



European Quarterly High Yield and Leveraged Loan Report

EUROPEAN HIGH YIELD ASSOCIATION

Autumn 2007

The European High Yield Association, in conjunction with the Securities Industry and Financial Markets Association, is pleased to present the third issue of the *European Quarterly High Yield and Leveraged Loan Report*. The report analyzes and presents aggregate information and trends related to the European leveraged finance marketplace, including both high yield corporate bonds and leveraged loans, including issuance, credit quality and returns on investment. Unless otherwise noted, the data are through the third quarter of 2007.

European Leveraged Finance Volume Drops to €7.4 Billion in the Third Quarter as Liquidity Dries Up, But Year-to-Date Issuance Remains Ahead of Last Year at €43.3 Billion and There Are Signs of Renewed Market Vitality at Quarter-End

Highlights

- Investor risk aversion, heightened volatility, depressed and uncertain pricing and substantially reduced liquidity led to diminished market conditions in the European high-yield bond and leveraged loan markets in the third quarter of 2007.
- Market conditions led to spread widening and negative returns for the quarter. However, there were signs of recovery with credit spreads tightening and volatility moderating late in the quarter. The high-yield market turned positive in September.
- Credit quality metrics still appear benign with favourable rating trends and historically low default rates. After an extended period in which issuers and sponsors dictated lending terms, investors were able to exert themselves as market conditions tightened and the outcomes for a substantial volume of deals still uncertain.
- Leveraged finance issuance (combined leveraged loan and high-yield bond volume) declined to €7.4 billion compared to €17.4 billion in the second quarter; issuance year-to-date remained ahead of last year at €43.3 billion compared to €198.0 billion issuance year-to-date 2006. High yield issuance totaled €4.6 billion in the third quarter compared to €21.5 billion in the second quarter and €5.7 billion in the third quarter of 2006.
- Despite the weakened market tone in the third quarter, the underlying economic environment for European high yield borrows remains solid on elevated profit levels and economic growth.

Economic and Market Environment

Market Conditions

- The global credit markets, including the European high-yield market, experienced a substantial repricing of credit risk in the quarter, evidenced by significant spread-widening and a contraction of market liquidity.
- The credit turmoil started as a reaction to the downturn in the market for RMBS and CDOs backed by U.S. subprime residential mortgage loans. The failures and retrenchments of several key European and U.S. investment funds focused on leveraged credit and with U.S. subprime exposure added to investor concern. Central banks, including the ECB, infused liquidity to stem the deteriorating credit market conditions, providing greater market stability.

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- Money market rates started to decrease during the latter part of the quarter, suggesting a reduction in risk premium in Europe. For example, the overnight Euro lending rate came down by 67 basis points to 4.01 percent from September 5 to September 13.
- Strong investor demand in the early part of the year gave way to significant investor trepidation on credit risk sensitivity and reduced market liquidity in the quarter. CLO issuance has fallen, and hedge fund appetite has weakened. Traditional investor segments are expected to be important sources of renewed investor interest, helped perhaps by the emergence of “opportunity” funds.
- The higher volatility raised investor risk sensitivity, and global credit risk repricing led to European high yield credit spread widening, with returns turning negative for the quarter. The appreciating Euro should boost Euro denominated bond returns relative to U.S. dollar denominated bonds. While there is still curtailed issuance activity in European leveraged finance and it will take time for volume to pick up, the global corporate credit market tone appeared to be improving at quarter-end.

Economic Trends

- Tighter financing conditions reduce access to business credit. The October 2007 quarterly ECB bank lending survey reflects the tighter credit conditions with 31 percent of the banks reporting “somewhat tighter” conditions compared to 3 percent in the previous survey in July, but with few indicating “considerably tightening conditions.” An analysis of the survey results by Moody’s Economy.com concluded that access to finance has not worsened for “a large share of borrowers” and the effect on economic activity in the Euro-zone should only be moderate and not as pronounced as feared.
- Underlying economic fundamentals remain strong with sustained economic growth, a record low unemployment level and elevated profits leading to a still favourable outlook.
- European macroeconomic growth is expected to moderate this year and into next year from the above-trend rate of 2.75 percent in 2006 as the economic cycle matures, the effect of the upward valuation of the Euro currency works its way through the economy, and higher oil prices take hold. The ECB is projecting about 2.5 percent growth this year and 1.8 to 2.8 percent in 2008.
- The moderating pace of growth, along with the appreciating Euro, should ease inflationary pressures. Although “headline” inflationary data have moderated and the most recent reading is below the target of 2.0 percent, central bank policies are sensitive to inflationary pressures from approaching capacity levels and labour price demands.
- The economic outlook will be affected by Euro-area real benchmark interest rates. In view of global financial market conditions, the ECB in September maintained short-term interest rates at 4.0 percent, which is still considered accommodative, after eight consecutive quarter rate increases.

