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The US High-Yield Market: A More Cautious 2014

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Investor enthusiasm for U.S. high-yield bonds continued in 2013.[1] The market delivered the second-strongest year by volume, despite the summer's increased interest rates and volatility resulting from speculation about the Federal Reserve's tapering of asset purchases and the October government shutdown. As in 2012, lower returns on other investments made high-yield bonds an attractive alternative for investors, while issuers continued to enjoy low coupons and issuer-friendly terms.

With primary issuances totaling approximately $320 billion, the 2013 U.S. high-yield market volume fell just short of the approximately $340 billion record set in 2012. The near-record volume in 2013 also occurred alongside a strong market for initial public offerings.

Key trends from 2012 continued into 2013, with issuer-favorable covenant packages and more speculative uses of proceeds, including for dividend payments and leveraged buyouts (LBOs). The U.S. high-yield market in 2013 also included a large number of issuances of $1 billion or more and a near-record volume of "payment-in-kind" (PIK) toggle issuances, which allow the issuer, at its option, to pay interest with additional notes.

Many of the fundamental drivers of volume in 2012 and 2013 remain in place. However, market-specific factors, together with macroeconomic factors, may temper the volume of high-yield issuances in 2014.

Key Trends of 2013

Large Issue Size. More than 50 issues of $1 billion or more came to market in 2013. Almost a quarter of these issuances were in September, including Sprint's two-tranche issuance of $6.5 billion of bonds, setting the record for the third-largest high-yield offering — after issuances by TXU ($7.5 billion) and First Data ($7.065 billion) in 2007 — and the second-largest single tranche issue (after the $6.34 billion Harrah's LBO issuance in 2007).

Other significant high-yield issuances in 2013 included those to fund acquisitions of MetroPCS ($3.5 billion), H.J. Heinz ($3.1 billion), BMC Software ($1.625 billion) and Dell ($1.5 billion). Further illustrating the market's demand for multiple large offerings from a single issuer, T-Mobile USA completed $7.6 billion of offerings in 2013, and Sprint issued another $2.5 billion of bonds in December 2013.

September's $48 billion of primary issuances, following the Federal Reserve's announcement that it would delay tapering of asset purchases, was the highest for any month since October 2007, exceeding the prior monthly high of $46.7 billion from September 2012. This trend was paralleled during the same month in the investment-grade market with Verizon Communication's record-setting $49 billion offering.

[1] Volume and other statistical data discussed in this article are based on information provided by HighYieldBond.com and the Debtwire High Yield Database.

PIK Toggle Notes. A near-record volume of PIK toggle notes was issued in 2013 — more than 20 issuances totaling more than $10 billion — the greatest volume since 2008's $13.4 billion. Most of the PIK toggle notes issued in 2013 were holding company issuances to fund shareholder dividends or share repurchases, primarily in the third and fourth quarters.

Neiman Marcus also issued $600 million of PIK toggle notes, together with $960 million of cash-pay notes, in October to partially fund its re-LBO. The Neiman Marcus offering was the first time that a PIK toggle bond had been issued at an operating company level to fund an LBO since before the financial crisis. Coming full circle, Neiman Marcus was one of the first companies to issue PIK toggle notes when it did so to partially fund its first LBO in 2005. Before the Neiman Marcus issuance in October 2013, the last PIK toggle issue to fund an LBO was BWAY Corporation's $335 million issuance in October 2012.

As with other issuances, many of the PIK toggle notes reflected more issuer-favorable terms, including a more issuer-friendly equity clawback feature and more flexibility to pay PIK interest for the life of the notes.

Covenant Quality and Use of Proceeds. The U.S. high-yield market in 2013 also included a continuation of key trends from 2012 in issuer-favorable covenant packages and more speculative uses of proceeds. According to Moody's, credit quality reached a record-low level in September as a result of lower-rated credits going to market with more aggressive structures, including PIK toggle notes.

Among the more controversial issuer-favorable covenants in 2013 was an early redemption feature that would permit an issuer to redeem notes during the first two years at a premium lower than the traditional make-whole premium. Investors typically view such a provision as an indication that the company may be positioning itself for a change of control during that period. Over the past several years, few issuers have been able to negotiate this provision into their notes, often expressly tied to the occurrence of a change of control, with redemption prices generally well in excess of the typical 101 percent required to be paid in a standard change of control offer. However, the feature received particular attention in June 2013 when Yankee Candle pulled its notes offering, the proceeds of which were to be used to pay a dividend to its private equity sponsor. Among other issuer-favorable features included in the proposed offering was a provision that would have permitted Yankee Candle to redeem the notes at its option during the first two years at only 101.5 percent, with the redemption price stepping up thereafter to the more traditional declining premium schedule. Yankee Candle cited market conditions in pulling the deal, leading some to question whether the terms of the notes were too aggressive — even for the robust 2013 high-yield market.

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The issuer-favorable climate continued to allow the use of proceeds of high-yield offerings for more speculative purposes. Of total 2013 deal volume, 6 percent funded dividends and share repurchases for principal shareholders and 24 percent funded acquisitions (including LBOs), with a greater portion of this activity in the second half of the year. Refinancings made up 56 percent of 2013 deal volume. In comparison, for 2012, 61 percent of total deal volume was used for refinancings, 23 percent to fund acquisitions (including LBOs) and 6 percent to fund dividends.

