Primary European Leveraged Credit Markets Improve in the Second Quarter; Global Credit Market Conditions Remain Weak But Show Signs of Improvement; Recession May be Nearing an End

**Highlights**

- Leveraged finance issuance, which includes leveraged loans and high yield bonds, declined to €16.5 billion in the second quarter of 2009, up from €6.3 billion in the previous quarter, but less than €52.6 billion in the same period in 2008.
- High yield bond issuance of €3.1 billion was recorded on ten deals in the second quarter of 2009, compared to €0.3 billion of issuance on one deal in the previous quarter. There were no high yield bond deals in all four quarters of 2008.
- Leveraged loan issuance was €13.4 billion in the second quarter of 2009, compared to €6.0 billion in the first quarter and €52.6 in the same year-earlier period.
- There were no European emerging market bonds issued for the third consecutive quarter compared to €4.1 billion issued in the second quarter of 2008.¹
- Investor risk sensitivity, subdued global investor demand, prospects for weak economic growth and uncertain pricing contributed to continued depressed market conditions in the European high yield bond and leveraged loan markets.
- European high yield bond and leveraged loan returns increased in the second quarter over the prior quarter. The Merrill Lynch High Yield Index and the S&P LCD European Leverage Loan Index returned 28.2 percent and 16.8 percent, respectively, in the second quarter of 2009, compared to 8.0 percent and 5.3 percent in the first quarter and gains of 1.7 percent and 5.3 percent in the second quarter of 2008.
- The European leveraged loan pipeline backlog ended the quarter with €1.4 billion on bank books, 22 percent below the €1.8 billion recorded at the end of the previous quarter and far less than the €28.7 billion recorded a year ago. In the U.S., leveraged deals in the pipeline have remained low but increased 18 percent in the second quarter, rising to €1.3 billion at end-June from €1.1 billion at end-March.
- Tightened financing conditions and lower-to-negative profit and economic growth trends continue to be potential downsides.
- Credit quality risk rose further in the second quarter from a period of historically low default rates during which corporate issuers built up their financial positions in an environment of low borrowing costs.
- Elevated leverage levels and sharply reduced credit availability, along with a eurozone recession, add to the likelihood of significantly higher default rates throughout the rest of the year.

¹ European emerging market bonds were introduced as a separate category in this report in the second quarter of 2008.
Market and Economic Environment

Market Conditions

- Despite efforts by the European Central Bank (ECB) to improve liquidity in the eurozone banking system, credit markets remain largely frozen due to continued high levels of risk aversion, a weakened global economic outlook and minimal credit market liquidity.
- Financing conditions improved marginally during the second quarter over the previous quarter. According to the July 2009 ECB bank lending survey, banks slightly decreased net tightening of credit standards for loans to households for house purchase, consumer credit and other lending. Businesses' credit standards remained tight, especially for large businesses. However, overall there was a decline in the net tightening of credit standards compared to the previous quarter. Balance sheet constraints and cost of funds continue to be concerns for businesses, particularly for the larger firms. Business and household demand for loans stayed at low levels reflecting the weak economy and housing market and low consumer confidence.
- Beginning in the second half of 2008, central banks injected massive amounts of liquidity to ease deteriorating credit market conditions and provide for greater market interbank funding stability. In June 2009, the ECB loaned €442.2 billion at a 1.0 percent interest rate for a year or more to over 1,100 banks.
- The three-month LIBOR rate fell to 0.60 percent as of end-June from 1.19 percent at end-March, and fell further to 0.48 percent in early August. The LIBOR-overnight indexed swap (OIS) spread tightened to 38 basis points at end-June from 97 basis points at end-March and tightened further to 29 basis points in early August. The LIBOR-OIS spread, which measures the difference between the overnight index swap rate and the three-month LIBOR rate, averaged roughly 11 basis points over the ten years prior to 2008. The LIBOR-OIS spread is considered an indicator of both banks’ willingness to lend to each other and concerns over liquidity. A wider spread implies funding is scarce.
- At the beginning of the second quarter, the euro initially fell against the U.S. dollar, reaching a low of 1.29 on April 20, but then increased for the remainder of the quarter to finish at 1.41 to the dollar compared with 1.33 at the end of the previous quarter.

