Fitch Ratings 2019 Outlook: European High-Yield and Leveraged Credit

Peak Multiples and Funding Conditions to Constrain Supply

Fitch's Sector Outlook: Stable

European high-yield bond and leveraged loan default rates are set to remain benign at less than 2%. Refinancing since 2016 resulted in long maturities, low coupons and loose covenants, which offset concern over high leverage and recurring financial market volatility as net global central bank asset purchases reverse.

Rating Trajectory: Stable

A bias towards 'BB' credits in European high-yield bonds and financial sponsor emphasis on secular growth targets in single-'B' European leveraged loans also support a benign fundamental credit outlook. Operating cash flows remain supportive of comfortable debt-service burdens. The exceptions relate to retail and construction, where credit stress developed from online disruption and emerging-market exposure. UK and Italian issuers face demands for spread premium given uncertainty over the Brexit transition and the EU budget impasse.

Peak Multiples and Funding Conditions

Primary market debt multiples peaked in 1H18, as expected recoveries assigned to senior secured instruments constrained the rise in senior leverage that accompanied the ECB's CSPP. The ECB's tapering announcement in mid-2018 coincided with a trough in unsecured 'CCC' spread levels and constrained total leverage. Volatility will lead to primary market new issue declines in high-yield (-30%) and loans (-20%) while CLOs remain flat to 2018.

Fixed Rate Issuance Vulnerable

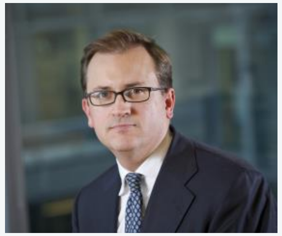
Funds-flow sensitivity implies volatility for fixed-rate bonds in comparison to senior secured floating rate products. Senior CLO liabilities remain supportive of demand. Junior tranches may require wider (though affordable) primary market pricing. Floating-rate products benefit from less volatile funding conditions, sponsor bias towards non-call features and absence of duration risk.

What to Watch

- Rising volumes and pricing power must offset tighter funding conditions.
- Weak covenants & incremental facilities may keep leverage elevated.
- Market contagion from US leveraged credit markets where debt service is weaker.
- Failure to de-leverage may raise spectre of maturity wall in early 2020s.

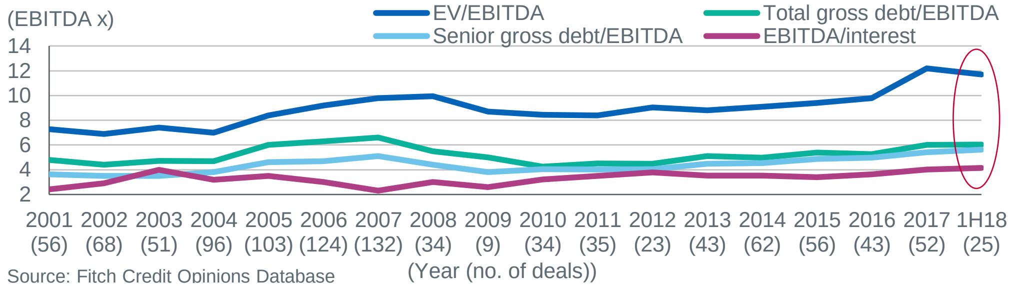
Edward Eyerman, Managing Director

"Fitch forecasts a stable if not robust operating environment for European high-yield bond and leveraged loan issuers. Strong asset selection and ample debt-service headroom offset concern over financial market volatility and peak multiples. Default rates will remain low while new issuance may suffer as investors become selective and secondary market discounts challenge primary."



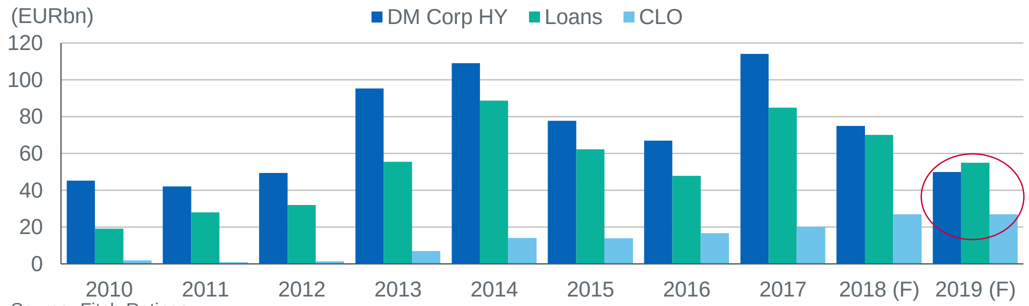
Enterprise Value, Leverage and Interest Cover Multiples at Closing (Median)

2001-1H18, primary market LBO/SBO/TBO/QBO



Source: Fitch Credit Opinions Database

European Leverage Credit and CLO Issuance



Source: Fitch Ratings

Sector Forecast

Search for Yield Ebbs

Global investor allocations to European high-yield, leveraged loan funds and junior CLO tranches may subside as alternative yields develop in short-dated US treasury markets and more liquid investment-grade credit products. The end of the ECB's corporate securities purchase programme (CSPP) in 2019 raises further uncertainty over the demand conditions for European 'BBs'. Investors will likely emphasise pricing distinctions for fallen angel 'BBs' attempting to return to investment grade compared with mid-market 'BBs'.

