

European Leveraged Finance
Special ReportRating European High Yield
HoldCo PIK Notes

Analysts

Roger Coyle
+44 20 7862 4105
roger.coyle@fitchratings.com

Daragh Murphy, CFA
+44 20 7417 6344
daragh.murphy@fitchratings.com

■ Executive Summary

Between end-November 2004 and end-February 2005 the European high yield market saw a surge in the issuance of deeply subordinated pay-in-kind ("PIK") high yield notes issued by holding companies of leveraged issuers ("HoldCo PIK notes"). These issues have been largely well received, mainly due to the strong liquidity in the European high yield market. While cash-pay high yield notes issued in Europe since 2003 have usually benefited from subordinated upstream guarantees, HoldCo PIK notes do not have guarantees and effectively take the place of equity in the capital structure.

Fitch believes that the issuance of HoldCo PIK notes will typically have no effect on the issuer's existing ratings providing a number of conditions are met. These conditions, which are outlined in more detail in this report, include the notes being PIK for their entire life, issued by a HoldCo and ranking as unsecured and unguaranteed obligations with a final maturity date beyond that of all of the issuer's other debt obligations.

The ratings assigned to HoldCo PIK notes will reflect the limited recovery prospects for noteholders in the event of a default. Noteholders will typically only have an equity claim on the operating group and will rank behind significant levels of higher priority debt claims, including trade creditors, in an insolvency or distressed restructuring procedure. Given their very poor recovery prospects, Fitch expects that most HoldCo PIK notes will be rated below existing cash-pay high yield notes.

■ Recent Issuance

The first of the recent HoldCo PIK issues in Europe was a EUR400 million transaction by Kabel Deutschland GmbH ("KDG") in early December 2004. This has since been followed by a further EUR1.5 billion of issuance in January and February 2005 from four other European high yield issuers. All of the HoldCo PIK note issues to date have been used to finance dividends to shareholders.

Fitch expects further issuance of HoldCo PIK notes in Europe in the near future as high yield market conditions remain strong.

■ Fitch Rating Actions

In December 2004, Fitch affirmed KDG's senior notes at 'B+', Senior Unsecured rating at 'BB-' (BB minus) and its Senior Secured rating at 'BB+'. The agency noted that "the PIK notes do not affect the cash flows within the group, given their non-cash pay nature". KDG's HoldCo PIK notes are not rated.

In January 2005, Fitch affirmed Jefferson Smurfit Group's ("JSG") senior notes rating at 'B', Senior Unsecured Rating at 'B+' and Senior Secured Rating at 'BB'. JSG's newly issued Subordinated PIK notes were assigned a rating of 'CCC+' to reflect their deeply subordinated position within the group structure. More details of JSG are given in an example in the Appendix of this report.

Fitch is currently carrying out a broad review of its notching policy for securities. For further details see the special report entitled *The Role of Recovery Analysis in Ratings – Enhancing Informational Content and Transparency*, February 2005 available on www.fitchratings.com

Recent Examples of Holdco PIK Notes

Company	Kabel Deutschland	Jefferson Smurfit Group	Eco-Bat	Avio	Cognis
Issuer	Kabel Deutschland Holding GmbH & Co KG	JSG Holdings plc	EB Holdings Inc	Aero Invest 1 SA	Cognis Holding GmbH & Co
Deal Date	Dec 04	Jan 05	Feb 05	Feb 05	Jan 05
Amount (EURm)	400	325	250	375	530
Issue Price	99	100	100	99	99
Pricing	E+850	11.50%	10%	E+850	E+900
Maturity	Dec 14	Oct 15	Feb 15	Mar 15	Jan 15
Callable	May 05	Jan 07	Feb 07	Mar 06	Jul 05
Call Price	100	102	102	100	101
Prepayment Penalties	NC6m,100,102,101	NC2, 102,101	NC2, 102,101	NC1,100,102,101	NC6m, 101,102,101

Source: Fitch Ratings

Recent Issuance

Holdco PIK note transactions have become increasingly popular in Europe in recent months, with almost EUR1.9bn issued since December 2004, and the level of investor demand has allowed several issuers to increase the size of the transactions. Avio's HoldCo PIK notes issue was upsized from EUR350m to EUR375m, the issue from Cognis was increased from EUR500m to EUR530m and JSG increased its issue size from EUR300m to EUR325m.

