



European Quarterly High Yield and Leveraged Loan Report

EUROPEAN HIGH YIELD ASSOCIATION

First Quarter, 2008

The European High Yield Association (EHYA), an affiliate of the Securities Industry and Financial Markets Association, is pleased to present the fifth quarterly issue of the *European High Yield and Leveraged Loan Report*. The report analyses and presents aggregate information and trends related to the European leveraged finance marketplace. It incorporates both high yield corporate bonds and leveraged loans, including issuance, credit quality and returns on investment. Unless otherwise noted, the data are through the first quarter of 2008.

Primary European Leveraged Credit Markets Remain Subdued Amidst Continued Global Market Stress as Total Issuance Drops to €11.1 Billion in First Quarter with No High Yield Bond Issues in the Quarter; Signs of Firming Prices Late in the Quarter

Highlights

- Leveraged finance issuance declined to €11.1 billion in the first quarter compared to €9.4 billion over the same period in 2007.
- There were no high yield bond deals in the first quarter of 2008 compared to €12.7 billion in the first quarter of 2007. Leveraged loan issuance fell to €1.1 billion in the first quarter compared to €6.7 billion in the first quarter of 2007.
- Investor risk sensitivity, subdued demand, further diminished liquidity and uncertain pricing contributed to continued depressed market conditions and sharply lower issuance volumes in the European high yield bond and leveraged loan markets in the first quarter.
- Markets conditions are unlikely to change substantially in the near term, and issuance levels are expected to remain below last year's peak levels for an extended period of time.
- European leveraged credit pricing was volatile and weaker in the quarter. Both high yield bond and leveraged loan spreads were wider with negative high yield returns for the quarter. Following central bank actions, especially by the US Federal Reserve, to stabilise the credit markets late in the quarter, European high yield spreads tightened but remain at historically elevated levels. In addition, recently, there has been a reduction of the substantial backlog of the leveraged loan pipeline with nearly €47.0 billion held on bank books in Europe compared nearly €70.0 billion in the US. The number of leveraged deals in the pipeline has been much slower to reduce in Europe compared to the US.
- Despite tightened financing conditions, the underlying economic environment for European high yield borrowers has generally remained positive. However, global pressures are leading to lower profit and economic growth trends.
- Credit quality risk is rising after a period of historically low default rates when corporate issuers built up their financial positions as borrowing costs were low. The prospect of moderating to slower economic expansion, rising leverage levels in recent years and reduced credit availability in 2008 adds to the possibility of rising default rates later this year. The relatively low volume of refinancing requirements through the first half of the year should delay the effect of reduced access to the leveraged credit markets.

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Economic and Market Environment

Market Conditions

- The markets remain “stressed” with a continuation of the reappraisal of risk, global economic exposure to the U.S. housing-led slowdown and diminished credit market liquidity. Credit repricing and increased investor risk aversion have led to wider spreads and rising borrowing costs. Segments of the higher risk sectors of the European leveraged credit universe have been characterised as “frozen.”
- Financing conditions have tightened as demonstrated by the rising risk premium. The European Central Bank (ECB) lender survey reported tightened underwriting standards.
- Beginning with the second half of 2007, central banks, including the ECB, have infused liquidity to ease the deteriorating credit market conditions and to provide for greater market interbank funding stability. The ECB has been injecting additional 3-month and 6-month loans but the interbank lending market is still characterised as tight. LIBOR (London Interbank Offered Rate) remains historically elevated and volatile, despite a return to some level of stability and lower money market rates when compared to year-end. The 3-month LIBOR rate was at 3.33 percent as of 22 January, 151 basis points lower than the previous month. The rate decreased following a period of aggressive central bank responses, especially by the US Federal Reserve. Illustrative of continued volatility, the 3-month LIBOR rate stood at 2.74 percent as of 15 April. A day later, the 3-month LIBOR jumped eight basis points – its biggest one-day increase since August 2007.
- Volatility measures remain elevated. The higher volatility has increased investor risk sensitivity, and global credit risk repricing led to the European high yield credit spread “blow out” and negative returns for the first quarter of the year.
- Reduced investor demand and resulting diminished liquidity has been further exacerbated by a pullback of newer investors such as hedge funds and CLOs. Euro-denominated CLO issuance has fallen from €35.6 billion the first quarter of 2007 to €2.3 billion the first quarter of 2008. Traditional investors, along with the entry of “opportunity” funds to take advantage of increasing volumes of distressed debt, will need to be important sources of renewed investor interest. Indeed, a recent EHFA/SIFMA publication, *Primary Distribution Survey Report*, showed traditional investors account for the majority of primary market distribution with hedge funds accounting for approximately 10 percent.