Senior-Secured Constrained by Recovery

Jumbo LBOs remain supportive of new issuance outlook, however the pace of recapitalisations in 'B' leveraged credit markets will slow. Dividend and secondary buyout recaps accelerated with ECB stimulus into frequently all-senior structures. However, rising senior leveraged resulted in low expected recoveries towards 50%-55% limiting addressable assets in primary for CLO buyers. Consequently, a peak in senior debt-to-EBITDA multiples appeared in mid-2017 and subsequent issuance reflected lower senior leverage.

Unsecured Constrained by Volatility

Total leverage also appears to have peaked as pricing and execution risk in unsecured and expressly subordinated debt products appear more uncertain. EMEA 'CCC' category high-yield notes generally reflect 'unsecured' fixed-rate instruments subordinated to senior secured loans or notes. Spreads on 'CCCs' reached historical troughs in 1H18 before trading wider at year-end against broader financial market volatility. Volatility may provide investors with more selectivity in secondary markets, challenging the search for yield in primary.

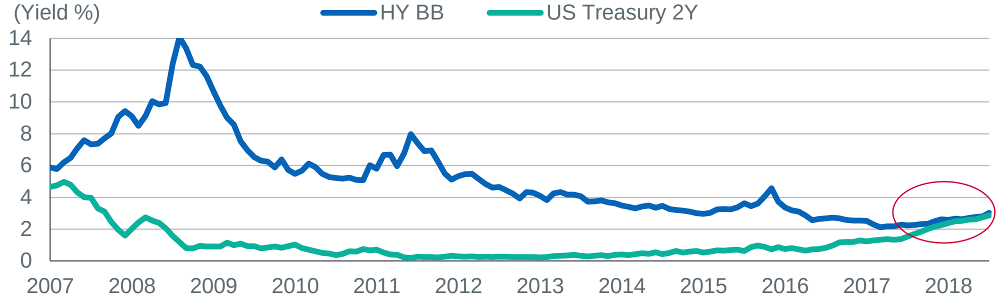
Private Debt Support Creditworthy

Despite material spread widening, most issuers can afford higher coupons given cash-flow generation and legacy debt-service headroom. Performing credits will find backstop secondary market investors, and execution risk in M&A-related new issues will be mitigated by private debt direct lending, credit opportunities, and special situation funding vehicles.

What to Watch

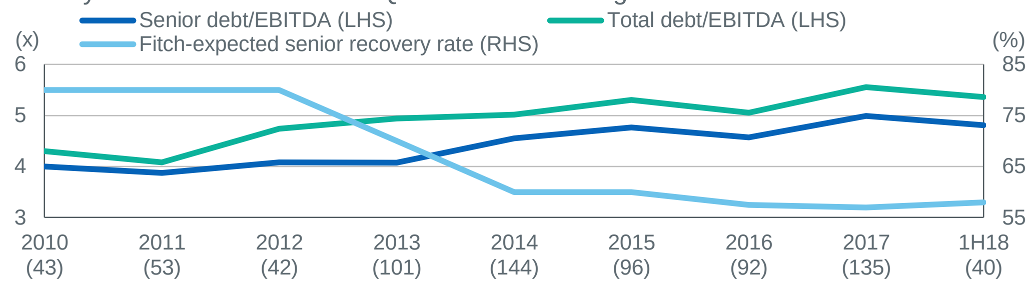
- End of ECB's CSPP impact on investment-grade corporate bond spreads.
- Volatility from US high-yield market on European high-yield funds flow.
- Credit gaps in secondary market between performing and profit-warning credits.