The table above summarises Europe's most recent HoldCo PIK note transactions. Some of their key characteristics can be summarised as follows:

Call Options

- Potential IPO candidates in the short term:** The Cognis deal is callable after six months, which gives the sponsors the flexibility to float the business quickly. KDG's HoldCo PIK notes are also callable within six months, and Avio's after one year, also permitting potential IPOs for these businesses in the near term.
- Not IPO candidates:** The HoldCo PIK notes issued by both JSG and Eco-Bat have similar longer call protection, since neither are IPO-candidates in the short term.

Coupon

- Recent issuance has been fairly evenly split between fixed- and floating-rate PIK notes. The floating-rate HoldCo PIK notes from KDG and Avio are structured to offer investors protection against potential future interest rate increases.

Use of Proceeds

- All of the recent HoldCo PIK note deals in Europe have been used to make cash payments to shareholders.

Rating Approach to HoldCo PIKs/

Effect on Issuer's Existing Ratings

Fitch analyses the impact of HoldCo PIK note issuance on the existing ratings of the issuer. The agency believes this will usually be negligible providing a number of conditions are met (see below).

The issuance of a new security will impact an issuer's Long Term Credit Rating ("LTCR" - see page 3) if it materially increases or decreases the probability of the issuer failing to meet its financial commitments on a timely basis. As HoldCo PIK notes do not bear cash interest payments and are non-amortising, they do not increase the probability of the issuer failing to meet its financial commitments on a timely basis (i.e. default probability) before the maturity of the HoldCo PIK notes.

The agency recognises the possibility that an issuer of HoldCo PIK notes may meet all interest and repayment obligations on its more senior classes of debt and then fail to refinance the HoldCo PIK notes at final maturity. However, Fitch views this scenario as highly unlikely since having repaid all of its more senior debt (which should mature before the HoldCo PIK notes, as described below), the issuer should be in a position to refinance the HoldCo PIK notes with cash-pay debt. It is, of course, most likely that the issuer's debt will be refinanced before maturity upon a sale, IPO or recapitalisation of the company and Fitch will re-assess the issuer's ratings at this time based on its revised capital structure.

Ratings on existing instruments will be impacted if a new issuance materially affects the recovery prospects of, for example, senior secured lenders or the holders of any existing high yield notes, in the event of an issuer default. The issuance of HoldCo PIK notes is considered unlikely to impair the recovery prospects of existing issues since, due to the structure of HoldCo PIK notes, in a distress

scenario noteholders should receive consideration only when all prior claims are satisfied.

Accordingly, the ratings assigned to HoldCo PIK notes will reflect the limited recovery prospects for noteholders, who are typically unsecured and deeply subordinated and who will rank behind significant levels of debt with higher priority claims in an insolvency or distressed restructuring procedure.

Fitch expects that most HoldCo PIKs will be rated below any existing cash-pay high yield notes. More specifically, HoldCo PIK notes are likely to be rated two, or even three, notches below the issuer's LTCR or Senior Unsecured rating (see box below).

Issuer and Issue Long Term Credit Rating

Fitch assigns a Long Term Credit Rating (LTCR) to both issuers and issues. The exercise of assigning a rating to any debt instrument is a two-step process.

Step One: Assign Issuer LTCR

The issuer Long Term Credit Rating, also known as an entity or default rating is a senior unsecured rating that focuses primarily on the probability of default. The issuer LTCR is derived through traditional credit analysis.

