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Unrated European LBOs: Refinancing Burden Eases but Default Risk Remains High for Weakest Companies

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Analyst Contacts:

LONDON +44.20.7772.5454

Sebastien Cieniewski +44.20.7772.1964
Assistant Vice President - Analyst
sebastien.cieniewski@moodys.com

Julien Suche +44.20.7772.1945
Associate Analyst
julien.suche@moodys.com

Chetan Modi +44.20.7772.5451
Managing Director - Corporate Finance
chetan.modi@moodys.com

- The overall refinancing burden of unrated European leveraged buyouts (LBOs) has materially reduced since our last study in May 2012 and the unrated universe has shrunk to 288 companies.[1] This study comments on total debt of €122 billion, down from €171 billion. This reduction has been largely driven by refinancing of loans with high-yield bonds, as companies have taken advantage of recent extraordinary market appetite for this product.
- This refinancing activity, combined with significant "amend-and-extend" (A&E) activity, has flattened the previous 2014-2015 refinancing peak. About 44% of debt now matures after 2015, double the 22% in the 2012 study.
- Predictably, the relatively larger and more credit-worthy unrated companies have undertaken most refinancing. However, the maturities of a problematic stub of smaller and weaker companies remain largely unaddressed.
- Although the strong refinancing activity has kept the default rate subdued despite the weak European macro environment, we continue to expect that the default rate for these unrated names will increase materially over the next couple of years. It remains possible that up to a quarter of the companies in this study (representing a smaller portion of debt) could default.
- Funding dynamics will remain important factors in this context. These include ongoing access to the high-yield market at reasonable terms, the pressures around bank deleveraging, and developments regarding the pace of new collateralised loan obligation (CLO) formation since existing CLOs will have mostly entered their amortisation period by the end of 2013. The return of capital markets turbulence and increased investor risk aversion at this juncture may prove decisive.

[1] This report excludes our Unpublished Monitored Loan Ratings. This universe of names has no material debt maturity prior to 2017, and hence does not impact the conclusions of this report.

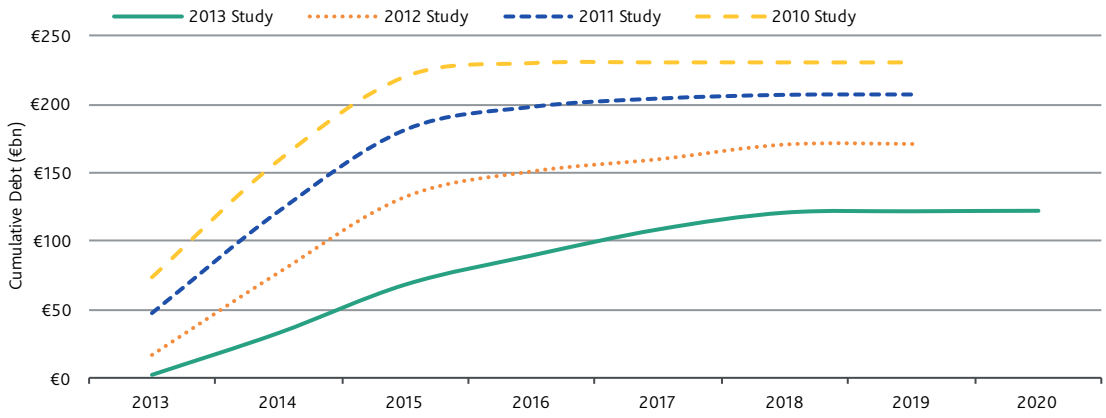
Boom in high-yield issuance fuelled by LBO refinancing

This study updates our previous analyses on the aggregate debt maturity profile of the unrated European LBO universe. The studied universe comprises 288 companies, down from 368 last year. The total amount of debt fell to €122 billion from €171 billion. Exhibit 1 shows that 159 of these 288 companies have €68 billion of debt maturing though 2015, compared to 254 companies with debt of €133 billion in our previous study.

