

European leveraged debt lifts off

Loans and high yield bonds make a comeback as economic vitality breeds confidence among investors and issuers



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Leveraged debt is alive and kicking

It has been a banner year for the leveraged debt markets, and despite a number of political and economic headwinds, 2018 could be even stronger

As we enter a new year, we are happy to report that the leveraged finance market is flourishing in Europe and the rest of the world. This welcome news comes after a disappointing 2016 and an uncertain start to 2017.

And it is even more welcome against a backdrop of geopolitical uncertainty across the world. Fortunately, the global economy has been more benign, with the US and EU showing growth and many emerging economies strengthening.

As we predicted in the previous issue of our report, the ongoing competition for market position between the covenant-lite term loan B and high yield bonds continues. The term loan B had a strong start to the year, although high yield caught up later in 2017 with a surprising surge. High yield had a momentary pause in the third quarter, as market participants caught their breath from the robust round of activity, but the fourth quarter saw a renewed uplift.

Convergence, which has been a long-running theme in all of our annual reports, continues unabated. In 2017, the meeting of the minds between the US and Europe has taken the form of both regions seemingly trying to outdo each other in the covenant flexibility or covenant erosion realm, depending on your point of view.

And what of the year ahead? There is every reason to believe that the trends seen in 2017 will continue—at least, in the short term. However, there could well be headwinds, as geopolitical uncertainties exert their influence. MIFID II, new ECB regulations, Brexit and interest rate increases could weigh heavily on EMEA markets in 2018. However, attention will be on the developments in the US where there is talk of deregulation under the Trump Administration, which runs counter to the continuing tightening regulatory environment in Europe.

On a positive note, buy-side demand remains strong with sell-side assets available. As a result, we can expect a combination of refinancings; private equity and acquisition-based lending; and opportunistic (including dividend) new money deals. There should also be interesting prospects in a more settled high yield market, a bridge-to-bond and term loan B product mix as well as the more traditional European bank financing structures. Other financial products, such as asset-backed securitisations, are expected to add to this diversity of options, and an optimist may even argue that adapting to new regulation will create new opportunities.



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Leveraged debt storms back in 2017

HEADLINES

- Leveraged loan value outstripped 2016 level by €131.3 billion in 2017
- Value of high yield bonds has surpassed 2016 by 32 percent
- Refinancing and repricing drive the market
- Leveraged loans continue primacy over high yield bonds

While geopolitical risks dominated headlines in 2017, the European leveraged debt market did its best to ignore the vagaries of Brexit negotiations, the unpredictable Trump Administration and a spate of continental elections. Instead, issuers took advantage of attractive market conditions, while investors continued their search for higher yielding assets as the European Central Bank (ECB) continued to put money into the system with interest rates hovering at zero.



87%

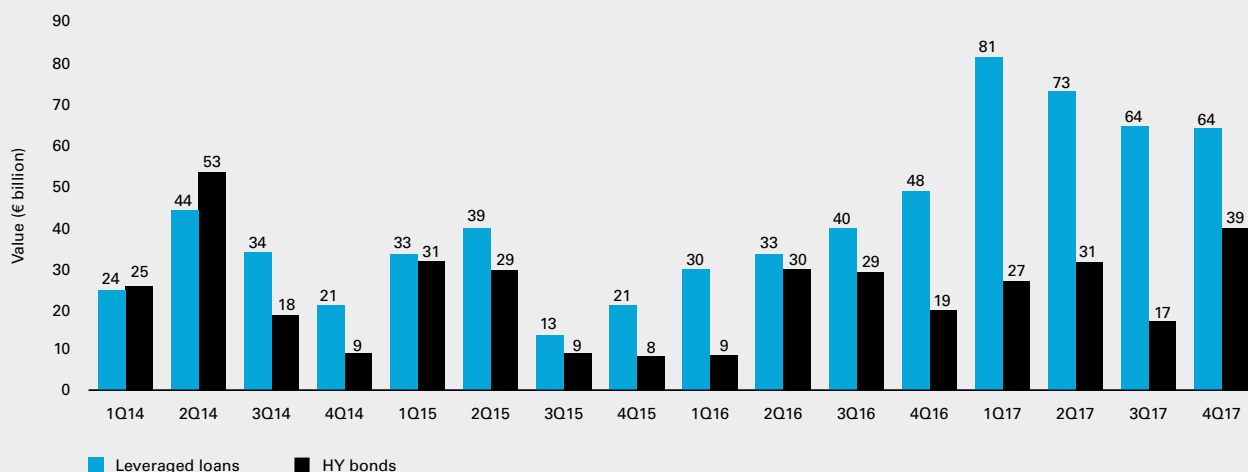
The rise in leveraged loan value in 2017 compared to 2016

While election victories for moderate candidates in France and the Netherlands brought greater stability to the continent, the most important incentive may have been the improving global economic picture.

Europe continued its strong recovery, with the International Monetary Fund's (IMF) November *Regional Economic Outlook* showing that the continent had become an engine of global trade. According to the IMF, the euro area economy is on track to grow at its fastest pace in a decade this year,

with real gross domestic product (GDP) forecast at 2.2 percent—substantially higher than the 1.7 percent estimates made in the spring. The EU economy was expected to outstrip expectations with robust growth of 2.4 percent in 2017, up from 1.7 percent in 2016. However, unlike in the past, the ECB is holding fire, and interest rates are not expected to increase until mid-2019. This is in contrast to the UK and US, which have both begun a slow and steady path back to what may be recognised as monetary normalcy.

Leveraged loan vs. high yield bond issuance—quarterly



Source: Debtwire

Meanwhile, US GDP expanded at a 3.1 percent rate in the second quarter, having dipped in the first quarter, and at 3.2 percent in the July to September period, beating analyst expectations of 2.5 percent.

Up, up and away

Issuance across both the leveraged loan and high yield bond markets got off to a strong start, and the momentum continued through the majority of 2017.

