



European Quarterly High Yield and Leveraged Loan Report

EUROPEAN HIGH YIELD ASSOCIATION

Fourth Quarter, 2008

The European High Yield Association (EHYA), an affiliate of the Securities Industry and Financial Markets Association, is pleased to present the eighth 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 and emerging market marketplace. It provides for both high yield corporate bonds and leveraged loans, new issuance, credit quality and returns on investment. Unless otherwise noted, the data is through the fourth quarter of 2008.

Primary European Leveraged Credit Markets Were Silent in Winter with No High Yield Bond Issues in the Fourth Quarter; Difficult Global Credit Market Conditions Dominate the Outlook

Highlights

- Leveraged finance issuance, which includes leveraged loans and high yield bonds, declined to €73.7 billion for full year 2008 compared to €240.3 billion in 2007.
- There were no high yield bond deals recorded at all in 2008 compared to issuance of €0.4 billion in the fourth quarter of 2007 and €30.8 billion in full year 2007.
- Full year 2008 leveraged loan issuance was €73.7 billion, compared to €209.5 in the previous year.
- There were no European emerging market bonds issued in the fourth quarter compared to €1.9 billion in the third quarter and €4.1 billion in the second quarter.¹
- Investor risk sensitivity, subdued global investor demand, prospects for slower economic growth and uncertain pricing contributed to continued depressed market conditions and sharply lower issuance volumes in the European high yield bond and leveraged loan markets.
- European high yield bond and leveraged loan returns remained negative in the fourth quarter. The European leveraged loan pipeline backlog ended the year with €32 billion on bank books, above the €22 billion recorded at the end of the third quarter, but less than the €34 billion at the end of 2007. In the U.S. leveraged deals in the pipeline have continued to decline; the backlog fell from €106 billion at the start of the year to €12 billion at year-end.
- The steep drop in commodity prices, such as oil, eased European leveraged credit issuers' concern over inflationary pressure. However, tightened financing conditions and lower-to-negative profit and economic growth trends continue to be potential downsides.
- Credit quality risk has risen sharply in recent months 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 euro zone recession, add to the likelihood of significantly higher default rates over the next year.

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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

- Credit markets remain largely frozen due to high levels of risk aversion, a weakened global economic outlook and minimal credit market liquidity.
- Financing conditions tightened significantly during the third quarter, as reported in the European Central Bank (ECB) lender survey, with banks becoming increasingly concerned about the economic outlook as well as the ability to access market financing. According to the October 2008 ECB bank lending survey, banks increased net tightening of credit standards for loans to households for house purchase, consumer credit and other lending. Businesses tightened their credit standards, with large businesses tightening the most due to greater balance sheet constraints. Business and household demand for loans declined further reflecting the weak economy, weak home market and declining consumer confidence.
- Beginning in the second half of 2008, central banks injected massive amounts of liquidity to ease the deteriorating credit market conditions and provide for greater market interbank funding stability. In addition, euro zone policy makers agreed on 12 October to temporarily guarantee bank refinancing and vowed to keep important banks from failing. LIBOR (London Interbank Offered Rate) steadily decreased over the fourth quarter. The three-month LIBOR rate fell to 1.43 percent as of end-December from 4.05 percent at end-September, and fell further to 1.18 percent as of 30 January. The LIBOR-overnight indexed swap (OIS) spread tightened to 121 basis points at end-December from 232 basis points at end-September and tightened further to 92 basis points at end-January. 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.
- The euro barely moved against the U.S. dollar in the fourth quarter, finishing the year at 1.40 to the dollar, but declined to 1.28 as of 5 February.

Economic Conditions

- The euro zone entered into its first recession since the adoption of the euro, contracting by 0.2 percent in both the second and third quarter of 2008. The European Commission predicted GDP to shrink another 1.5 percent in the fourth, followed by a 1.8 percent contraction in full-year 2009 and growth of 0.5 percent in 2010. The ECB forecast is less pessimistic with an outlook for a contraction of up to 1.0 percent in 2009 and 2010 growth between 0.5 and 1.5 percent.
- The European Commission forecast that 11 out of the 16 euro zone countries would be in a recession in 2009, compared to only two countries, Germany and Italy, being in a recession in 2008.
- Euro zone unemployment rose to 8.0 percent in December and consumer confidence continued falling from 74.9 in November to 67.1 in December, the lowest consumer sentiment reading since the European Commission began tracking this statistic in January 1985.
- The ECB predicted that tight credit conditions will hamper growth for the rest of this year, but that the outlook for 2010 is fairly positive based on recently enacted policies 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 2.50 percent at year end, and cut a further 50 basis points to 2.0 percent on 15 January. Despite complaints from several economists that the ECB should lower the rate further, Jean-Claude Trichet said he will not act until March. By contrast the Bank of England cut the interest rate on 5 February to a record low 1.00 percent.