Economic Conditions

- The eurozone economy, which entered into a recession in the third quarter of 2008, contracted by 0.1 percent in the second quarter of 2009 compared to a contraction of 2.5 percent in the prior quarter. The European Commission predicted GDP would shrink by 4.6 percent in full-year 2009 and decline 0.3 percent in 2010. The International Monetary Fund forecast largely concurred with an outlook for contractions of 4.8 percent and 0.3 percent in 2009 and 2010, respectively.
- Germany and France surprised most economists by pulling out of the recession in the second quarter, with both economies growing 0.3 percent. Other eurozone economies remain fragile, however. Spain’s GDP, for example, contracted 1.0 percent in the second quarter.
- Eurozone unemployment rose for the 13th consecutive month in June reaching a ten-year high of 9.4 percent, up from 9.3 percent in May and 7.5 percent in June 2008. Unemployment is expected to reach 11.5 percent by 2010. Consumer confidence edged up for the fourth consecutive month to 76.0 in July from 73.2 in June. The eurozone’s purchasing managers index, which measures the health of the manufacturing sector, increased to 47.0 in July from 44.6 in June. Although a reading below 50 indicates that the eurozone is in a recession, the rise in July suggests that the worst of the downturn may have passed.
- The ECB predicted that tight credit conditions will continue to hamper growth for the rest of 2009, but that the outlook for 2010 is fairly positive based on decreases in commodity prices, enacted policies taking effect, and rate cuts which should eventually restore confidence for businesses and consumers.
The ECB has gradually lowered its target interest rate from 4.25 percent in October 2008 to 1.00 percent on 7 May. Jean-Claude Trichet, President of the ECB, declined to say if 1.00 percent is the floor, but did say that he intends to leave it at that low level for some time to come. In June, the ECB commenced buying €60 billion worth of covered bonds and announced that it would inject €440 billion into the eurozone’s commercial banking sector in an effort to improve liquidity.

Inflation continued to decrease in the eurozone, falling 0.7 percent from June to July and is expected to remain weak in the second half of the year. Core inflation, which excludes food and energy, fell by 0.1 percent. The European Commission forecast inflation of 0.5 percent for full year 2009 and 1.1 percent in 2010.

European credit growth has been slowing with M3 (the broadest measure of credit) declining to a seasonally adjusted annual growth rate of 3.5 percent at end-June, compared to 6.0 percent at the end of the previous quarter and 11.6 percent at end-December 2007. The decline in M3 growth is attributable to deleveraging by firms in the financial sector as well as decreased lending activity to the private sector and reduced contributions of short-term deposits. Short-term deposits consist of deposits redeemable at a period of notice of up to three months and with a maturity of up to two years.

**Issuance**

- Conditions in the primary market strengthened in the second quarter with total European high yield bond and leveraged credit issuance reaching €16.5 billion in the second quarter of 2009 compared to €6.3 billion in the first quarter.
- There were ten high yield bonds issued totaling €3.1 billion, compared with one high yield bond totaling €0.3 billion issued in the previous quarter. There was no high yield issuance in all four quarters of 2008.
- Based on Thomson Reuters’ Loan Pricing Corporation (LPC) data, total European leveraged loan volume (including mezzanine financing) was €13.4 billion in the second quarter of 2009, of which the entire amount was first lien loans.
- The leading leveraged loan sectors were construction (€9.3 billion) and telecommunications (€3.4 billion), according to Reuters’ LPC.
- There were no European emerging market bonds issued in the second quarter of 2009 following none issued in the previous two quarters.
- Market conditions wiped out the appetite for aggressive non-traditional deal structures. According to Fitch Ratings, there were no payment-in-kind (PIK) transactions for the fourth consecutive quarter.
- Market conditions considerably slowed leveraged buy-outs (LBO) and other acquisition debt financing, including private-equity sponsored deals. According to Reuters’ LPC, leveraged loan LBO and recap volumes were nonexistent in the second quarter of 2009.
- Globally, there has been a reduction in the leveraged loan deal calendar as some deals closed under revised terms and others were removed from the calendar. According to S&P Leveraged Commentary and Data (LCD), the U.S. backlog increased to €1.3 billion by end-June from €1.1 billion at the end of the previous

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2 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 (see http://www.ecb.int/home/html/index.en.html).

3 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 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.

4 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.