While initial predictions for 2017 were for a swing to the term loan B leveraged loan market, as the year began high yield proved to be a resilient product choice. Leveraged loan deals reached €282 billion in 2017, topping the €151 billion posted in 2016. It was a similar story for high yield bonds, which saw issuance at €114 billion, surpassing the 2016 figure of €86 billion.

While loans kept pace through the year, high yield activity reduced somewhat in the third quarter. However, the pause was temporary and attributed to market participants catching their breath and preparing for the next wave of transactions in the fourth quarter.

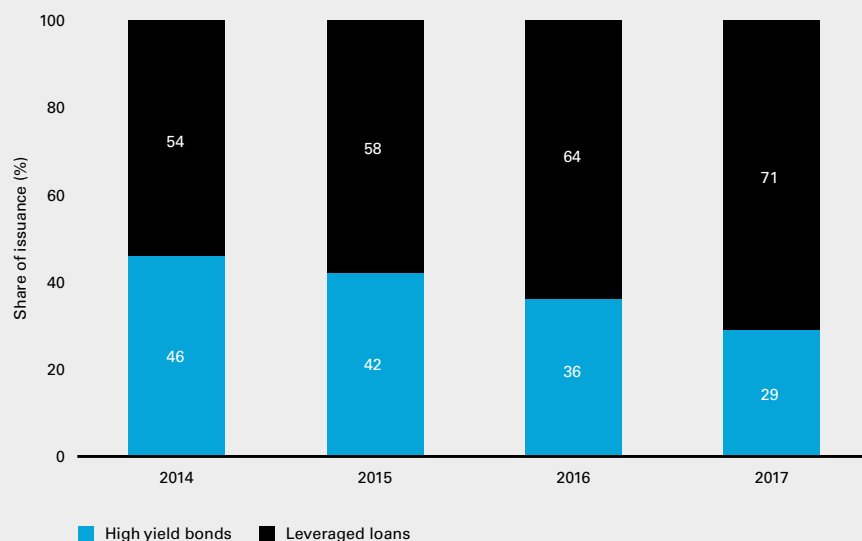
Markets benefitted from a decent pipeline of leveraged buyout (LBO) deals, but there were not enough event-driven deals to meet demand. As with last year, the real impetus was re-pricings and refinancings, as companies looked to lock in funding and push out maturities. These accounted for 55 percent of leveraged loan issuance by value, while 45 percent emanated from new money. This represented an increase from last year's figures where the refinancing component comprised 51 percent of the total tally and a substantial jump from the 38 percent reported in 2015.

Investor appetite was reflected in the strong demand for the Italian telecom group Wind Tre's issue, which was the largest refinancing transaction of the year. It came to the market with €7.3 billion worth of high yield senior secured notes and €3.4 billion worth of loans.

Leveraged loans retain the crown

As in the past couple of years, leveraged loans have trumped high yield bonds, although bonds fought

Share of leveraged loan/HY bond issuance



Source: Debtwire

back toward the year end. Loans comprised 71 percent of leveraged debt issuance in 2017 while high yield bonds accounted for 29 percent, according to Debtwire research. This was partly driven by the buoyant demand for collateralised loan obligations (CLO), which not only offer better risk-adjusted returns than other fixed income strategies but whose floating rate notes offer protection against a rising rate environment. Borrowers have tended to prefer leveraged loan structures because they do not require public reporting and often are cheaper to repay in an exit scenario, even though their covenant protection may be tighter in certain areas.

Creditflux data showed that European CLO issuance jumped to €7.7 billion in the fourth quarter of 2017—up 54 percent for the same period in 2016. Refinancings and re-sets, which were the main factors, amounted to €2.1 billion and €2.4 billion respectively, during the quarter. Re-set volume for 2017 came in at €13.8 billion, while refinancings stood at €11.4 billion.

US issuers continue to cross pond

Another significant trend is the steady march of US borrowers crossing the Atlantic to diversify



71%

The proportion of leveraged loan issuance in 2017



55%

The percentage of leveraged loans accounting for refinancing in 2017—up from 51 percent in 2016

their investor base and take advantage of the lower borrowing costs available in the European market. The migration started around two years ago, and reverse Yankee loans have continued their upward climb, reaching €24.8 billion while corresponding bond issuance was €13.2 billion. This represents a year-on-year increase of 116 percent for reverse Yankee loan issuance and 43 percent for reverse Yankee bond issuance. As an example, in September, data centre operator Equinix tapped into the market for €1 billion after initially seeking €250 million.

Come together

Meanwhile, the US and European markets continue to converge. Europe has adopted many of the same practices as the US in terms of leveraged loan market practice, execution and documentation.

The spotlight increasingly has been turned on the so-called 'cov-lite' structures (loans that have bond-like incurrence covenants, rather than traditional and more restrictive maintenance covenants). Over the past three years, they have become incorporated into the European fabric, as the market has deepened with a broader and more diverse

issuer as well as investor base. For more on cov-lite structures, see *Lite for life*, page 10.