Fitch European HY BB Index vs US Treasury 2Y



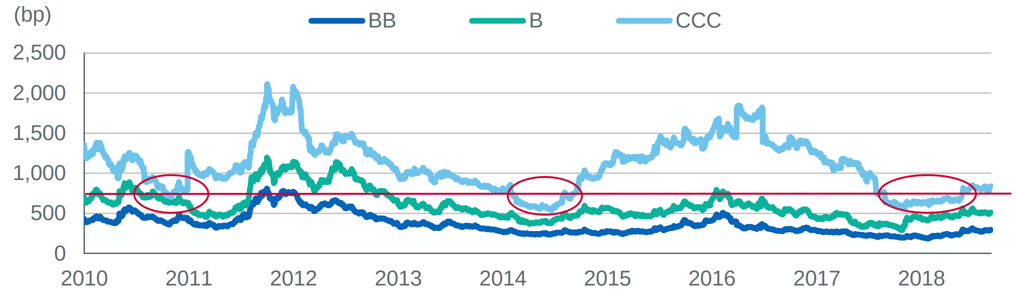
Source: Fitch European High Yield Corporate Bond Index , Bloomberg

Median Leverage Versus Fitch's Senior Recoveries Expectations
Primary market LBO/SBO/TBO/QBO and refinancings



Source: Fitch Ratings

European HY CCC Spreads Trough at 600bp in 2011, 2014 and 2018



Source: Factset

Fundamental Outlook

Default Rates Remain Low

European high-yield bond and leveraged-loan default rates hit post-crisis lows in 2018 and are set to remain below 2%. Rolling over maturities via refinancing will be more challenging given peak multiples and more expensive debt; however, maturities don't become a material concern until the early 2020s. Market volatility will, however, translate into discounts to par and lower portfolio NAVs unless policy responses develop.

European HY Strong Credit Quality

The 'BB' component of European high-yield volumes remains above 50%, reflecting legacy issuance from post-crisis fallen angels and mid-market champions with modest leverage. In addition, many cyclical sectors such as chemicals and auto suppliers consolidated and embraced de-leveraging strategies. The European cable sector also consolidated and embraced lower leverage profiles than under pre-crisis sponsor ownership.

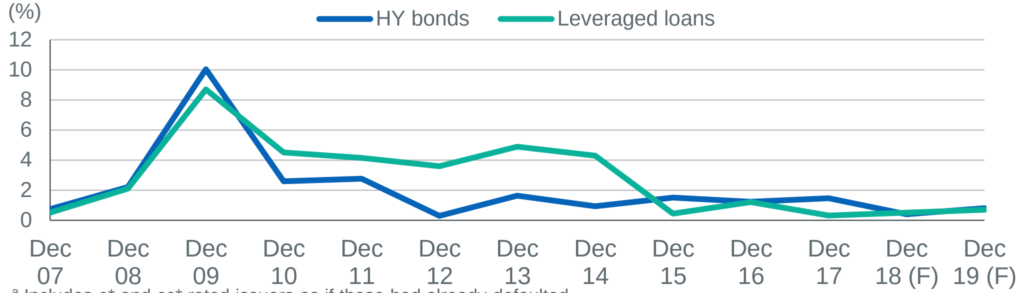
Maturities a Medium-Term Concern

Concern over financial market volatility will be reflected in wider spreads, tighter primary market conditions and discounts to par. Current credit profiles supported by long-dated maturities and ample debt-service and liquidity headroom may become more challenged if capital market conditions remain volatile for an extended period and the economic cycle turns. Refinancing issues will more likely reflect tighter underwriting standards expressed in lower primary market debt multiples rather than higher spreads and coupons.

What to Watch

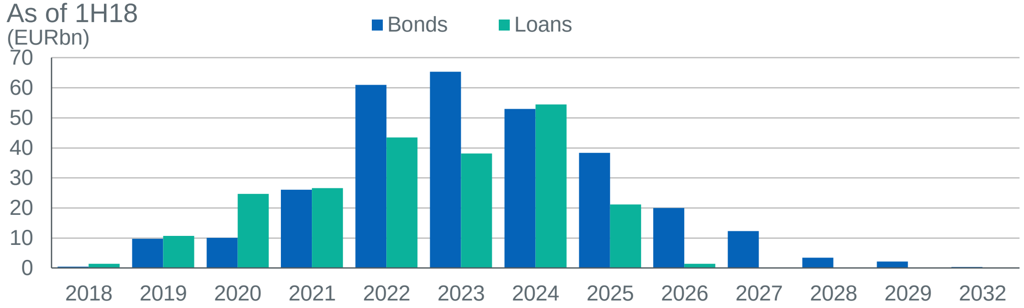
- Corporate financial policies shift towards debt reduction in anticipation of tighter credit.
- Cost reduction and forecasted synergies remain a critical execution risk for recent LBOs.
- Economic conditions may limit pricing power to offset higher funding costs.
- Fallen angels increase European high-yield supply and market conditions may tighten further.