- With oil and other commodity prices falling dramatically, inflation has become much less of a concern. Inflation in the euro zone in January declined to 1.1 percent from 1.6 percent in December. The European Commission forecast inflation of 1.0 percent in 2009 and just below 2.0 percent in 2010.
- European credit expansion has been tightening with M3, the broadest measure of credit, declining to a seasonally adjusted annual growth rate of 7.8 percent at end-November, compared to 8.7 percent at end-September and 11.5 percent at end-December 2007.² Although M3 growth had been declining throughout the year, it remained steady in September and October and was still growing at a good pace, which partially 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. Reduced contributions from both short-term deposits and marketable instrument volumes were the main reasons why M3 growth resumed its decline in November 2008, the latest statistics available.

Issuance

- The primary market was virtually closed in the fourth quarter with total European high yield bond and leveraged credit issuance reaching only €73.7 billion for full year 2008 compared to €240.3 billion in 2007.
- There were no high yield bond issues in all four quarters of 2008 compared to €0.4 billion in the fourth quarter of 2007 and €30.8 billion in 2007 as a whole.³ Based on Thomson Reuters' Loan Pricing Corporation (LPC) data, total European leveraged loan volume (including mezzanine financing) was €73.7 billion in 2008, of which €7.3 billion was mezzanine and €1.9 billion second lien loans, compared to €209.5 billion in 2007.⁴
- There were no European emerging market bonds issued in the fourth quarter of 2008, compared to €1.9 billion in the third quarter and €4.1 in the second quarter.⁵
- Market conditions wiped out the appetite for aggressive non-traditional deal structures. According to Fitch Ratings, there were no payment-in-kind (PIK) transactions in the third and fourth quarters of 2008 and only 21 for 2008 as a whole, compared with 22 PIK transactions for the 12 months ending 31 December 2007.
- In 2008, the leading leveraged loan sectors were health care (€20.4 billion), real estate (€6.0 billion) and general manufacturing (€5.5 billion), according to Reuters' LPC.
- Market conditions considerably slowed leveraged buy-outs (LBO) and other acquisition debt financing, including private equity sponsored deals. According to Reuters' LPC, in 2008 leveraged loan LBO and recap volumes were €48.4 billion and €4.4 billion, respectively, compared to €96.4 billion and €89.5 billion in 2007.

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.

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- 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 declined to €12.1 billion by end-December from €32.0 billion at end-September and €106.3 billion at the end of 2007. The European leveraged loan backlog declined for the last few quarters, but increased to €31.6 billion at end-December compared to €21.7 billion in the previous quarter and €33.9 billion at end-2007.