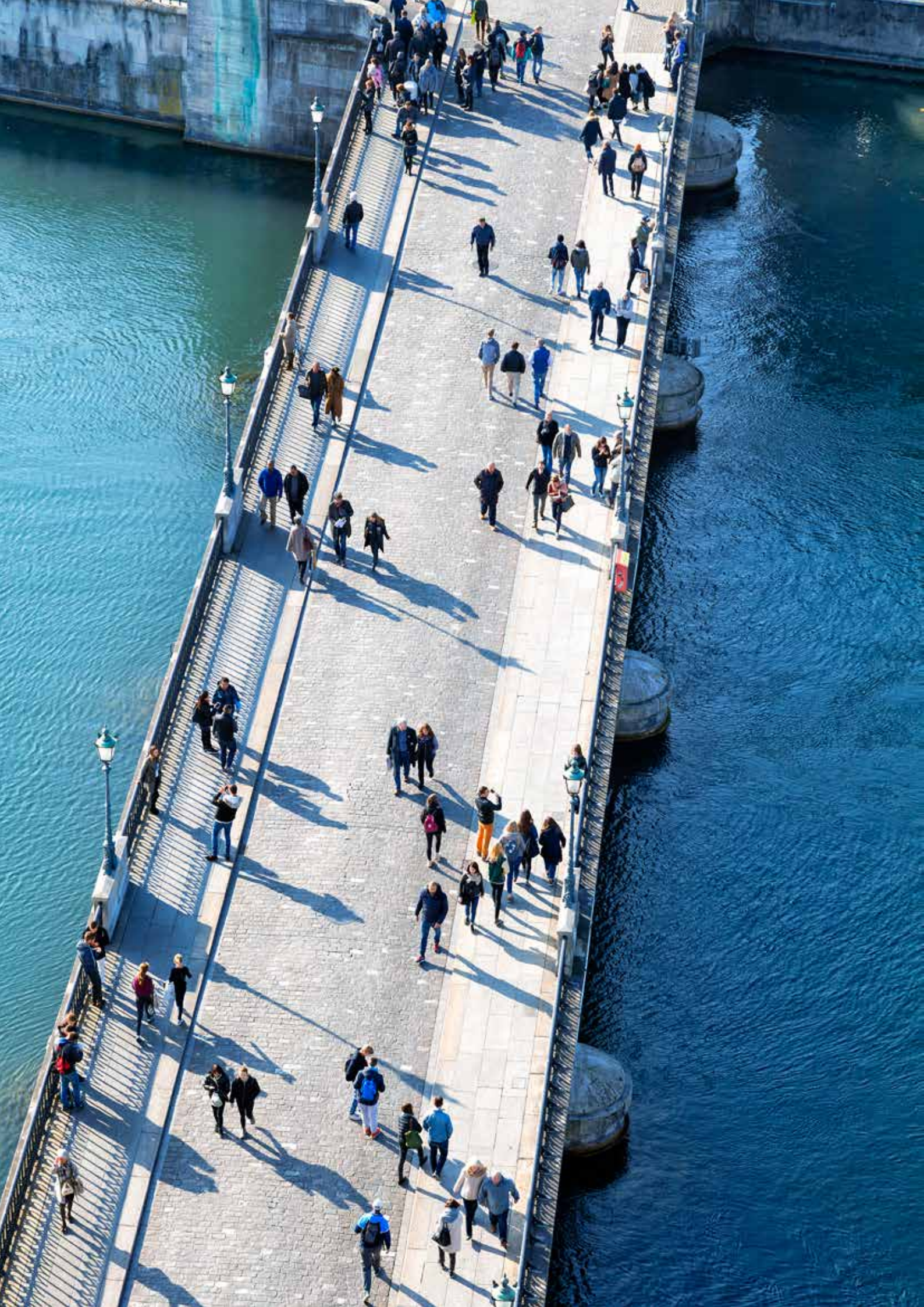
Moreover, loan investors have become more open to looser covenants in exchange for higher returns (in relation to other asset classes) since the ECB launched its corporate-sector purchase programme last May in an attempt to revive inflation. This only served to dampen investment in corporate debt, while the quantitative easing programme introduced in March 2015 has kept government bond yields depressed.

Although there has been some disquiet over this type of documentation, low default levels and accelerating global growth have helped ease concerns. Equally as important, the average leverage on new leveraged loan deals remains below the pre-crisis peak, while the average equity contribution in buyouts is higher than the roughly 40 percent seen between 2013 and 2015. Both factors act as positive forces on recovery rates. In addition, supply-and-demand dynamics, not changes in credit quality, are the main underlying forces, as sponsors and companies are pushing for similar terms they had been receiving from issuing high yield bonds in the post-crisis resurgence of the loan market.

However, there are still some distinct differences between the two regions. The covenant quality protection is somewhat tighter in Europe than in the US, while European leveraged loan borrowers want greater control and are imposing tougher restrictions on which investors can hold debt in portfolio companies. This is typically to prevent distressed or similar investors purchasing debt in a workout. The US, by contrast, is more borrower friendly and the restrictions on the transferability of debt are typically less stringent.



The US and European markets continue to converge. Europe has adopted many of the same practices as the US in terms of leveraged loan market practice, execution and documentation.



Issuers in the driving seat

HEADLINES

- Average size of leveraged loan increases significantly
- Weighted margin of first-lien loan drops to lowest level in years
- Term loan B issuance outstripped 2016 levels within the first three quarters of 2017
- Cov-lite deals march on

As the asset class has grown in popularity, the average leveraged loan size in Europe has leapt up. In 2017, it grew to €782 million—up from €705 million in 2016 and €586 million in 2015.

On the refinancing front, one of the more notable deals was the aforementioned WindTre deal. As for M&A-inspired transactions that grabbed the headlines, one standout was UK Micro Focus International's €7.86 billion issuance that backed its acquisition of Hewlett Packard Enterprise's software business.

Issuers vs investors

To date, the flex activity—when pricing on a leveraged loan is cut

or increased during the syndication process, depending on investor demand—demonstrates that this is very much an issuers' and sponsors' market. In 2017, downward flexes have outpaced investor-friendly upward flexes by a ratio of nearly 5:1 and in the fourth quarter by 7:1. Moreover, borrowers seem to have the technical upper hand due to the absence of original issue discounts and benchmark floors that have moved lower.

Against this competitive backdrop, it is no surprise that spreads and yields have tightened across the asset classes. The average weighted margin for first-lien institutional loans stooped



39%

The rise on the value of term loan B issuance compared to 2016

to their lowest levels in several years at 346 bps versus 414 bps in 2016. The same descent occurred in yield-to-maturity, which came in at 4.3 percent in 2017. The spreads widened in the third quarter, with prices firming to 370 bps up from 355 bps in the second quarter, before tightening to 322 bps in the fourth quarter.