Issuance

- Led by strong issuance in the first half of the year, high yield bond issuance¹ volume totaled €38.9 billion through the first three quarters of 2007, 61.4 percent higher than the first three quarters of 2006. Third quarter high-yield issuance was much lower, €4.6 billion compared to €21.5 billion in the second quarter and €5.7 billion in the third quarter of 2006. Based on Reuters Loan Pricing Corporation data, total European leveraged loan² volume (including mezzanine financing) was €204.4 billion through the third quarter, of which €7.6 billion were mezzanine and €9.5 billion were second lien loans. Third

¹ 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+. CDs, General term notes and split-junk rated transactions are excluded. Includes all European issuers and all international issuers that issue in a European currency. Excludes ABS, federal credit agency, supranational agency, sub-sovereign, and sovereign debt transactions. Excludes transactions without a manager, non-underwritten transactions, self funded ineligible transactions, and transactions that are not rank eligible (due to submission guidelines).

² 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.

quarter volume was €2.8 billion (€0.9 billion mezzanine) compared to €5.9 billion (€2.7 billion mezzanine) in the second quarter. Combined, leveraged finance volume was slightly over €43.3 billion, 22.9 percent higher than year-to-date 2006 and €47.4 billion in the third quarter of this year compared to €17.4 billion in the second quarter. Unrated bonds³ totaled €6.4 billion through the third quarter, nearly double the amount issued in the first three quarters of 2006. On a quarter-over-quarter basis, unrated bond issuance fell by 50 percent, €1.1 billion, down from €2.2 billion.

- Market conditions dramatically reduced the appetite for aggressive non-traditional deal structures. Once popular “covenant lite” deals have disappeared from the market. According to Fitch Ratings, on a 12-month trailing basis, issuance of payment-in-kind (PIK) transactions rose to €8.0 billion through the third quarter of 2007, up from €4.0 billion in the 12 months ending with third quarter of 2006, although this trend came to a halt in the third quarter as credit risk repriced. Third quarter PIK volume was €496 million compared to €1.7 billion in the second quarter.
- Standard & Poor’s (S&P) “BB”-rated bond issuance totaled €15.9 billion, “B” totaled €15.1 billion and “CCC & Below” totaled €1.2 billion through the third quarter. “BB” issuance accounted for 40.9 percent of year-to-date issuance and 52.2 percent of third quarter issuance. The industrial sector accounted for €9.9 billion in issuance year-to-date, nearly 51.2 percent of total high yield issuance.
- Through the first three quarters of the year, the industry sectors with the most leveraged borrowing were the media (€5.2 billion), chemicals (€18.6 billion), telecom (€17.4 billion) and general manufacturing (€16.3 billion) sectors, according to Reuters Loan Pricing Corporation.
- M&A and LBO transactions, including private equity sponsored deals, have led bond and loan issuance volume growth in recent years. LBO transactions, however, were much more difficult and expensive to finance in the third quarter, and thus volumes slowed appreciably. Based on Merrill Lynch data, approximately 18.9 percent of high yield bond proceeds were used to finance M&A/LBO deals through the third quarter, compared to 41.1 percent in 2006 and 7.8 percent in 2001. Refinancing, which includes refinancing of LBO deals, accounted for an additional 43.5 percent of high yield bond financing through the first three quarters of this year. Combined, LBO (46.4 percent) and recap (36.2 percent) accounted for 82.6 percent of leveraged loan volume year-to-date 2007, according to Reuters Loan Pricing and 82.4 percent in the third quarter. Total loan financing of LBO transactions were €20.2 billion (€15.0 billion recap) in the third quarter compared to €38.4 billion (€40.7 billion recap) in the second quarter.
- The fixed-rate share of high yield bond issuance rose to €7.3 billion in the first three quarters of 2007 (70.1 percent of total issuance), up from €7.0 billion (70.6 percent) during the same period of 2006. Floating rate issuance rose to €1.6 billion (29.9 percent of total issuance) from €7.1 billion (29.4 percent of total issuance) in the same period of 2006. During the third quarter, fixed-rate issuance accounted for 82.6 percent and floating rate accounted for 17.4 percent.
- There remains a substantial backlog of leveraged finance deals. Globally, there was some reduction in the deal calendar late in the quarter as some deals closed under revised terms and others were removed from the calendar.

Credit Quality

- Credit fundamentals remain solid, even taking into account the repricing of risk. However, there are indications that some pick-up in defaults could occur later in the year especially for high-yield issuers who face more restricted access to credit markets.

³ Unrated are defined as all bonds that either are not rated or for which the rating is “not available,” according to Bloomberg.

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- As of the end of August 2007, the S&P Global Fixed Income Research 12-month trailing European speculative-grade default rate declined to 1.39 percent. S&P noted that while default rates remain subdued, a rise in market-based indicators such as the increasing cost of protection in the CDS market during the quarter suggest rising default expectations. Rising credit derivative spreads during the quarter were also attributed to the higher risk premium demanded by investors. S&P's high yield bond downgrade to upgrade ratio has generally declined over the last several years. There have been 23 upgrades and 14 downgrades through the third quarter of 2007.
 - Fitch Ratings reports a similar trend in mezzanine loan default rates that are well below the peak in 2003 and slightly lower in the third quarter at 1.7 percent.
 - High yield bond recoveries have picked up from 11 percent in 2001 to 49 percent in 2006 before declining to 39 percent through the third quarter of the year, as calculated by Fitch Ratings. The recovery rate was virtually unchanged between the second and third quarter. Recovery rates are approximated by dividing the price of defaulted bond issues one month after default by the bond volume before default.
 - Trends in the investment rating composition over recent years confirm the potential for increased risk exposure as the European leveraged finance markets expand. S&P Loan Commentary and Data reported a relative decline over the last two years in the leveraged loan rating mix of "BB" rated issuers through the third quarter, and S&P Global Fixed Income Research reports that over the last three years the "BB" rated issuer share of the European high yield or speculative-grade market has declined while the "B" rated share has increased. Reflecting the benign credit quality trends in recent years, S&P reported an increase in "BB" rated entities by 6 in the quarter (14 year-to-date) and "B" rated and below declining by one in the quarter (and 13 year-to-date) in its high-yield bond universe.
 - As a measure of credit exposure, Fitch reports a jump in leverage ratios over the last several years. In the third quarter, the median senior leverage increased to 5.8 times and total leverage increased to 7.0 times EBITDA in the third quarter. The third quarter increase in leverage would appear to be surprising in view of leveraged syndications stalling during the quarter. The Fitch calculations are based on the shadow rated transactions, which include older vintage deals that were updated during the quarter and new transactions, most of which would have been arranged either at the end of June (and rated in July) or in early July prior to the height of the credit market turmoil and thus more representative of the syndication market at its peak.