Credit Quality

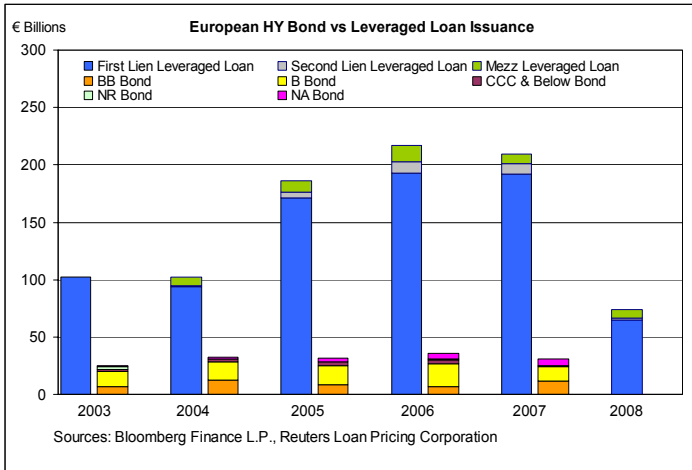
- According to S&P Global Fixed Income Research, 126 companies defaulted in 2008 compared to 22 and 30 defaults in 2007 and 2006, respectively. From the beginning of 2009 through 22 January, an additional 15 companies defaulted. Although U.S. issuers are largely responsible for the increase in the global default rate in the fourth quarter of 2008, most macroeconomic indicators in Europe are showing weakness, which should push default rates higher in 2009. 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 2.54 percent for the twelve months ending in December 2008, well above the 2007 default rate of 0.99 percent, but considerably less than the 2008 U.S. speculative-grade default rate of 4.02 percent. S&P Global Fixed Income Research reported 13 European high-yield upgrades and 152 downgrades in the fourth quarter, compared to 17 upgrades and 59 downgrades in the third quarter and 35 upgrades and 38 downgrades in the fourth quarter of 2007. S&P expects credit spreads to remain elevated, reflecting investor uncertainty and increasing default rates over the next four quarters.
- Fitch Ratings reported that the European mezzanine loan default rate was 0.87 percent, or 3.9 percent when adjusted for "distressed" restructurings, below the recent peak in 2003. These numbers are based on the last twelve months' defaulted volumes of €276 million on three defaulted issuers.
- European high-yield bond recoveries were between 51 and 70 percent with an average around 69 percent for the twelve months ending 31 December, 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 share decreased in the fourth quarter. In the U.S. there were only three speculative-grade deals issued in the fourth quarter while there was none in Europe. With investors wary of the future state of the economy, speculative grade issuance will likely remain subdued this year.
- Leverage ratios, as reported by Fitch, used as a measure of credit risk, have increased over the last several years but declined slightly in the fourth quarter of 2008. In the fourth quarter the median senior leverage ratio of Fitch-rated shadow credits was 3.9 times and the median total leverage was 5.5 times. The corresponding median leverage ratios in the third quarter were 4.3 times for senior and 5.5 times for total.

Relative Value

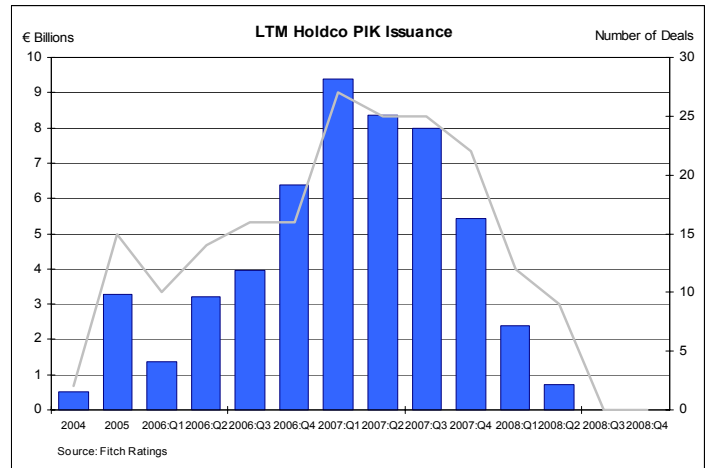
- European high-yield sector returns were negative and spreads widened in the fourth quarter. Based on the Merrill Lynch High Yield Index, the total market return was -22.7 percent for the fourth quarter 2008. At the end of the quarter, the Merrill Lynch High Yield Index reported a 2,204 basis-point credit spread, 996 basis points wider than at the end of the previous quarter and 1,713 basis points wider than year end 2007. Similarly, the spread in the credit derivatives market as measured by the iTraxx Cross-over Index (iTRAXX.EU.XO) was 1,028 basis points, 447 basis points wider than at the end of the third quarter and 689 bps wider than at the end of fourth quarter 2007.
- The leveraged-loan index return also remained negative for the fourth quarter. The S&P LCD European Leveraged Loan Index (ELLI-Total Return) was -23.69 percent for the fourth quarter compared to a loss of 4.99 percent in the third quarter and a gain of 0.32 percent in the fourth quarter of 2007. S&P LCD reported a tightened primary weighted-average institutional loan spread of 340 basis points in the fourth quarter compared to 361 basis points at the end of the third quarter and 305 basis points at the end of 2007.

