



European Quarterly High Yield and Leveraged Loan Report

EUROPEAN HIGH YIELD ASSOCIATION

Third Quarter, 2008

The European High Yield Association (EHYA), an affiliate of the Securities Industry and Financial Markets Association, is pleased to present the seventh 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 third quarter of 2008.

Primary European Leveraged Credit Markets Remained Quiet in the Autumn with No High Yield Bond Issues in the Third Quarter; Difficult Global Credit Market Conditions Dominate the Outlook

Highlights

- Leveraged finance issuance, which includes leveraged loans and high yield bonds, declined to €67.0 billion for the first three quarters of 2008 compared to €243.3 billion over the same period in 2007.
- There were no high yield bond deals recorded in the third quarter and the first three quarters of 2008 compared to issuance of €4.0 billion and €30.5 billion in the same periods of 2007. Leveraged loan issuance fell to €67.0 billion in the first three quarters of 2008 compared to €213.3 in the same year-earlier period.
- European emerging market bond issuance, which was introduced as a separate category last quarter, was €1.9 billion this quarter.
- 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.
- September 2008 was one of the worst months in the history of financial markets. European high yield bond and leveraged loan returns both turned negative in the third quarter from the second quarter's positive territory. There was a reduction in the substantial European leveraged loan pipeline backlog with €22 billion on bank books at the end of September compared to €34 billion at the start of the year and €29 at the end of the second quarter. The number of leveraged deals in the pipeline has been much slower to reduce in Europe than in the US, where comparatively the backlog went from €106 billion at the start of the year to €32 billion by the end of September. There has been a virtual halt in new leveraged deals coming into the pipeline.
- The steep drop in commodity prices, such as oil, eased European leveraged credit issuers' concern over inflationary pressure. However, tightened financing conditions, sharply 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. The prospect of slower economic expansion or possibly a global recession, elevated leverage levels and sharply reduced credit availability add to the likelihood of significantly higher default rates over the next year.

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Market and Economic Environment

Market Conditions

- Markets remain largely frozen with high levels of risk aversion, a weakened global economic outlook and minimal credit market liquidity.
- Financing conditions loosened slightly during the second quarter, as reported in the European Central Bank (ECB) lender survey, although, banks have become increasingly concerned about the economic outlook. According to the July 2008 ECB bank lending survey, while banks reduced net tightening of credit standards for loans to businesses and for home purchases, they increased net tightening of standards for consumer credit and other lending to households. The ECB reported that 45 percent of the banks surveyed expect credit standards for both large and small businesses to tighten in the third quarter.
- Beginning in the second half of 2007, central banks have injected massive amounts of liquidity to ease the deteriorating credit market conditions and provide for greater market interbank funding stability. In addition to injecting liquidity in global money markets; eurozone policy makers agreed on 12 October to temporarily guarantee bank refinancing and vowed to keep important banks from failing. LIBOR (London Interbank Offered Rate) remains historically elevated, although rates appear to be stabilising. The three-month LIBOR rate was 3.47 percent as of 29 October, down from the previous month's level of 4.05 percent. In contrast, the LIBOR-overnight indexed swap (OIS) spread widened to 253 basis points compared to a spread of 231 basis points at end-September. The LIBOR-OIS spread, which measures the difference between the overnight index swap rate from the three-month LIBOR rate, averaged roughly 11 basis points over the ten years prior to 2008. A wide LIBOR-OIS spread indicates that banks believe the other banks they are lending to have an increased risk of defaulting on the loans.
- Euro-denominated collateralised loan obligations issuance (CLO) increased to €2.8 billion in the third quarter of 2008 from €2.3 billion in the immediately preceding quarter. All of the third quarter CLO issuance was done in July and August.
- From end-December 2007 through mid-July 2008 the Euro trended upwards against the US dollar gaining 11 percent, but has fallen 20 percent to 1.27 as of 31 October from its peak in mid-July of 1.59.

Economic Conditions

- Eurostat estimated that eurozone GDP growth turned negative in the second quarter of 2008, down 0.2 percent from first quarter growth of 0.7 percent, marking the first contraction since the launch of the euro. The European Commission forecast of eurozone growth for the third quarter and full year 2008 is 0.1 percent and 1.4 percent, respectively. The Commission reduced its forecast for 2008, previously 1.7 percent, and forecast growth in 2009 and 2010 to be 0.2 percent and 1.1 percent, respectively.
- Consumer spending decreased in the second quarter of 2008, declining by 0.2 percent from the previous quarter, and is expected to have remained weak in the third quarter as stock markets declined further. Consumer confidence was also at a low level, falling to 80.4 points in October. The last time consumer sentiment was this low was in July 1993 with 73.0 points recorded, during which many European countries were in a recession.
- Although the ECB is forecasting slower economic growth for 2008 it raised its estimate for 2009 to 1.7 percent, up from their previous forecast of 1.5 percent. Tight credit conditions are expected to hamper growth for the rest of this year, but the outlook for 2009 is fairly positive based on recently enacted policies and rate cuts which should eventually restore confidence for businesses and consumers.