EXHIBIT 1

Significant reduction in unrated LBO debt

European Unrated LBOs Cumulative Maturities

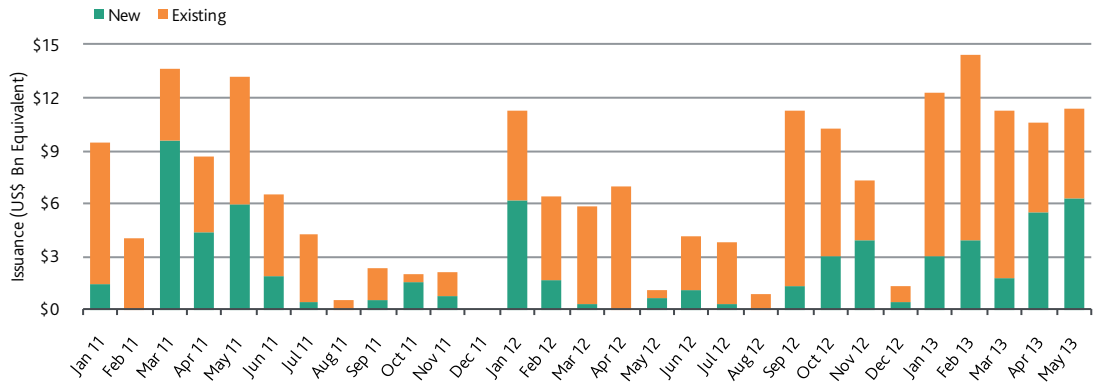


Source: Moody's research

This reduction has been largely driven by refinancing of loans with high-yield bonds, as companies have taken advantage of recent extraordinary market appetite for this product, as illustrated in Exhibit 2. The issuance of high-yield bonds by EMEA speculative-grade companies in 2013 reached $60 billion by end-May, compared with $70 billion for full-year 2012, which itself was a record. Other factors contributing to the reduced universe include trade sales, ongoing repayments, and debt restructuring. These were not offset by primary LBO activity, which remained very limited.

EXHIBIT 2

Strong high-yield issuance drives reduction in unrated LBOs



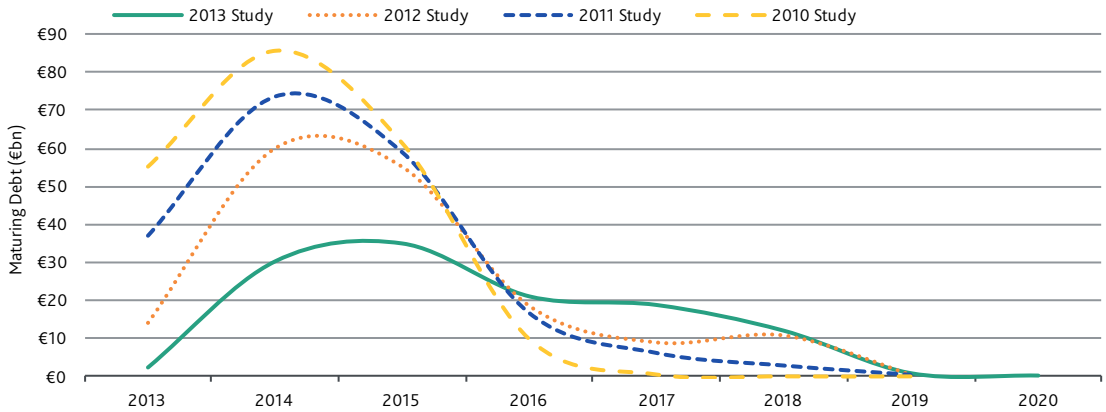
Source: Moody's research

Exhibit 3 shows how this refinancing, combined with significant A&E activity, has flattened the previous 2014-2015 refinancing peak. The impact of these A&Es, which typically extend debt maturities by two years, is also demonstrated in the increase in the 2016-17 maturities. About 44% of debt now matures after 2015, double the 22% in the 2012 study.