Relative Value

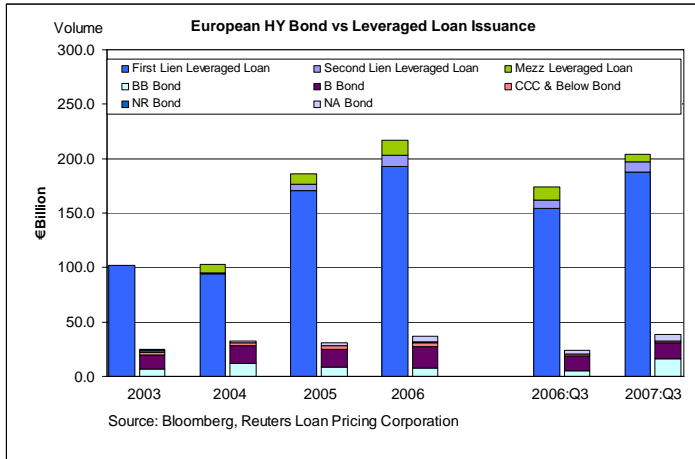
- According to both iBoxx and Merrill Lynch indices, European high yield sector returns were negative for the third quarter, and spreads dramatically widened. The sector began to recover during the latter part of the quarter and through the first half of October. Some renewed global credit market concerns as a result of additional weakness in the U.S. mortgage market during the week of 15 October led to spread softening and giving back gains picked up earlier in the month. Based on the Merrill Lynch High Yield Index, total market return was -1.70 percent for the third quarter, +2.26 percent for September and +0.06 percent year-to-date. As of the end of the quarter, the Merrill Lynch High Yield Index was reporting a 368 basis point yield spread, having rallied back from 410 basis points a month earlier but still wider than the 226 basis point spread at the beginning of the quarter. As of 18 October, the spread tightened further from quarter-end to 346 basis points. The spread widening in the credit derivatives market had been more dramatic as measured by the iTraxx cross-over index (iTRAXX.EU.XO) early in the third quarter but, that spread also tightened at quarter-end and through the first half of October. The iTraxx cross-over index spread widened by about 100 basis points in the quarter to 327 at quarter-end, with the spread having reached 406 basis points at the end of July. The cross-over index spread tightened by 8 basis points in September and, as of 18 October, the spread was at 316 basis points.

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- The leveraged loan index also turned negative in the quarter. The S&P LCD European Leveraged Loan Index (ELLI-Total Return) was -3.70 percent for the third quarter compared to +1.50 percent in the second quarter and +1.62 percent in the third quarter of 2006. S&P LCD reported a wider primary weighted-average institutional loan spread of 276 basis points on 30 September compared to 254 basis points on 30 June. In late September, market participants noted improved pricing in leveraged assets suggesting a tentative recovery, although trading activity remains soft compared to the frenzied activity in the first half.
 - To download issuance data, please click on the attached link below.