European Default Rates



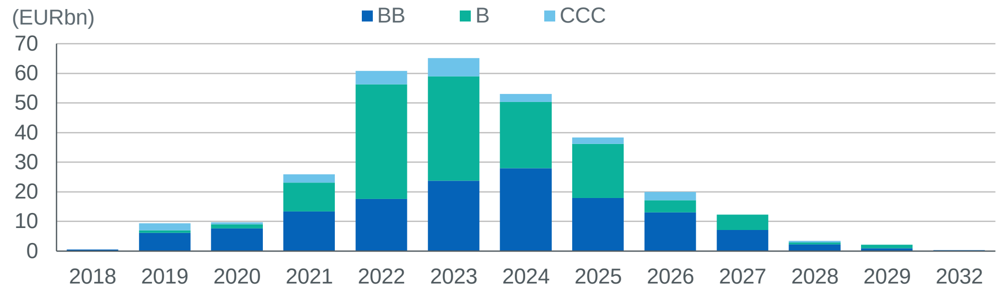
[a] Includes c* and cc* rated issuers as if those had already defaulted
Source: Fitch Leveraged Credit Database

Leveraged Finance Maturities
As of 1H18



Source: Fitch Leveraged Finance Database

European HY Bond Maturities
As of 1H18



Source: Fitch Leveraged Finance Database

Minimal "At-Risk" Leveraged Credits

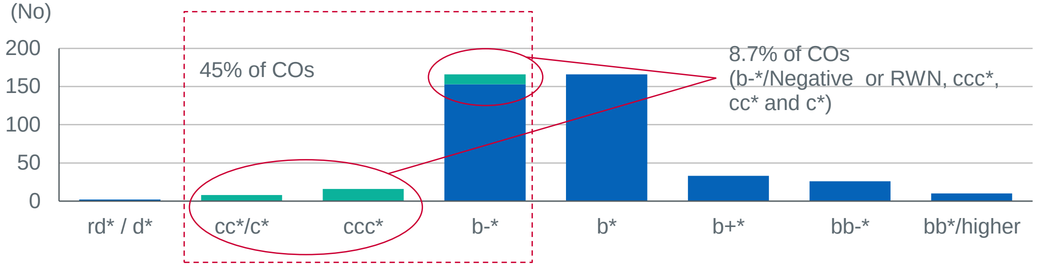
Fitch's "At-Risk" leveraged credit portfolio of credit opinions at 'b-'* negative outlook and below hit a post-crisis low of 8.7% in 1H18. The relative shortage of 'ccc' rated leveraged credit reflects successful restructuring of legacy pre-crisis credits, ECB-supported liability management, operating cash flow supported by economic recovery and post-crisis financial sponsor asset selection away from cyclical and toward secular growth targets.

Debt Service and Liquidity Key Stability

ECB CSPP vintage credits witnessed re-leveraging and looser underwriting standards which apply to practically all European leveraged credits. Notable distinctions in single-'b' category leveraged credits relate to size and scale. In the mid-market, distinctions between 'b'* vs. 'b-'* typically relate to leverage, operating profit margins and free cash flow profiles, while the distinctions between debt-service and liquidity appear minimal.

The 'At-Risk' Portion of the Portfolio

45% of COs are rated b-* or lower



Source: Fitch Leveraged Credit Database

What to Watch

- Leveraged credit forecasts discount M&A cost savings and gains from scale.
- Buy-and-build strategies reflect high market multiples in 2017 and 2018.
- Weak covenants can increase vulnerability to subordination risk and collateral transfer.

Fitch European Leveraged Credit Portfolio

Median statistics as of June 18	bb-*/ above	b+*	b*	b-*	ccc*	cc*/c*
Number of transactions	36	33	166	166	16	8
Net sales (EURm)	1,743	1,283	445	442	657	615
EBITDA (EURm)	355	304	93	58	63	53
EBITDA margin (%)	19.7	27.1	20.5	13.9	9.3	10.2
EBITDA/cash interest (x)	8.4	5.3	4.2	3	1.7	1.8
Total debt (incl. PIK[a])/EBITDA (x)	3.3	4.6	4.9	5.5	10.5	8.9
FFO adjusted leverage (x)	4	4.6	5.4	6.5	8.8	8.2
FCF margin – year 1 (%)	2.8	1.2	2.2	0.3	-2.7	-4.8
Liquidity ratio[b] (x)	1.7	1.4	2.4	2.2	1.6	0.7

Note: This table does not constitute a prescriptive grid to determine ratings but rather it is a descriptive summary of statistics in Fitch Ratings' credit opinions portfolio
[a] In case of Holdco PIK loans not in compliance with Fitch Ratings' methodology
[b] (Cash + Undrawn RCF) / (Debt Service N+1)
Source: Fitch Leveraged Credit Database

Outlooks and Related Research

2019 Outlooks
Global Economic Outlook (September 2018)
European Leveraged Loan Chart Book (September 2018)
Leveraged Credit Multiples Are in Focus As ECB Tightens (September 2018)
Snr Secured Definitions May Change CLO Recovery Expectations (November 2018)
Peak Multiples Limit Recaps in EMEA Leveraged Credit (November 2018)

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