EXHIBIT 3

Refinancing peak in 2014-2015 has flattened

European Unrated LBOs Annual Maturities



Source: Moody's research

In undertaking A&E agreements, companies have benefited from CLO market dynamics. As existing CLOs have moved progressively out of their reinvestment periods, they have faced pressure to have sufficient assets invested into their amortisation phase. Given limited primary LBO activity and prepayments of loans that are refinanced by bonds, CLOs have generally strongly supported this A&E trend. There has also been some A&E for stressed companies with no other refinancing options, but this has been relatively limited. We expect A&Es to remain strong throughout 2013 but are more uncertain after that date due to the more limited capacity of CLOs to extend their commitments following the end of their reinvestment periods.

Increasing concentration of weak companies in the unrated LBO universe

To assess the credit quality of unrated LBO debt, we map broadly our unpublished credit estimates (CEs) to our long-term rating scale, as set out in our credit estimate rating implementation guidance (RIG).[2] CEs are not expressed through the use of our traditional Aaa-C alphanumeric long-term rating scale, but are instead expressed on a simple numerical scale of 1-21. They are calibrated, however, to be broadly comparable to our alphanumeric rating scale, with 16 being comparable to B3, and 17 to Caa1, etc.

The recent robust refinancing, including through the issuance of high-yield bonds, has mostly addressed the needs of companies with relatively better credit profiles. Exhibit 4 shows that in the last 12 months, CEs scored at 15 (comparable to B2), showed the greatest decrease in outstanding debt maturing through 2015 (about €22 billion, compared to a decrease of only €8.5 billion for CEs scored 16).

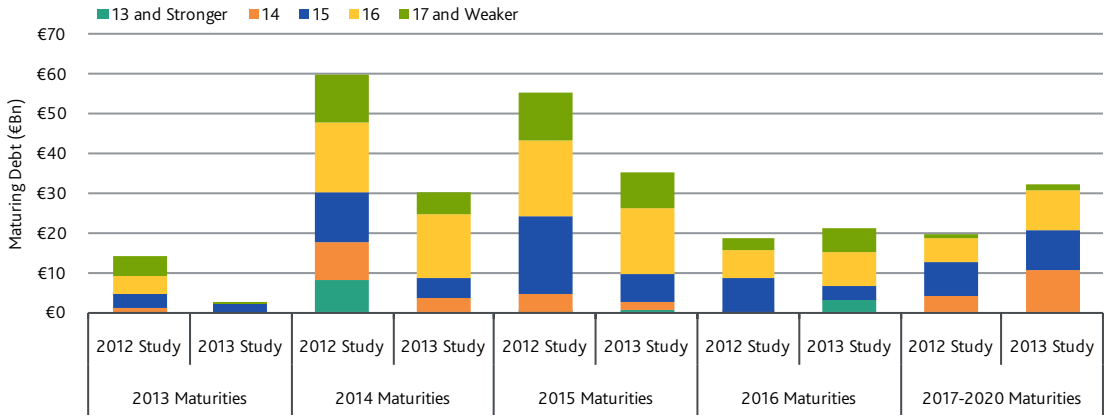
[2] See "Updated Approach to the Usage of Credit Estimates in Rated Transactions", published in October 2009. As described more fully in this RIG, credit estimates are opinions of approximate credit quality, and do not represent a traditional Moody's credit rating.

The unrated LBO universe continues to retain many stressed companies with material default risk. The refinancing of many stronger companies has in fact led to a concentration of weaker companies in the universe. For example, 61% of European unrated LBO debt is now scored at 16 or weaker, compared with 52% in the 2012 study. CEs at 17 or weaker, which imply more stressed capital structures, account for around 19% of the unrated LBO debt and represent those companies which may face the greatest refinancing challenges. The maturity profile of this weaker pool therefore remains concentrated around 2014 and 2015. About 70% of unrated European LBO debt maturing through 2015 is scored at 16 or weaker, compared with 55% in the 2012 study.

Although the heightened refinancing activity has kept the default rate subdued despite the weak macro environment in Europe, we continue to expect that the default rate for these unrated names will increase materially over the next couple of years. On a cumulative basis up to a quarter of the companies (representing a smaller percentage of debt) could default, with a peak number of defaults in 2014-2015. This number could increase significantly if the high yield bond market closes for an extended time.