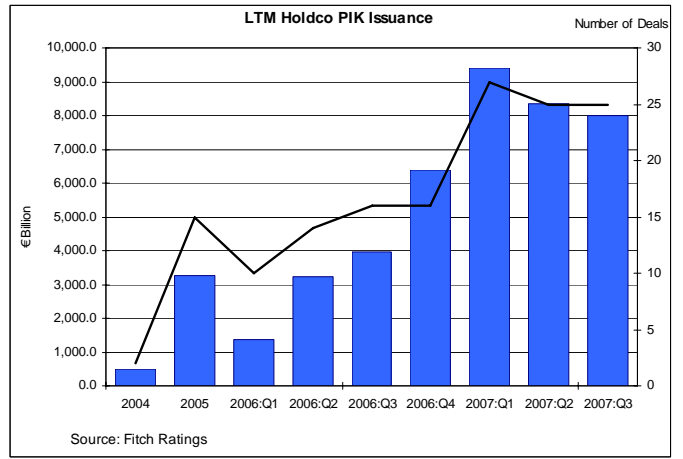
Download Data.
Microsoft Excel

European High Yield Report - Issuance Volume

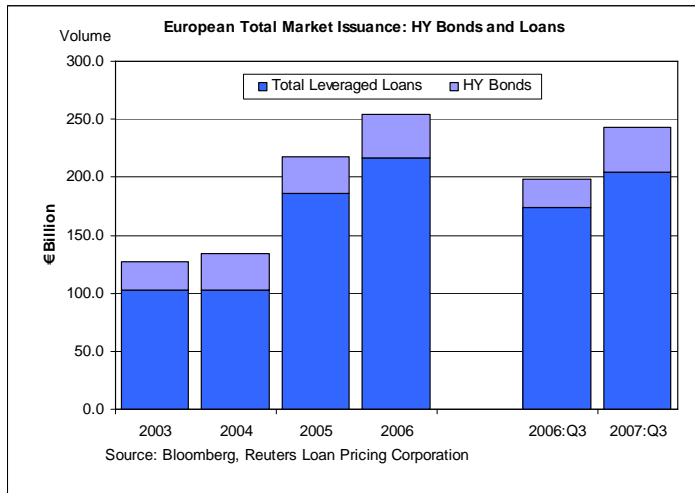
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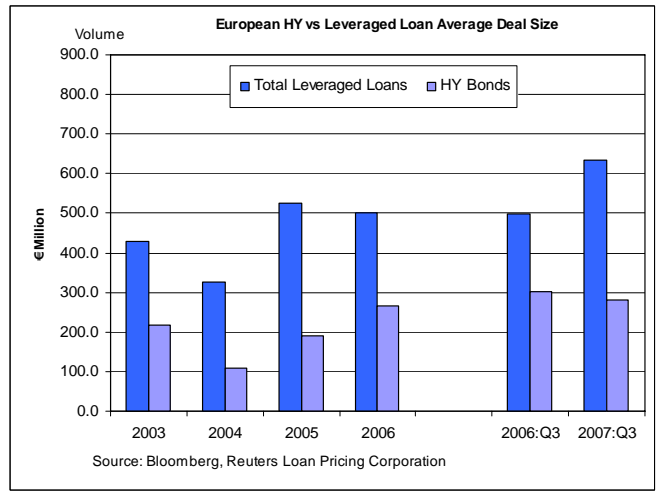
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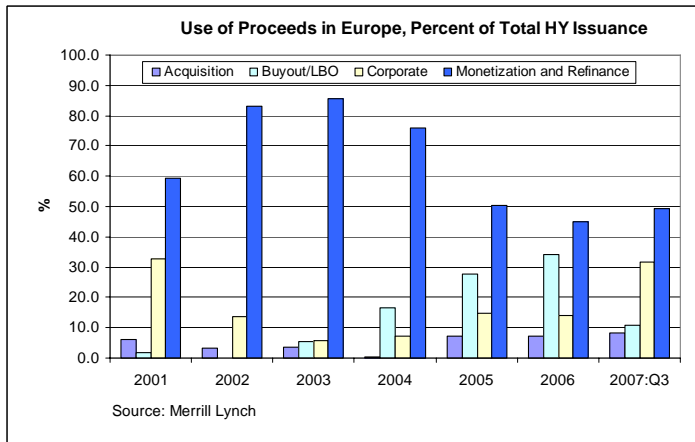
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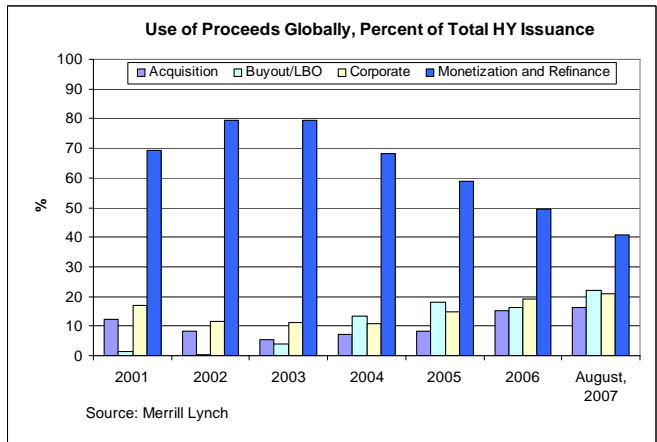
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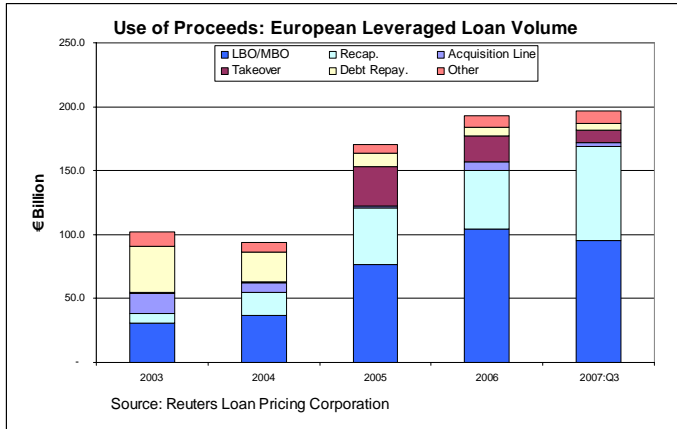
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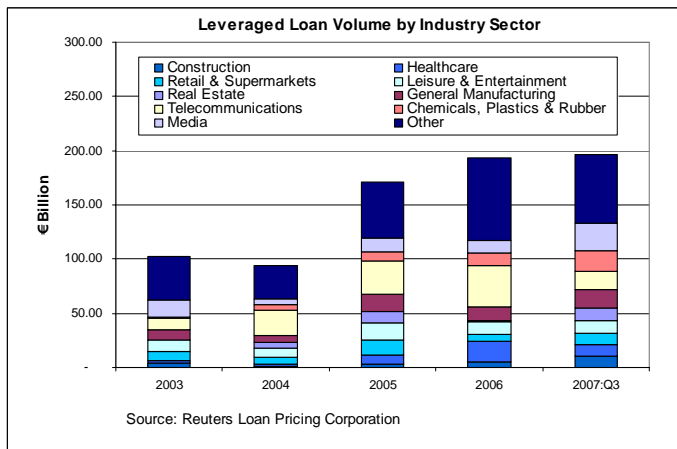
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2007:Q3 Long-Term European HY Issuance By Industry Sector (in € Millions)

