LEVERAGED COMMENTARY & DATA

A GUIDE TO THE EUROPEAN LOAN MARKET

NOVEMBER 2013
Standard & Poor’s Ratings Services’ corporate analytical methodology organizes the analytical process according to a common framework, and it divides the analysis into several categories so that all salient issues are considered. The first categories analyze the company’s business risk profile, followed by an evaluation of its financial risk profile, which we then combine to determine an issuer’s anchor. We then use several subsequent analytical steps to determine the ultimate rating conclusion.
TO OUR CLIENTS

S&P Capital IQ Leveraged Commentary & Data (LCD) and Standard & Poor’s Ratings Services are pleased to publish the seventh edition of our Guide To The European Loan Market. As usual, this includes our updated and amended primer on the European leveraged loan market, together with several ratings commentaries covering European defaults, recoveries, and guidance on the various different ratings that can be obtained for speculative-grade corporates. Also, we have included a highly topical paper providing our perspective on the potential for institutional investors and other alternative lenders to provide funding for mid-market companies.

So far, 2013 has been a crucial year in the reinvigoration of the European leveraged loan market. As the future regulatory and supervisory landscape for banks becomes clearer, and the economic storm clouds start to lift across Europe, demand from corporates for new debt financing increasingly appears to be the main limiting factor in the growth of bank and institutional funding. Available supply continues to outstrip demand, as evidenced by the growing oversubscriptions of primary deals in the bond and leveraged loan markets. Although this augurs well for sustaining future growth, particularly when investment spending and merger and acquisition activity picks up, we must remain attentive to the lasting lessons of the recent financial crisis. Excessive liquidity, search for yield, higher leverage, and more aggressive capital structures all combined to create a paradox of profligacy. Lured by the market, and focusing on relative value, lenders too easily lost sight of the longer term absolute credit risks that still lurked beneath the surface.

In this context, McGraw Hill Financial seeks to support the controlled development of the European leveraged finance market as a more diverse and sophisticated issuer and investor base becomes established. Whether it is through our market leading data, research, and commentary provided by S&P Capital IQ LCD or leveraged loan, high-yield bond, and recovery ratings that analyse key components of credit risk provided by Standard & Poor’s Rating Services, we strive to provide lenders and investors with the unbiased, independent perspective required to support their credit appraisal and ongoing monitoring. Indeed, Standard & Poor’s Ratings Services’ is redesigning its corporate criteria to provide better clarity on the framework we use in the fundamental analysis of corporate credit and the construction of our corporate ratings.

Nevertheless, we are always open to new suggestions and welcome feedback from market participants to ensure that our services are best aligned with the requirements of an evolving market.

If you want to learn more about our leveraged finance market services, all the appropriate contact information is listed in the back of this publication. You can access this report and other relevant articles on LCD’s Web site, www.lcdcomps.com. Ratings-related articles, videos, and newsletters from Standard & Poor’s Rating Services can be found at www.sandprecoveryratings.com as well as on RatingsDirect.

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Corporate lending is a key route that European companies use to access the debt markets, combined with increasing issuance into the high-yield bond market. Since the euro launched in 1999, the syndicated loan market in particular has become the dominant way for European issuers to tap banks and other institutional capital providers for loans.

A syndicated loan is one that is provided by a group of lenders and is structured, arranged, and administered by one or several commercial or investment banks known as arrangers. They are less expensive and more efficient to administer than traditional bilateral, or individual, credit lines.

At the most basic level, arrangers raise investor funds for an issuer in need of capital. The issuer pays the arranger a fee for this service, and, naturally, this fee increases with the loan’s complexity and riskiness of the loan. As a result, the most profitable loans are those to leveraged borrowers—issuers whose credit ratings are speculative grade and who are paying spreads (premiums above LIBOR or another base rate) sufficient to attract the interest of nonbank term loan investors, typically LIBOR+200 basis points (bp) or higher, though this threshold moves up and down depending on market conditions. In the U.S., corporate borrowers and private equity sponsors fairly evenly-handedly drive debt issuance. Europe, however, has far less corporate activity and its issuance is dominated by private equity sponsors, who, in turn, determine many of the standards and practices of loan syndication.

Indeed, large high-quality, or investment-grade, companies pay little or no fee for a plain-vanilla loan, typically an unsecured revolving credit instrument that is used to provide support for short-term commercial paper borrowings or for working capital. In many cases, moreover, these borrowers will effectively syndicate a loan themselves, using the arranger simply to craft documents and administer the process. For leveraged issuers, the story is a very different one for the arranger, and, by “different,” we mean more lucrative. A new leveraged loan can carry an arranger fee of 1% to 5% of the total loan commitment, generally speaking, depending on (1) the complexity of the transaction, (2) how strong market conditions are at the time, and (3) whether the loan is underwritten. Merger and acquisition (M&A) and recapitalization loans will likely carry high fees, as will exit financings and restructuring deals. Seasoned leveraged issuers, by contrast, pay lower fees for refinancings and add-on transactions.

Because investment-grade loans are infrequently used and, therefore, offer drastically lower yields, the ancillary business is as important a factor as the credit product in arranging such deals, especially because many acquisition-related financings for investment-grade companies are large in relation to the pool of potential advisors, which would consist solely of banks.
The “retail” market for a syndicated loan consists of banks and, in the case of leveraged transactions, finance companies, hedge funds, and institutional investors. The balance of power among these different investors groups is different in the U.S. than in Europe. The U.S. has a capital market where pricing is linked to credit quality and institutional investor appetite. In Europe, although institutional investors have increased their market presence over the past few years, banks remain a key part of the market. Consequently, although market-flex language has become standard, pricing is not yet fully driven by capital market forces.

Banks have historically dominated the European debt markets because of the intrinsically regional nature of the arena. Regional banks have traditionally funded local and regional enterprises because they are familiar with regional issuers and can fund in the local currency. Since the eurozone was formed in 1998, the growth of the European leveraged loan market has been fuelled by the efficiency provided by this single currency as well as an overall growth in M&A activity, particularly leveraged buyouts (LBO) due to private equity activity. Regional barriers [and sensitivities toward consolidation across borders] have fallen, economies have grown, and the euro has helped to bridge currency gaps.

Until the credit crunch hit, more and more leveraged buyouts occurred and grew in size as arrangers have been able to raise bigger pools of capital to support larger, multinational transactions. To fuel the growing market, a broader array of banks from multiple regions now funds these deals, along with European institutional investors as well as U.S. institutional investors. The LBO market has since begun to recover, and although these deals are not as aggressive as they were in the bull market days, syndication does follow a similar pattern.

The European market has taken advantage of many of the lessons from the U.S. market while maintaining its regional diversity. In Europe, the regional diversity allows banks to maintain a significant lending influence and fosters private equity’s dominance in the market.

The “retail” market for a syndicated loan consists of banks and, in the case of leveraged transactions, finance companies and institutional investors. Before formally launching a loan to these retail accounts, arrangers will often get a market read by informally polling select investors to gauge their appetite for the credit. Based on these discussions, the arranger will launch the credit at a spread and fee it believes will clear the market. In the early years of the market, once the pricing was set, it was set, except in the most extreme cases. If the loan were undersubscribed, the arrangers could very well be left above their desired hold level. After the 2007 credit crunch, however, arrangers have adopted market-flex language, which allows them to change the pricing of the loan based on investor demand—in some cases within a predetermined range—as well as shift amounts between various tranches of a loan, as a standard feature of loan commitment letters.

Initially, arrangers invoked flex language to make loans more attractive to investors by hiking the spread or lowering the price. However, market-flex can also be used as a tool either to increase or decrease pricing of a loan, based on investor reaction.

Using market flex, a loan syndication today can function as a “book-building” exercise, in bond-market parlance. A loan is originally launched to market at a target spread or with a range of spreads referred to as price talk [i.e., a target spread of, say, LIBOR+250 to LIBOR+275]. Investors then will make commitments that in many cases are tiered by the spread. For example, an account may put in for $25 million at LIBOR+275 or $15 million at LIBOR+250. At the end of the process, the arranger will total up the commitments and then make a call on where to price the paper. Following the example above, if the paper is oversubscribed at LIBOR+250, the arranger may slice the spread further. Conversely, if it is undersubscribed even at LIBOR+275, then the arranger will be forced to raise the spread to bring more money to the table.

**Types Of Syndications**

Globally, there are three types of syndications: an underwritten deal, a “best-efforts” syndication, and a “club deal.” The European leveraged syndicated loan market almost exclusively consists of underwritten deals, whereas best-efforts
deals are common in the U.S. for opportunistic transactions.