Economic Conditions

- The European economy has benefited from solid domestic demand, exports and employment growth with unemployment rates at a 25-year low. While consumer spending is expected to contribute to expansion, higher energy and food prices are becoming a drag on consumer spending. Recent surveys suggest a decline in consumer confidence levels. The ECB, however, has commented that the surveys are consistent with continued though moderating rate of growth and is projecting consumer spending at 1.1 percent to 1.7 percent in 2008 compared to 1.6 percent in 2007.
- Capacity utilisation levels approaching full capacity and internal cash flow from the recent period of profit growth support investment spending expansion. The most recent industrial production data indicate continued growth.
- The year 2007 GDP growth was at an above-trend pace of 2.6 percent. The ECB is forecasting slower growth at 1.3 percent to 2.1 percent in 2008 and 1.3 percent to 2.5 percent in 2009 based on the expectation of a resilient global economy. (The European Commission reported a forecast of 1.7 percent GDP growth rate for 2008 and 1.5 percent for 2009 on 28 April). The forecasts have been revised slightly downward. There are downside risks to the growth outlook, including the effect of the financial market turmoil, higher global commodity prices, slower housing and construction activity and European currency appreciation against the dollar. The impact of the stronger Euro clearly poses an important downside risk but the effect of the appreciation has been relatively muted to date.

- The ECB has held the refinancing rate steady as it is in a position of balancing the multiple objectives of supporting credit market stability and liquidity and also managing inflation and inflationary expectations. According to Moody's economy.com rising interest rate futures suggest that the market is not expecting aggressive rate cutting. Controlling inflation remains an important ECB objective. The ECB expects higher labour costs but tighter profit margins reflective of GDP growth moderation.
- European credit expansion remains robust. Financial institution lending has been growing at a double digit pace. The broadest aggregate of liquid assets in the financial system, measured by M3¹, rose a record by 12.0 percent in the fourth quarter and moderated only slightly in January, the most recent available data. The rise is somewhat exaggerated as it reflects a preference for shorter term assets attributable to the flat yield curve and reduced demand for higher credit risk assets in the current volatile credit market environment. There has also been a growth in assets held by financial institutions which is, in part, explained by the re-intermediation trend as banks are retaining a higher portion of securitised pools.

Issuance

- The primary market was virtually closed for much of the first quarter. The total European leveraged finance issuance slowed to a trickle in the first quarter to €1.1 billion compared to €9.4 billion in the first quarter a year ago.
- There were no high yield bond issues² in the first quarter compared to €2.7 billion in the first quarter of 2007. Based on Reuters' Loan Pricing Corporation (LPC) data, total European leveraged loan³ volume (including mezzanine financing) was €1.1 billion in the quarter compared to €6.7 billion in the first quarter of 2007. During the quarter, €0.5 billion were mezzanine and €0.2 billion were second lien loans.
- There were no unrated bonds⁴ issued in the first quarter, compared to €3.0 billion in the first quarter of 2007.
- Market conditions, to a large extent, wiped out the appetite for aggressive non-traditional deal structures. According to Fitch Ratings, there were no Payment-In-Kind (PIK) transactions in the first quarter. For the 12 months ending 31 March 2008, there were 12 PIK transactions compared to 22 PIK transactions for the 12 months ending 31 December 2007.
- In the first quarter, the sectors with the most leveraged loan borrowing were the real estate (€1.5 billion), telecom (€1.1 billion) and general manufacturing (€0.8 billion) sectors, according to Reuters' LPC.
- The changed market conditions dramatically slowed leveraged buy-outs (LBO) and other acquisition debt financing, including private equity sponsored deals. Leveraged loan LBO (€6.2 billion) and recap (€1.5 billion) volumes declined precipitously in the first quarter, according to Reuters' LPC.
- There remains a substantial backlog of European leveraged finance deals. Globally, there has been a reduction in the deal calendar as some deals closed under revised terms and others were removed from the calendar. According to Merrill Lynch, the U.S. volume has declined to €70.0 billion, down from €194.0 billion at the beginning of the credit crisis last summer. The European decline has been much slower, with about €47.0 billion held by banks.

¹ M3 includes physical currency, demand deposits, time-related deposits, savings deposits, non-institutional money-market funds, large time deposits, institutional money market funds, and repurchase agreements.

² High yield bond transactions are defined as transactions with an S&P rating equal to or less than BB+, a Moody rating equal to or less than Ba1, or a Fitch rating equal to or less than BB+. Includes all European issuers and all international issuers that issue in a European currency. CDs, general term notes and split-junk rated transactions are excluded. ABS, federal credit agency, supranational agency, sub-sovereign, and sovereign debt transactions are excluded. Transactions without a manager, non-underwritten transactions, self funded ineligible transactions, and transactions that are not rank eligible (due to submission guidelines) are excluded.