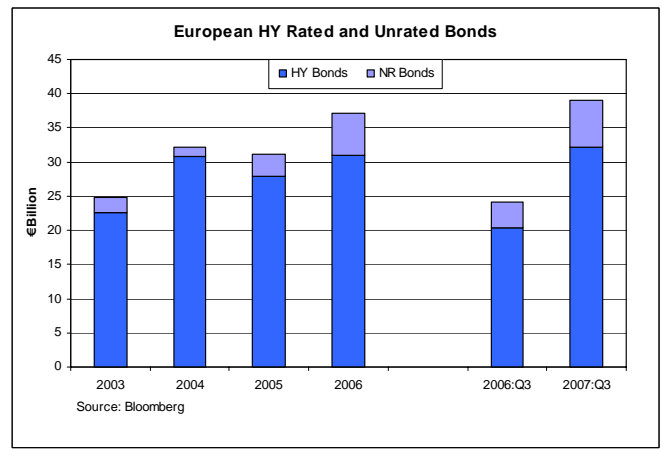
| Sector | S&P BB Rating | S&P B Rating | S&P CCC Rating | S&P NR Rating | S&P NA Rating |
|-----------------------|-----------------|-----------------|----------------|---------------|----------------|
| Banking | 711.4 | 736.5 | 54.2 | | 3,073.4 |
| Finance | 1,773.0 | 4,686.6 | 250.5 | | 1,078.7 |
| Industrial | 10,021.1 | 8,179.5 | 892.3 | 275.0 | 550.1 |
| Special Purpose | 2,671.9 | 1,509.1 | | | 1,742.4 |
| Utility | 745.1 | | | | |
| Industry Total | 15,922.5 | 15,111.7 | 1,197.0 | 275.0 | 6,444.6 |