European High Yield Report - Issuance Volume

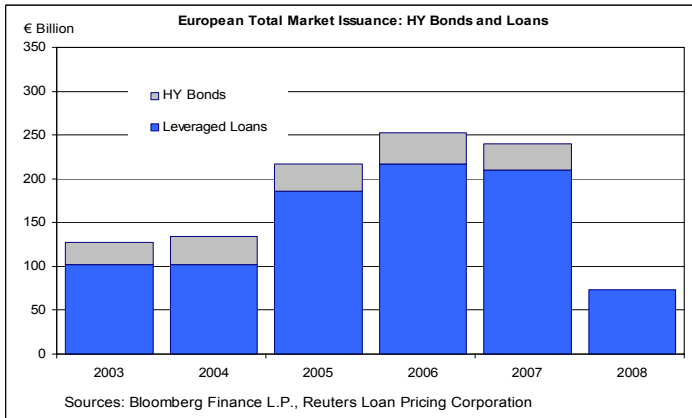
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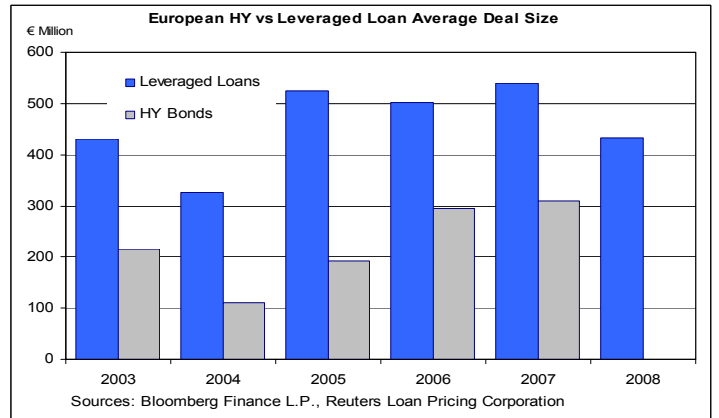
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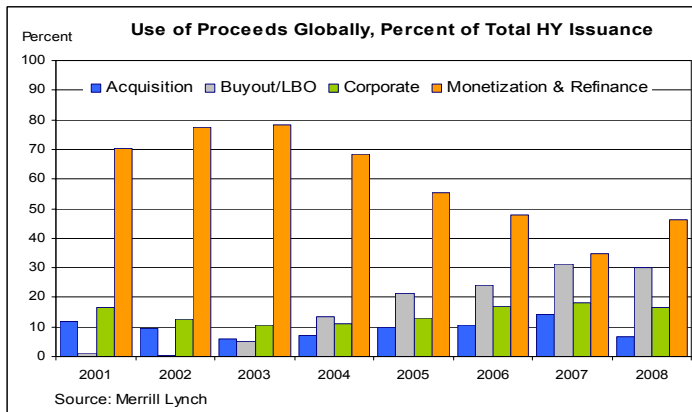
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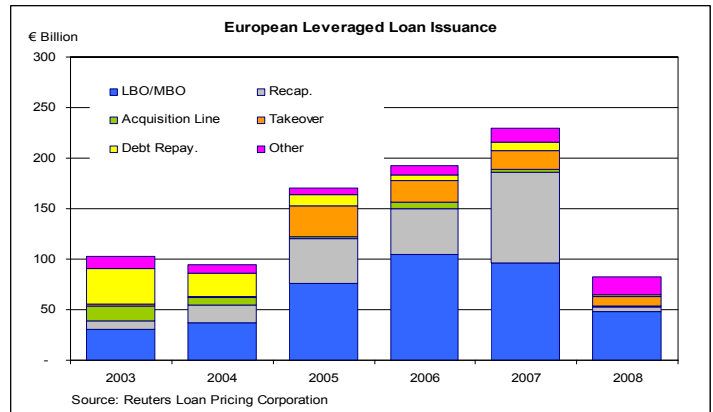