³ Leveraged loans include first lien and second lien loans generally with below-investment grade ratings or spreads of at least 150 basis points and mezzanine loans.

⁴ Unrated are defined as all bonds that either are not rated or for which the rating is "not available," according to Bloomberg.

Credit Quality

- There are signs of increased credit risk exposure following an extended period of strengthened balance sheets and low default rates boosted by a protracted period of profit growth. The expectation is for additional defaults later in 2008, as access to credit markets for refinancing existing debt becomes more restricted and profit growth and margins are expected to moderate or slow.
- The S&P Global Fixed Income Research default rate remains subdued but with the expectation that it will rise during the course of 2008 and into 2009. According to S&P, the default rates have been held back by limited refunding requirements and structural concessions that avert defaults. The S&P European default rate as of February was 0.75 percent, compared to 0.98 at year-end. In the EHYA-*Financial News* survey, the average forecast is a 4.7 percent default rate at the end of 2008.
- S&P Fixed Income Research reported 18 European high yield upgrades and 35 downgrades in the first quarter, compared to 35 upgrades and 28 downgrades in the fourth quarter and 46 upgrades and 19 downgrades in the first quarter a year ago. S&P expects downward pressure on ratings as a result of slower economic growth, an appreciated Euro, reduced profit margins and tighter credit market conditions.
- Fitch Ratings reports that the mezzanine loan default rates are well below the peak in 2003 at 0.32 percent (or 0.8 percent when adjusted for "distressed" restructurings). The numbers are based on last twelve months defaulted volumes of €2.6 million or two defaulted issuers. There were no defaults recorded during the first quarter.
- High yield bond recoveries remained at 40 percent for the 12 months ending March 31, as calculated by Fitch Ratings. Recovery rates are approximated by dividing the price of defaulted bond issues one month after default by the bond volume before default.
- Trends in the investment rating composition over recent years confirm the potential for increased risk exposure as the European leveraged finance markets expand. S&P noted credit market deepening, risk appetite and reduced intermediation that has led to a gradual shift to high yield ("speculative-grade") ratings over the last several years, especially prior to the credit market turmoil but the average rating was still investment-grade. S&P Global Fixed Income Research reported that the "BB" rated issuer share of the European high yield or speculative-grade market declined while the "B" rated share has increased over the last five years. The movement towards the decline in the leveraged credit rating mix in Europe has recently slowed amid the credit market turbulence, increased investor risk sensitivity and some reversal in the disintermediation trend. The "BB" rated share of the European high yield has increased slightly over the past year, and S&P Loan Commentary and Data (S&P LCD) reported a relative increase in "BB" rated loans in the first quarter.
- As a measure of credit exposure as we enter a period of a slowing to moderating economic environment, Fitch reports increased leverage ratios over the last several years. The senior leverage (median) of Fitch-rated shadow credits in the first quarter was at 4.8 times, and the total leverage (median) was at 6.9 times. These leverage ratios include new but also existing transactions that Fitch rated during the quarter. The corresponding (median) leverage ratios of new and launched transactions in the first quarter were 4.5 times (senior) and 5.7 times (total). In the fourth quarter, the median senior leverage was 5.1 times (a full-year 2007 median of 5.2 times) and total leverage of 6.7 times EBITDA (a full-year 2007 average of 6.3 times).

Relative Value

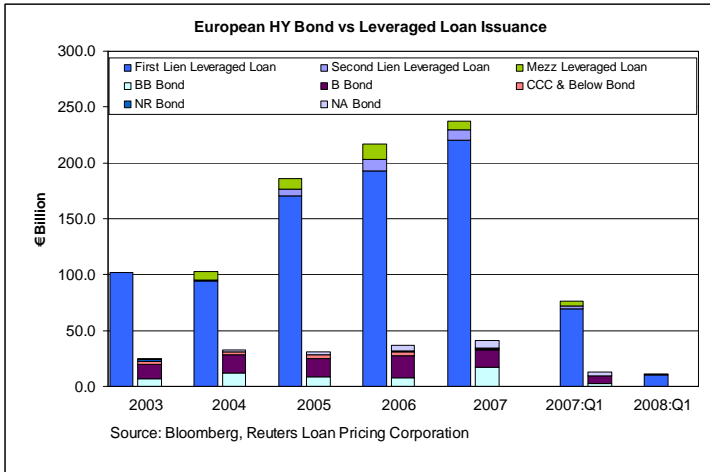
- European high yield sector returns were negative for the quarter and full year 2007, and spreads dramatically widened on illiquidity, credit repricing and credit market volatility. Based on the Merrill Lynch High Yield Index, total market return was -6.22 percent for the first quarter. At the end of the quarter, the Merrill Lynch High Yield Index reported a 765 basis-point credit spread, having widened by 274 basis points since year-end. There was spread widening in the credit derivatives market as measured by the iTraxx Cross-over Index (iTRAXX.EU.XO) to 577 basis points, 238 basis points wider than at year-end. Both the cash and derivatives indices have since tightened, the derivative index has moved to 488 basis points and the cash index to 676 basis points as of 17 April. According to J.P. Morgan, the rally has been supported by low volume of new supply and indication of relatively more stable capital flows.
- The leveraged-loan index was negative for the first quarter. The S&P LCD European Leveraged Loan Index (ELLI-Total Return) was -8.56 percent for the first quarter compared to -0.47 in the fourth quarter and 1.41 percent in the first quarter of 2007. S&P LCD reported a wider primary weighted-average institutional loan spread of 320 basis points in the first quarter and 305 basis points at the end of 2007.