Through September 30, 2007
Source: Bloomberg

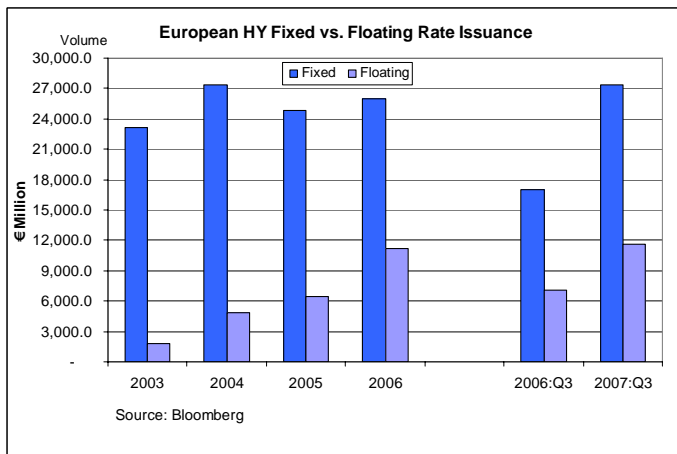
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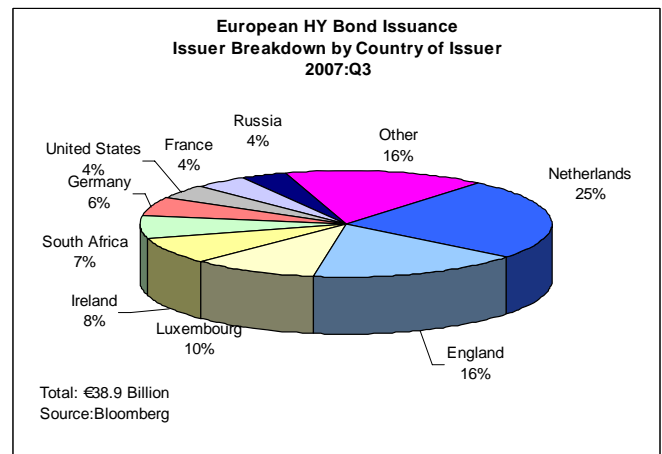
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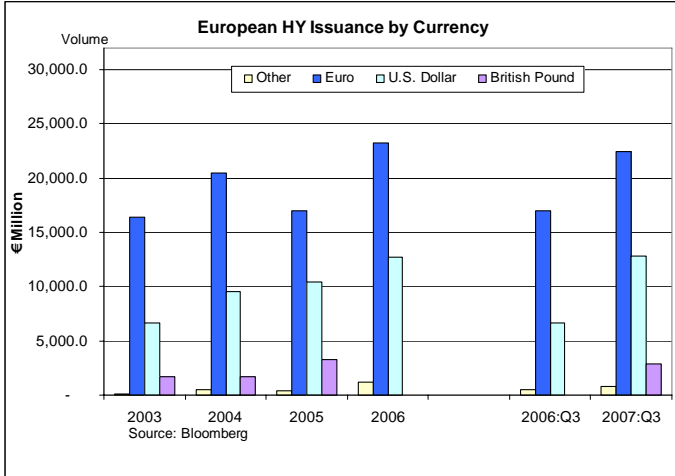
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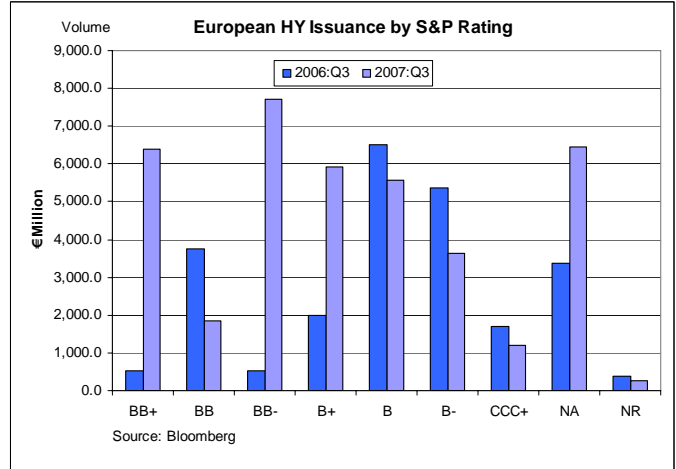
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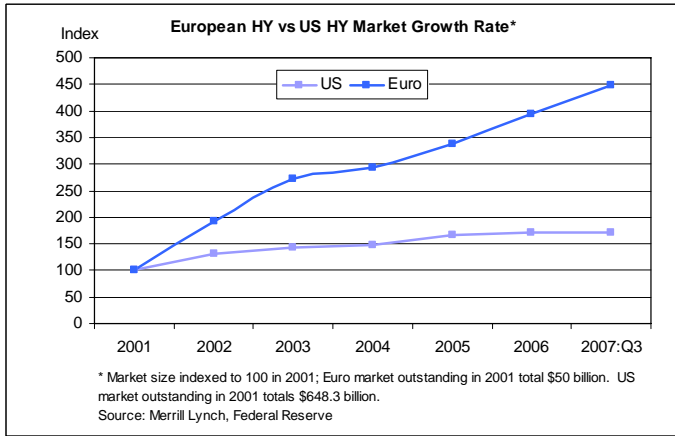
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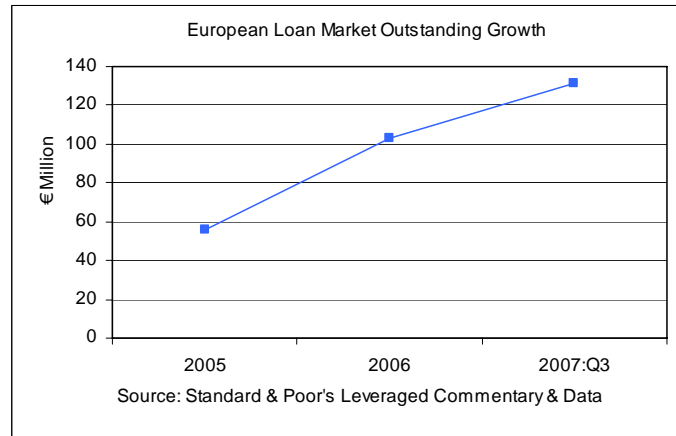
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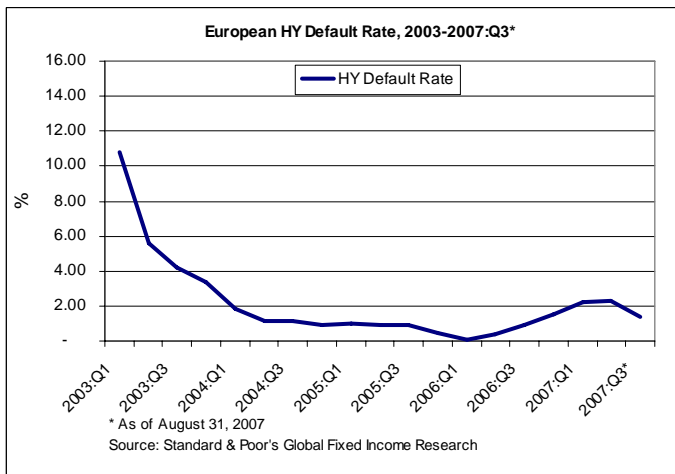