- In an effort to improve interbank lending, central banks in the US, Canada, England, Sweden and Switzerland coordinated a rate cut. The ECB lowered its target interest rate by 50 basis points to 3.75 percent on 8 October. Most economists expect the ECB to cut the interest rate again before the end of the year.
- Inflation growth picked up in the second quarter of 2008 and was increasing into the third quarter, but with oil and other commodity prices falling dramatically, inflation has become less of a concern. The ECB forecast inflation of 3.5 percent for 2008; however, this estimate will likely be lowered at the next meeting.
- European credit expansion has been tightening with M3, the broadest measure of credit, declining to a seasonally adjusted annual growth rate of 8.6 percent at end-September, compared to 9.5 percent at end-June and 11.5 percent at end-December 2007.¹ Although M3 growth has been declining the last few months it is 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 continued to decline in September 2008, the latest statistics available.

Issuance

- The primary market was virtually closed for much of the third quarter. Total European high yield bond and leveraged credit issuance was €67.0 billion in the first nine months of 2008 compared to €243.3 billion in the same period a year ago.
- There were no high yield bond issues in the first three quarters of 2008 compared to €4.0 billion in the third quarter of 2007 and €30.1 billion in the first three quarters of 2007 as a whole.² Based on Thomson Reuters' Loan Pricing Corporation (LPC) data, total European leveraged loan volume (including mezzanine financing) was €67.0 billion in the first three quarters of 2008, of which €2.8 billion was mezzanine and €0.2 billion second lien loans, compared to €213.3 billion in the first three quarters of 2007.³
- European emerging market bond issuance data began to be reported separately last quarter in this report. European emerging market bonds are defined as 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.⁴ Further, due to differences in terms and documentation, Russian ruble-denominated issuance is excluded. There were €1.9 billion in European emerging market bonds issued in the third quarter of 2008, compared to €4.1 billion in the second quarter.
- Market conditions, to a large extent, 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 quarter, compared with 9 PIK transactions for the 12 months ending 30 June 2008.
- In the first three quarters of 2008, the leading leveraged loan sectors were health care (€17.3 billion), real estate (€5.9 billion) and retail and supermarkets (€4.7 billion), according to Reuters' LPC.

¹ 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>).

² 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.

³ Leveraged loans include second lien and second lien loans generally with below-investment grade ratings or spreads of at least 150 basis points and mezzanine loans.

⁴ 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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- Market conditions considerably slowed leveraged buy-outs (LBO) and other acquisition debt financing, including private equity sponsored deals. According to Reuters' LPC, in the first nine months of 2008, leveraged loan LBO and recap volumes were €41.4 billion and €3.3 billion, respectively.
 - 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 US backlog declined to €32.0 billion by end-September from €51.6 billion at end-June and €106.3 billion at the end of 2007. The European leveraged loan backlog decline has been considerably slower, with roughly €21.7 billion held by banks at end-September compared to €33.9 billion at the end of last year.