EXHIBIT 4

Maturities of weakest companies not yet addressed



Source: Moody's research

Funding dynamics will continue to influence the default rate

Funding dynamics will continue to influence companies that still need to refinance, and the resulting default rate. These dynamics include ongoing access to the high-yield market at reasonable terms, pressure on banks to deleverage and developments in the CLO market.

The high-yield market has shown great strength in recent years, and in Europe especially since the September 2012 policy statements by the European Central Bank that supported the surge in issuance. Pricing of high-yield bonds has also reached record lows, as investors have looked for yield. This cheap pricing in particular has benefited many companies carrying debt burdens that in previous cycles might have been considered unsustainable, but have now been able to refinance. Recent capital market dislocations and increased investor risk aversion may indicate a change in this trend. It is too early to say how changes in market sentiment will play out between investor demands for improved pricing and terms, and the refusal to even consider purchasing bonds of lower-rated companies. However, at the very least they highlight the risk borne by companies with highly leveraged capital structures and upcoming maturities.

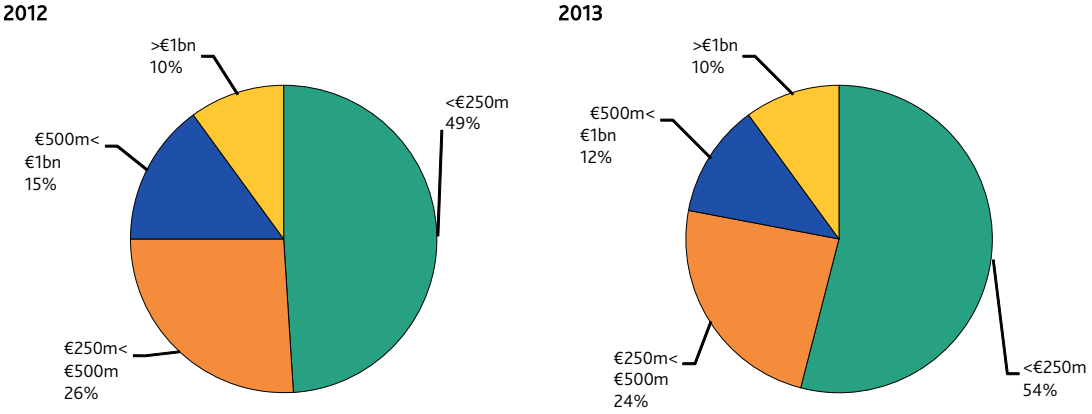
Regarding CLO dynamics, it remains uncertain how easily companies will be able to undertake A&Es once the pressure eases on existing CLOs to maximise their assets as they proceed into amortisation. We have also seen the tentative return in 2013 of new European CLOs, which are looking for collateral assets. However, options for new CLOs to invest in existing distressed credit may be limited; future growth of the European CLO market will also depend on the impact of regulation, as well as new asset formation through a return of primary LBO activity.

Unrated LBO universe is increasingly concentrated around smaller companies

Due in part to the minimum size required to issue a high-yield bond, only relatively larger companies have accessed the capital markets to refinance maturing debt. Smaller companies have relied on A&Es to extend their maturities. The unrated LBO universe has thus become increasingly skewed towards smaller credits. Exhibit 5 shows how in this study group, 54% of companies have outstanding debt of less than €250 million, compared to 49% in last year's study. However, these smaller companies represent only 16% of total outstanding debt.