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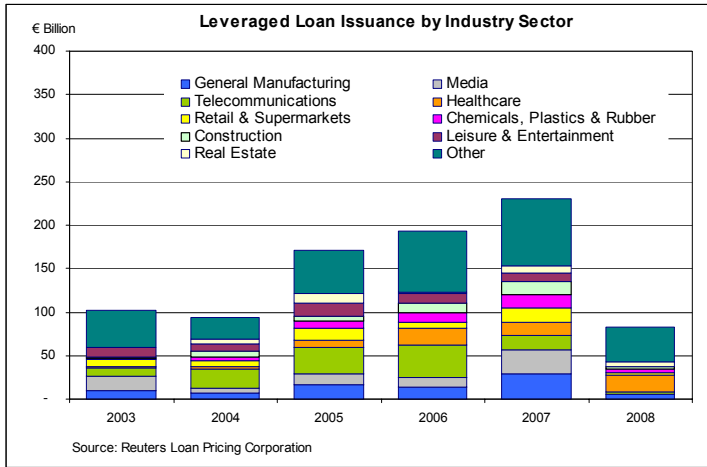
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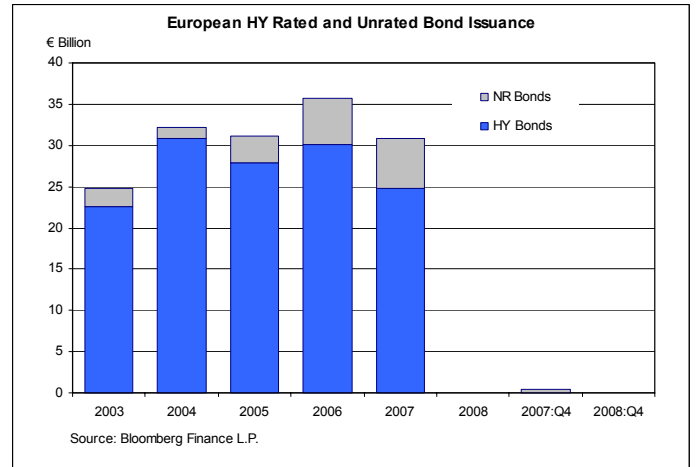
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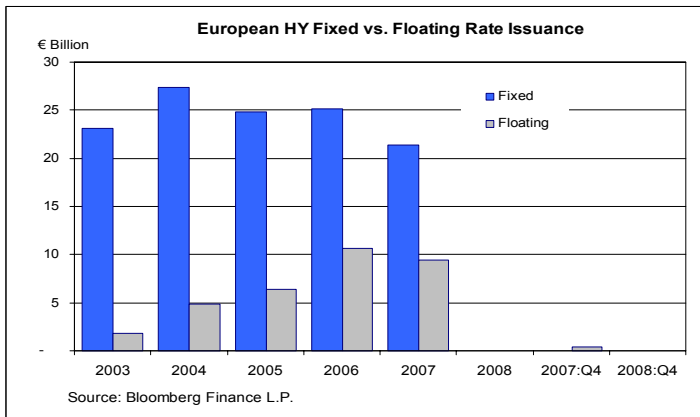
