4.5 times in 2010 to 5.4 times in the first quarter of 2013. Other standard credit metrics, including cash flow-based metrics, have displayed similar weakening trends over recent years. Interestingly, interest coverage has remained fairly stable despite the record-low interest rates over the first half of 2013.

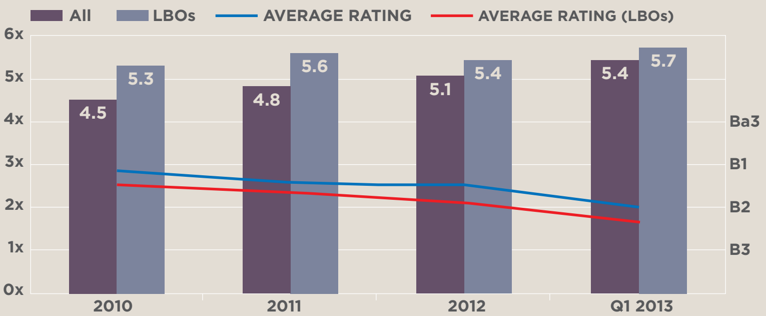
The impact of this trend on ratings is material. The share of single-B rated issuers at first-time rating assignment rose to 85% in the first quarter of 2013, from 73% in 2010, primarily driven by LBOs that generally tend to be highly leveraged. Similarly, Caa-rated issuers at first-time rating assignment represented 7% of new issuers in the first quarter of 2013, compared with only 2% in 2010.

The potential for issuer credit profile improvement is typically a key consideration of the rating process, including the ability to deleverage through debt reduction or operating performance improvements. First-time rated issuers in the first quarter of 2013 also do not compare well in this regard. The expected reduction in leverage over a three-year forecast period following rating assignment is 1.2 times, the lowest in the study. The expected reduction in net debt over this period, even in later years, is also considerably weaker.

Growth is often the main path to deleveraging as many capital structures of first-time rated issuers have a considerable amount of non-amortising debt such as bonds. Interestingly, the revenue

DEBT/EBITDA AT FIRST-TIME RATING ASSESSMENT

Debt/EBITDA for new issuers has increased.



growth expectations provided to us by these new issuers in the first quarter of 2013 are slightly more optimistic at 6.5% per annum, compared with 5.5% per annum in 2012. This remains well below the 7-8% that first-time issuers expected in 2010 and 2011, however, despite higher expected investments into the business. Emerging market issuers have the highest revenue growth expectations, which is consistent with our view that EMEA markets outside the euro area will grow faster in 2013 and 2014.

The study also showed that first-time speculative-grade issuers are looking towards margin expansion for deleveraging. Issuers are primarily doing this through cost cutting, but margin expansion may also include improving operational processes or optimising product and input mixes. Whatever the measures, we believe this indicates that issuers are finding it difficult to reduce leverage by business expansion alone.

Issuers also increasingly present pro forma and run-rate adjustments to EBITDA for refinancing and valuation purposes when they are rated for the first time. These measures typically involve the adjustment of an audited financial performance to include single or multiple positive factors (for example, a contract win or acquisitions with assumed synergies) as if it were present over the full-year period; or they exclude single or multiple negative factors, which they view as one-offs. While this may be warranted in exceptional cases, we view this as an aggressive approach towards measuring operating performance. It also disguises actual opening leverage, while achieving higher pro forma and run-rate adjusted EBITDA will be more challenging.

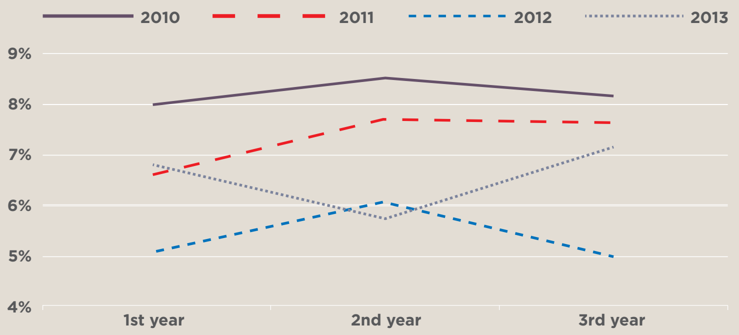
LBOs represent the largest group of new issuers, comprising 72% of total new issuers in 2010-13. They have a similar expectation of higher leverage for issuers rated for the first time in 2013, although this is less pronounced compared with the total group of new issuers. This expectation is not surprising, however, since their initial leverage is on average already 1.5 times higher than that of other non-emerging market issuers. At first rating assignment, LBO issuers in 2013 also expect to invest less in the business when measured relative to sales and they expect less debt reduction than other first-time rated issuers during the forecast period.

Compared with previous years, however, first-time LBO issuers in 2013 are slightly more optimistic regarding revenue growth over the forecast period compared with issuers at rating assignment in 2012 – similar to the wider group of issuers rated the first time in 2013. They also expect to invest considerably more relative to sales compared with the 2012 cohort of LBOs and expect significant EBITDA growth from margin expansion. Nevertheless, the 2013 first-time rated LBO issuers also expect the weakest cash flow generation across the universe and less debt reduction for the next three years. These issuers are very sensitive to deviations from their forecasts and rely on the ability to deliver margin improvements to achieve deleveraging.

Markets showed some slowdown in June with reduced issuance volumes, some repricing, increased focus on bond terms and overall more selective investment decisions by investors. Nevertheless, we do not believe that 2013 is a repeat of 2011 when market concerns around the European single currency negatively impacted high-yield issuance in the second half of the year. Judging from the first three months of 2013, credit quality continues to weaken in 2013. These new issuers, dominated by LBOs, have less room to underperform on financial forecasts and will be more vulnerable to external shocks, including weaker economic growth or changes in the interest rate environment.

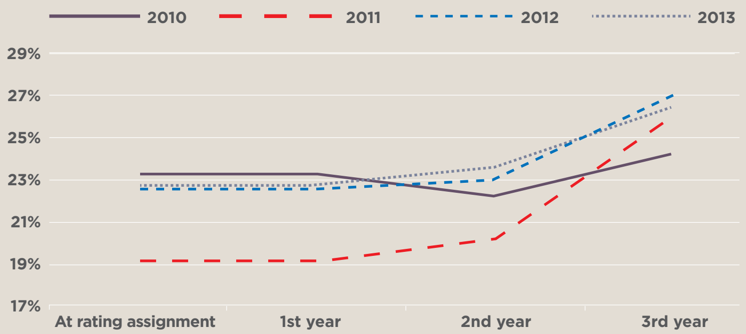
REVENUE GROWTH

Revenue growth expectations remain high, but are lower than 2011-12 issuers.



EBITDA MARGIN

First-time issuers expect significant margin expansion.



SOURCE OF GRAPHS: MOODY'S INVESTORS SERVICE

> Bond markets have rapidly become a key source of funding for speculative-grade corporates in Europe

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