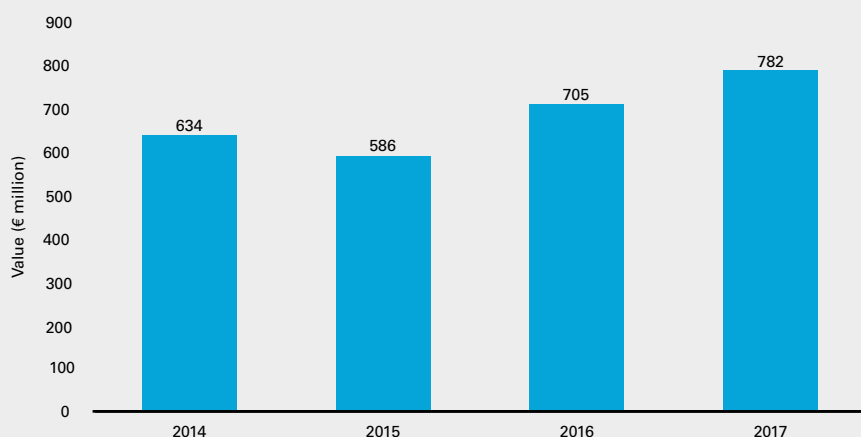
As in the underlying loan market, CLO spreads have come under pressure across the stack in each quarter this year. CLO AAA spreads tightened to an average of 77 bps in the fourth quarter of 2017, ranging from 72 bps to 85 bps on individual deals. Spreads on the other liability tranches have followed a similar trend, reaching their lowest level of the year in the fourth quarter, with AA tranches averaging 123 bps most recently and BB tranches at 510 bps.

Risk and refinancing revival

The search for yield has also meant a shift towards riskier credits, with 62 percent of leveraged loans which are rated B+ and below compared to 53 percent last year. It is a similar development on the bond side, with 43 percent of rated credits at B+ or lower, up from 30 percent a year ago.

Term loan B (TLB) has also gained a wide following, with issuance of €92.6 billion in 2017 exceeding the €55.1 billion worth of deals done in 2016. TLB cov-lite have been a particular favourite, with €74.1 billion coming onto the

Average leveraged loan deal size



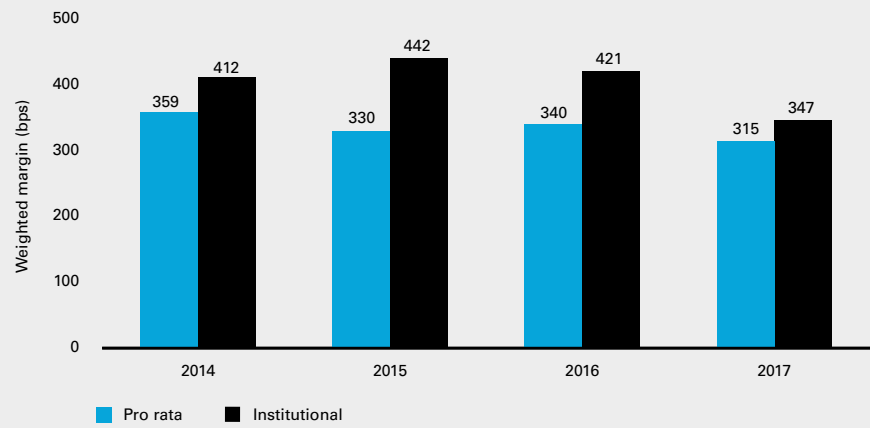
Source: Debtwire

market, a substantial hike from the €29.4 billion seen last year.

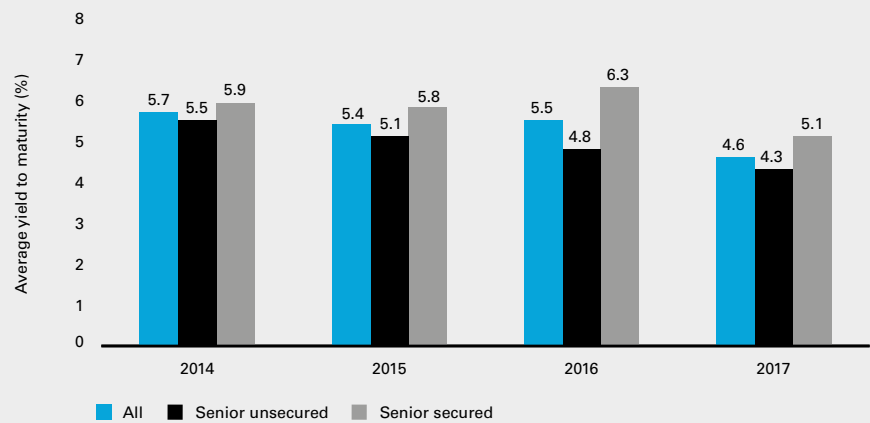
Although refinancing has been the most popular theme, M&A volume has also been supportive, with healthy deal flows that have already exceeded last year's level—jumbo loans have been a major feature of 2017. This is reflected in Debtwire's figures, which show that leveraged loans emanating from M&A activity (excluding LBOs) were worth €35.7 billion in 2017 compared to the €16.8 billion in 2016. Meanwhile, high yield bond issuance for M&A (excluding LBOs) was €7.8 billion, up from €4.7 billion last year.

Research from Debtwire also found that the average total adjusted leverage ratio for the deals it analysed was 5.3x, while M&A transactions came in at 5.8x. On a net adjusted level, leverage averaged 4.9x overall and 5.6x for M&A deals. This is in line with the ECB guidance, issued earlier in the year, which stated that leverage ratios should not exceed six times.