Credit Quality

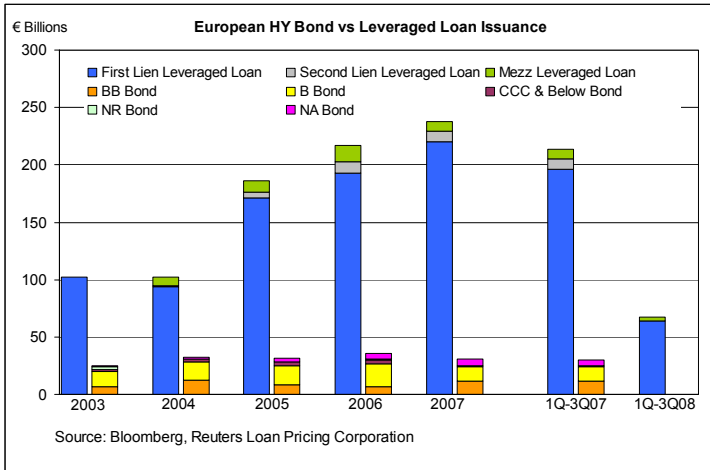
- Although US issuers are largely responsible for the increase in the global default rate in the third quarter of 2008, most macroeconomic indicators in Europe are showing weakness, which should push default rates higher for the remainder of 2008 and into 2009. In addition, weaker profits and limited access to the credit markets are putting downward pressures on credit quality.
- The S&P Global Fixed Income Research speculative-grade default rate was 2.04 percent for the twelve months ending in September, well below its long term average of 4.35 percent between the years 1981 and 2007, but above the 1.84 percent recorded in the previous month. According to S&P, from the beginning of the year through 15 October 2008, there were 75 global defaults worth \$226 billion compared to 22 global defaults on debt worth \$8.1 billion in the same period of 2007. S&P Global Fixed Income Research reported 18 European high-yield upgrades and 60 downgrades in the third quarter, compared to 37 upgrades and 57 downgrades in the second quarter and 32 upgrades and 36 downgrades in the third quarter a year ago. S&P expects credit spreads to remain elevated, reflecting investor uncertainty, and default rates to increase in the next four quarters.
- Fitch Ratings reported that the mezzanine loan default rates was 0.64 percent, or 1.05 percent when adjusted for "distressed" restructurings, well below the recent peak in 2003. These numbers are based on the last twelve months' defaulted volumes of €199 million or three defaulted issuers.
- High-yield bond recoveries were between 51 and 70 percent for the twelve months ending 30 September, 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 declined while the "B" rated share has increased over the last five years. The movement towards the decline in the leveraged credit rating mix in Europe has slowed amid the credit market turbulence, increased investor risk sensitivity and some reversal in the disintermediation trend. The "BB" rated share of European leveraged loans has increased slightly over the past year, and S&P LCD reported a slight decrease in "BB" rated loans in the third quarter.
- Leverage ratios, as reported by Fitch, used as a measure of credit risk, have increased over the last several years but declined over the first two quarters of 2008 as financing terms have tightened. The median senior leverage ratio of Fitch-rated shadow credits in the third quarter was 4.3 times and the median total leverage was 5.5 times. The corresponding median leverage ratios in the second quarter were 3.9 times for senior and 4.9 times for total.

Relative Value

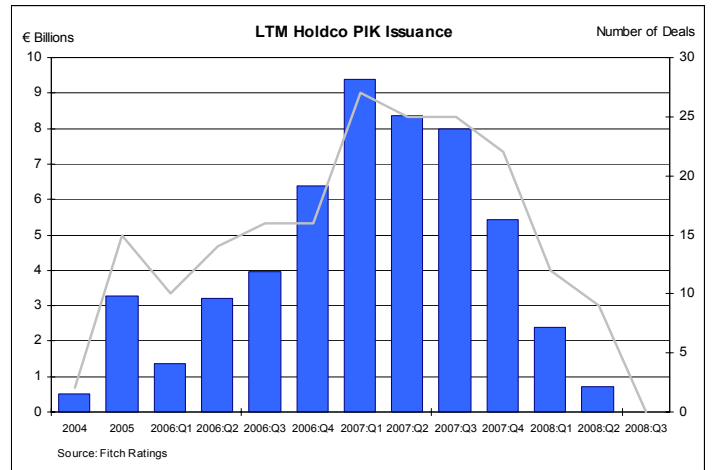
- European high-yield sector returns turned negative for the third quarter and spreads widened. Based on the Merrill Lynch High Yield Index, the total market return was -10.75 percent for the third quarter 2008. At the end of the quarter, the Merrill Lynch High Yield Index reported a 1,208 basis-point credit spread, 717 basis points wider than at beginning of the year and 840 basis points wider than at the end of the third quarter 2007. Similarly, the spread in the credit derivatives market as measured by the iTraxx Cross-over Index (iTRAXX.EU.XO) was 581 basis points, 62 basis points wider than at the end of the second quarter and 242 bps wider than at the end of fourth quarter 2007.
- The leveraged-loan index return also turned negative for the third quarter. The S&P LCD European Leveraged Loan Index (ELLI-Total Return) was -4.99 percent for the third quarter compared to a gain of 5.29 percent in the second quarter and -3.70 percent in the third quarter of 2007. S&P LCD reported a wider primary weighted-average institutional loan spread of 361 basis points in the third quarter compared to 339 basis points at the end of the second quarter.