To download issuance data, please click on the attached link below.

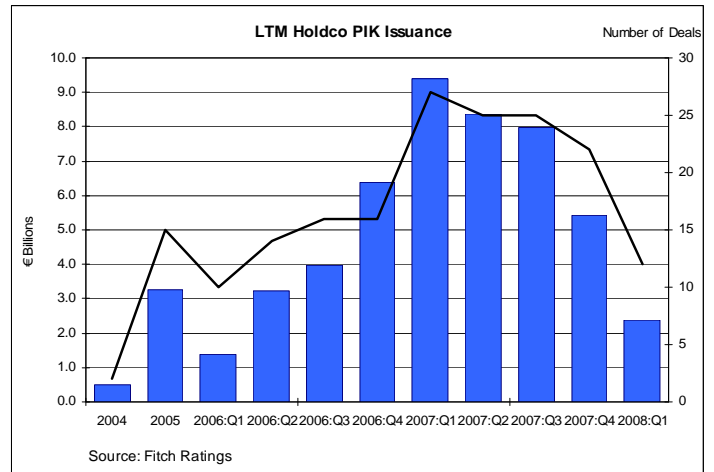
Download Data.
Microsoft Excel

European High Yield Report - Issuance Volume

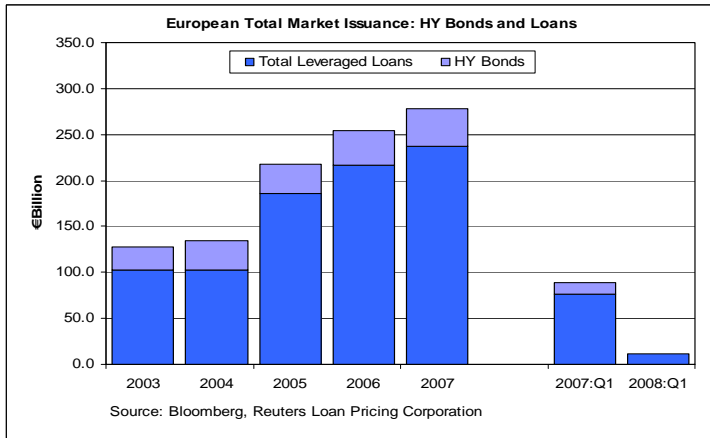
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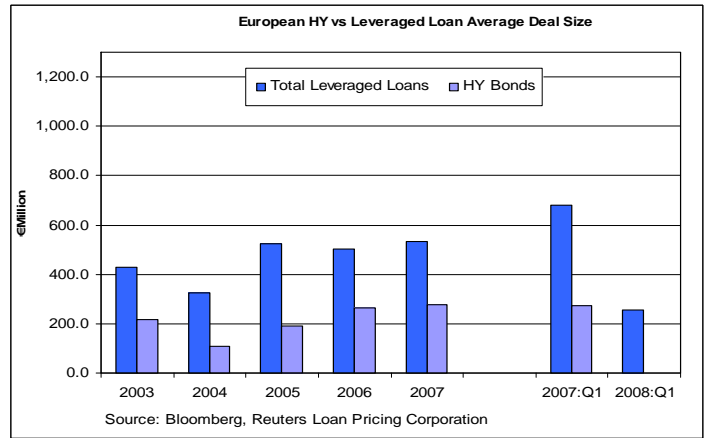
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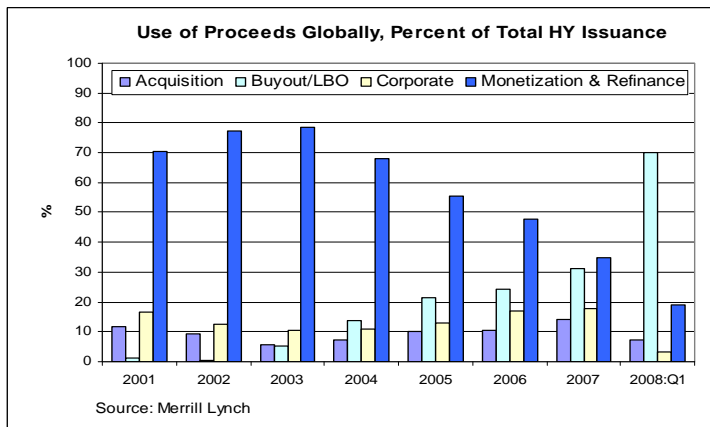