Leveraged loan pricing



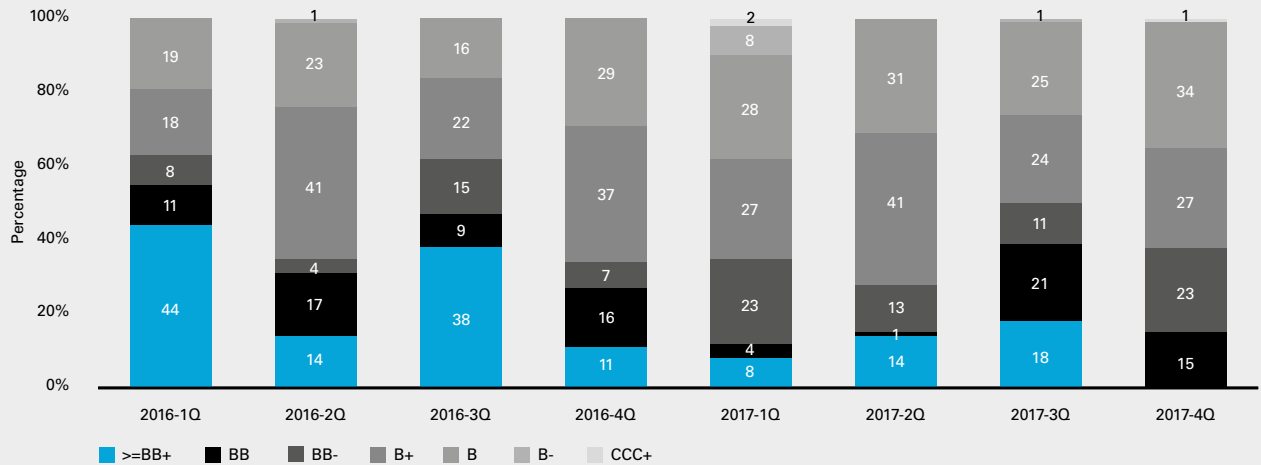
High yield bond pricing



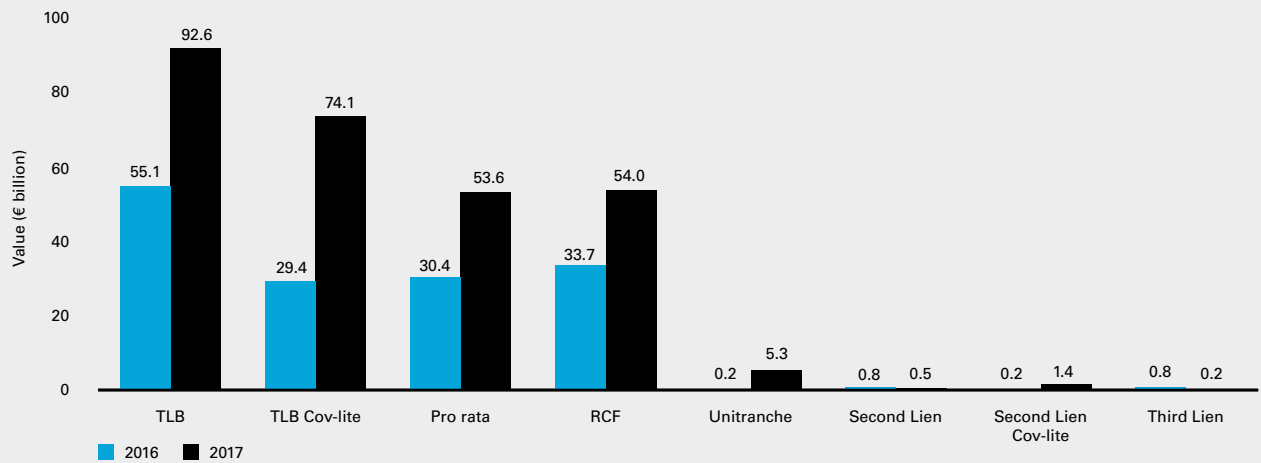
Source: Debtwire



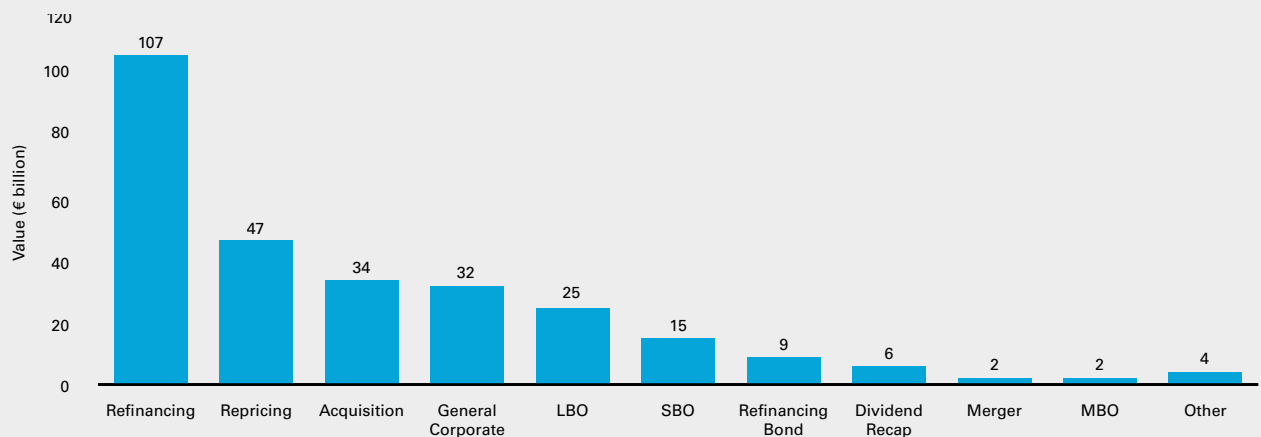
Leveraged loan issuance by rating



Value of leveraged loan instrument by value



Leveraged loan issuance use of proceeds, 2017



Lite for life

Although they barely existed in the pre-financial crisis days, cov-lite loans have become a firm fixture of the European leveraged loan landscape.

The growth and popularity of cov-lite deals reflects the shifting balance of power between borrowers and lenders in an era of looser monetary policy, lower interest rates and an increasing institutional investor base. In other words, yield-seeking investors are willing to embrace more risk against limited deal flow. In 2017, the share of first-lien institutional loan issuance that was cov-lite topped 76 percent, up from a 27 percent share in the first half of 2016 and 52 percent in H2 2016.