Continued Positive Fundamentals and More Macroeconomic Certainty but Cautious Expectations

The outlook for the U.S. high-yield market in 2014 is one of caution. Many of the fundamental drivers of volume remain, and the Federal Reserve's forward guidance, together with the new federal budget deal, eliminate the related uncertainty and volatility that negatively impacted the market in the summer and fall of last year. However, some uncertainty still remains, including as to the impact of future economic data, the transition in leadership at the Federal Reserve and the need for Congress to negotiate the federal debt ceiling in early 2014. Further, given the large number of refinancings over the past two years, the 2014 U.S. high-yield market may be more dependent on speculative uses of proceeds, such as acquisitions and dividend payments, to drive volume. In addition, some issuers may abandon the U.S. high-yield market altogether, preferring instead to tap the European high-yield market or to issue equity and take advantage of a record U.S. stock market for their capital raising needs.

Positive Fundamental Drivers. Many fundamental drivers of U.S. high-yield market volume in 2012 and 2013 are continuing into 2014. Yields of other fixed-return investments remain low, corporate default rates also remain low, and issuers continue to enjoy low coupons and issuer-friendly terms on their high-yield bonds.

More Macroeconomic Certainty. The economy is continuing to expand at a moderate pace, and the Federal Reserve provided the much-awaited forward guidance with respect to its asset purchases and its views on inflation and short-term interest rates.

In December 2013, the Federal Reserve put an end to the speculation about tapering of quantitative easing when it announced that it would begin reducing asset purchases in January 2014, by $10 billion per month. The Federal Reserve also provided additional guidance on future short-term interest rates, stating that it expects to maintain the federal funds target in its current near-zero range well past the time that the unemployment rate falls below 6½ percent, especially if inflation continues to remain below 2 percent. Some have interpreted this to mean that the Federal Reserve will not increase short-term interest rates until 2015 or possibly as late as 2016.

The forward guidance provided by the Federal Reserve with respect to the tapering of its asset purchases and its views on inflation and short-term interest rates mitigates much of the related uncertainty and volatility that negatively impacted the high-yield market in the summer months and again in the fall of 2013. In addition, the fact that the Federal Reserve is still infusing money into the economy, just at a slower pace, and the expectation of continued low short-term interest rates until at least 2015, could have a positive impact on high-yield issuances in 2014.

However, some uncertainty still remains. Federal Reserve Chairman Ben Bernanke acknowledged that asset purchases are not on a predetermined course and are dependent on economic data — the Federal Reserve could end the reduction in asset purchases if the economy is not performing as well as expected or could accelerate them if the economy is performing better than expected. In addition, on February 1, 2014, Janet Yellen will succeed Bernanke as Federal Reserve Chairman. Bernanke stated in his December press conference that he consulted closely with Yellen on the decisions with respect to asset tapering and that she supports the decisions. However, it remains to be seen whether there may be policy changes under Yellen's leadership.

New Federal Budget Deal. Also in December 2013, President Obama signed a budget deal to fund federal agencies through the fall of 2015. The deal eased the automatic sequestration spending cuts, provided a greater level of certainty on government spending and reduced the risk of another government shutdown, subject to Congress passing a detailed spending bill in early 2014, which appears likely. However, the agreement did not raise the federal debt ceiling, which Congress must address in 2014.

More Speculative Drivers of Volume. Most of the issuance volume in 2013 was to refinance existing debt, leading to a lower potential for refinancings in 2014, particularly when viewed together with the large number of refinancings in prior years. As a result, volume in the U.S. high-yield market in 2014 may depend more on speculative uses of proceeds, including acquisitions and dividend payments (see Global M&A/"US M&A: Looking Back at 2013 and Forward to a Brighter 2014"). In addition, based on a number of large pending acquisitions currently backed with bridge loans, several large high-yield acquisition financings, particularly in the health care and telecommunications industries, may be in the pipeline for 2014.

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Dividend deals also may continue to have a place in 2014 as investors continue to search for higher-yielding investments. Typically, the resurgence of PIK toggle issuances at a level not seen since 2007 would be interpreted by the market as a warning sign that debt structures are becoming too aggressive. However, many of the PIK toggle issuances in 2013 were by better-performing credits with lower leverage than was seen at the peak of the credit crisis and included features such as shorter maturities and special call options or equity clawback provisions designed to facilitate a near-term initial public offering.

The "Great Rotation" from Bonds to Stocks. The U.S. stock market set record highs in 2013. Both the Dow and the S&P 500 ended the year up nearly 30 percent from 2012, and the Nasdaq Composite Index was up almost 40 percent. In contrast, the average year-to date clearing yield on U.S. high-yield bonds was only 6.59 percent for 2013, a decline of 65 bps from 2012. As a result, issuers and investors may favor stocks over bonds in 2014. The IPO market also is expected to remain strong in 2014.

European High-Yield Market. The European high-yield market enjoyed a record year in 2013, with volume more than doubling over 2012. Continued strength in the euro market in 2014 could provide U.S. issuers with an alternative to the U.S. high-yield market.

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The U.S. high-yield market in 2014 likely will be less robust than in 2012 and 2013, with a greater portion of the volume driven by acquisition financings and dividend payments. Continued low interest rates, forward guidance from the Federal Reserve and a new deal on government spending should have a positive effect on the market. However, some continued uncertainty as to potential changes in the Federal Reserve's levels of asset purchases as a result of new economic data and the need for Congress to address the debt ceiling in early 2014 could unfavorably impact the market. In addition, a strong U.S. stock market and strong European high-yield market may attract issuers and investors away from the U.S. high-yield market in 2014.