Step Two: Notch the Debt Instrument Rating Up or Down from the Issuer LTCR

This reflects the relative position of the debt instrument in the capital structure and therefore the agency's view as to likely recovery rates in a distress situation. The main areas of focus include the capital structure of the transaction, collateral and covenant package and the applicable insolvency regime.

Senior secured loans and mezzanine facilities in most instances benefit from a position at or near the top of the capital structure, and are generally secured, the latter on a second secured basis. Therefore, there is potential to notch the senior secured and mezzanine ratings up from the issuer LTCR. By way of contrast, European high-yield bonds are generally notched down from the issuer LTCR to reflect their structurally subordinated position and weaker recovery prospects.

Fitch is currently carrying out a broad review of its notching policy for securities. For further details see the special report entitled *The Role of Recovery Analysis in Ratings – Enhancing Informational Content and Transparency*, February 2005 available on www.fitchratings.com

A HoldCo PIK note issue is unlikely to affect Fitch's issuer LTCR or ratings on existing instruments if it satisfies the following tests:

PIK for Life

HoldCo PIK notes have less impact on default probability, and hence an issuer's LTCR, than traditional cash-pay high yield notes, primarily because they do not impose an obligation to pay cash interest and thus have no impact on the issuer group's cash flow until their maturity date. This differs significantly from some discount notes, which begin to impose a cash interest payment obligation during their life. For example, Fitch downgraded the ratings of Intelsat Ltd and Intelsat Bermuda Ltd on 8 February 2004 to 'CCC+' from 'B-' and to 'B' from 'B+' respectively due to the group's issuance of Senior discount notes that turn cash-pay in 2010.

The HoldCo PIK notes issued in Europe in late-2004 and early-2005 were all PIK for life, although interest on the HoldCo PIK notes issued by KDG, Cognis and will become payable in cash if the issuer makes a "permanent cash-pay election". Fitch believes it to be unlikely that this election will be made as once the company is in a position to service more cash-pay debt, it should be more economical to refinance the HoldCo PIK notes with senior secured debt or cash-pay high yield notes at lower interest rates.

The agency also notes the restrictions on making upstream payments that are typically contained in senior secured facility agreements and the indenture for existing cash-pay high yield notes.

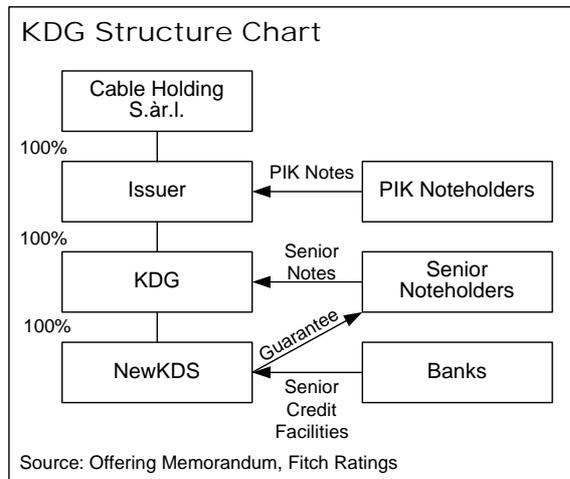
Should future HoldCo PIK notes feature mandatory cash-pay provisions similar to those in existing Senior discount notes, Fitch will treat these notes more like cash-pay debt, i.e. they will be more likely to impact the issuer's existing ratings.

Issued by HoldCo Outside Existing Group

Historically, the structurally subordinated position of high yield notes in Europe has helped maximise recoveries for senior secured lenders. Indeed, when several European cable operators defaulted on their high yield notes in 2002-3, they continued to service their senior secured facilities and it was only the bond-issuer holding company that went into default.

