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## High yield issues surge once again

Issuers downgraded to “speculative grade” and seeking new financing are now benefiting from an exceptional appetite for yield.

Since mid-May, European issuers of high yield bonds (HYB) such as Fresenius Medical, UPC, Virgin Media, Pernod Ricard, Wind, Fiat, Wendel, Renault and, more recently, HeilbergCement have rushed to the market to obtain financing. They have accounted for nearly €20 billion in HYB issues in 2009, following zero in 2008 (see chart). *“The U.S. primary market picked up at an even faster rate and has already reached USD 140 billion,”* says Philippe Descheemaeker, a product specialist at Axa IM, who manages USD 5.5 billion of his USD 6 billion in assets in this segment. At end-2008, average bond spreads [i.e. yield on the bonds — coupon, plus or minus purchase-price premium/discount — relative to the risk-free rate, ed.] widened to historic levels, thereby attracting investors once again. These massive inflows first went toward investment grade bonds, averaging spreads of around 800 basis points (bp) in early 2009. When spreads on those bonds decreased, however, inflows shifted to speculative grade bonds [bonds rated below BBB- by S&P and Fitch and below Baa3 by Moody’s, ed.]. These inflows largely targeted the secondary market, as investors initially sought out steep discounts relative to the bonds’ face value. Such discounts are synonymous with high default probabilities and increased yields (*L’Agefi Hebdo*, June 4). After two difficult years, specialised funds have reported yields of between 20% and 60% since early 2009, and *“the bulk of the lost ground has been won back,”* according to Hugues Rialan, the Head of Investment Management at Banque Robeco, who added that *“these bonds could, at this point, be less sensitive to a rise in interest rates.”*

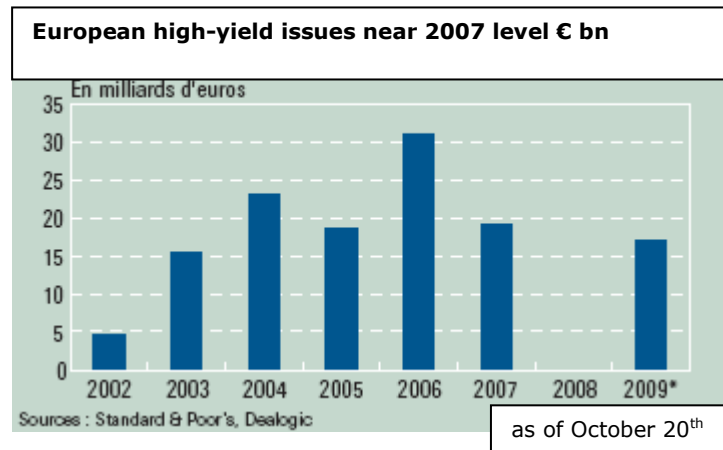
## Fallen angels

*“As long as spreads remained very high, it was difficult for speculative grade companies to issue new bonds without incurring a high cost,”* explained Sune Højholt Jensen, senior portfolio manager of Denmark-based Sparinvest. Once spreads narrowed in light of the increased demand, however, new issues gradually became possible once again, and liquidity partially shifted from the secondary to the primary market. As a result, there have been 20 new speculative issues (including Peugeot, which barely qualifies for this category) since May 16 in Europe, where the market re-opened much later than in the United States. The first companies to test the market, such as UPC, Virgin Media, Wind and ISS, offered still very attractive – and therefore costly – yields, as they sought to refinance their bank debt and bonds reaching maturity.

The main novelty of the recent activity is that the issuers, including Pernod Ricard, Renault and Fiat, consist mainly of companies normally found among investment grade issuers but downgraded during the crisis. *“We have not yet seen a return to a dynamic market as in 2006, when we would see new issuers through medium-sized companies, including even some unrated companies offering CCC rated bonds as part of LBO refinancings,”* noted Denis Loubignac, the Chief Executive Officer of Delff Asset Management (LFPUGF Group). Even in the United States, the market comprises mainly companies rated BB and B, with only a few rated CCC. That reassures investors, who know which listed companies have dropped to sub-investment grade, presumably only temporarily. *“It’s a gradual process,”* says one banker responsible for high-yield bond origination. *“The market has reopened for higher-risk products, but also in areas where ample liquidity exists, in other words the fallen angels. Eventually, the trend will spread to lesser known companies. For now, spreads are still high for medium-sized companies, and consequently they are waiting until they have an urgent need.”* Are investors currently being adequately compensated for the risk? Although spreads narrowed