**Underwritten deal**

An underwritten deal is one for which the arrangers guarantee the entire commitment, and then syndicate the loan. If arrangers cannot fully subscribe the loan, they are forced to absorb the difference, which they may later try again to sell to investors. This is easy, of course, if market conditions or the credit’s fundamentals improve. If not, the arranger may be forced to sell at a discount and, potentially, even take a loss on the paper. Or the arranger may just be left above its desired hold level of the credit. So, why do arrangers underwrite loans? First, offering an underwritten loan can be a competitive tool to win mandates. Second, underwritten loans usually require more lucrative fees because the agent is on the hook if potential lenders balk. Of course, with flex-language now widely accepted, underwriting a deal does not carry the same risk as it did when the pricing was set in stone before syndication.

**Best-efforts syndication**

A best-efforts syndication is one for which the arranger group commits to underwrite less than the entire amount of the loan, leaving the credit to the vicissitudes of the market. If the loan is undersubscribed, the credit may not close—or may need major surgery to clear the market.

**Club deal**

A “club deal” is a smaller loan (usually €50 million–€150 million, but as high as €300 million) that is premarketed to a group of relationship lenders. The arranger is generally a first among equals, and each lender gets a full cut, or nearly a full cut, of the fees. Club deals are traditionally rare from the perspective of transactions syndicated across regions, but they are common regional plays in Europe, where regional banks provide the funding.

Club deals became much more prominent during 2008/2009 as the credit crunch sidelined the bulk of institutional investors, and banks scaled back their lending. During this period club deals of more than €150 million became common.

**The Syndication Process**

**Purpose and preparation in leveraged lending**

Leveraged transactions fund a number of purposes. They provide support for general corporate purposes, including capital expenditures, working capital, and expansion. They refinance the existing capital structure or support a full recapitalization including, not infrequently, the payment of a dividend to the equity holders. Their primary purpose, however, is to fund M&A activity, specifically leveraged buyouts, where the buyer uses the debt markets to acquire the acquisition target’s equity.

The core of European leveraged lending comes from borrowers owned by private equity funds. In the U.S., these are called “sponsored transactions.” In Europe, all sponsor-related activity, including refinancings and recapitalizations, are referred to as LBOs.

The transaction originates well before lenders see the transaction’s terms. In an LBO, the company is first put up for auction. A company that is for the first time up for sale to private equity sponsors is a primary LBO. A secondary LBO is one that is going from one sponsor to another sponsor [and a tertiary LBO is one that is going for the second time from sponsor to sponsor]. A public-to-private transaction (P2P) occurs when a company is going from the public domain to a private equity sponsor.

As prospective acquirers are evaluating target companies, they are also lining up debt financing. A staple financing package may be on offer as part of the sale process. By the time the auction winner is announced, that acquirer usually has funds lined up via a financing package funded by its designated mandated lead arrangers (MLA).

Where the loan is not part of a competitive auction, an issuer usually solicits bids from arrangers before awarding a mandate. The competing banks will outline their syndication strategy and qualifications, as well as their view on the way the loan will price in the market. In Europe, where mezzanine funding is a market standard, issuers may choose to pursue a dual track approach to syndication whereby the MLAs handle the senior debt and a specialist mezzanine fund oversees placement of the subordinated mezzanine portion.
The information memo, or "bank book"

Before awarding a mandate, an issuer might solicit bids from arrangers. The banks will outline their syndication strategy and qualifications, as well as their view on the way the loan will price in the market. Once the mandate is awarded, the syndication process starts. The arranger will prepare an information memo (IM) describing the terms of the transactions. The IM typically will include an executive summary, investment considerations, a list of terms and conditions, an industry overview, and a financial model. Because loans are not securities, this will be a confidential offering made only to qualified banks and accredited investors.

If the issuer is speculative grade and seeking capital from nonbank investors, the arranger will often prepare a "public" version of the IM. This version will be stripped of all confidential material such as management financial projections so that it can be viewed by accounts that operate on the public side of the wall or that want to preserve their ability to buy bonds or stock or other public securities of the particular issuer [see the Public Versus Private section]. Naturally, investors that view materially nonpublic information of a company are disqualified from buying the company’s public securities for some period of time.

As the IM (or "bank book," in traditional market lingo) is being prepared, the syndicate desk will solicit informal feedback from potential investors on what their appetite for the deal will be and at what price they are willing to invest. Once this intelligence has been gathered, the agent will formally market the deal to potential investors. Arrangers will distribute most IMs—along with other information related to the loan, pre- and post-closing—to investors through digital platforms. Leading vendors in this space are Intralinks, Syntrak, and Debt Domain.

The IM typically contain the following sections:

- The executive summary will include a description of the issuer, an overview of the transaction and rationale, sources and uses, and key statistics on the financials.
- Investment considerations will be, basically, management’s sales “pitch” for the deal.
- The list of terms and conditions will be a preliminary term sheet describing the pricing, structure, collateral, covenants, and other terms of the credit (covenants are usually negotiated in detail after the arranger receives investor feedback).
- The industry overview will describe the company’s industry and competitive position relative to its industry peers.
- The financial model will be a detailed model of the issuer’s historical, pro forma, and projected financials including management’s high, low, and base case for the issuer.

Most new acquisition-related loans are kicked off at a bank meeting at which potential lenders hear management and the sponsor group [if there is one] describe what the terms of the loan are and what transaction it backs. Some bank meetings are conducted via a Webex or conference call, although many issuers prefer in-person gatherings.

At the meeting, management will provide its vision for the transaction and, most important, tell why and how the lenders will be repaid on or ahead of schedule. In addition, investors will be briefed regarding the multiple exit strategies, including second ways out via asset sales. (If it is a small deal or a refinancing instead of a formal meeting, there may be a series of calls or one-on-one meetings with potential investors.)

Once the loan is closed, the final terms are then documented in detailed credit and security agreements. Subsequently, liens are perfected and collateral is attached.

Loans, by their nature, are flexible documents that can be revised and amended from time to time. These amendments require different levels of approval [see Voting Rights section]. Amendments can range from something as simple as a covenant waiver to something as complex as a change in the collateral package or allowing the issuer to stretch out its payments or make an acquisition.

The loan investor market

Loans are "launched" to the market in a series of steps. The roles of each of the players in the each of those phases are based on their relationships in the market and access to paper. On the arrangers’ side, the players are determined by how well they can access capital in the market and bring in lenders. On the lenders’ side, it’s about getting access to as many deals as possible.
There are three primary phases of syndication. During the underwriting phase, the sponsor or corporate borrower designates the MLA (or the group of MLAs) and the deal is initially underwritten. During the subunderwriting phases, other arrangers are brought into the deal. In general syndication, the transaction is opened up to the institutional investor market, along with other banks that are interested in participating in the transaction.

There are two primary investor constituencies in Europe: banks and institutional investors.

Banks, in this case, can be either a commercial bank, a savings and loan institution, or a securities firm that usually provides investment-grade loans. These are typically large revolving credits that back commercial paper or are used for general corporate purposes or, in some cases, acquisitions. In Europe, the banking segment is almost exclusively made up of commercial banks. For leveraged loans, banks typically provide any unfunded revolving credits, letters of credit (LOC), and amortizing term loans, under a syndicated loan arrangement.

Institutional investors in the loan market are principally structured vehicles known as collateralized loan obligations (CLO). In addition, private equity funds, hedge funds, high-yield bond funds, pension funds, insurance companies, and other proprietary investors also participate in loans.

CLOs are special-purpose vehicles set up to hold and manage pools of leveraged loans. The special-purpose vehicle is financed with several tranches of debt [typically a ‘AAA’ rated tranche, a ‘AA’ tranche, a ‘BBB’ tranche, and a mezzanine tranche] that have rights to the collateral and payment stream in descending order. In addition, there is an equity tranche, but the equity tranche is usually not rated. CLOs are created as arbitrage vehicles that generate equity returns through leverage, by issuing debt 10 to 11 times their equity contribution. There also are market-value CLOs that are less leveraged—typically three to five times—and allow managers more flexibility than more tightly structured arbitrage deals. CLOs are usually rated by two of the three major ratings agencies and impose a series of covenant tests on collateral managers, including minimum rating, industry diversification, and maximum default basket.

Through 2005–2007, CLOs became the dominant institutional investor vehicle in Europe, but other vehicles, such as credit funds, also took a share of the market. This share began to fall, once the 2007 credit crunch halted CLO issuance in Europe.

Credit funds are open-ended pools of debt investments. Unlike CLOs, however, they are not subject to ratings oversight or restrictions regarding industry or rating diversification. They are generally lightly levered [two to three times] or unlevered and allow managers significant freedom in picking and choosing investments and are subject to being marked to market.

Mezzanine funds are also investment pools, which traditionally focused on the mezzanine market only. However, when second lien entered the market, it eroded the mezzanine market. Consequently, mezzanine funds expanded their investment universe and began to commit to second lien as well as payment-in-kind (PIK) portions of transactions. As with credit funds, these pools are not subject to ratings oversight or diversification requirements, and allow managers significant freedom in picking and choosing investments. Mezzanine funds are, however, riskier than credit funds in that they carry both debt and equity characteristics.