European High Yield Report - Issuance Volume

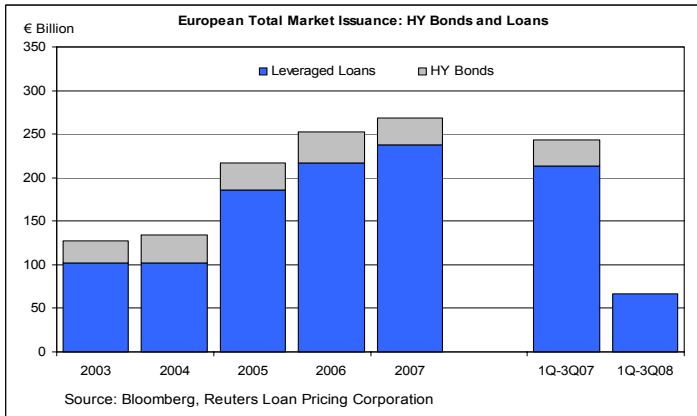
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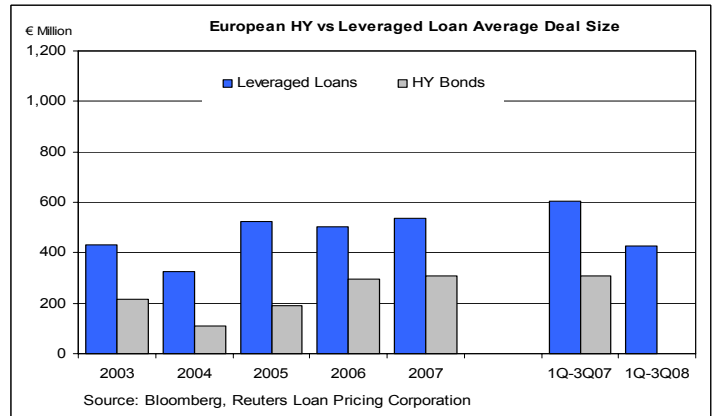
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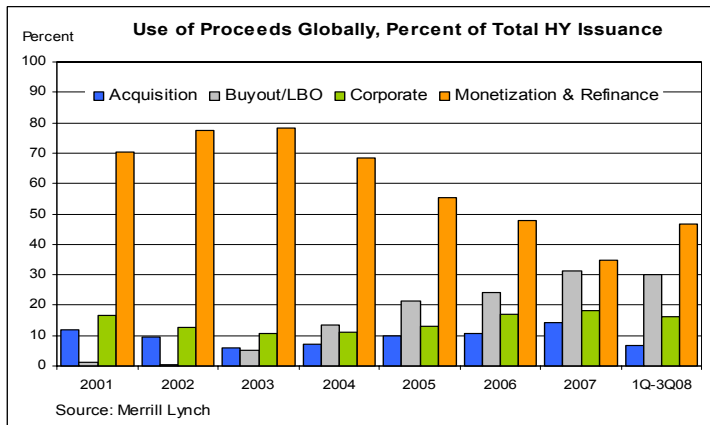
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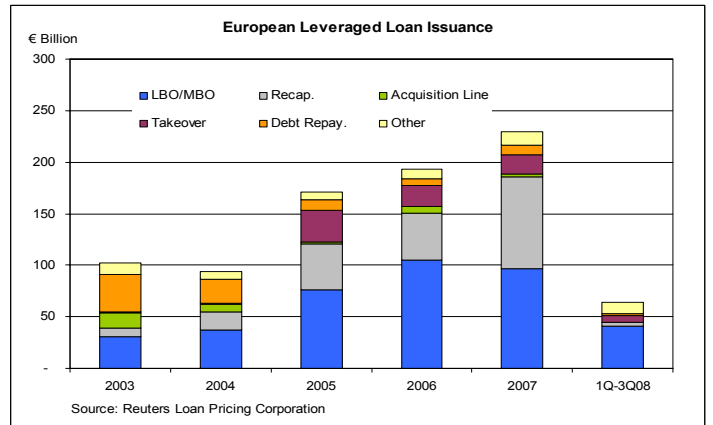
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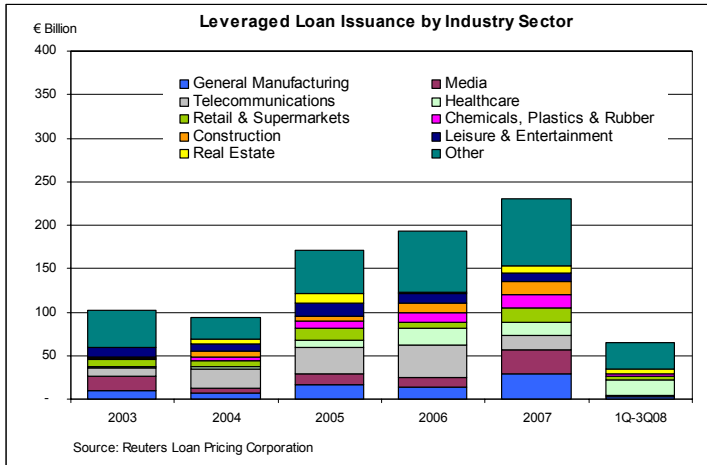
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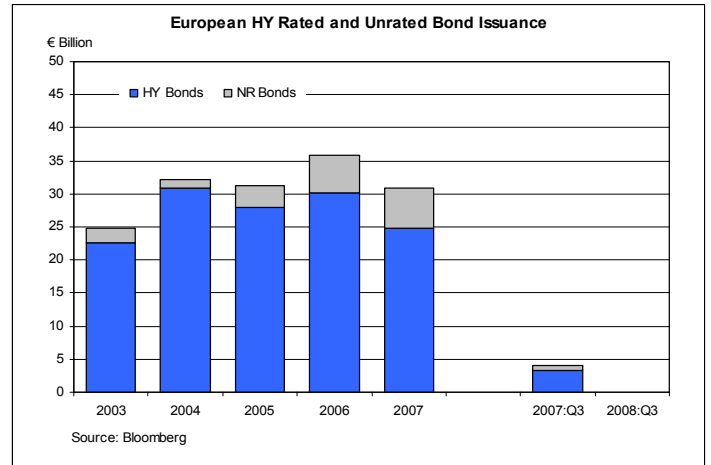
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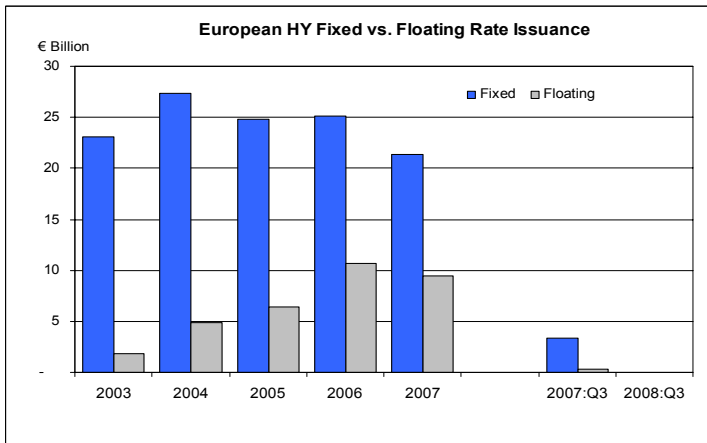
