Primary European Leveraged Credit Markets Improve in the Third Quarter; The Worst May Be Over, But Global Credit Market Conditions Remain Tight

Highlights

- Leveraged finance issuance, which includes leveraged loans and high yield bonds, was €18.6 billion in the third quarter of 2009, up from €16.5 billion in the previous quarter, but less than €24.7 billion in the same period in 2008.

- High yield bond issuance of €8.6 billion was recorded on 15 deals in the third quarter, compared to €3.1 billion on 10 deals in the previous quarter. There were no high yield bond deals in all four quarters of 2008.

- Leveraged loan issuance was €10.0 billion in the third quarter, compared to €13.4 billion in the second quarter and €24.7 in the same year-earlier period.

- Following three consecutive quarters of no issuance, the market for European emerging market bonds returned in the third quarter of 2009 with issuance of €1.8 billion on 5 deals.¹

- Decreased investor risk sensitivity and prospects for a global recovery contributed to improved market conditions in the European high yield bond and leveraged loan markets.

- European high yield bond and leveraged loan returns decreased in the third quarter compared with the prior quarter. The Merrill Lynch High Yield Index and the S&P LCD European Leveraged Loan Index returned 21.3 percent and 11.3 percent, respectively, in the third quarter of 2009, compared to 28.2 percent and 16.8 percent in the second quarter and losses of 10.8 percent and 5.0 percent in the third quarter of 2008.

- The European leveraged loan forward pipeline ended the third quarter with €0.8 billion on bank books, 43 percent below the €1.4 billion recorded at the end of the previous quarter and far less than the €2.17 billion recorded a year ago. In the U.S., leveraged deals in the pipeline picked up by 61 percent in the third quarter, rising to €2.0 billion at end-September from €1.3 billion at end-June.

- Tightened financing conditions and lower profit and economic growth trends continue to be potential downsides.

- Credit quality risk, which has been rising since the second half of 2008, rose further in the third 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.

- Reduced credit availability along with a eurozone recession adds to the likelihood of 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

• Efforts by the European Central Bank (ECB) to improve liquidity in the eurozone banking system appear to be slowly working; however, credit markets remain tight due to continued high levels of risk aversion and the still weakened global economic outlook.

• Financing conditions improved during the third quarter over the previous quarter. According to the October 2009 ECB bank lending survey, banks decreased net tightening of credit standards for loans to households for house purchase and for consumer credit. Businesses’ credit standards decreased considerably for all business sizes and brought an end of the net tightening. With banks gaining easier access to market financing, credit standards should continue to ease for businesses’ in the fourth quarter. Net demand for loans by businesses’ declined further while demand by households increased.

• 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. Banks that received funds from the ECB, however, have held onto most it to boost their balance sheets rather than lend it out

• Three-month LIBOR fell to 0.29 percent as of end-September from 0.60 percent at end-June. The LIBOR-overnight indexed swap (OIS) spread tightened to 12 basis points at end-September from 38 basis points at end-June and remained. The LIBOR-OIS spread, which measures the difference between the overnight index swap rate and the three-month LIBOR rate, has returned to its pre-crisis level, which 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.

• Throughout the third quarter, the euro generally rose against the U.S. dollar, reaching a high of 1.48 on September 22, but closed the quarter at 1.46 to the dollar compared with 1.40 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 first quarter. The European Commission predicted GDP would shrink by 4.0 percent for full-year 2009 and grow 0.7 percent in 2010. The International Monetary Fund forecast was less optimistic with an outlook for a contraction of 4.2 percent in 2009 and 0.3 percent growth in 2010.

• Budget deficits have ballooned in the eurozone because of the global economic crisis. The eurozone budget deficit totaled 0.6 percent of GDP in 2007 and increased to 0.8 percent in 2008. The European Commission forecast the deficit to increase to 5.3 percent in 2009 and 6.5 percent in 2010.

• Eurozone unemployment rose in September to a ten-year high of 9.7 percent, up from 9.6 percent in August and 7.1 percent in September 2008. The European Commission forecast unemployment to reach 10.7 percent in 2010. Consumer confidence edged up for the sixth consecutive month to reach 82.8 in September from 73.2 in June. The eurozone purchasing managers index, which measures the health of the manufacturing sector, increased to 50.9 in September from 44.6 in June. Although a reading below 50 indicates that the eurozone is in a recession, the rise in October suggests that the economy is gradually recovering.