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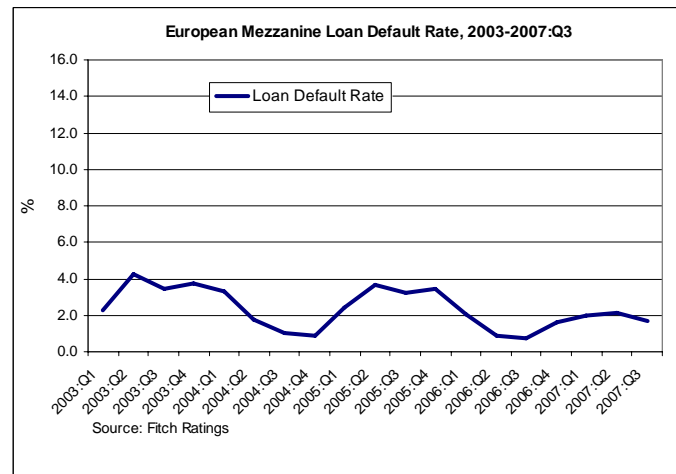


European High Yield Report - Credit Quality

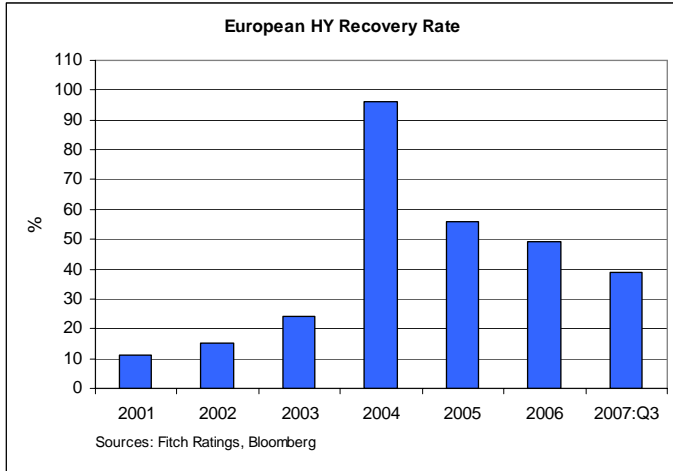
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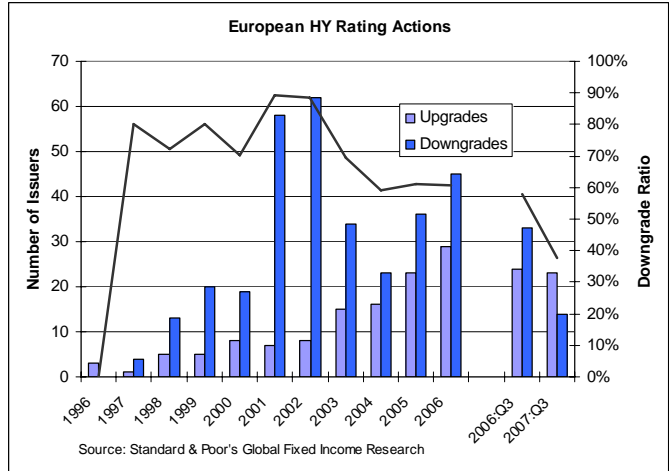
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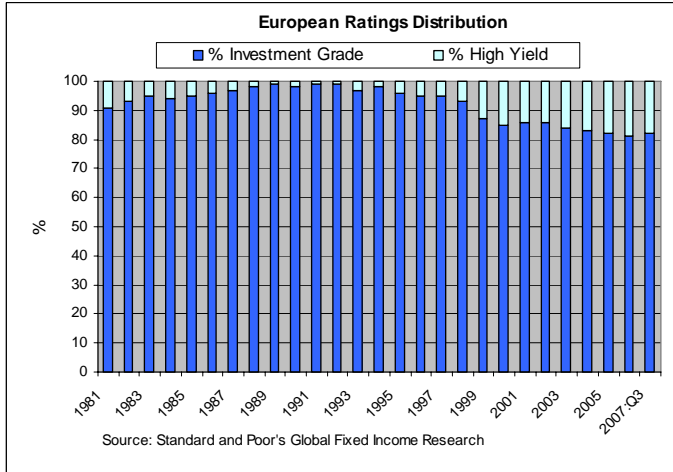
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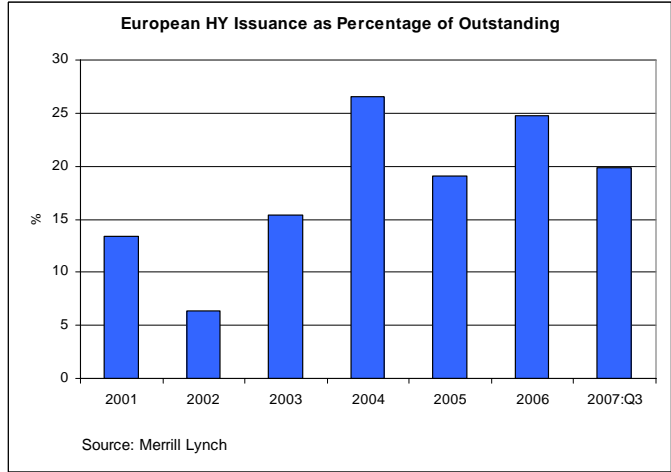
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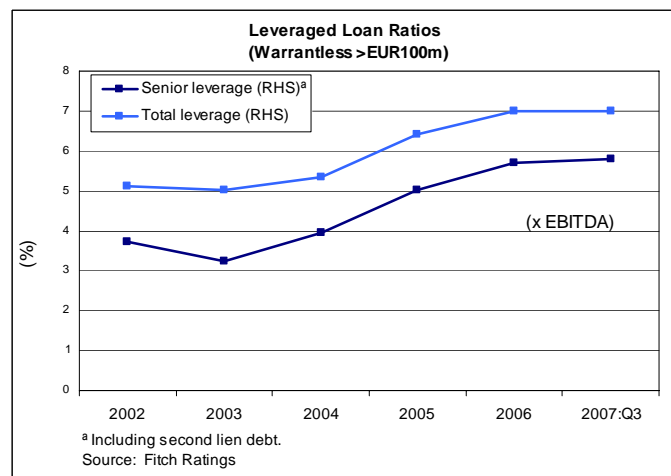
S&P European Leveraged Loan Index