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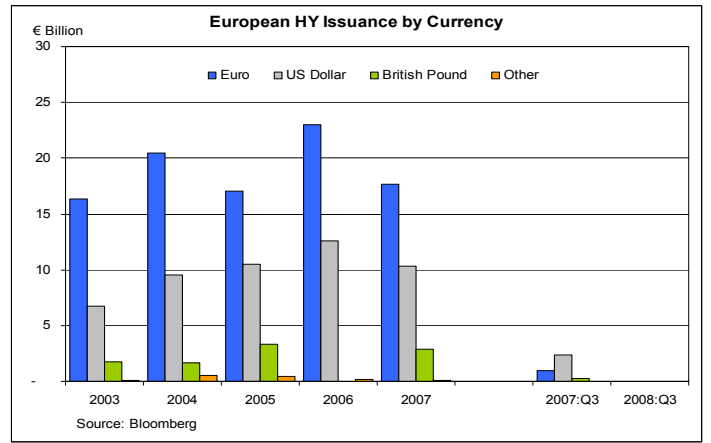
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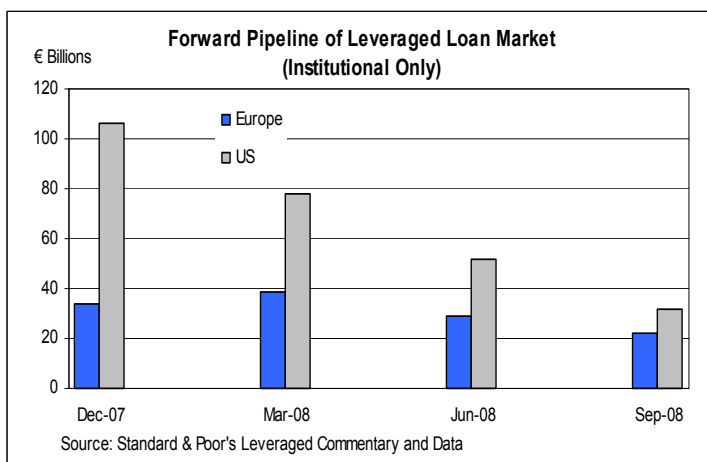
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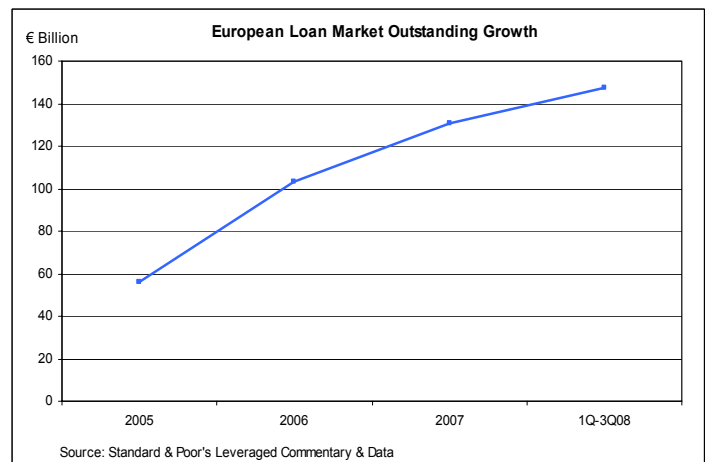
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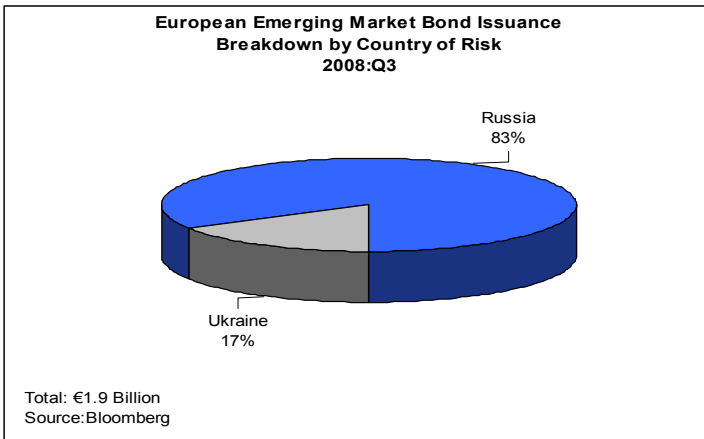
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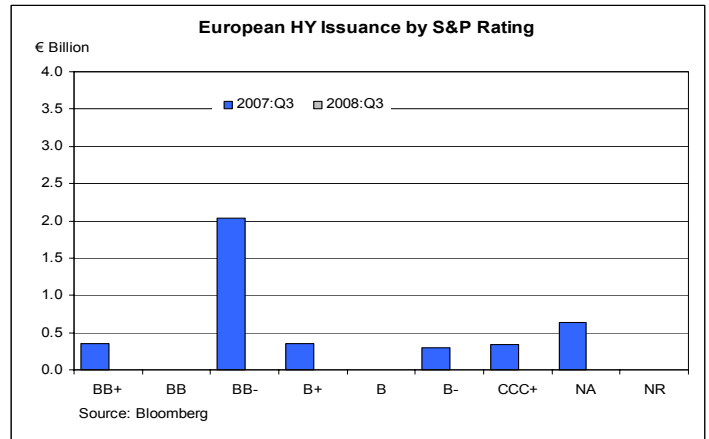
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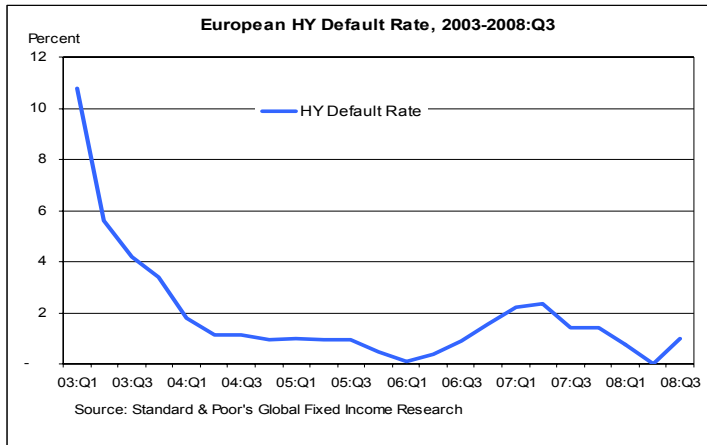
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European Emerging Market Bond Issuance 2008:Q3

