European High-Yield Market Looks Strong Coming Off Record Year

Skadden

January 2015

This article is from Skadden's *2015 Insights* and is available at skadden.com/insights.

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Investor enthusiasm in Europe for high-yield bonds reached a peak in July 2014, followed by a quiet August and September before the market returned, driven by M&A activity. Despite an inconsistent year, European high-yield bonds set a new annual value record, topping the €70 billion record set in 2013 with €72 billion of issuances in 2014.

The market for 2015 appears promising. The anticipated continuation of M&A activity has generated a strong pipeline, and we expect issuers with outstanding debt to continue to take advantage of low yields to refinance their debt so long as market conditions remain strong.

Key Trends in 2014 and Outlook for 2015

The rollercoaster year for European high-yield bonds in 2014 highlighted the tension between issuers and investors over bond terms. The strong second quarter stood in contrast to the third-quarter lull, prompted by the default by issuer Phones4U as well as the perception that high-yield bond interest rates were insufficient to cover risk. Covenant trends in 2014 included:

"Portable" Change of Control. A high-yield bond typically requires the issuer to offer to repurchase the bonds at 101 percent upon a change of control (CoC). In recent years, some European high-yield bonds have included a "portable" CoC provision, which does not require the 101 percent repurchase offer upon a CoC provided that a leverage test is met. A portable CoC can make it easier for the issuer's owner to sell the business (because the buyer is not required to make the repurchase offer). In 2014, issuances containing a portable CoC climbed from 30 percent in the first quarter to 41 percent in the second quarter and 47 percent in July. However, with the market cooling off, only one issuance in August through the end of the year contained a portable CoC. High-yield bonds in Europe peaked both in number and percentage of issuances with portable CoC in 2014, with 33 percent of issuances in 2014 containing a portable CoC. Whether this trend continues into 2015 will depend on the strength of the market, as a portable CoC largely tracks the issuer-friendly markets.

More Flexibility in Redemptions. In recent years, European high-yield bonds have provided issuers with more flexibility to redeem bonds, a trend that continued in 2014. In addition to shorter "non-call" periods, during which issuers can only redeem bonds at a "make-whole" premium, the market has seen an increase in the amount of bonds that issuers can redeem using equity offering proceeds (the "equity claw" redemption). Recent offerings have increased the traditional amount from 35 percent of bonds originally issued to 40 percent in some bonds (and even 45 percent in one deal in 2014). Certain bonds (mainly secured bonds) also contain an additional redemption provision permitting the issuer to redeem up to 10 percent of the bonds per year at 103 percent of principal amount over the first three years of the bond. Floating-rate bonds, which generally have much shorter "non-call" periods than fixed-rate bonds, also were popular in 2014, with issuances in 2014 surpassing 2013 levels by volume and number of issuances, and a tapering off from August through the end of the year. Continuing a trend started in 2013, most floating-rate issuances in 2014 allowed the issuer to redeem the bonds after just one year (at a premium of 101-102 percent), rather than the two-year non-call period commonly seen prior to 2013, reducing the non-call period by a year and the premium by 1 percent.

Covenant Trends. Strong investor appetite for bonds in the first half of 2014 enabled issuers to go to market with more flexible, issuer-favorable covenant packages, including an increased ability to pay dividends and make other "restricted payments" and to incur debt. For example, an increasing number of bonds permit an issuer to make any restricted payments upon meeting a leverage test (ranging from 1x to 4x of debt to EBITDA) — this provision was included in more than half of high-yield bond issuances in 2014, which is more than double the percentage in 2013. Many bonds issued in 2014 also gave the issuer increased flexibility to secure new debt with the bond collateral and to conduct certain affiliate transactions without obtaining a fairness opinion. In addition, many bonds issued in 2014 include "grower" baskets within the exceptions from the general limitation on debt and restricted payments. "Grower" baskets typically increase as the issuer's assets increase, with a small, but growing number of issuances providing for increases in baskets based upon EBITDA. With under 10 percent of issuances containing reduced covenants, high-yield lite issuances remain a smaller percentage of the European high-yield market than the U.S. market.

Investor Sentiment. Some investors have voiced concern over "looser" covenants. In particular, this relates to portable CoC provisions, decreased call protection, and issuers' increased capacity to pay dividends and dilute the collateral with additional secured debt. It remains to be seen whether bond terms will continue the trend of increasing issuer flexibility. Ultimately, investors' desire to push back against loosening covenants will be challenged in stronger markets.

Defaults. Default rates for European companies with speculative grade ratings have steadily declined since their peak in 2008. From 2013 to 2014, default rates fell from 5.1 to 4 percent. If default rates remain low, this should help drive a strong market for high-yield bonds in Europe.