5 European emerging market bonds are defined as subinvestment grade corporate bonds with a minimum issue size of €75.0 million issued by issuers with a European country of risk outside of the original twelve members of the European Union. Further, due to differences in terms and documentation, Russian ruble-denominated issuance is excluded. The original 12 members of the European Union are France, Germany, Italy, Belgium, Netherlands, Luxembourg, Denmark, Ireland, United Kingdom, Greece, Spain and Portugal.
quarter, but was well below the €51.6 billion at the end of the same year-earlier period. The European leveraged loan backlog declined to €1.4 billion at end-June compared to €1.8 billion in the previous quarter and €28.7 billion at end-June 2008.

Credit Quality

- According to S&P Global Fixed Income Research, 184 companies defaulted in the first half of 2009 compared to 48 defaults in the same year-earlier period. Although U.S. issuers account for the majority of the increase in the global default rate in the second quarter of 2009, most macroeconomic indicators in Europe are showing weakness, which may well push European default rates higher in the third quarter. In addition, weaker profits and limited access to the credit markets are putting downward pressure on credit quality.
- The S&P Global Fixed Income Research European speculative-grade default rate was 5.10 percent for the twelve months ending in June 2009, well above the previous quarter’s default rate of 4.08 percent, but considerably less than the second quarter U.S. speculative-grade default rate of 9.25 percent. S&P reported 11 European high-yield upgrades and 91 downgrades in the second quarter, compared to 13 upgrades and 144 downgrades in the prior quarter and 38 upgrades and 55 downgrades in the second quarter of 2008. Credit spreads are expected to remain relatively wide, reflecting investor uncertainty and increasing default rates over the next couple quarters.
- Fitch Ratings reported that the European mezzanine loan default rate was 4.21 percent, or 9.36 percent when adjusted for "distressed" restructurings. These numbers are based on the last twelve months’ defaulted volumes totaling €3.3 billion.
- European high-yield bond recoveries were between 10 and 30 percent with an average around 20 percent for the twelve months ending 30 June, 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.
- S&P Global Fixed Income Research reported that the “BB” rated issuer share of the European high-yield or speculative-grade market increased while the “B” rated issuer share decreased in the second quarter.
- Leverage ratios, as reported by Fitch, used as a measure of credit risk, have increased over the last several years and increased slightly in the second quarter of 2009. The median senior leverage ratio of Fitch-rated shadow credits was 4.8 times and the median total leverage was 6.2 times compared to 4.8 times for senior and 6.1 times for total in the previous quarter.

Relative Value

- European high-yield sector returns were positive and spreads tightened in the second quarter. Based on the Merrill Lynch High Yield Index, the total market return was 28.2 percent for the second quarter of 2009 compared to 8.0 percent in the previous quarter and 1.7 percent in the second quarter of 2008. At the end of the quarter, the Merrill Lynch High Yield Index reported a 1,422 basis-point credit spread, 571 basis points tighter than at the end of the previous quarter, but 689 basis points wider than the same year-earlier period.
- The leveraged-loan index return also increased in the second quarter. The S&P LCD European Leveraged Loan Index (ELLI-Total Return) was 16.8 percent for the second quarter compared to a gain of 5.3 percent in the first quarter and same year-earlier period.
European High Yield Association, Second Quarter 2009

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**European Leverage Loan Ratios**
(Warrants>EUR100m)

- Senior leverage
- Total leverage

* Including second lien debt
Source: Fitch Ratings

**European HY Bond Quarterly Total Returns**

Percent

0 1 2 3 4 5 6 7 8
2002 2003 2004 2005 2006 2007 2008 2009:Q2

Source: Merrill Lynch

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**European High Yield Report - Relative Value**

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**European Leveraged Loan Index - Total Returns**

Percent

-40 -30 -20 -10 0 10 20
2003 2004 2005 2006 2007 2008 2009Q2

Source: Standard & Poor's Leveraged Commentary & Data

**iBoxx Euro HY Bond Constrained and Unconstrained Index**

- Unconstrained Index
- Constrained Index

Source: International Index Company

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**European HY Bond Spreads and Weighted Average Institutional Loan Spread**

Basis Points

- WAIS
- Euro HY OAS

Sources: Merrill Lynch, Standard & Poor's Leveraged Commentary & Data