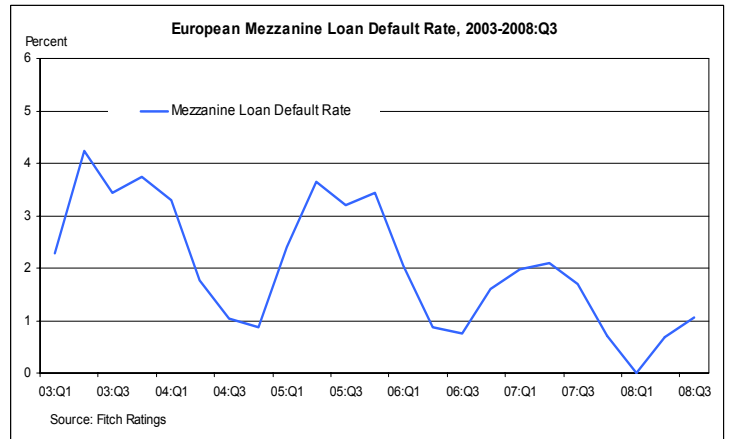
Company Name	Issue Date	Maturity Date	Coupon Rate	Amount Issued (€)	Country of Risk	S&P Rating
Ukraine ISS	4/08/2008	11/08/2011	12.00%	160,500,000	Ukraine	B+
Ukrainian MTN FIN	28/07/2008	4/08/2011	9.25%	801,875,000	Ukraine	BB-
Steel CAP	29/07/2008	29/07/2013	9.75%	301,815,000	Russia	BB
Eurasia CAP	11/08/2008	11/08/2011	11.75%	94,275,000	Russia	B+
PSB Finance	15/07/2008	15/07/2013	10.75%	384,900,000	Russia	BB-
TMK Capital	29/07/2008	29/07/2011	10.00%	158,825,000	Russia	B+