EXHIBIT 5

Increased concentration of companies with debt below €250M

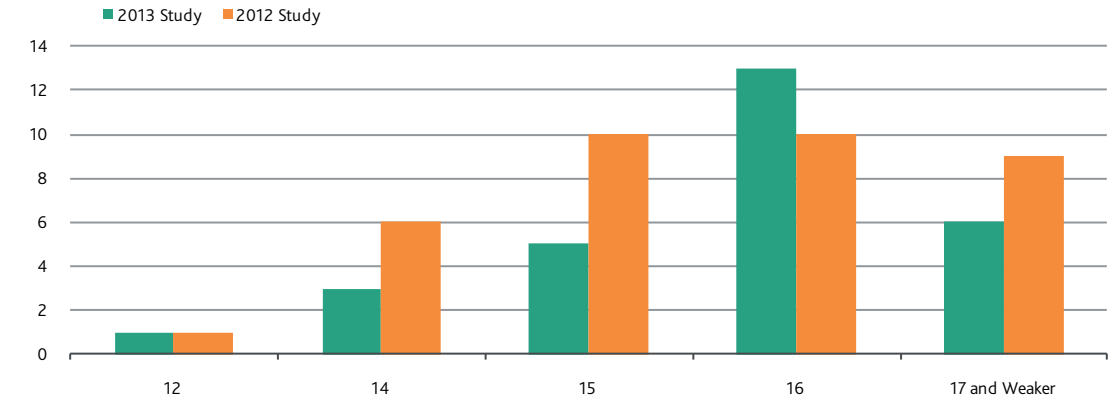


Source: Moody's research

However, although larger companies generally have more funding options, their credit quality remains a paramount consideration. Despite strong funding market conditions, there has still been only limited appetite among European high-yield investors for bonds from Caa-rated companies. Exhibit 6 shows the credit distribution of the unrated LBOs with more than €1 billion of debt, showing the greater concentration of names scored at 16.

EXHIBIT 6

A larger proportion of companies with > €1 Billion of debt are weak credits



Source: Moody's research

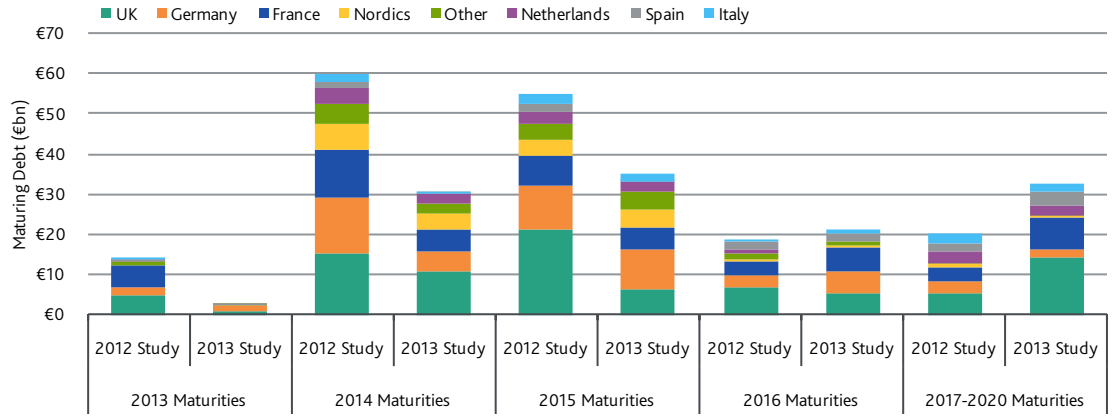
Reduction in debt burden has been geographically diverse

The maturity profile by country shows that the UK (€38 billion), France (€24 billion), and Germany (€23 billion) continue to have the largest amount of unrated LBO debt.

Exhibit 7 shows that the reduction of outstanding unrated European LBO debt by country or region this year compared with last year has been relatively homogenous. The Nordics showed the least reduction, with 23%, compared with the Netherlands with the most at 37%. Germany and the UK both showed drops of 30%, while France's dropped by 24%. Within the euro area periphery, Spain and Italy now represent about €11 billion of unrated LBO debt, compared with €16 billion in last year's study.