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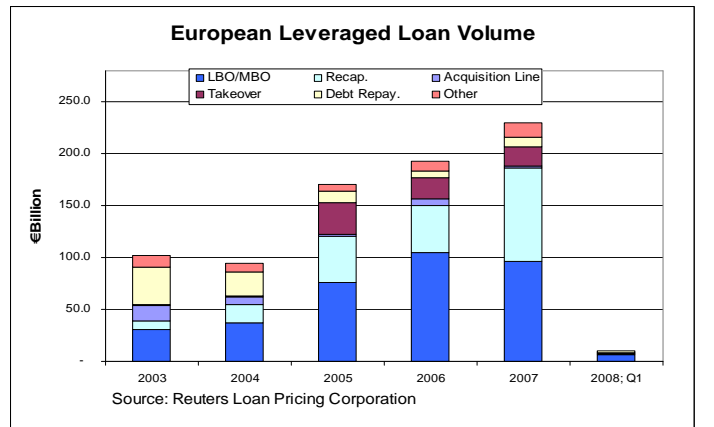
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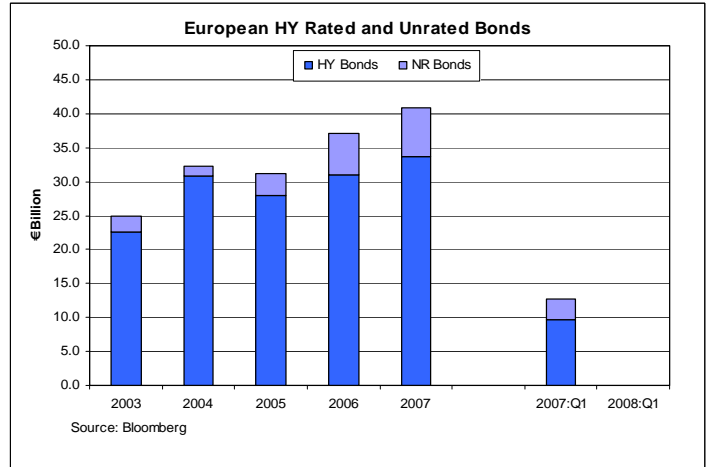
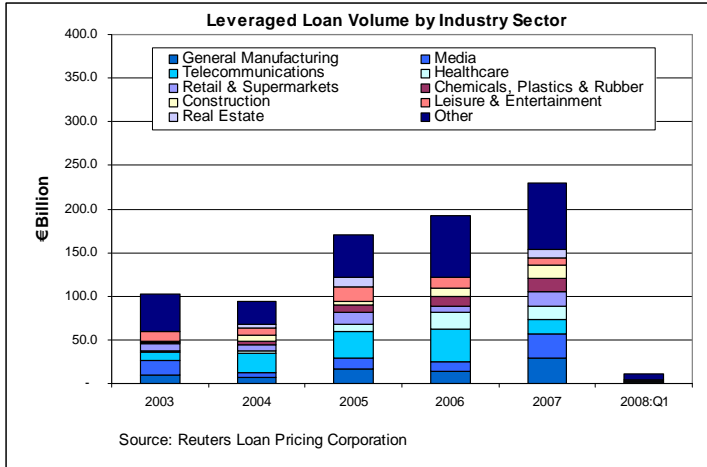
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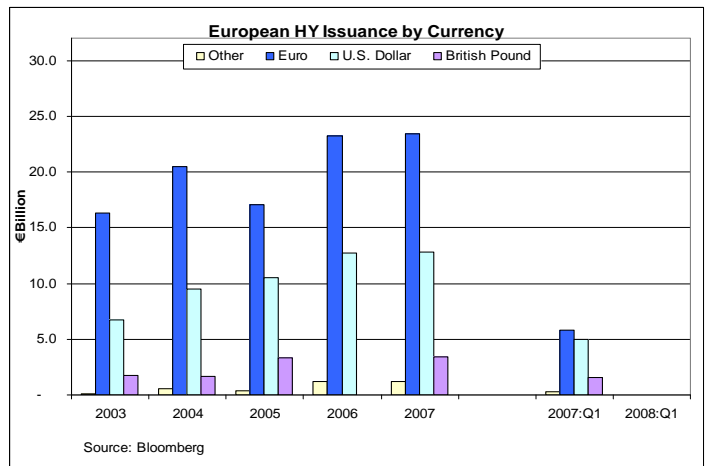
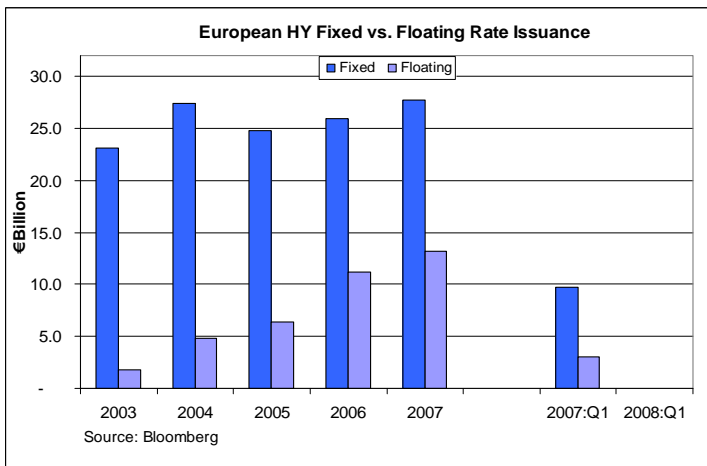