European High Yield Report - Credit Quality

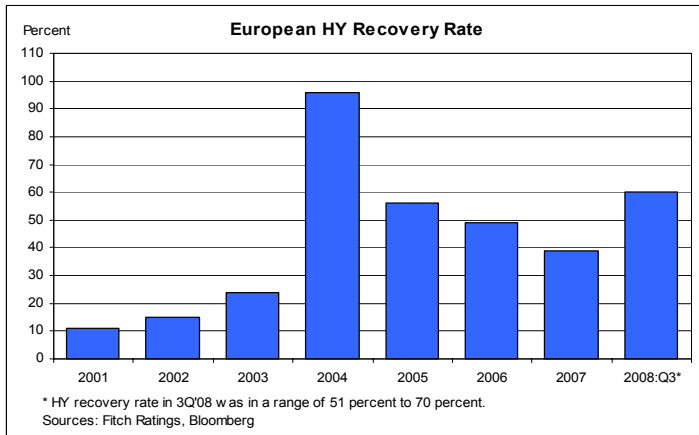
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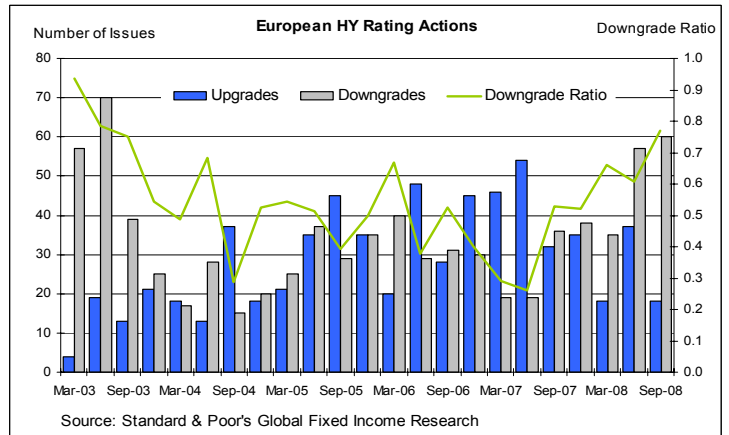
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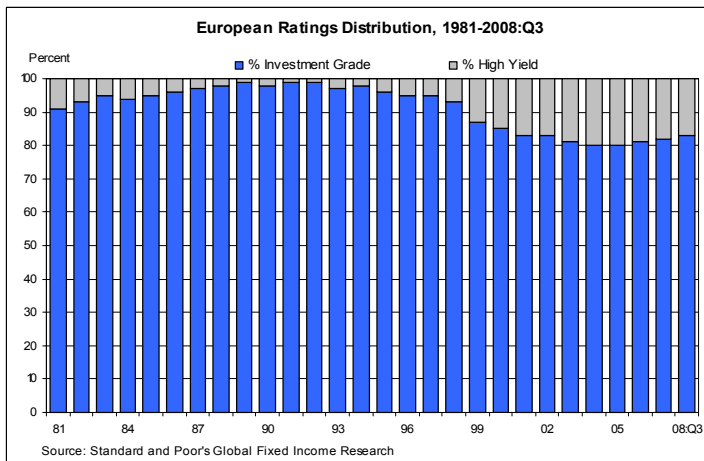
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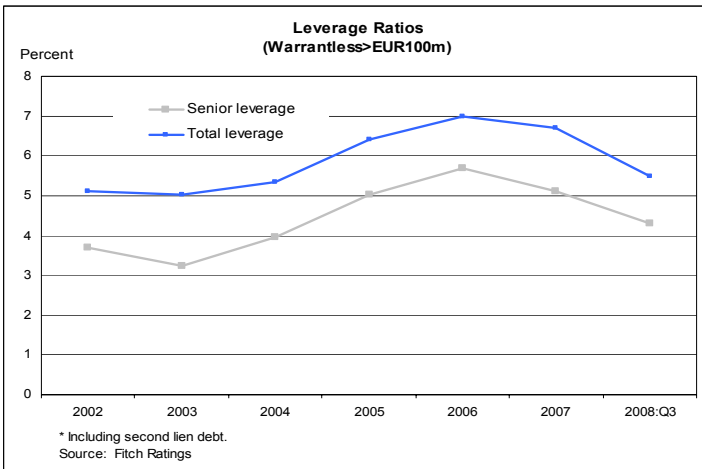
S&P European Leveraged Loan Index