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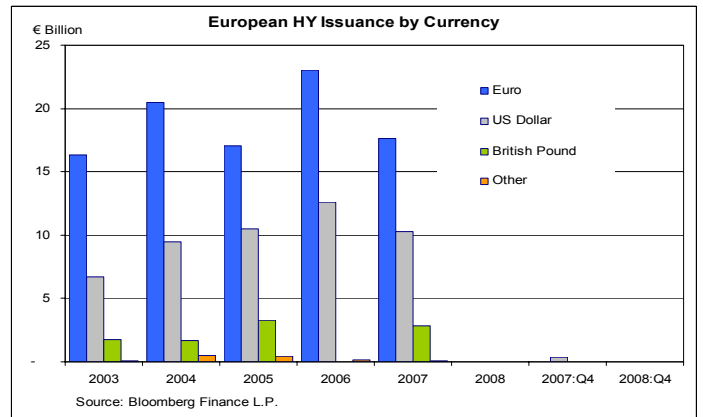
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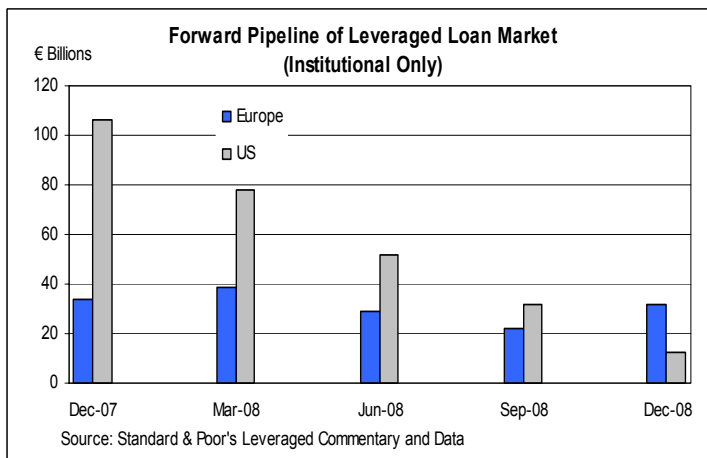
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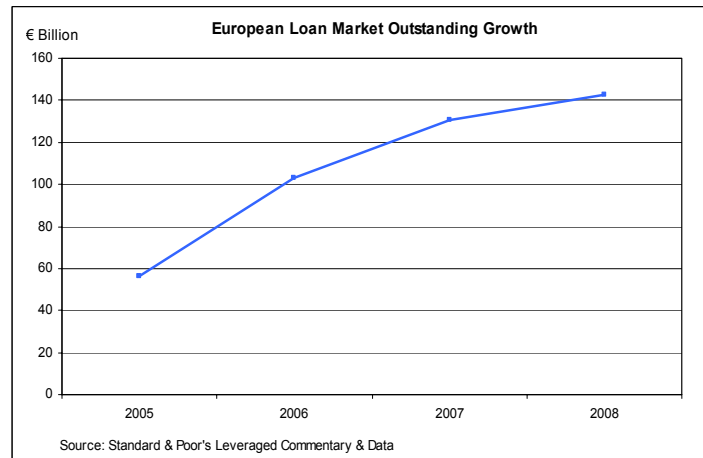
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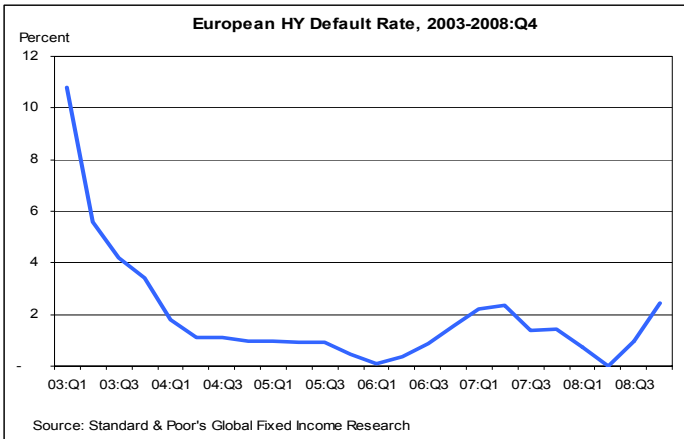