significantly in recent months, they remain at higher levels than in 2006 and 2007. For example, spreads are now 300 bp (compared with only 100 bp previously) for BBB rated debt, 500 bp (versus 150 bp) for BB rated debt and 900 bp (versus 400 bp) for CCC rated debt, thereby offering significant differentiation between the various risk levels. Meanwhile, an appetite for debt and low risk-free interest rates are prompting investors to lower their threshold of acceptable risk in order to obtain yield.

**Current average yields for HYB are around 10%, with a coupon on the primary market of around 8%.**



### Reduced default rates

"The concept of risk must be put into perspective relative to the default rate," says Sébastien Barthélémi, the Head of Credit Research at Louis Capital Markets, after acknowledging such high-profile defaults as Belvédère, Akerys, LyondellBasell, Wind Hellas and Truvo. *"Before June, the rating agencies expected default rates to reach approximately 24% at year-end in the United States, which remains the benchmark market even though default rates are statistically higher than in Europe. Since then, they have revised these estimates downward, as default rates peaked at just over 12% in November before declining in 2010 to very reasonable levels of around 6% or less."* Says Philippe Descheemaeker: *"If we remain at these levels, default rates will never have reached the levels anticipated by the spreads."* His point is echoed by Denis Loubignac, who notes that *"the bulk of the new issues involved short-term refinancing. However, the liquidity inflows on a massive and unparalleled scale since 2003, stemming mainly from institutional investors who underweighted bonds and then missed the beginning of the rally in early 2009, began to limit automatically (over time) the default risk for companies, which can find the necessary resources to refinance."*

These liquidity inflows will create new possibilities for issuers. They will also cause prices to rise on the secondary market, where valuations remain low, with some bonds trading at steep discounts of 20% to 40%. Yields could therefore exceed 20% if prices were to return to par. The recent issue by HeidelbergCement, a highly cyclical company rated B+ and teetering on the brink of default last winter, of three tranches (5, 7 and 10 years), for €2.5 billion, with more than €10 billion in subscriptions, symbolises this investor appetite for high yield.

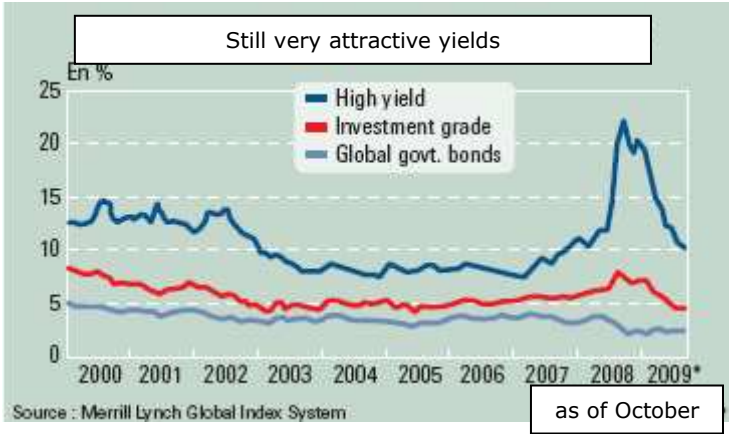
### Negotiations with lenders

As a result, companies formerly rated investment grade have been able to issue bonds in a certain climate of confidence while retaining their traditionally streamlined documentation in terms of technical and financial covenants. *"The documentation reflects supply and demand; it's impossible to know whether it is too lenient, since everyone considers it adequate at the time of signing,"* says one specialist, responding to recent studies by Standard & Poor's and Barclays Capital critical of a potential return to the undisciplined approach that reigned prior to the crisis. These covenants, which are mandatory for bank loans, continue to be applied across the board to traditional high-yield bonds, especially for protection in the event of a change in controlling ownership or an LBO.\* Although LBOs are not presently a factor, they nevertheless weighed heavily on

the corporate debt of companies such as ISS and TXU in 2006-2007. "Who knows if today's issuers won't experience a deterioration in their financial statements or balance sheets in three to five years?" note some analysts, adding that banks had everything to gain by syndicating substantial volumes of bonds. The economic crisis does not seem to be over, and crises typically end with resurgent merger and acquisition activity.