Prime funds allow U.S. retail investors to access the loan market. They are mutual funds that invest in leveraged loans and are sold only in the U.S.—there is no European equivalent. However, U.S. prime funds have made significant allocations to investments in European loans; an estimated 10% of some of the largest funds in the U.S. are available for funding European loans.

Public Versus Private

In Europe, the line between public and private information in the loan market is far simpler than in the U.S. European loans are strictly on the private side of the wall and any information transmitted between the issuer and the lender group is considered confidential. High-yield bonds are public instruments. However, because most European debt is in the form of loans, privacy reigns.

In the U.S., since the late 1980s, that line has begun to blur as a result of two market innovations. The first was more active secondary trading that sprung up to support
the entry of nonbank investors in the market, such as insurance companies and loan mutual funds and (2) to help banks sell rapidly expanding portfolios of distressed and highly leveraged loans that they no longer wanted to hold. This meant that parties that were insiders on loans might now exchange confidential information with traders and potential investors who were not (or not yet) a party to the loan. The second innovation that weakened the public-private divide was trade journalism that focuses on the loan market. In Europe, the same trends began to emerge, thanks in part to a period of rapid growth in the institutional investor base.

Nonetheless, there has been growing concern among issuers, lenders, and regulators in the U.S. and Europe that this migration of once-private information into public hands might breach confidentiality agreements between lenders and issuers and, more importantly, could lead to illegal trading. The market has contended with these issues through:

- **Traders.** To insulate themselves from violating regulations, some dealers and buy-side firms have set up their trading desks on the public side of the wall. Consequently, traders, salespeople, and analysts do not receive private information even if somewhere else in the institution the private data are available. This is the same technique that investment banks have used from time immemorial to separate their private investment banking activities from their public trading and sales activities.

- **Underwriters.** As mentioned above, in most primary syndications, arrangers will prepare a public version of an information memo that is scrubbed of private information like projections. These IMs will be distributed to accounts that are on the public side of the wall. As well, underwriters will ask public accounts to attend a public version of the bank meeting and distribute to these accounts only scrubbed financial information.

- **Buy-side accounts.** On the buy side there are firms that operate on either side of the public-private fence. Accounts that operate on the private side receive all confidential materials and agree to not trade in public securities of the issuers for which they get private information. These groups are often part of wider investment complexes that do have public funds and portfolios but, via Chinese walls, are sealed from these parts of the firms. There are also accounts that are public. These firms take only public IMs and public materials and, therefore, retain the option to trade in the public securities markets even when an issuer for which they own a loan is involved. This can be tricky to pull off in practice because in the case of an amendment the lender could be called on to approve or decline in the absence of any real information. Or, the account could either designate one person who is on the private side of the wall to sign off on amendments or empower its trustee or the loan arranger to do so. But it’s a complex proposition.

- **Vendors.** Vendors of loan data, news, and prices also face many challenges in managing the flow of public and private information. In general, the vendors operate under the freedom of the press provision of the U.S. Constitution’s First Amendment and report on information in a way that anyone can simultaneously receive it—for a price of course. Therefore, the information is essentially made public in a way that doesn’t deliberately disadvantage any party, whether it’s a news story discussing the progress of an amendment or an acquisition, or it’s a price change reported by a mark-to-market service. This, of course, doesn’t deal with the underlying issue that someone who is a party to confidential information is making it available via the press or prices to a broader audience.

Another way in which participants deal with the public-versus-private issue is to ask counterparties to sign “big-boy” letters. These letters typically ask public-side institutions to acknowledge that there may be information they are not privy to and they are agreeing to make the trade in any case. They are, effectively, “big boys” who will accept the risks.

**Credit Risk: An Overview**

Pricing a loan requires arrangers to evaluate the risk inherent in a loan and to gauge investor appetite for that risk. The principal credit risk factors that banks and institutional investors contend with in buying loans are default risk and loss-given-default
risk. Among the primary ways that accounts judge these risks are ratings, credit statistics, industry sector trends, management strength, and sponsor. All of these, together, tell a story about the deal.

Brief descriptions of the major risk factors follow.

**Default risk**

Default risk is simply the likelihood of a borrower’s being unable to pay interest or principal on time. It is based on the issuer’s financial condition, industry segment, and conditions in that industry and economic variables and intangibles, such as company management. Default risk is most visibly expressed by a public rating from Standard & Poor’s Ratings Services or another ratings agency. These ratings range from ‘AAA’ for the most creditworthy loans to ‘CCC’ for the least. The market is divided, roughly, into two segments: investment grade (loans rated ‘BBB-’ or higher) and leveraged (borrowers rated ‘BB+’ or lower). Default risk, of course, varies widely within each of these broad segments.

The European market is less transparent because public ratings are not commonly required to get a deal syndicated. This is a by-product of the bank dominance of the investor market as well as the strong relationship that exists between lenders and sponsors. Investors rely on their own understanding of default risk and their own assessment of the credit, rather than relying on independent credit analysis. CLO managers need ratings on the credits they invest in, to comply with their internal tests, but they usually obtain private “credit estimates” from ratings agencies, rather than full public ratings.

It is important to note that default risk is much harder to quantify in Europe than in the U.S. because distressed transactions tend to privately restructure rather than publicly default. Due to the nature of the U.S. bankruptcy courts, their transparency and focus on restructuring versus liquidation, both borrowers and lenders are comfortable with public defaults. In Europe, both parties are subject to the vagaries of the array of bankruptcy regimes; as a result, they are more likely to come to a private restructuring and the influence and support provided by sponsors in these events cannot be underestimated.

Up until the end of 2008, ratings in Europe were still primarily private, but as of December 2008, Standard & Poor’s will no longer give credit estimates on deals where the debt is worth more than €750 million, signaling a shift toward a greater role for public ratings in Europe.

**Loss-given-default risk**

Loss-given-default risk measures how severe a loss the lender would incur in the event of default. Investors assess this risk based on the collateral (if any) backing the loan as well as the amount of any priority debt and other claims that may affect the likely level of recoveries. Lenders will also look to covenants to provide a way of coming back to the table early—that is, before other creditors—and renegotiating the terms of a loan if the issuer fails to meet financial targets. Investment-grade loans are, in most cases, senior unsecured instruments with loosely drawn covenants that apply only at incurrence, that is, only if an issuer makes an acquisition or issues debt. As a result, loss given default may be no different from risk incurred by other senior unsecured creditors. Leveraged loans, by contrast, are, in virtually all cases, senior secured instruments with tightly drawn maintenance covenants, i.e., covenants that are measured at the end of each quarter whether or not the issuer carries out any additional fund raising. Loan holders, therefore, almost always are first in line among prepetition creditors and, in many cases, are able to renegotiate with the issuer before the loan becomes severely impaired. It is no surprise, then, that loan investors historically fare much better than other creditors on a loss-given-default basis.

**Credit statistics**

Credit statistics are used by investors to help calibrate both default risk and loss-given-default risk. These statistics include a broad array of financial data, including credit ratios measuring leverage (debt to capitalization and debt to EBITDA) and coverage (EBITDA to interest, EBITDA to debt service, operating cash flow to fixed charges). Of course, the ratios investors use to judge credit risk vary by industry. In addition to looking at trailing and pro forma ratios, investors look at management’s projections and the assumptions behind these projections to see if the issuer’s game plan will allow it to pay...
its debt comfortably. There are ratios that are most geared to assessing default risk. These include leverage and coverage. Then there are ratios that are suited for evaluating loss-given-default risk. These include collateral coverage, or the value of the collateral underlying the loan relative to the size of the loan. The ratio of senior secured loans to junior debt in the capital structure is also used. Logically, the likely severity of loss-given-default for a loan increases with the size of the loan as a percentage of the overall debt structure. After all, if an issuer defaults on $100 million of debt, of which $10 million is in the form of senior secured loans, the loans are more likely to be fully covered in bankruptcy than if the loan totals $90 million.

Industry sector

Industry is a factor, because sectors, naturally, go in and out of favor. For that reason, having a loan in a desirable sector can really help a syndication along. Also, loans to issuers in defensive sectors (like consumer products) can be more appealing in a time of economic uncertainty, whereas cyclical borrowers (like chemicals or autos) can be more appealing during an economic upswing.

The European market is not as industry diversified as the U.S. market, and is primarily dominated by a handful of industries such as cable, telecom, services, and chemicals.

Sponsorship

Sponsorship is a factor, too. Needless to say, many leveraged companies are owned by one or more private equity firms. These entities, such as Kohlberg Kravis & Roberts or Carlyle Group, invest in companies that have leveraged capital structures. To the extent that the sponsor group has a strong following among loan investors, a loan will be easier to syndicate and, therefore, can be priced lower. In contrast, if the sponsor group does not have a loyal set of relationship lenders, the deal may need to be priced higher to clear the market. Among banks, investment factors may include whether or not the bank is party to the sponsor’s equity fund. Among institutional investors, weight is given to an individual deal sponsor’s track record in fixing its own impaired deals by stepping up with additional equity or replacing a management team that is failing.