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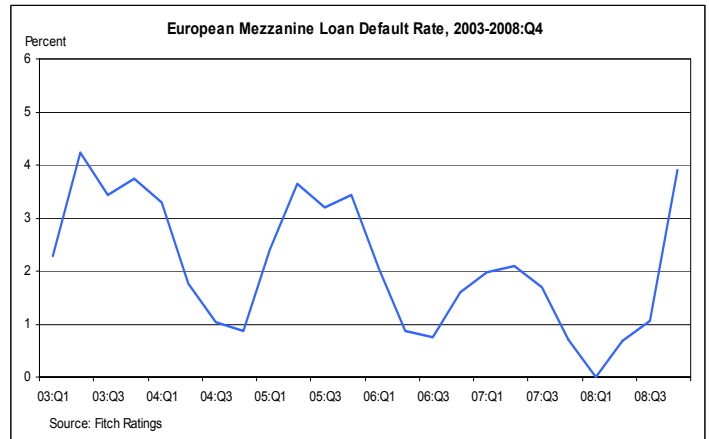


European High Yield Report - Credit Quality

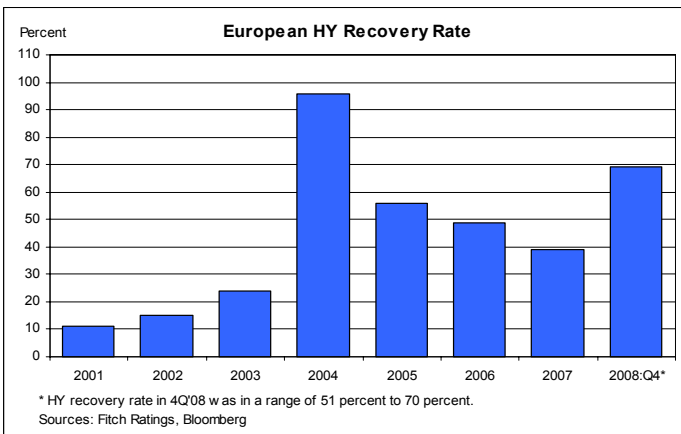
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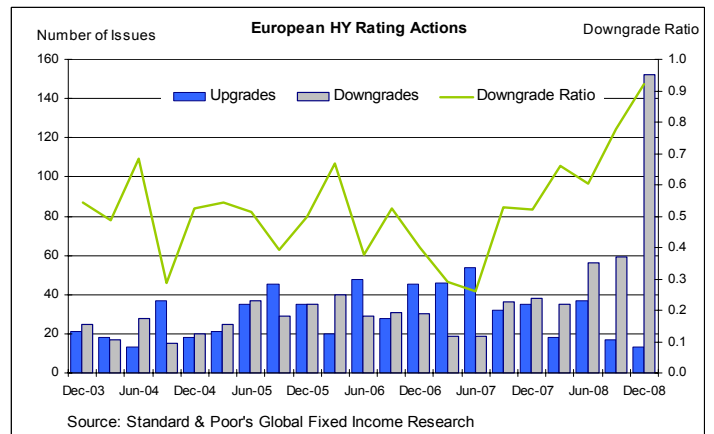
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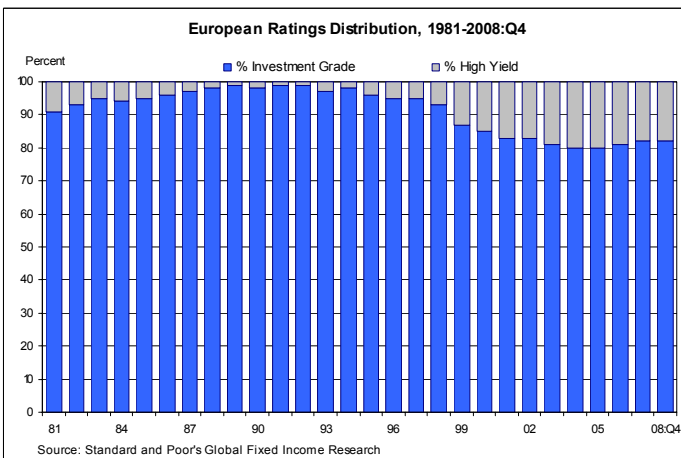
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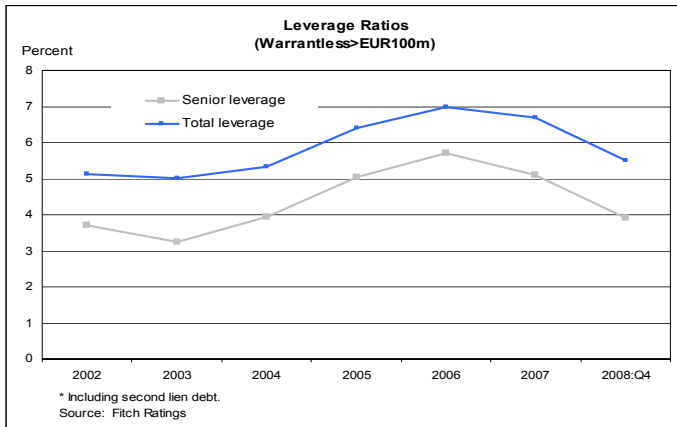
S&P European Leveraged Loan Index