In the meantime, these bonds may deflect the threat of breaching covenants on bank debt. Issuers lacking other refinancing opportunities in the absence of available bank debt strike a deal with their senior bankers, who are prepared to exit at or near par instead of holding onto to poorly valued mark-to-market debt on the balance sheet. Virgin Media adopted this strategy in late October. These issues require negotiations with the old and new lenders, who then receive senior secured HYBs, i.e. bonds aligned *pari passu* with the senior debt repayment priorities, and even direct guarantees on the assets. Such was the case in the United States for medium-sized companies such as Ardagh Glass last June and Reynolds in October. In the latter case, the bond issue also served to finance the company's ownership change. "The arrival of issuers such as Campofrio Food, with a €500 million issue in mid-October, is the first sign of a return to normal," says Sébastien Barthélémi. It marks the return to a "true" high yield market, which will see new LBO financing. All the specialists will therefore have to be selective, as is always the case during transition periods.

\* According to Bloomberg, this year half of the issues at the bottom of the investment grade category in the United States contained poison put clauses, which enable investors to be repaid at 101% in the event of a change in controlling ownership.



**Unrated bonds as well**

Christian Dior, Rallye, Air France-KLM, Lagardère, Adidas, Heineken and, recently, Havas... A dozen unrated issuers have issued bonds since September, representing a noticeable first foray into the bond market for some of these companies. These issues reflect a gradual market. Investors seeking even though some purchase only limited The Air France-KLM issue €500 million to €700 oversubscribed by a factor the A.P. Moller and, more Meanwhile, Lagardère's nevertheless placed €1



normalisation of the credit yield bought up these issues, investors are authorised to amounts of unrated bonds. was therefore increased from million after being of 10. The same was true for recently, Havas issues. bond issue, which billion over five years, has

fared especially poorly. The bond market offers these companies a lower cost of financing than do syndicated bank loans, as well as greater funding volume and longer maturities (seven years for Rallye, Air France-KLM, Campari and Heineken). With the current investor appetite for risk and these companies' good ratings, the price difference with rated bonds is narrowing, even though most are considered high yield by investors. These issuers seldom tap the market and still have no incentive to pay for a rating,

especially since they would prefer to see the current enthusiasm directed toward their shares.



**OPINION...**

**Youssef Khat, Global Head of High Yield Capital Markets business at Calyon**

**“It’s the main source of liquidity today”**

**How would you characterize the high-yield market today?**

It has become the main source of liquidity for companies seeking to refinance their bank debt and bonds in the short, medium and long term. Some acted quickly starting in late spring to avoid being caught up in a massive rush in 2010 or 2011. Although they paid slightly more initially, they shouldn’t have any regrets. In fact, some are again starting to offer new issues. Others are also seeking to raise fresh capital for new investment spending. Finally, LBO portfolio companies may soon be coming along to refinance on this market.

**Do you expect new investor categories, for example retail investors, to become involved?**

There is indeed talk of greater participation of indirect investors with a more retail and stable approach, especially through private banks, but only for some very well known issuers [such as Air France-KLM, Rallye, Campari and HeilbergCement, which issued bonds in €1,000 denominations, ed.] The bulk of the market remains dominated by institutional investors, however, who are able to obtain higher yields than on their investment grade bonds and limited volatility, even if the returns do not match those of equities.

**Should a strong issuer premium be offered systematically?**

That was crucial to the market’s reopening in the spring to encourage investors who already held the respective companies’ bonds to reinvest or even refinance the existing debt. Market conditions are more favorable today, so that may seem less essential. In spite of the market stabilisation, however, there is still no general rule. The same can be said for the legal documentation accompanying these issues. Everything is on a case by case basis.

***Fabrice Anselmi***

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