Syndicating A Loan By Facility

Most loans are structured and syndicated to accommodate the two primary syndicated lender constituencies: banks (domestic and foreign) and institutional investors (primarily structured finance vehicles, mutual funds, and insurance companies). As such, leveraged loans consist of two parts:

- **Pro rata debt** consists of the revolving credit and amortizing term loan (TLa), which are packaged together and, usually, syndicated to banks. In some loans, however, institutional investors take pieces of the TLa and, less often, the revolving credit, as a way to secure a larger institutional term loan allocation. Why are these tranches called “pro rata”? Because arrangers historically syndicated revolving credit and TLas on a pro rata basis to banks and finance companies.

- **Institutional debt** consists of term loans structured specifically for institutional investors, although there are also some banks that buy institutional term loans, especially in Europe. These tranches used to include first-lien TLb and TLc facilities, and second-lien loans, although TLc tranches have become rare since the 2007 credit crunch. Traditionally, institutional tranches were referred to as TLbs because they were bullet payments and lined up behind TLas.

The mechanism of structural flex allows arrangers to adapt the overall distribution of debt between first lien, second lien, and mezzanine to current market conditions. Under highly liquid market conditions, arrangers can structurally “flex” the deal by moving debt from the more expensive tranches, such as mezzanine, to less expensive tranches, like second or first lien. Likewise, in more difficult times, arrangers can do the opposite and move debt from first lien into second lien and second lien into mezzanine to complete syndication of the debt.

Pricing A Loan In The Primary Market

Pricing loans for the U.S. institutional market is a straightforward exercise based on simple risk/return consideration and market technicals. Pricing loans for the U.S. bank market, however, is more complex. Indeed, banks often invest in loans for more than pure spread income—they are also
driven by the overall profitability of the issuer relationship, including noncredit revenue sources.

Pricing loans in Europe is a simpler, but less efficient, process because pricing is not as flexible and market-driven as it is in the U.S. For many years, the European market had a well-established pricing “standard” where most deals started out. The pro rata tranches usually began general syndication at Euribor+225. The institutional tranches were each usually priced up by about 50 bps so the TLb was at Euribor+275 and the TLC at Euribor+325.

Until the market turned in July 2007, a rapidly decreasing number of deals opened at the old “standard” levels, and these were mainly more difficult or less liquid credits. The majority of mainstream deals launched at the slightly lower level of Euribor+200/250/300, in response to heavy demand for assets. However, once the market slowed down, the opening spread level on deals began to rise back up to, as well as above, the old “standard” levels.

During the credit crunch of 2008/2009, opening spreads increased to between Euribor+400-500 across the TLa and TLb, in response to the higher return requirements of investors, and have remained in that area or higher since.

Market flex language has also played a big part in adjusting spreads to market liquidity levels. Over the past few years, Europe adopted the U.S. practice of using market flex language to adapt pricing during general syndication a little more to market conditions. Until the liquidity crunch, the vast majority of flexes were downward, allowing borrowers to take advantage of the current hyper-liquid market conditions by reducing pricing and only a handful of upward flexes had occurred to make transactions struggling in syndication more appealing to investors. However, once the market turned bearish, market flex language allowed arrangers to upward flex pricing in an effort to reengage reluctant investors.

Pricing loans for bank investors
Banks operating in the European market vary considerably in their approach to booking risk in the form of leveraged loans. Over time, thanks in part to tightening regulation governing core capital requirements, some firms have stepped away from leveraged loans entirely, while others decided they could only lend if they earned additional fees from an arranging role. Others continue to run a portfolio of leveraged loans, and do so without needing ancillary business to make the investment more attractive. On the whole, the spread is of lesser importance to a typical European bank lender, compared with the bank’s own internal assessment of the credit risk.

As of September 2011, banks still made up 46% of the loan investor base. However, the bank landscape was shifting through 2011 and was expected to continue to change as banks reassess their commitment to the product. Banks that do stay engaged are likely to become more focused on spreads, to make leveraged lending attractive despite the risk capital requirements imposed by Basel III.

Pricing loans for institutional players
In pricing loans to institutional investors, it’s a matter of the spread of the loan relative to credit quality and market-based factors. This second category can be divided into liquidity and market technicals (i.e., supply/demand). Liquidity is the tricky part, but, as in all markets, all else being equal, more liquid instruments command thinner spreads than less liquid ones. In the old days—before institutional investors were the dominant investors and banks were less focused on portfolio management—the size of a loan didn’t much matter. Loans sat on the books of banks and stayed there. But now that institutional investors and banks put a premium on the ability to package loans and sell them, liquidity has become important. As a result, smaller executions—generally those of $200 million or less—tend to be priced at a premium to the larger loans. Of course, once a loan gets large enough to demand extremely broad distribution, the issuer usually must pay a size premium. The thresholds range widely. During the go-go mid-2000s, it was upwards of $10 billion. During the more parsimonious late-2000s, $1 billion was considered a stretch.

Market technicals, or supply relative to demand, is a matter of simple economics. If there are a lot of dollars chasing little product, then, naturally, issuers will be able to command lower spreads. If, however, the opposite is true, then spreads will need to increase for loans to clear the market.
Relative value. Institutional investors can buy paper in the secondary market as well as in primary, so arrangers also have to price primary issuance to be competitive against the value on offer in secondary. This can include the trading price of the issuer’s outstanding debt (if any), the price of comparable loans, and the price of comparable high-yield bonds.

Types Of Syndicated Loan Facilities

There are four main types of syndicated loan facilities:

- A revolving credit (within which are options for swingline loans, multicurrency-borrowing, competitive-bid options, term-out, and evergreen extensions);
- A term loan;
- An LOC; and
- An acquisition or equipment line (a delayed-draw term loan).

A revolving credit line allows borrowers to draw down, repay, and reborrow as often as necessary. The facility acts much like a corporate credit card, except that borrowers are charged an annual commitment fee on unused amounts, which drives up the overall cost of borrowing (the facility fee). Revolvers to speculative-grade issuers in the U.S. are often tied to borrowing-base lending formulas. This limits borrowings to a certain percentage of collateral, most often receivables and inventory. In Europe, revolvers are primarily designated to fund working capital or capital expenditures (capex). Revolving credits often run for 364 days. These revolving credits—called, not surprisingly, 364-day facilities—are generally limited to the investment-grade market. The reason for what seems like an odd term is that regulatory capital guidelines mandate that, after one year of extending credit under a revolving facility, banks must then increase their capital reserves to take into account the unused amounts. Therefore, banks can offer issuers 364-day facilities at a lower unused fee than a multiyear revolving credit. There are a number of options that can be offered within a revolving credit line:

- A swingline is a small, overnight borrowing line, typically provided by the agent.
- A multicurrency line may allow the borrower to borrow in several currencies.
- A competitive-bid option (CBO) allows borrowers to solicit the best bids from its syndicate group. The agent will conduct what amounts to an auction to raise funds for the borrower, and the best bids are accepted. CBOs typically are available only to large, investment-grade borrowers.
- A term-out will allow the borrower to convert borrowings into a term loan at a given conversion date. This, again, is usually a feature of investment-grade loans. Under the option, borrowers may take what is outstanding under the facility and pay it off according to a predetermined repayment schedule. Often the spreads ratchet up if the term-out option is exercised.
- An evergreen is an option for the borrower—with consent of the syndicate group—to extend the facility each year for an additional year.

A term loan is simply an installment loan, such as a loan one would use to buy a car. The borrower may draw on the loan during a short commitment period and repays it based on either a scheduled series of repayments or a one-time lump-sum payment at maturity bullet payment). There are two principal types of term loans:

- An amortizing term loan (A-term loans, or TLa) is a term loan with a progressive repayment schedule that typically runs six years or less in the U.S., or seven years in Europe. These loans are normally syndicated to banks along with revolving credits as part of a larger syndication.
- An institutional term loan (B-term, C-term, or D-term loans) is a term-loan facility with a portion carved out for nonbank, institutional investors. These loans are priced higher than amortizing term loans because they have longer maturities and bullet repayment schedules. This institutional category also includes second-lien loans and “covenant-lite” loans, which are described below.

LOCs differ, but, simply put, they are guarantees provided by the bank group to pay off debt or obligations if the borrower cannot.

Acquisition/equipment lines (delayed-draw term loans) are credits that may be drawn down for a given period to purchase specified assets or equipment or to make acquisitions. The issuer pays a fee during the commitment period (a ticking fee). The lines are then repaid over a specified period (the term-out period). Repaid amounts may not be reborrowed.
Second-Lien Loans

Second-lien loans are another classic example of a U.S. import to the Europe leveraged loan market. This asset class came to Europe in 2004, but its U.S. history goes back to the mid-1990s. These facilities fell out of favor after the Russian debt crisis caused investors to adopt a more cautious tone. But after default rates fell precipitously in 2003, arrangers in the U.S. rolled out second-lien facilities to help finance issuers struggling with liquidity problems. By 2005, the market had accepted second-lien loans to finance a wide array of transactions, including acquisitions and recapitalizations.