Thus, an issuer's existing instrument ratings are more likely to be maintained if new HoldCo PIK notes are structurally subordinated to all existing debt. This subordination is reinforced if the HoldCo's assets are shares of a subsidiary rather than an intercompany loan since this ensures that the HoldCo PIK notes effectively take the place of

equity and have only a residual shareholder's claim over the operating companies below.



Unsecured and Unguaranteed

The recovery prospects and hence instrument ratings of an issuer's existing senior secured facilities and high yield notes may be affected if new HoldCo PIK notes have security or guarantees that allow them to influence the distribution of recovery proceeds in any restructuring or insolvency procedure.

Ratings on senior secured credit facilities reflect the benefits of the senior security package and the ability of senior secured lenders to effectively control insolvency and restructuring proceedings in certain jurisdictions. Ratings for high yield notes reflect their structural subordination to senior secured facilities and the limited benefit of subordinated upstream guarantees, where provided.

While issue ratings depend on a case-by-case review of recovery value, capital structure and jurisdictional issues, it is clear that HoldCo PIK notes, which are unsecured and unguaranteed, should have limited impact on existing debt ratings.

Maturity After Existing Obligations

For an issuer's existing ratings to remain unaffected by the issuance of HoldCo PIK notes, it is generally expected that the new notes have a final maturity beyond that of the issuer's existing debt obligations. Should the HoldCo PIK notes fall due for repayment while other debt obligations are still outstanding, this increases the risk of the issuer group defaulting during the lifetime of its existing debt instruments. In this scenario, Fitch will look closely at the effects of such a default on the other debt of the group, in particular at the security and acceleration rights of HoldCo PIK noteholders and the cross default provisions of other debt instruments.

JSG has USD292m of Yankee Bonds maturing in 2025, after the PIK notes issued by the Group in January 2004. In affirming its LTCR on JSG Acquisitions and the existing debt instruments of JSG Acquisitions and JSG Funding, Fitch took comfort from the fact that the new HoldCo PIK notes were unsecured and would not trigger cross defaults due to the structurally subordinated position of the HoldCo PIK Issuer (see page 6).

Rating of HoldCo PIK Notes

As HoldCo PIK notes that satisfy the above criteria are deeply subordinated and effectively take the place of equity, their ratings will reflect their relatively low recovery prospects.

Fitch expects that most HoldCo PIKs will be rated below any existing cash-pay high yield notes. More specifically, HoldCo PIK notes are likely to be rated two, or even three, notches below the issuer's LTCR.

It became the market norm in 2004 for cash-pay high yield notes to benefit from subordinated upstream guarantees and for the proceeds to be downstreamed as shareholder loans rather than equity. The recent HoldCo PIK issues have benefited from no such guarantees, even on a tertiary basis, and the HoldCos have only an indirect shareholding in, rather than a shareholder loan to, the companies below them in the structure. While this can help to maintain the ratings on the issuer's existing obligations, it means that the HoldCo PIK noteholders have only an equity claim on the issuer's operating companies and thus rank behind all other debt, even trade creditors, in insolvency. Furthermore, HoldCo PIK noteholders are unlikely to have significant influence over the outcome of any distressed restructuring procedure.

As discussed above, instrument ratings depend on a case-by-case review of recovery value, capital structure and jurisdictional issues. However, since HoldCo PIK notes are most likely to be issued by companies that already have high financial leverage and cannot support further cash-pay debt, their recovery prospects are likely to be very limited.

For example, KDG's HoldCo PIK Note issuance in December 2004 increased its Total Debt/EBITDA ratio above 6x. Since the multiples paid for cable operators in 2003 and 2004 were in the range of 5x-8x enterprise value/EBITDA, there is a very limited equity cushion below the HoldCo PIK notes.

Actual recovery for HoldCo PIK noteholders will depend on the amount of outstanding debt ranking ahead of the HoldCo PIK notes at the time of insolvency or distressed restructuring. Although subject to financial covenants, this may be higher

than at the time of issuance. The agency also notes that the enterprise value realised for a business upon an enforced sale is likely to be based on a lower EBITDA and lower multiple than that at the time the deal is structured.