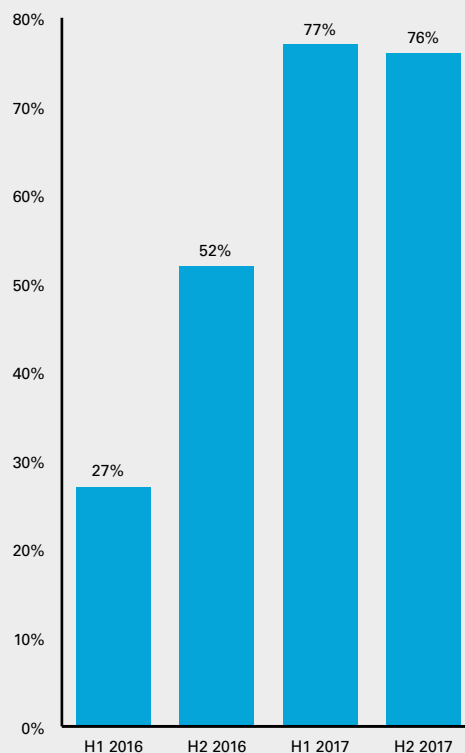
While a European cov-lite loan sees the removal of maintenance covenants, it also typically has a so-called springing leveraged covenant in the revolving credit facility. Historically, these were tested when between

25 percent and 30 percent of the revolving credit facility was drawn. However, usage triggers have moved higher in 2017, with 47 percent of credits having a trigger greater than 35 percent compared to 18 percent of loans last year.

The use of portability, which was a regular hallmark of the high yield bond market, has also become more common in the loan market. It has risen from only 3 percent of loans in the second half of 2016 to 13 percent in the first half of 2017, although this slipped back to 8 percent in the second half of the year.

This year has also seen a loosening of restrictions on acquisitions, with covenants not subjecting acquisitions to any monetary cap or any form of leverage ratio tests. The percentage of loans having no such restrictions climbed to 74 percent in the second half of 2017 versus 71 percent in the first half of the year.

Covenant-lite share of institutional loans



Source: Xtract Research

From high yield bond to IPO

A high yield bond issuance could act as a stepping stone when a company issues public equity

An initial public offering (IPO) may be a natural step after a high yield bond issuance but, as with any public flotations, market conditions have to be right. For example, Play Communications, the owner of Poland's current largest mobile network operator, Play, raised approximately €1.03 billion when the company floated in the summer and the Gamenet Group, an Italian gaming operator, completed its public listing in the fourth quarter.

The IPO process can leverage key sections of a high yield bond offering memorandum such as risk factors, business, management's discussion and analysis and industry, which provide a good foundation for equity offering documents. The information is easily transferrable and in a readily usable form for the listing process. Moreover, given the ongoing reporting obligations in the high yield bond covenant package, a substantial amount of the business and financial disclosure can be easily updated with pre-existing materials. This is even the case if some time has passed since the issuer's high yield bond offering.



The continued popularity of cov-lite deals reflects the shifting balance of power between borrowers and lenders in an era of looser monetary policy and lower interest rates.

Sector watch

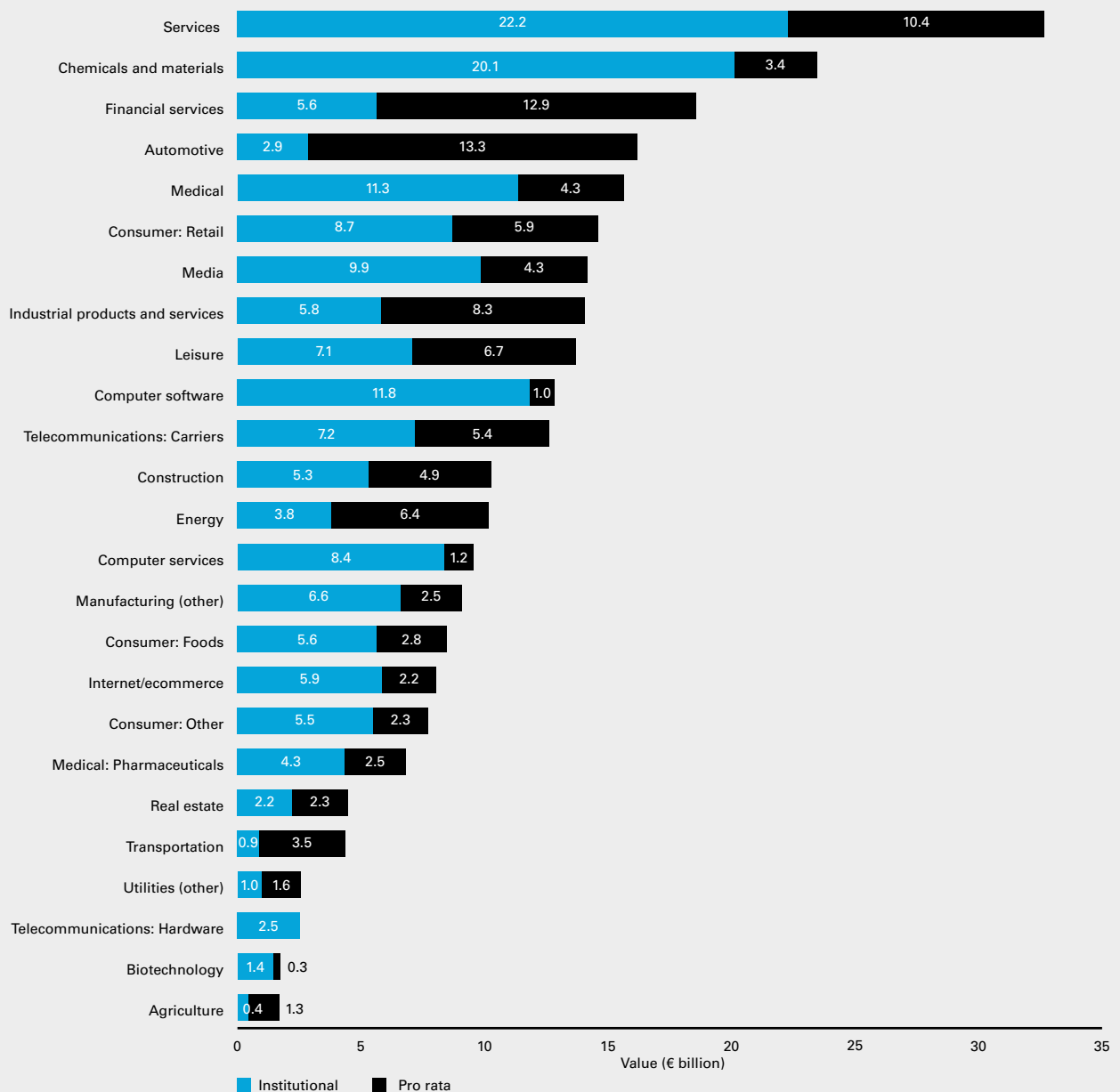
During 2017, services (€32.6 billion), chemicals and materials (€23.5 billion) and financial services (€18.6 billion) were the top three sectors comprising over 25 percent of leveraged loan issuance. Automotive at €16.2 billion