However, second lien never served as rescue financing in Europe. By the time it reached this side of the Atlantic, it joined the ranks of mezzanine as a financing alternative for private equity backed transactions, including buyouts and recapitalizations and for a time it became almost an intrinsic part of an LBO financing.

As their name implies, the claims on collateral of second-lien loans stand behind those of first-lien loans but ahead of bonds and mezzanine.

Unlike the U.S. (where second-lien loans also typically have less restrictive covenant packages in which maintenance covenant levels are set wider than the first-lien loans), European second-lien credits share the same covenant package as first-lien facilities.

Due to its secondary ranking in the priority line, second-lien deals carry a spread premium over its first-lien counterparts. For example, during the market boom, the TLb/TLc tranches had an average spread of anywhere from Euribor+275 to Euribor+325, while the average second lien is priced in the Euribor+500 area. But pricing varied widely depending on the complexity and riskiness of the underlying credit. Second-lien loans became much less common in the wake of the 2007 credit crunch as investor appetite for these tranches evaporated. By 2011, second-lien made rare appearances as arrangers searched for different pools of liquidity.

Mezzanine Loans

A mezzanine loan is a subordinated instrument that carries second-ranking security or third-ranking security if the capital structure also includes second lien. Historically, mezzanine has been a financing option of choice for small transactions, while the high-yield bond market provided subordinated financing for large deals. However, mezzanine has extended its reach to include large deals, becoming a staple of LBO financings ranging in size from €10 million to €1 billion.

Mezzanine is popular with private equity groups because unlike public high-yield bonds, it is a private instrument, syndicated to a group of lenders ranging from traditional shops that specialize in mezzanine to new investors, such as hedge funds. In addition to being subordinated debt, mezzanine includes a number of unique features. The interest consists of a cash and PIK margin above a base rate. Due to its secondary or tertiary position in the priority line, the total margin is considerably higher than on senior bank loans. In 2011, it ranged from from Euribor+1,000 to Euribor+1,200, depending on the tranche’s size and credit quality, and on the level of appetite for mezzanine.

In addition to spread, mezzanine has traditionally included warrants to provide lenders an unlimited upside potential should the issuer perform well. Deals with warrants carry lower spreads than those without them. Mezzanine often has a non-call provision, for one to three years, plus prepayment penalties at 102 bps and 101 bps in subsequent years. This also appeals to private equity groups because when they decide to exit the company it will be cheaper to repay mezzanine than high-yield bonds, which have longer non-call periods.

This instrument carries the same financial covenants as senior bank loans. Some facilities have identical covenant levels as the first ranking debt while others include a “haircut.” “Haircut” refers to how much looser the mezzanine covenants are compared with senior debt. Usually this number is around 10%.

The standard mezzanine standstill periods are either 60/90/120 days or 90/120/150 days for mezzanine payment defaults/financial covenant defaults/other mezzanine defaults, respectively. During the 2008/2009 credit crunch, mezzanine tranches were less common in LBO structures as mezzanine funds sought much higher spreads—in the mid- to high teens—on these tranches to compensate for losses on restructured deals. Private equity subsequently switched to all-senior structures where possible, and also...
began to make greater use of the high-yield bond market.

**Covenant-Lite Loans**

Like second-lien loans, covenant-lite loans are really just another type of syndicated loan facility. But they also are sufficiently different to warrant their own section in this primer. At the most basic level, covenant-lite loans are loans that have bond-like financial incurrence covenants rather than traditional maintenance covenants that are normally part and parcel of a loan agreement.

Incurrence covenants generally require that if an issuer takes an action (paying a dividend, making an acquisition, issuing more debt), it would need to still be in compliance. So, for instance, an issuer that has an incurrence test that limits its debt to 5x cash flow would only be able to take on more debt if, on a pro forma basis, it was still within this constraint. If, not then it would have breached the covenant and be in technical default on the loan. If, on the other hand, an issuer found itself above this 5x threshold simply because its earnings had deteriorated, it would not violate the covenant.

Maintenance covenants are far more restrictive. This is because they require an issuer to meet certain financial tests every quarter whether or not it takes an action. So, in the case above, had the 5x leverage maximum been a maintenance rather than incurrence test, the issuer would need to pass it each quarter and would be in violation if either its earnings eroded or its debt level increased. For lenders, clearly, maintenance tests are preferable because it allows them to take action earlier if an issuer experiences financial distress. What’s more, the lenders may be able to wrest some concessions from an issuer that is in violation of covenants (a fee, incremental spread, or additional collateral) in exchange for a waiver.

Conversely, issuers prefer incurrence covenants precisely because they are less stringent. Covenant-lite loans, therefore, thrive only in the hottest markets when the supply/demand equation is tilted persuasively in favor of issuers.

Covenant-lite loans made only a brief appearance in the European market, and disappeared with the credit crunch.

**Toggle Facilities**

Toggle facilities are primarily a by-product of hyper-liquid markets. They provide issuers with a “pay if you want” feature that allows them to switch off any cash-pay element and convert all spread to PIK without consulting the lending group. The toggle feature has appeared on second-lien as well as mezzanine facilities.

**Cross-Border Loans**

Cross-border loans are transactions that are syndicated simultaneously into multiple markets. The most common cross-border transaction is one that is sold to both U.S. and European investors. However, cross-borders can also be transactions sold in Asia and the U.S., Asia and Europe, or even Asia, the U.S., and Europe.

The tranches that make up a cross-border loan are denominated in currencies to match the markets that they are being sold to. Thus, the U.S. portion of a cross-border will be denominated in U.S. dollars and the European portion will be denominated in euros.

For a cross-border transaction to be viable, the issuer must have operations in all of the markets that it is selling debt to. For example, a traditionally U.S. issuer, such as HCA Inc., must also have assets and/or business in Europe to support a euro tranche sold to European investors.

**Lender Titles**

Lender titles in Europe reflect either the banks’ position in the arrangement and underwriting of the transaction or their administrative role. The MLA designation remains the most significant lender title for the bank (or banks) providing the primary arrangement and initial underwriting, and receiving the majority of fees. As the loan market has grown and matured, however, the array of other lender titles has proliferated.

The largest lenders aside from the MLAs are typically designated joint lead arrangers (JLA). The JLAs make the largest underwriting commitments and, in turn, receive the largest fees. Titles assigned during general syndication include arranger, co-arranger, and lead manager. These titles have become largely ceremonial, routinely awarded for what amounts to no more than large retail commitments in exchange for upfront fees.
The primary administrative title is that of bookrunner (or joint bookrunner when there is more than one bank involved). The bookrunner role is almost always assigned to the MLA[s] and it takes on the administrative tasks generally associated with the administrative agent and syndication in the U.S.

The other administrative titles seen regularly in the European market are the facility agent and security agent. The facility agent administers the syndicate, keeping track of syndicate members’ commitments, repayments, secondary trades, and also handling alterations to documentation via waivers.

The security agent oversees the management of the underlying security, particularly with regards to the intercreditor agreement and guarantees. This role occurs primarily only in the case of complex security packages.

Secondary Sales
Secondary sales occur after the loan is closed and allocated, when investors are free to trade the paper. Loan sales are structured as either assignments or participations, with investors usually trading through dealer desks at the large underwriting banks. Dealer-to-dealer trading is almost always conducted through a “street” broker.


Assignments
In an assignment, the assignee becomes a direct signatory to the loan and receives interest and principal payments directly from the administrative agent.

Assignments typically require the consent of the borrower and agent. Consent may be withheld only if a reasonable objection is made and the borrower frequently loses its right to consent in the event of default.

The loan document usually sets a minimum assignment amount, usually £2.5 million–€5 million for pro rata commitments. In the late 1990s, however, administrative agents in the U.S. started to break out specific assignment minimums for institutional tranches, and Europe has since done likewise, typically setting the minimum size at €1 million–€2.5 million.

Participations
A participation is an agreement between an existing lender and a participant. As the name implies, it means the buyer is taking a participating interest in the existing lender’s commitment.

The lender remains the official holder of the loan, with the participant owning the rights to the amount purchased. Consents, fees, or minimums are almost never required. The participant has the right to vote only on material changes in the loan document (rate, term, and collateral). Nonmaterial changes do not require approval of participants. A participation can be a riskier way of purchasing a loan, because, if a lender becomes insolvent or defaults, the participant does not have a direct claim on the loan. In this case, the participant then becomes a creditor of the lender and often must wait for claims to be sorted out to collect on its participation.

Sub-participations are also a mechanism for transferring paper in Europe. In the case of a sub-participation, the participant has no right to vote as its position in the lending group is only based on its agreement with the lender of record.