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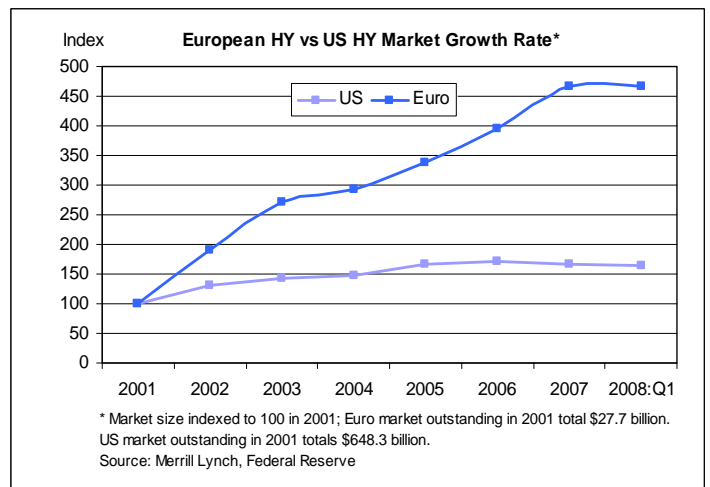
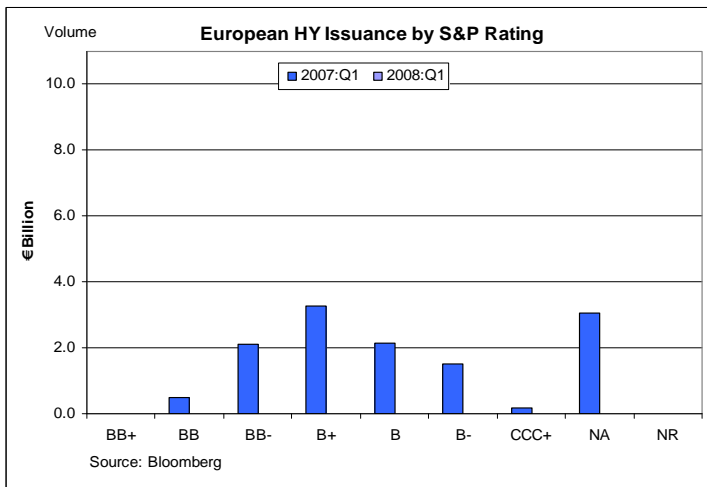
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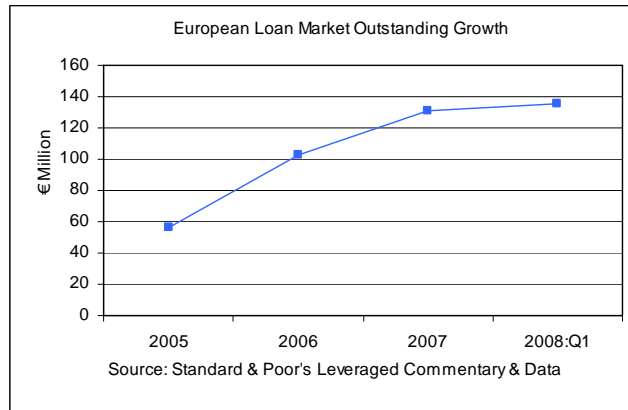
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