• Despite contracting in the second quarter of 2009, the ECB predicts that the eurozone economy is gradually recovering. To ensure the recovery takes hold the ECB said it has no plans to eliminate any of its stimulative policies, including maintaining low lending rates.
• The ECB gradually lowered its target interest rate to 1.00 percent in May 2009 from 4.25 percent in October 2008. Although the eurozone economy shows signs of stabilizing, most economists do not think the ECB will consider raising the target interest rate until the third quarter of 2010.

• Inflation continued to decrease in the eurozone, falling 0.1 percent from September to October and is expected to remain weak in the fourth quarter. Core inflation, which excludes food and energy, increased by 1.2 percent from August to September and is expected to remain at 1.2 percent in October. The ECB president, Jean-Claude Trichet, expects a return to moderately positive inflation within a month. The European Commission forecast inflation of 0.4 percent for full year 2009 and 1.2 percent in 2010.

• European monetary growth has been slowing with M3 (the broadest measure of money supply) declining to a seasonally adjusted annual growth rate of 2.5 percent at end-August, compared to 3.0 percent at the end of July and 11.6 percent at end-December 2007. The decline in M3 growth is attributable to lower growth of both short-term deposits and marketable instruments. 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 third quarter with total European high yield bond and leveraged credit issuance reaching €18.6 billion in the third quarter of 2009 compared to €16.5 billion in the second quarter.

• There were 15 high yield bonds issued totaling €8.6 billion in the third, compared with 10 high yield bond totaling €3.1 billion issued in the previous quarter, and one deal totaling €0.3 billion in the first quarter. There were no high yield bonds issued in 2008.

• Based on Thomson Reuters’ Loan Pricing Corporation (LPC) data, total European leveraged loan volume (including mezzanine financing) was €9.8 billion in the third quarter of 2009, nearly all of which were first lien.

• In the first nine months of 2009, the leading leveraged loan sectors were construction (€11.7 billion) and telecommunications (€5.9 billion), according to Reuters’ LPC.

• There were €1.8 billion European emerging market bonds issued on three deals in the third quarter of 2009 following three quarters of no issuance.

• Market conditions have not been conducive to aggressive non-traditional deal structures. According to Fitch Ratings, there were no payment-in-kind (PIK) transactions for the fifth consecutive quarter.

• Though market conditions were still slow for leveraged buy-outs (LBO) and other acquisition debt financing, including private-equity sponsored deals, market activity improved in the third quarter of 2009. According to Reuters’ LPC, leveraged loan LBO and recap volumes were €1.0 billion and €0.4 billion, respectively, compared to no volume in the second quarter.

• There has been some improvement, albeit from historically low levels, in the leveraged loan deal calendar globally. According to S&P Leveraged Commentary and Data (LCD), the U.S. forward pipeline increased to €2.0 billion by end-September from €1.3 billion at the end of the previous quarter, but was well below
the €32.0 billion at the end of the same year-earlier period. However, the European leveraged loan forward pipeline declined to €0.8 billion at end-September compared to €1.4 billion in the previous quarter and €21.7 billion at end-September 2008.

Credit Quality
- According to S&P Global Fixed Income Research, in the year-to-early November, 239 companies defaulted compared to 82 defaults in the same year-earlier period. U.S. issuers account for the majority of the increase in the global default rate in 2009; however, there are several macroeconomic indicators in Europe still showing weakness, which may well push European default rates higher in the fourth 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 7.61 percent for the twelve months ending in September 2009, well above the previous quarter’s default rate of 5.10 percent, but considerably less than the third quarter U.S. speculative-grade default rate of 10.75 percent. S&P reported 13 European high-yield upgrades and 59 downgrades in the third quarter, compared to 12 upgrades and 92 downgrades in the prior quarter and 17 upgrades and 57 downgrades in the third 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 5.0 percent, or 11.8 percent when adjusted for "distressed" restructurings. This is the highest default rate recorded by Fitch since it began tracking mezzanine defaults in 2001.
- S&P Global Fixed Income Research reported that the “BB” rated issuer share of the European high-yield or speculative-grade market decreased slightly while the “B” rated issuer share increased in the third 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 third quarter of 2009. The median senior leverage ratio of Fitch-rated shadow credits was 5.0 times and the median total leverage was 6.3 times compared to 4.8 times and 6.2, respectively, in the previous quarter.