Loan Derivatives
Loan credit default swaps
Traditionally, accounts bought and sold loans in the cash market through assignments and participations. Aside from that, there was little synthetic activity outside over-the-counter total rate of return swaps. By 2008, however, the market for synthetically trading loans was budding.

Loan credit default swaps (LCDS) are standard derivatives that have secured loans as reference instruments. In June 2006, The International Settlement and Dealers Association issued a standard trade confirmation for LCDS contracts.

Like all credit default swaps (CDS), an LCDS is basically an insurance contract. The seller is paid a spread in exchange for agreeing to buy at par, or a renegotiated price, a loan if that loan defaults. LCDS
enables participants to synthetically buy a loan by going short the CDS or to sell the loan by going long the CDS. Theoretically, then, a loanholder can hedge a position either directly (by buying CDS protection on that specific name) or indirectly (by buying protection on a comparable name or basket of names).

Moreover, unlike the cash markets, which are long-only markets for obvious reasons, the CDS market provides a way for investors to short a loan. To do so, the investor would buy protection on a loan that it doesn’t hold. If the loan subsequently defaults, the buyer of protection should be able to purchase the loan in the secondary market at a discount and then deliver it at par to the counterparty from which it bought the LCDS contract. For instance, say an account buys five-year protection for a given loan, for which it pays 250 bps per year. Then in year two the loan goes into default and the market price falls to 80% of par. The buyer of the protection can then buy the loan at 80 and deliver to the counterpart at 100, a 20-point pickup. Or instead of physical delivery, some buyers of protection may prefer a cash settlement in which the difference between the current market price and the delivery price is determined by polling dealers or using a third-party pricing service. Cash settlement could also be used if there’s not enough paper to physically settle all LCDS contracts on a particular loan.

**LCDX/LevX**

Introduced in 2006, the LevX is an index of 40 senior first-lien LCDS obligations that participants can trade. The index provides a straightforward way for participants to take long or short positions on a broad basket of loans, as well as to hedge their exposure to the market. A subordinated version of LevX was also established. However, both indices gradually became illiquid in the aftermath of the 2007 credit crunch and trading became very rare.

Introduced in 2007 in the U.S., LCDX is an index of 100 LCDS obligations.

Markit Group administers the LCDX, a product of CDS Index Co., a firm set up by a group of dealers. Like LCDS, the LCDX Index is an over-the-counter product.

The LCDX is reset every six months, with participants able to trade each vintage of the index that is still active. The index will be set at an initial spread based on the reference instruments and trade on a price basis. According to the primer posted by Markit [http://www.markit.com/information/affiliations/lcdx/alertParagraphs/01/document/LCDX%20Primer.pdf], “The two events that would trigger a payout from the buyer [protection seller] of the index are bankruptcy or failure to pay a scheduled payment on any debt [after a grace period], for any of the constituents of the index.”


**Total rate-of-return swaps**

This is the oldest way for participants to purchase loans synthetically. And, in reality, a total rate-of-return swap (TRS) is little more than buying a loan on margin. In simple terms, under a TRS program a participant buys the income stream created by a loan from a counterparty, usually a dealer. The participant puts down some percentage as collateral, say 10%, and borrows the rest from the dealer. Then the participant receives the spread of the loan minus the financial cost plus LIBOR on its collateral account. If the reference loan defaults, the participant must buy it at par or cash settle the loss based on a mark-to-market price or an auction price.

Here is how the economics of a TRS work, in simple terms. A participant buys via a TRS a $10 million position in a loan paying L+250. To effect the purchase, the participant puts $1 million in a collateral account and pays L+50 on the balance (meaning leverage of 9:1). Thus, the participant would receive:

- L+250 on the amount in the collateral account of $1 million, plus
- 200 bps (L+250 less the borrowing cost of L+50) on the remaining amount of $9 million.

The resulting income is LIBOR+250 times $1 million plus 200 bps times $9 million. Based on the participants’ collateral amount—or equity contribution—of $1 million, the return is L+2020. If LIBOR is 5%, the return is 25.5%. Of course, this is not a risk-free proposition. If the issuer defaults and the value of the loan goes to 70 cents on the euro, the participant will lose $3 million. And, if the loan does not default but is marked
down for whatever reason—market spreads widen, it is downgraded, its financial condition deteriorates—the participant stands to lose the difference between par and the current market price when the TRS expires. Or, in an extreme case, the value declines below the value in the collateral account and the participant is hit with a margin call.

Pricing Terms
Rates
Loans usually offer borrowers different interest-rate options. Several of these options allow borrowers to lock in a given rate for one month to one year. Pricing on many loans is tied to performance grids, which adjust pricing by one or more financial criteria. Pricing is typically tied to ratings in investment-grade loans and to financial ratios in leveraged loans.

Syndication pricing options are either a broad LIBOR, CD, and other fixed rate options:

- The prime is a floating-rate option. Borrowed funds are priced at a spread over the reference bank’s prime lending rate. The rate is reset daily, and borrowings may be repaid at any time without penalty. This is typically an overnight option, because the prime option is more costly to the borrower than LIBOR or CDs.

- The Euribor option is so called because, with this option, the interest on borrowings is set at a spread over Euribor for a period of one month to one year. The corresponding Euribor rate is used to set pricing. Borrowings cannot be prepaid without penalty.

- Local currency options. Facilities can fund in a number of currencies other than the euro, particularly the U.S. dollar and the British pound. U.S. dollar- and sterling-denominated tranches will generally use their respective LIBORs as the base rate. Tranches denominated in other local currencies, such as the Swiss franc or the Swedish krona, can float over a local money market base rate, but usually also provide a further option to fund in a more common currency such as the euro or the U.S. dollar and will thus use the relevant base rate.

LIBOR floors
As the name implies, LIBOR floors put a floor under the base rate for loans. If a loan has a 3% LIBOR floor and three-month LIBOR falls below this level, the base rate for any resets default to 3%. For obvious reasons, LIBOR floors are generally seen during periods when market conditions are difficult and rates are falling as an incentive for lenders. LIBOR floors are much more common in the U.S. than they are in Europe, but a number of cross-border deals do include this feature.

Fees
The fees associated with syndicated loans are the upfront fee, the commitment fee, the facility fee, the administrative agent fee, the LOC fee, and the cancellation or prepayment fee.

An arranger fee is the fee paid by the issuer to the arranger for the service it provides in underwriting and arranging the debt. This will be a one-time, upfront payment.

An upfront fee is a fee paid by the issuer at close. It is often tiered, with the lead arranger receiving a larger amount in consideration for structuring and/or underwriting the loan. Co-underwriters will receive a lower fee, and then the general syndicate will likely have fees tied to their commitment. Most often, fees are paid on a lender’s final allocation. For example, a loan has two fee tiers: 100 bps [or 1%] for $25 million commitments and 50 bps for $15 million commitments. A lender committing to the $25 million tier will be paid on its final allocation rather than on initial commitment, which means that, in this example, the loan is oversubscribed and lenders committing $25 million would be allocated $20 million and the lenders would receive a fee of $200,000 [or 1% of $20 million]. Sometimes upfront fees will be structured as a percentage of final allocation plus a flat fee. This happens most often for larger fee tiers, to encourage potential lenders to step up for larger commitments. The flat fee is paid regardless of the lender’s final allocation. Fees are usually paid to banks, mutual funds, and other non-offshore investors at close. CLOs and other offshore vehicles are typically brought in after the loan closes as a “primary” assignment, and they simply buy the loan at a discount equal to the fee offered in the primary assignment, for tax purposes.

A commitment fee is a fee paid to lenders on undrawn amounts, under a revolving
credit or a term loan before draw-down. On term loans, this fee is sometimes referred to as a “ticking” fee.

A facility fee, which is paid on a facility’s entire committed amount, regardless of usage, may be charged instead of a commitment fee on revolving credits to investment-grade borrowers.

A usage fee is a fee paid when the utilization of a revolving credit falls below a certain minimum. These fees are applied mainly to investment-grade loans and generally call for fees based on the utilization under a revolving credit. In some cases, the fees are for high use and, in some cases, for low use. Often, either the facility fee or the spread will be adjusted higher or lower based on a preset usage level.

A prepayment fee is a feature generally associated with institutional term loans. This fee is seen mainly in weak markets as an inducement to institutional investors. Typical prepayment fees will be set on a sliding scale; for instance, 2% in year one and 1% in year two. The fee may be applied to all repayments under a loan or “soft” repayments, those made from a refinancing or at the discretion of the issuer (as opposed to hard repayments made from excess cash flow or asset sales).

An administrative agent fee is the annual fee typically paid to administer the loan (including to distribute interest payments to the syndication group, to update lender lists, and to manage borrowings). For secured loans [particularly those backed by receivables and inventory], the agent often collects a collateral monitoring fee, to ensure that the promised collateral is in place.