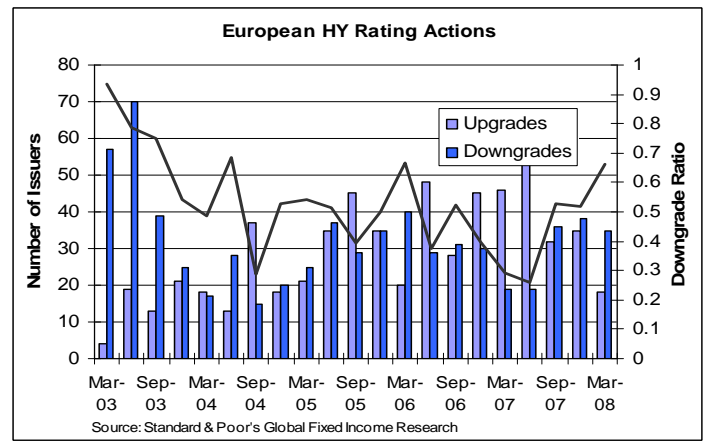
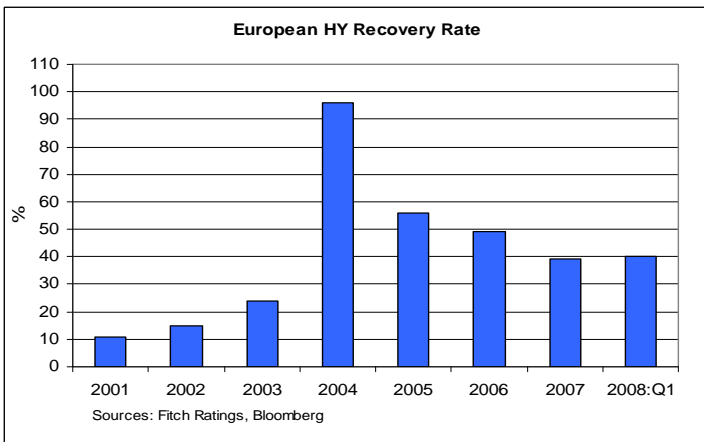
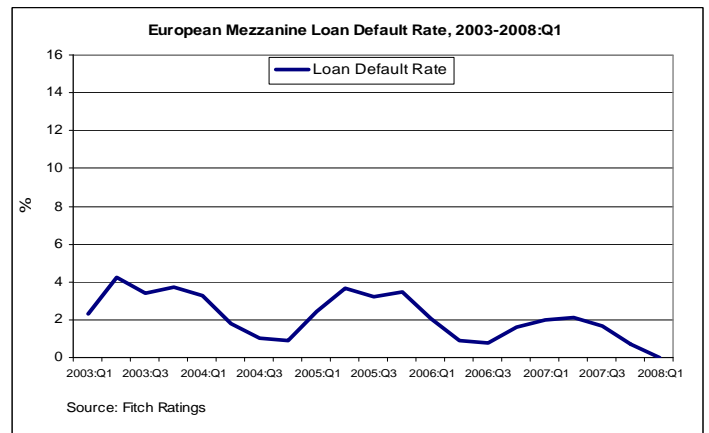
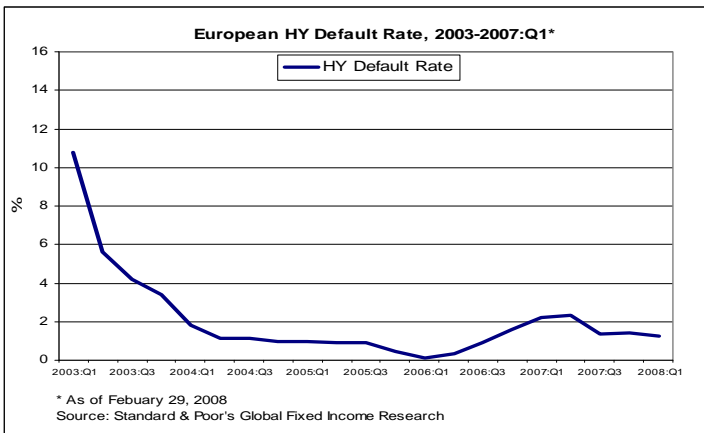
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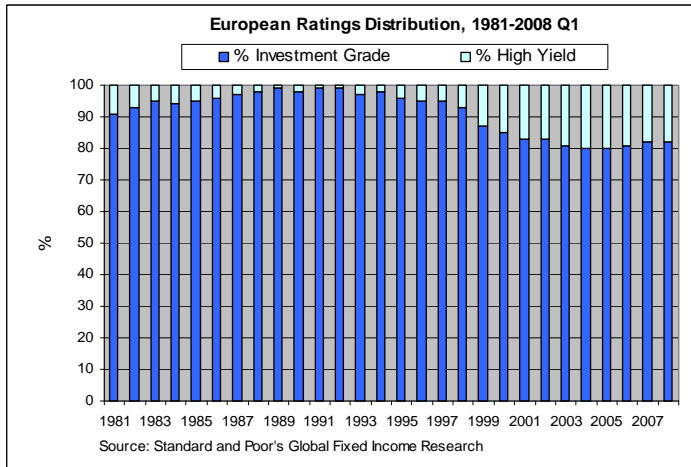