EXHIBIT 7

UK, France and Germany have most unrated LBO debt



Source: Moody's research

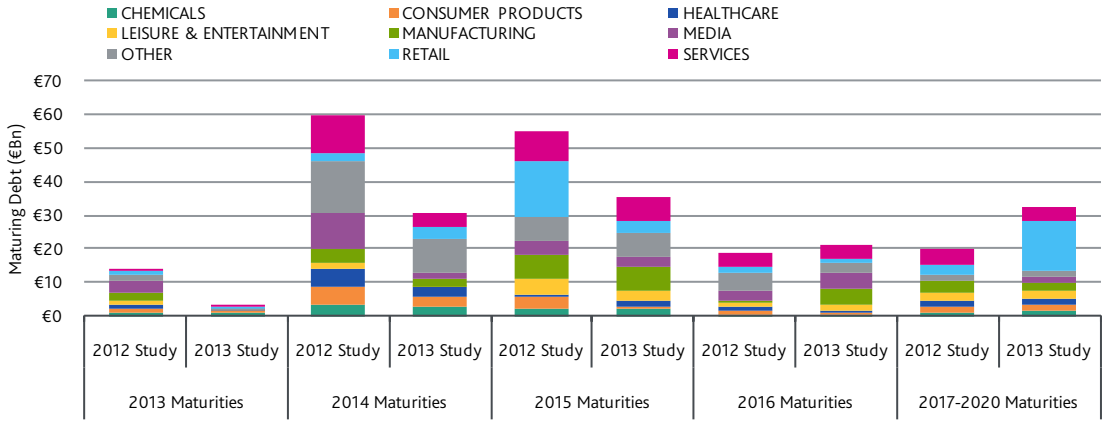
Disparities between industries in terms of refinancing remain

Exhibit 8 shows that the retail industry has the largest amount of unrated LBO debt outstanding (about €24 billion), followed by services and manufacturing at €19 billion and €16 billion, respectively. Services and manufacturing have the largest amount of debt maturing through 2015, at approximately €10 billion, followed by retail at €7 billion.

Exhibit 8 also indirectly illustrates the sectors that have been most active in refinancing leveraged loans with high-yield bonds. The manufacturing and chemicals industries, which represent about 20% of total debt, reduced outstanding debt by just 12% and 9%, respectively, in the past year. By contrast the consumer products sector reduced its outstanding debt by 54%, media by 44% and services and healthcare each by 36%.

EXHIBIT 8

Consumer products industry lowers its outstanding debt the most from a year earlier

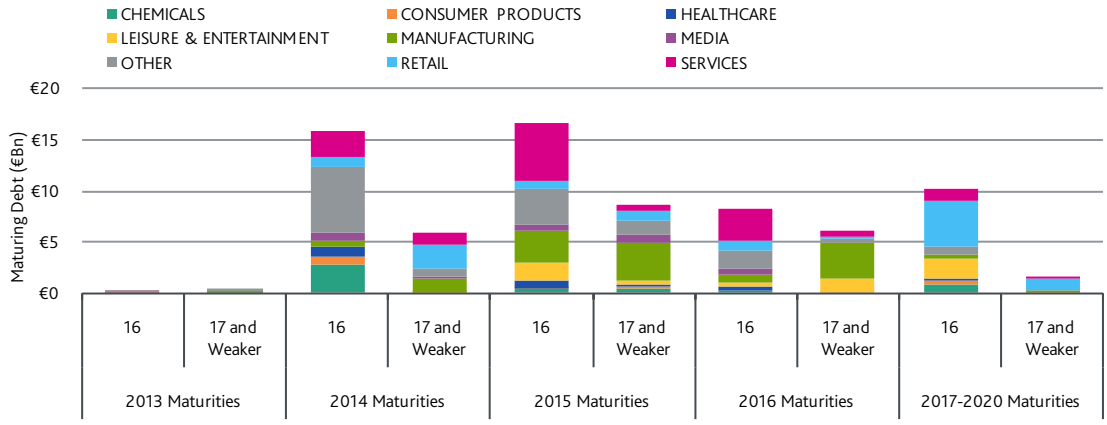


Source: Moody's research

Exhibit 9 provides further analysis of industry exposure according to credit quality. Most of the weakly positioned debt (scored at 16 or weaker) maturing through 2015 is held by companies operating in the manufacturing, services, retail, and chemical industries.

EXHIBIT 9

Industry segmentation by credit quality



Source: Moody's research

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Authors
Sebastien Cieniewski
Chetan Modi
Julien Suche

Financial Writer
Anne Colden

Production Specialist
Shubhra Bhatnagar

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