Ratings Diversification

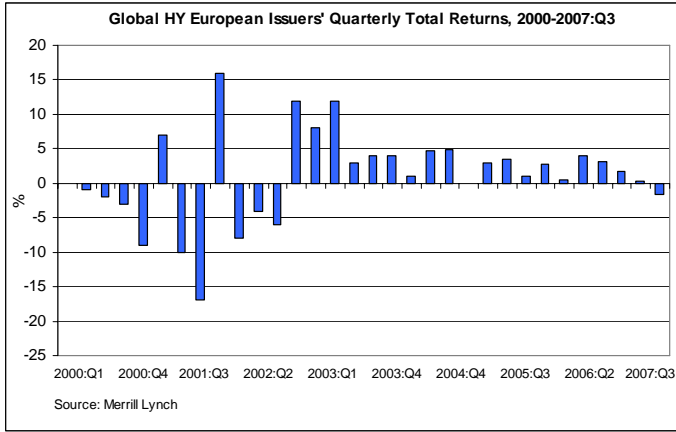
| | S&P BB Rating | S&P B Rating | S&P NR Rating | Other |
|---------|---------------|--------------|---------------|-------|
| 2005 | 15.5% | 74.5% | 9.7% | 0.3% |
| 2006 | 9.6% | 77.5% | 12.9% | 0.0% |
| 2007:Q3 | 9.6% | 75.9% | 13.6% | 0.9% |

Source: Standard & Poor's Leveraged Commentary and Data

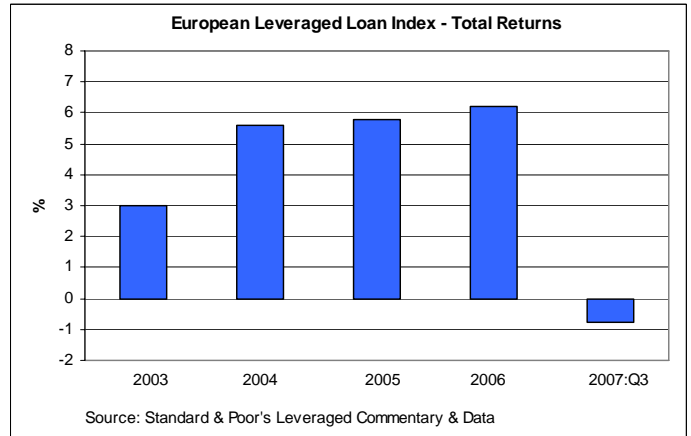
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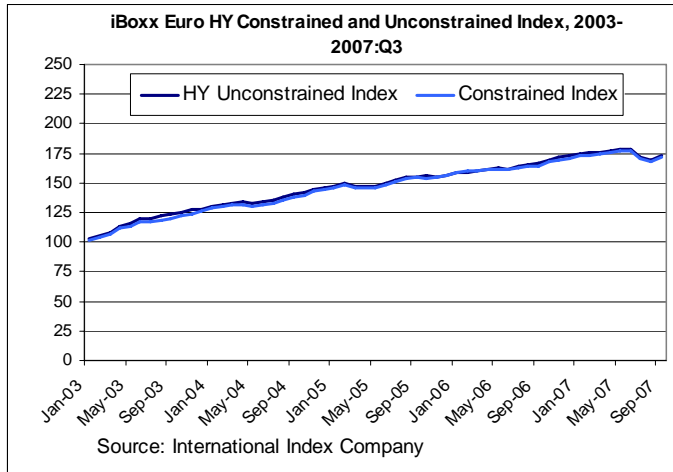
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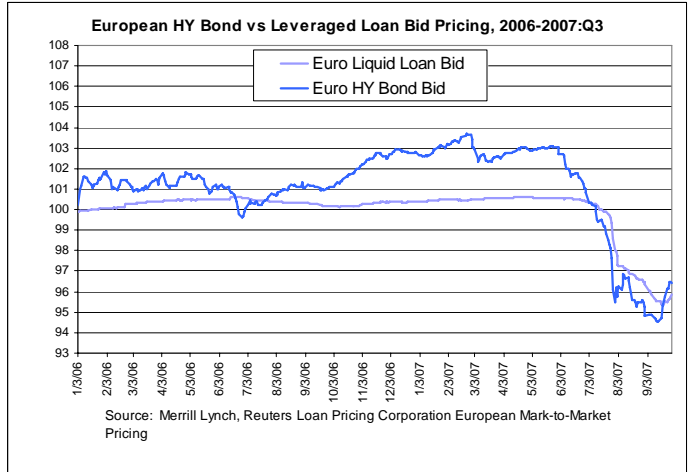
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