Relative Value
- European high-yield sector returns were positive and spreads tightened in the third quarter of 2009. Based on the Merrill Lynch High Yield Index, the total market return was 21.3 percent for the third quarter compared to 28.2 percent in the previous quarter and a 10.8 percent loss in the third quarter of 2008. At the end of the quarter, the Merrill Lynch High Yield Index reported an 883 basis-point credit spread, 539 basis points tighter than at the end of the previous quarter, but 325 basis points wider than the same year-earlier period.
- The leveraged-loan index return remained positive in the third quarter. The S&P LCD European Leveraged Loan Index (ELLI-Total Return) was 11.3 percent for the third quarter compared to a gain of 16.3 percent in the previous quarter and a 5.0 percent loss in the same year-earlier period.
European High Yield Report - Issuance Volume

1. European HY Bond vs Leveraged Loan Issuance

2. European LTM Holdco PIK Issuance

3. European HY Bond and Leveraged Loans Total Issuance

4. European HY Bond vs Leveraged Loan Average Deal Size

5. European Leveraged Loan Issuance by Purpose

6. European Leveraged Loan Issuance by Industry Sector

Source: Bloomberg Finance L.P., Reuters Loan Pricing Corporation

Source: Fitch Ratings

Source: Reuters Loan Pricing Corporation
**European Emerging Market Bond Issuance 2009:Q3**

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Issue Date</th>
<th>Maturity Date</th>
<th>Coupon Rate</th>
<th>Amount Issued (€)</th>
<th>Country of Risk</th>
<th>S&amp;P Rating</th>
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<td>Central Euro Media Enter</td>
<td>17/09/2009</td>
<td>15/09/2016</td>
<td>11.63%</td>
<td>200,000,000</td>
<td>Czech Republic</td>
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<td>Kazmunaigaz Finance Sub</td>
<td>23/07/2009</td>
<td>23/01/2015</td>
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<td>30/07/2012</td>
<td>13.00%</td>
<td>586,847,856</td>
<td>Ukraine</td>
<td>CCC+</td>
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**European High Yield Report - Credit Quality**

**European HY Bond Default Rate**

Source: Standard & Poor's Global Fixed Income Research

**European Mezzanine Loan Default Rate**

Source: Fitch Ratings

**European HY Bond Rating Actions**

Source: Standard & Poor's Global Fixed Income Research

**European Bond Ratings Distribution**

Source: Standard and Poor's Global Fixed Income Research
S&P European Leveraged Loan Index

Ratings Diversification

<table>
<thead>
<tr>
<th>Year</th>
<th>BB Rating</th>
<th>B Rating</th>
<th>NR Rating</th>
<th>Other</th>
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<td>2005</td>
<td>15.5%</td>
<td>74.5%</td>
<td>9.7%</td>
<td>0.3%</td>
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<td>2006</td>
<td>9.3%</td>
<td>77.9%</td>
<td>12.9%</td>
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<td>2007</td>
<td>8.4%</td>
<td>77.7%</td>
<td>13.1%</td>
<td>0.9%</td>
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<tr>
<td>2008</td>
<td>13.4%</td>
<td>66.0%</td>
<td>15.3%</td>
<td>5.3%</td>
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<td>2009:Q3</td>
<td>10.3%</td>
<td>61.2%</td>
<td>15.0%</td>
<td>13.5%</td>
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</tbody>
</table>

Source: Standard & Poor's Leveraged Commentary and Data

European Leveraged Loan Ratios

(Warrantless>EUR100m)

Percent

Senior Leveraged Loans
Total Leveraged Loans

European HY Bond Quarterly Total Returns

Source: Merrill Lynch

European High Yield Report - Relative Value

European Leveraged Loan Index - Total Returns

Source: Standard & Poor's Leveraged Commentary & Data

iBoxx Euro HY Bond Constrained and Unconstrained Index

Source: International Index Company
European High Yield Bond Spreads and Weighted Average Institutional Loan Spreads

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