Ratings Diversification

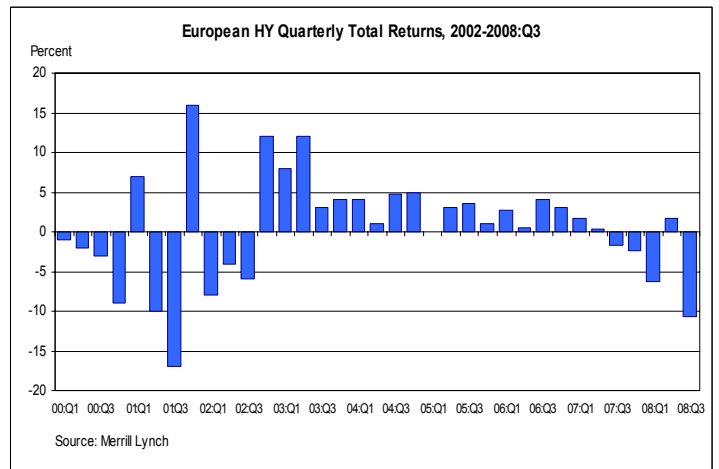
	BB Rating	B Rating	NR Rating	Other
2005	15.5%	74.5%	9.7%	0.3%
2006	9.3%	77.9%	12.9%	0.0%
2007	8.4%	77.7%	13.1%	0.9%
1Q-3Q08	14.6%	69.0%	14.7%	1.7%

Source: Standard & Poor's Leveraged Commentary and Data

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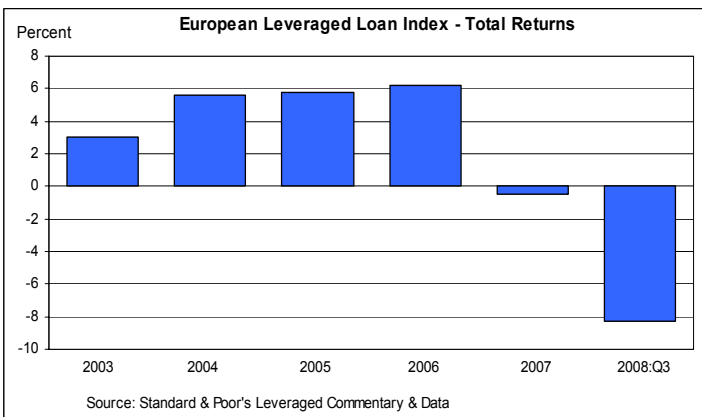


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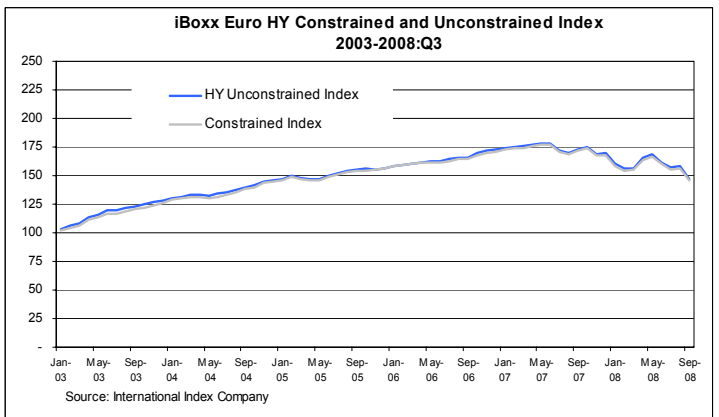


European High Yield Report - Relative Value

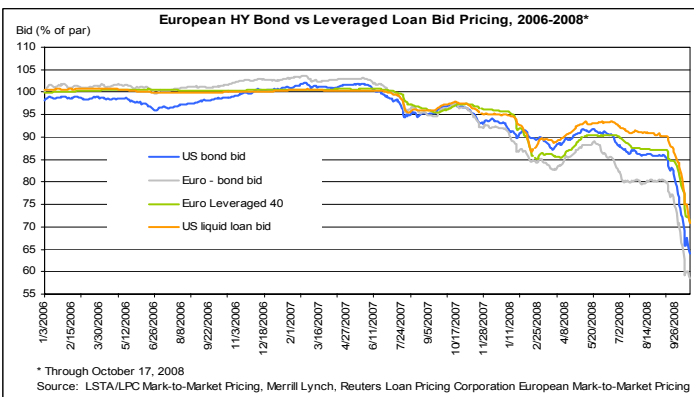
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