and medical at €15.6 billion were next in line. While refinancings were a key factor, others also tapped the markets for new money.

On the high yield side, financial services were out in front with €19.33 billion and a 17 percent

share of the total bond issuance value. Debt service providers such as Cabot Credit Management, the UK's largest debt collector, and Amigo Loans have been most active as they looked to refinance both debt and new capital.

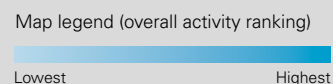
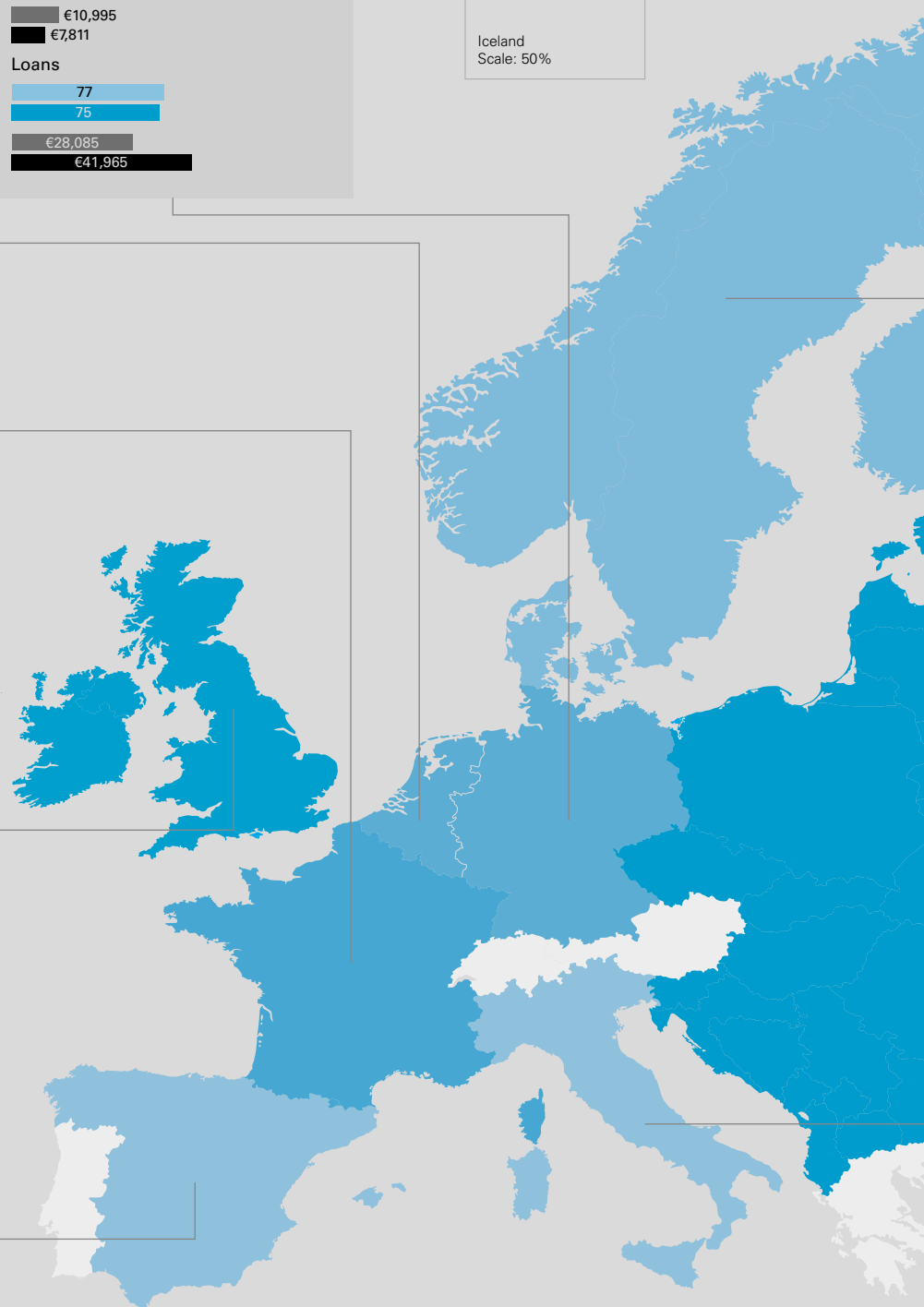
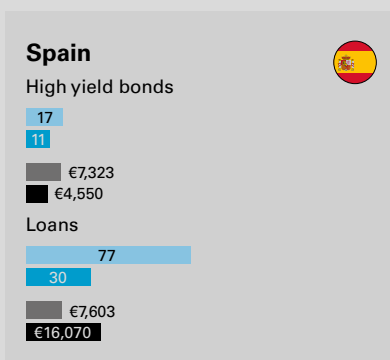
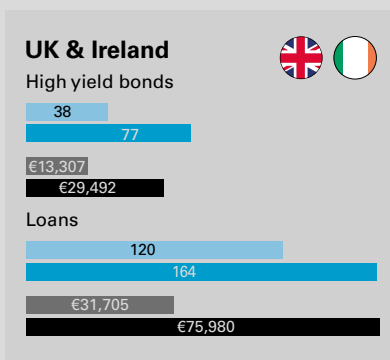
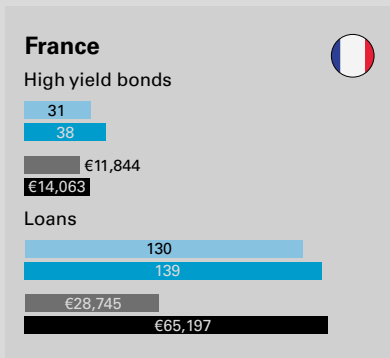
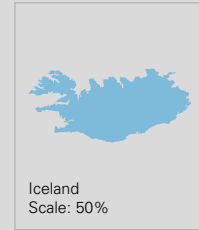
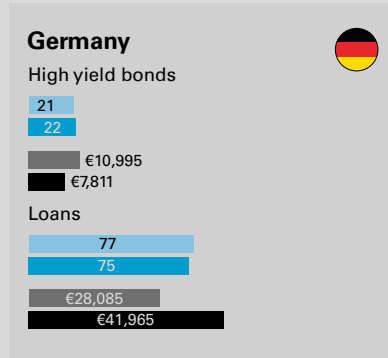
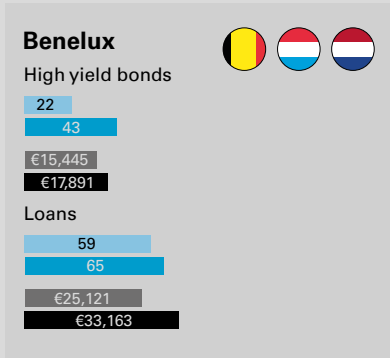
Leveraged loan issuance by industry – pro rata vs. institutional