Other Implications of HoldCo PIK Issuance *Reduced Equity Commitment?*

While it is impossible to quantify the perceived level of support an equity sponsor provides to a specific leveraged buy-out (“LBO”) issuer, it is apparent that the withdrawal of a significant portion of a sponsor commitment may reduce the likelihood of future support in the event of distress.

Is This a Sign of Changing Financial Policy?

Although the issuance of HoldCo PIK notes is certainly an aggressive use of financial leverage, the agency does not believe that it represents a change in financial policy by private equity shareholders. Fitch expects private equity owners of businesses to seek to return their equity as quickly as possible, whether through an IPO or sale of the business or, increasingly, through a recapitalisation and increase of debt.

Recapitalisations of LBOs may be either on the basis of improved business performance, EBITDA growth,

the removal of specific business risks or simply due to an increased risk tolerance in the credit markets, as has been behind the growing number of recapitalisations seen in the European market recently. The market for HoldCo PIK notes is being opportunistically exploited in the same way as the senior secured and cash-pay high yield markets are being tapped to increase senior and total leverage multiples. Currently, there is ample investor demand for HoldCo PIK notes, given falling returns in the high yield market.

How About Refinancing?

The agency believes that some HoldCo PIK notes are likely to be refinanced before their final maturity. Indeed, the HoldCo PIK notes issued by KDG and Cognis have early call options and margin step-up provisions that provide an incentive for early repayment or refinancing.

If the HoldCo PIK notes are refinanced with cash-pay debt, the default probability of the issuer will be increased. The incurrence and servicing of additional cash-pay debt will typically be tightly controlled by the covenants of senior debt facilities. Should these covenants be amended and further senior debt incurred, the issuer’s ratings will be reviewed at that time.

■ **Example – Jefferson Smurfit Group**
 Investors may have had a sense of déjà-vu when JSG announced plans for EUR300m HoldCo PIK notes in January 2005. Almost a year earlier in February 2004, it had attempted to sell EUR250m equivalent of 10-year-non-call five Senior PIK notes.

The US and European high yield markets were awash with liquidity at the time. A USD450m PIK note transaction from Nalco and a USD250m issue by Dex Media funded dividends to the respective equity sponsors in January 2004.

However, JSG’s proposed transaction was cancelled in February 2004 as investors grew more cautious and demanded more yield. The higher yield made the transaction unattractive from JSG’s point of view and the plans were shelved.

In contrast, even though the recent HoldCo PIK note transaction from JSG was larger than the previously proposed deal, the issue was increased from EUR300m to EUR325m. This indicates a shift in the risk appetite of investors in the European high yield market.

Structure

The EUR325m PIK notes were issued by a holding company, JSG Holdings Plc. JSG Holdings is the 100% owner of JSG Funding Plc, which is the issuer of the senior notes due 2012 and senior subordinated notes due 2015.

Effect on Issuer’s Existing Ratings

Fitch affirmed JSG’s existing ratings at the time of the proposed PIK transaction in February 2004. In January 2005, Fitch again affirmed the existing ratings of JSG following the issuance of the EUR325m HoldCo PIK notes.

Although the issue increased JSG’s financial leverage, the interest on the notes will remain non-cash unless the issuer elects to pay cash interest and, therefore, should not affect the group’s cash interest coverage ratios until maturity.

The HoldCo PIK notes do not benefit from any guarantees, nor would a default under the HoldCo PIK notes trigger a default on JSG’s existing liabilities.