An LOC fee can be any one of several types. The most common—a fee for standby or financial LOCs—guarantees that lenders will support various corporate activities. Because these LOCs are considered “borrowed funds” under capital guidelines, the fee is typically the same as the Euribor margin. Fees for commercial LOCs [those supporting inventory or trade] are usually lower, because in these cases actual collateral is submitted. The LOC is usually issued by a fronting bank [usually the agent] and syndicated to the lender group on a pro rata basis. The group receives the LOC fee on their respective shares, while the fronting bank receives an issuing [or fronting, or facing] fee for issuing and administering the LOC. This fee is almost always 12.5 bps to 25 bps [0.125% to 0.25%] of the LOC commitment.

Original issue discounts (OID)

This is yet another term imported from the bond market. The OID is the discount from par at which a loan is offered in the new issue market as a spread enhancement. A loan may be issued at 99 to pay par. The OID in this case is said to be 100 bps, or 1 point.

OID versus upfront fees

At this point, the careful reader may be wondering just what the difference is between an OID and an upfront fee. After all, in both cases the lender effectively pays less than par for a loan.

From the perspective of the lender, actually, there isn’t much of a difference. But for the issuer and arrangers, the distinction is far more than semantics. Upfront fees are generally paid from the arrangers underwriting fee as an incentive to bring lenders into the deal. An issuer may pay the arranger 2% of the deal and the arranger, to rally investors, may then pay a quarter of this amount, or 0.5%, to the lender group.

An OID, however, is generally borne by the issuer, above and beyond the arrangement fee. So the arranger would receive its 2% fee and the issuer would only receive 99 cents for every dollar of loan sold.

For instance, take a $100 million loan offered at a 1% OID. The issuer would receive $99 million, of which it would pay the arrangers 2%. The issuer then would be obligated to pay back the whole $100 million, even though it received $97 million after fees.

Now, take the same $100 million loan offered at par with an upfront fee of 1%. In this case, the issuer gets the full $100 million. In this case, the lenders would buy the loan not at par, but at 99 cents on the dollar. The issuer would receive $100 million of which it would pay 2% to the arranger, which would then pay one-half of that amount to the lending group. The issuer gets, after fees, $98 million.

Clearly, OID is a better deal for the arranger and, therefore, is generally seen in more challenging markets. Upfront fees, conversely, are more issuer friendly and therefore are staples of better market conditions. Of course, during the most muscular bull markets, new-issue paper is generally sold at par and therefore requires neither upfront fees nor OIDs.
Voting Rights
Amendments or changes to a loan agreement must be approved by a certain percentage of lenders. Most loan agreements have three levels of approval: required-lender level, full vote, and supermajority:
• The “required-lenders” level, usually just a simple majority, is used for approval of nonmaterial amendments and waivers or changes affecting one facility within a deal.
• A full vote of all lenders, including participants, is required to approve material changes such as RATS (rate, amortization, term, and security; or collateral) rights, but, as described below, there are occasions when changes in amortization and collateral may be approved by a lower percentage of lenders (a supermajority).
• A supermajority is typically 67% to 80% of lenders and is sometimes required for certain material changes such as changes in amortization [in-term repayments] and release of collateral. Used periodically in the U.S. in the mid-1990s, these provisions fell out of favor by the late 1990s. In Europe it is still commonly seen for material changes, simply known as “majority.”
• The “Yank The Bank” clause provides for the replacement of a minority nonconsenting lender where the majority of lenders are in agreement. In Europe, this is generally only seen in LBO transactions.
• The “You Snooze, You Lose” clause excludes from the final calculation any lender who fails to reply in a timely fashion to an amendment request.

Covenants
Loan agreements have a series of restrictions that dictate, to varying degrees, how borrowers can operate and carry themselves financially. For instance, one covenant may require the borrower to maintain its existing fiscal-year end. Another may prohibit it from taking on new debt. Most agreements also have financial-compliance covenants, for example, that a borrower must maintain a prescribed level of equity, which, if not maintained, gives banks the right to terminate the agreement or push the borrower into default. The size of the covenant package increases in proportion to a borrower’s financial risk. Agreements to investment-grade companies are usually thin and simple.

Agreements to leveraged borrowers are often much more onerous.

The three primary types of loan covenants are affirmative, negative, and financial. Affirmative covenants state what action the borrower must take to comply with the loan, such as that it must maintain insurance. These covenants are usually boilerplate and require a borrower to pay the bank interest and fees, maintain insurance, pay taxes, and so forth.

Negative covenants limit the borrower’s activities in some way, such as regarding new investments. Negative covenants, which are highly structured and customized to a borrower’s specific condition, can limit the type and amount of investments, new debt, liens, asset sales, acquisitions, and guarantees.

Financial covenants enforce minimum financial performance measures against the borrower, such as that he must maintain a higher level of current assets than of current liabilities. The presence of these maintenance covenants—so called because the issuer must maintain quarterly compliance or suffer a technical default on the loan agreement—is a critical difference between loans and bonds.

Bonds and covenant-lite loans (see above), by contrast, usually contain incurrence covenants that restrict the borrower’s ability to issue new debt, make acquisitions, or take other action that would breach the covenant. For instance, a bond indenture may require the issuer to not incur any new debt if that new debt would push it over a specified ratio of debt to EBITDA. But, if the company’s cash flow deteriorates to the point where its debt to EBITDA ratio exceeds the same limit, a covenant violation would not be triggered. This is because the ratio would have climbed organically rather than through some action by the issuer.

As a borrower’s risk increases, financial covenants in the loan agreement become more tightly wound and extensive. In general, there are five types of financial covenants—coverage, leverage, current ratio, tangible net worth, and maximum capital expenditures:
• A coverage covenant requires the borrower to maintain a minimum level of cash flow or earnings, relative to specified expenses, most often interest, debt service [interest and repayments], fixed charges [debt service, capex, and/or rent].
• A leverage covenant sets a maximum level of debt, relative to either equity or cash flow, with the debt-to-cash-flow level being far more common.
• A current-ratio covenant requires that the borrower maintain a minimum ratio of current assets (cash, marketable securities, accounts receivable, and inventories) to current liabilities (accounts payable, short-term debt of less than one year), but sometimes a “quick ratio,” in which inventories are excluded from the numerator, is substituted.
• A tangible-net-worth (TNW) covenant requires that the borrower have a minimum level of TNW (net worth less intangible assets, such as goodwill, intellectual assets, excess value paid for acquired companies), often with a build-up provision, which increases the minimum by a percentage of net income or equity issuance.
• A maximum-capital-expenditures covenant requires that the borrower limit capital expenditures (purchases of property, plant, and equipment) to a certain amount, which may be increased by some percentage of cash flow or equity issuance, but often allowing the borrower to carry forward unused amounts from one year to the next. Some transactions include terms geared to diminish the impact of covenant testing:
  • A mulligan essentially allows the borrower a “do-over” on the covenant tests. If, for example, a company does not comply with its covenants for one quarter but is back in line the following quarter, the previous quarter is disregarded as if it never happened.

Mandatory prepayments
Leveraged loans usually require a borrower to prepay with proceeds of excess cash flow, asset sales, debt issuance, or equity issuance.
• Excess cash flow is typically defined as cash flow after all cash expenses, required dividends, debt repayments, capex, and changes in working capital. The typical percentage required is 50% to 75%.
• Asset sales are defined as net proceeds of asset sales, normally excluding receivables or inventories. The typical percentage required is 100%.
• Debt issuance is defined as net proceeds from debt issuance. The typical percentage required is 100%.

• Equity issuance is defined as the net proceeds of equity issuance. The typical percentage required is 50% to 100%. Often, repayments from excess cash flow and equity issuance are waived or relaxed if the issuer meets a preset financial hurdle, most often structured as a debt/EBITDA test.

Collateral and other protective loan provisions
In the leveraged market, collateral usually includes all the tangible and intangible assets of the borrower and, in some cases, specific assets that back a loan. Virtually all leveraged loans and some weaker investment-grade credits are backed by pledges of collateral. In the asset-based market, for instance, that typically takes the form of inventories and receivables, with the amount of the loan tied to a formula based on the value of these assets. A common rule is that an issuer can borrow against 50% of inventory and 80% of receivables. Naturally, there are loans backed by certain equipment, real estate, and other property.

In the leveraged market, there are some loans that are backed by capital stock of operating units. In this structure, the assets of the issuer tend to be at the operating-company level and are unencumbered by liens, but the holding company pledges the stock of the operating companies to the lenders. This effectively gives lenders control of these units if the company defaults. The risk to lenders in this situation, simply put, is that a bankruptcy court collapses the holding company with the operating companies and effectively renders the stock worthless. In these cases, loan holders become unsecured lenders of the company and are put back on the same level with other senior unsecured creditors.

Springing liens/collateral release
Some loans have provisions that borrowers that sit on the cusp of investment-grade and speculative-grade must either attach collateral or release it if the issuer’s rating changes. A ’BBB’ or ’BBB-’ issuer may be able to convince lenders to provide unsecured financing, but lenders may demand springing liens if the issuer’s credit quality deteriorates. Often, an issuer’s rating being lowered to ’BB+’ or exceeding its predetermined leverage level will trigger this provision. Likewise, lenders may demand collateral from
a strong, speculative-grade issuer, but will offer to release under certain circumstances, such as if the issuer gains an investment-grade rating.