Ratings Diversification

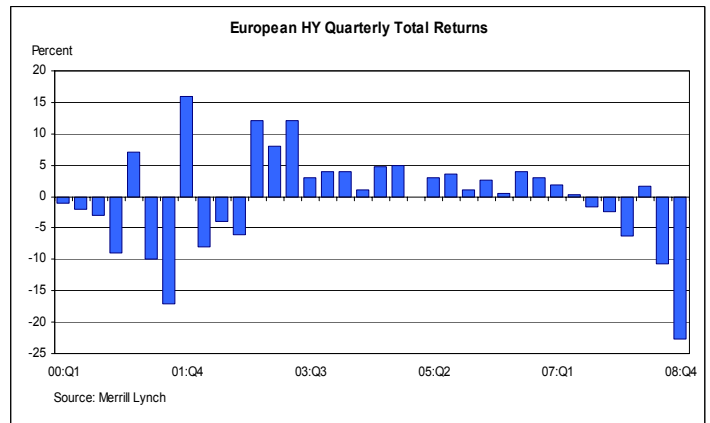
	BB Rating	B Rating	NR Rating	Other
2005	15.5%	74.5%	9.7%	0.3%
2006	9.3%	77.9%	12.9%	0.0%
2007	8.4%	77.7%	13.1%	0.9%
2008	13.4%	66.0%	15.3%	5.3%

Source: Standard & Poor's Leveraged Commentary and Data

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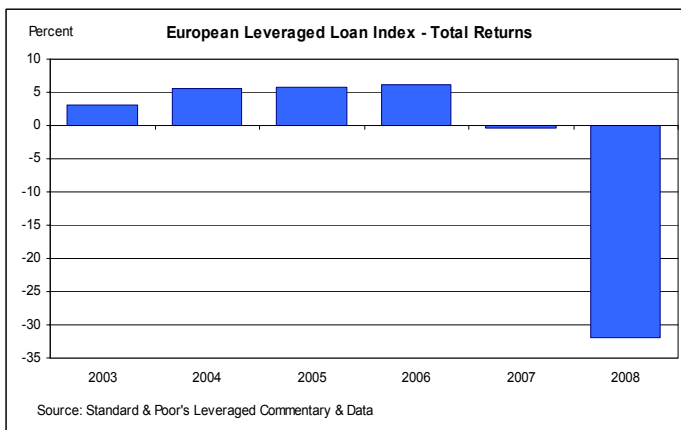


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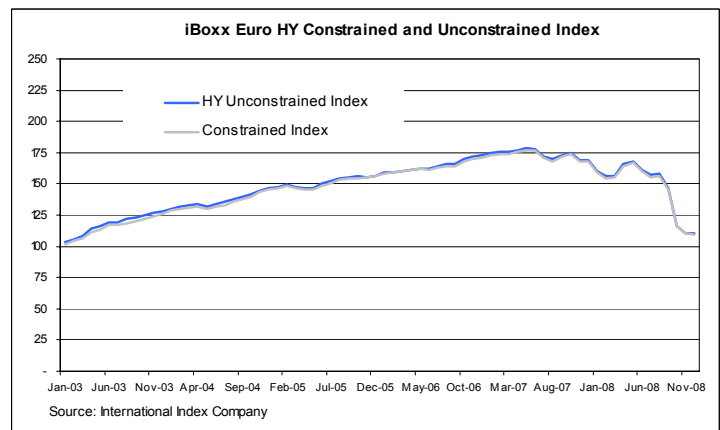


European High Yield Report - Relative Value

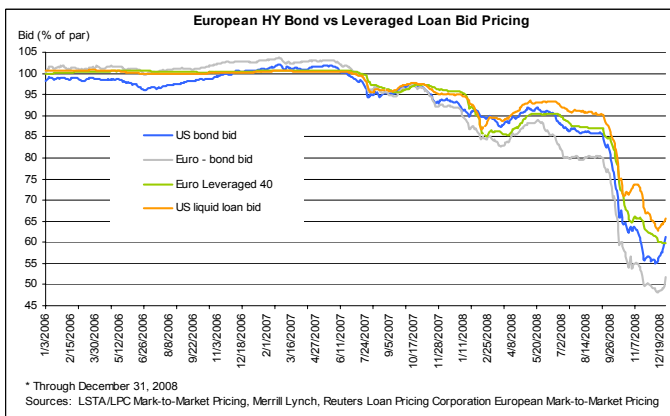
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