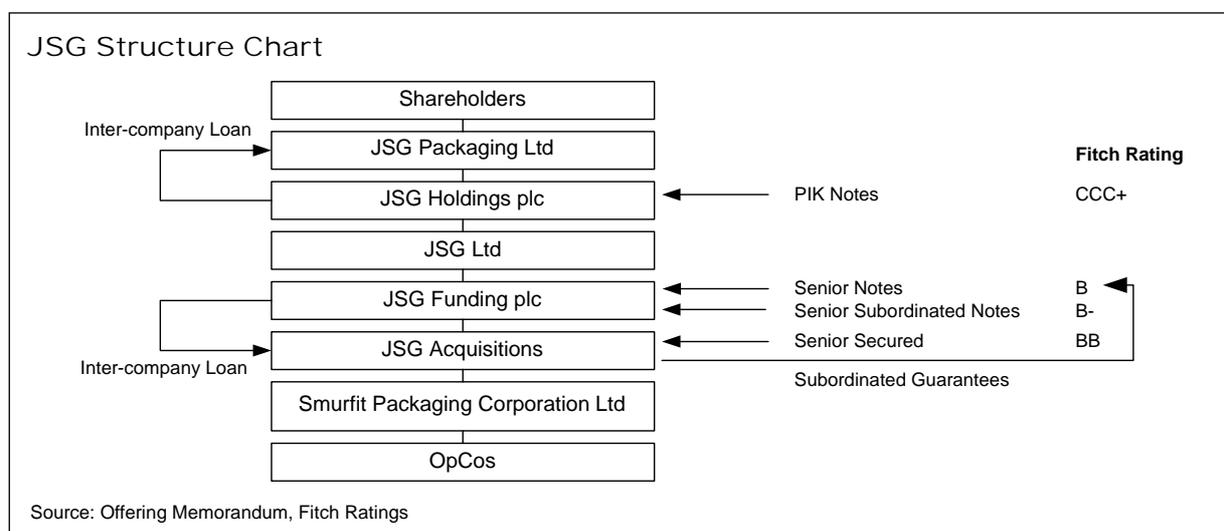
Furthermore, JSG Funding Plc and its subsidiaries are restricted by the indentures governing the existing senior secured facilities, senior notes and senior subordinated notes from paying dividends to JSG Holding.

The issuance of the HoldCo PIK notes does not impact the recovery prospects of existing debt issued by JSG. The HoldCo PIK notes are contractually and structurally subordinated to all existing liabilities within the group and their maturity falls beyond those of all existing debt instruments, except for the USD292m bonds due 2025.

HoldCo PIK Note Rating

The ‘CCC+’ rating assigned to the HoldCo PIK notes reflects their deeply subordinated position within the group structure. At 30 September 2004, *pro forma* for the Munksjo disposal, the refinancing transactions and the issuance of the HoldCo PIK notes, JSG had total debt of EUR3,154m.

The HoldCo PIK notes increase total debt/EBITDA to 6.3x from 5.6x, compared with the 6.0x EBITDA multiple Madison Dearborn paid for the company in 2002.



The HoldCo PIK notes rank behind EUR2,829m of outstanding debt. In addition, in an insolvency scenario, the HoldCo PIK noteholders would only have an indirect equity claim and would also rank behind unfunded pension liabilities and trade creditors. Fitch believes that recovery prospects for HoldCo PIK noteholders in a distress or restructuring scenario would be negligible.

JSG - Key Leverage Ratios

JSG Holdings Plc	PF 30 Sep 04	Debt/ EBITDA (x)*	Net Debt/ EBITDA (x)*
Senior Secured Facilities	725		
US Public Notes	415		
Securitisation Notes	210		
Capitalised Leases and Overdrafts	116		
Total Senior Debt	1,467	2.9	2.5
Senior Notes due 2012	983		
Senior Subordinated Notes Due 2015	379		
Total Debt Excluding HoldCo PIK Notes	2,829	5.6	5.2
PIK Notes Due 2015	325		
Total Debt	3,154	6.3	5.9
Cash	200		

* Pro Forma LTM Sep 2004 EBITDA adjusted for Munksjo disposal and issuance of new notes

Source: Offering Memorandum; Fitch Ratings

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