European High Yield Report - Credit Quality



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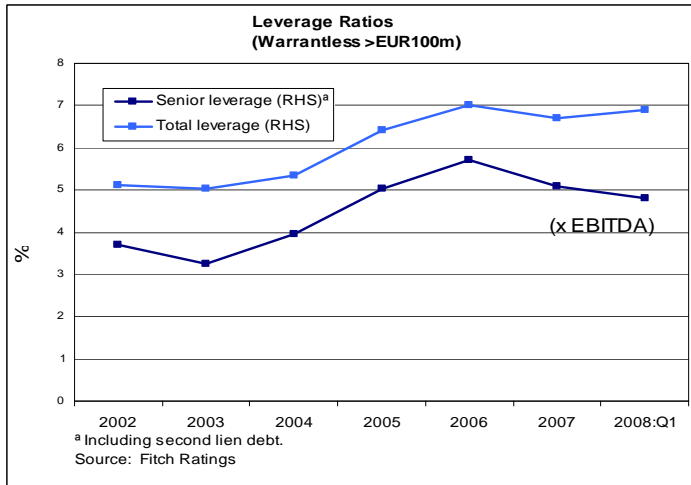
S&P European Leveraged Loan Index

Ratings Diversification

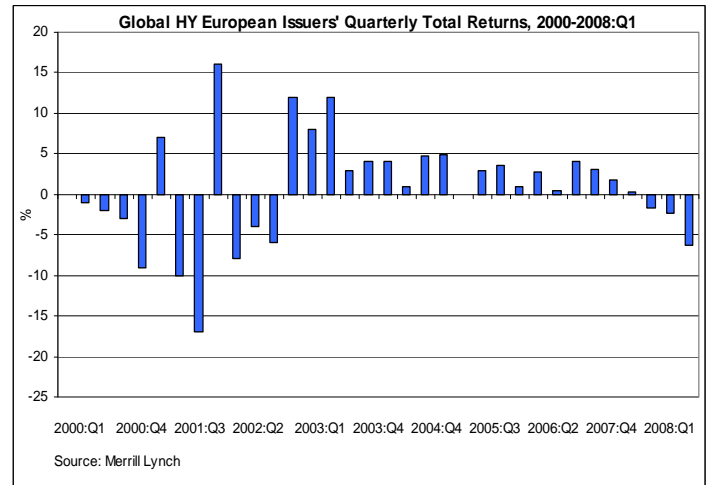
	S&P BB Rating	S&P B Rating	S&P NR Rating	Other
2005	15.5%	74.5%	9.7%	0.3%
2006	9.3%	77.9%	12.9%	0.0%
2007	8.4%	77.7%	13.1%	90.0%
2008:Q1	13.7%	70.6%	13.8%	1.9%

Source: Standard & Poor's Leveraged Commentary and Data

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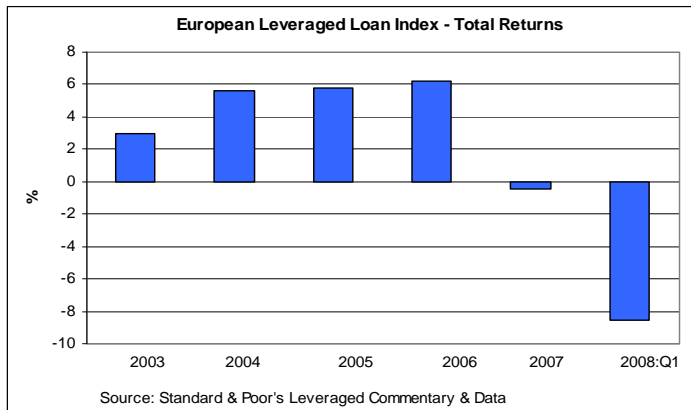


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European High Yield Report - Relative Value

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