Source: Debtwire

European leveraged debt in focus

Selected European leveraged loan and high yield bond markets by volume

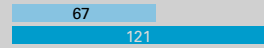


Source: Debtwire

The Nordics



High yield bonds

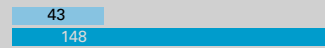


Loans

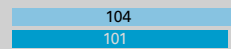


CEE

High yield bonds



Loans



Italy



High yield bonds



Loans



All graph legend

- Volume 2016
- Volume 2017
- Value (€m) 2016
- Value (€m) 2017

The future for European leveraged debt

Economies are strengthening and the outlook is probably the best it has been in 10 years, but there can be no room for complacency in the debt market





Although there will be turbulence next year, the big difference is the improved global economic picture. This is reflected in the IMF's November report, which raised growth forecasts to 3.6 percent this year and 3.7 percent in 2018.

The momentum is set to continue into 2018, although the dynamics could change on the back of rising interest rates in the US and UK. The steady stream of refinancings could ebb, although the European loan market is expected to remain an attractive market because the ECB has no plans to raise interest rates until mid-2019. It is gradually halving its monthly bond buying programme to €30 billion, which means there will still be plenty of liquidity in the system.

Solid fundamentals

However, any slowdown in refinancing is likely to be offset by a robust pipeline of M&A deal flow; strong CLO demand; broad investor appetite for leveraged loans; and a positive macroeconomic outlook across most of Europe, according to a report from Moody's released in November. In addition, the liquidity profile in the EMEA non-investment-grade universe should be solid next year, while the European default rate is likely to stay below 2 percent. This is due to improving credit quality, positive economic fundamentals and industry outlooks. Other contributing factors include low refinancing risks, stability in commodity prices and a relatively low high-yield spread. There may be defaults, but they will be isolated and occur among companies vulnerable to event risks or in weak sectors.

Market participants are also optimistic on the outlook for both US and European high yield debt due to an improving global economy, which has increased the likelihood of more upgrades than downgrades in ratings.

New rules

Regulations could take their toll, especially the ECB's guidance on leveraged transactions, which is being introduced to rein in risky bank lending and is similar to the

US Leveraged Lending Guidelines introduced in 2013. While some details are clear, including the definition of leveraged transactions as all types of loans or credit exposure with leverage of more than four times total debt to EBITDA, many questions are still outstanding. The most notable are the definition of total debt and the impact of the regulation on acquisition finance and banks' internal systems due to the introduction of a stricter 90-day limit for syndicating deals.

In addition, concerns persist over the statement that highly leveraged loans with leverage of six times total debt to EBITDA should remain exceptional, because many loans could fall into this category without further clarification.

One of the main issues is that the rules could create an uneven playing field in the leveraged finance space. For example, European central banks may put their own spin on the interpretation and implementation, while a disproportionately large number of higher leveraged transactions could be undertaken by banks not governed by the ECB's guidance. These range from institutions that do not participate in the Single Supervisory Mechanism (SSM) to those that are not regarded as 'significant' by the ECB and non-bank lenders. If this scenario materialises, it is unclear how regulators and supervisors will react. However, it is unlikely that the ECB would expand the number of institutions it regulates.

An optimistic outlook

Although there could be political headwinds next year, the big difference is the improved global economic picture. This is reflected in the IMF's October report, which raised forecasts for global growth to 3.6 percent this year and 3.7 percent

in 2018, compared with 3.2 percent in 2016. It noted broad-based upward revisions in the euro area, Japan, emerging Asia, emerging Europe and Russia.

The picture has not been this positive in Europe for ten years. Leveraged loans and high yield bonds will also benefit from strong investor appetite, low default rates, improved industry outlooks and a relatively low high yield spread.

Demand is expected to remain firm for loans, as the Federal Reserve lifts interest rates further and central banks begin winding down stimulus. However, in the US, all eyes will be on the possible repeal of the US Leveraged Lending Guidelines, which were implemented in 2013 to curb systematic risk in the banking sector by limiting their ability to underwrite highly leveraged loans. Yet this did not dampen investor appetite, and there is a view that relaxing the regulations could shift underwriting volume back to the investment banks, which potentially could lead to larger M&A-related loans.

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