**Change of control**
Invariably, one of the events of default in a credit agreement is a change of issuer control. For both investment-grade and leveraged issuers, an event of default in a credit agreement will be triggered by a merger, acquisition of the issuer, some substantial purchase of the issuer’s equity by a third party, or a change in the majority of the board of directors. For sponsor-backed leveraged issuers, the sponsor’s lowering its stake below a preset amount can also trip this clause.

**Equity cures**
These provisions allow issuers to fix a covenant violation—exceeding the maximum debt to EBITDA test for instance—by making an equity contribution. These provisions are generally found in private equity-backed deals, giving the sponsor the right, but not the obligation, to inject equity and cure a violation without having to request a waiver or amendment. The equity cure is a right, not an obligation. Therefore, a private equity firm will want these provisions, which, if they think it’s worth it, allows them to cure a violation without going through an amendment process, through which lenders will often ask for wider spreads and/or fees in exchange for waiving the violation even with an infusion of new equity. Some agreements do not limit the number of equity cures, while others cap the number to, say, one per year or two over the life of the loan, with the exact details negotiated for each deal. Bull markets tend to bring more generous equity cures as part of looser overall documentation, while in bear markets documentation is tighter and equity cures are less easily available.

**Intercreditor agreements and cross-guarantees**
European borrowers tend to have more complex corporate structures than U.S. firms due to the multijurisdictional nature of the eurozone, as well as the prevalence of private equity management. As a result, intercreditor agreements and cross-guarantees are significant parts of ensuring lender rights regarding a loan transaction particularly with regards to underperformance or default. The intercreditor agreement is an agreement to subordination and stipulates the priority of repayment to all lenders, senior and subordinated, in the case of default. It applies to lenders across borders and codifies their positions in the absence of intervention from individual bankruptcy courts. Similarly, cross-guarantees ensure that the varied operating units associated with a borrower guarantee its assets as collateral. Thus, should one part trigger a default, all the associated companies will be equally responsible and their assets will be available for repayment.

The fixed and floating liens are another type of guarantee from operating units of the borrower. This type of guarantee balances the need of the borrower to have the ability to actively manage its business with regards to acquiring and disposing of assets with that of the lender to have claim to those assets in the case of underperformance or default. The terms of this guarantee essentially allow the borrower to dispose of assets without consent (thus the floating aspect). However, the proceeds must go through certain channels, including certain designated accounts, so that the borrower has the right to freeze those assets (fixing them) under certain circumstances.

**Asset-Based Lending**
Most of the information above refers to “cash flow” loans, loans that may be secured by collateral, but are repaid by cash flow. Asset-based lending is a distinct segment of the loan market. These loans are secured by specific assets and usually governed by a borrowing formula [or a “borrowing base”]. The most common type of asset-based loans are receivables and/or inventory lines. These are revolving credits that have a maximum borrowing limit, say $100 million, but also have a cap based on the value of an issuer’s pledged receivables and inventories. Usually, the receivables are pledged and the issuer may borrow against 80%, give or take. Inventories are also often pledged to secure borrowings. However, because they are obviously less liquid than receivables, lender advance rates are less generous. Indeed, the borrowing base for inventories is typically in the 50% to 65% range. In addition, the borrowing base may be further divided into subcategories—for
instance, 50% of work-in-process inventory and 65% of finished goods inventory.

In many receivables-based facilities, issuers are required to place receivables in a “lock box.” That means that the bank lends against the receivable, takes possession of it, and then collects it to pay down the loan.

In addition, asset-based lending is often done based on specific equipment, real estate, car fleets, and an unlimited number of other assets.

**Subsidiary guarantees**

Though not collateral in the strict sense of the word, most leveraged loans are backed by the guarantees of subsidiaries so that if an issuer goes into bankruptcy all of its units are on the hook to repay the loan. This is often the case, too, for unsecured investment-grade loans.

**Negative pledge**

This is also not a literal form of collateral, but most issuers agree not to pledge any assets to new lenders to ensure that the interests of the loan holders are protected.

**Loan math—the art of spread calculation**

Calculating loan yields or spreads is not straightforward. Unlike most bonds, which have long no-call periods and high-call premiums, most loans are prepayable at any time typically without prepayment fees. And, even in cases where prepayment fees apply, they are rarely more than 2% in year one and 1% in year two. Therefore, affixing a spread-to-maturity or a spread-to-worst on loans is little more than a theoretical calculation.

This is because an issuer’s behavior is unpredictable. It may repay a loan early because a more compelling financial opportunity presents itself or because the issuer is acquired or because it is making an acquisition and needs a new financing. Traders and investors will often speak of loan spreads, therefore, as a spread to a theoretical call.

Loans, on average, between 1997 and 2004 had a 15-month average life. So, if you buy a loan with a spread of 250 bps at a price of 101, you might assume your spread-to-expect life as the 250 bps less the amortized 100 bps premium or LIBOR+170. Conversely, if you bought the same loan at 99, the spread-to-expect life would be LIBOR+330.

**Default And Restructuring**

There are two primary types of loan defaults: technical defaults and the much more serious payment defaults. Technical defaults occur when the issuer violates a provision of the loan agreement. For instance, if an issuer does not meet a financial covenant test or fails to provide lenders with financial information or some other violation that doesn’t involve payments.

When this occurs, the lenders can accelerate the loan and force the issuer into bankruptcy. That is the most extreme measure and rarely employed. In many cases, the issuer and lenders are able to agree on an amendment that waives the violation in exchange for a fee, spread increase, and/or tighter terms.

A payment default is a more serious matter. As the term implies, this type of default occurs when a company misses either an interest or principal payment. There is often a pre-set period of time, say 30 days, during which an issuer can cure a default [the “cure period”]. After that, the lenders can choose to either provide a forbearance agreement that gives the issuer some breathing room or take appropriate action, up to and including accelerating, or calling, the loan.

If the lenders accelerate, the company will generally declare bankruptcy and restructure its debt. If the company is not worth saving, however, because its primary business has cratered, then the issuer and lenders may be forced into liquidation in which the assets of the business are sold and the proceeds dispensed to the creditors. In this case, jurisdictional issues abound in the European loan market as most borrowers have operations in a multitude of countries. Additionally, each jurisdiction may treat lender seniority differently.

**Amend-To-Extend**

This technique allows an issuer to push out part of its loan maturities through an amendment, rather than a full refinancing. Amend-to-extend transactions appeared in 2009 as borrowers struggled to push out maturities in the face of difficult lending conditions that made refinancing prohibitively expensive.
Amend-to-extend transactions have two phases, as the name implies. The first is an amendment in which at least 50.1% of the bank group approves the issuer’s ability to roll some or all existing loans into longer-dated paper. Typically, the amendment sets a range for the amount that can be tendered via the new facility, as well as the spread at which the longer-dated paper will pay interest.

The new debt is pari passu with the existing loan. But because it matures later and, thus, is structurally subordinated, it carries a higher rate, and, in some cases, more attractive terms. Because issuers with big debt loads are expected to tackle debt maturities over time, amid varying market conditions, in some cases, accounts insist on most-favored-nation protection. Under such protection, the spread of the loan would increase if the issuer in question prints a loan at a wider margin.

The second phase is the conversion, in which lenders can exchange existing loans for new loans. In the end, the issuer is left with two tranches: (1) the legacy paper at the initial price and maturity and (2) the new facility at a wider spread. The innovation here: amend-to-extend allows an issuer to term-out loans without actually refinancing into a new credit (which obviously would require marking the entire loan to market, entailing higher spreads, a new OID, and stricter covenants).

Sub-Par Loan Buybacks
This is another technique that grew out of the bear market that began in 2007. Performing paper fell to levels not seen before in the loan market, with many trading south of 70. This created an opportunity for borrowers with the financial wherewithal and the covenant headroom to repurchase loans via a tender, or in the open market, at prices below par.

Sub-par buybacks have deep roots in the bond market. Loans didn’t suffer the price declines before 2007 to make such tenders attractive, however. In fact, most loan documents do not provide for a buyback. Instead, issuers typically need obtain lender approval via a 50.1% amendment.

Distressed exchanges
This is a negotiated tender in which classholders will swap their existing paper for a new series of bond that typically have a lower principal amount and, often, a lower yield. In exchange the bondholders might receive stepped-up treatment, going from subordinated to senior, say, or from unsecured to second-lien.

Standard & Poor’s consider these programs a default and, in fact, the holders are agreeing to take a principal haircut to allow the company to remain solvent and improve its ultimate recovery prospects. This technique is used frequently in the bond market but rarely for first-lien loans.
Amendment-to-extend (A-to-E). This technique allows an issuer to push out part of its loan maturities through an amendment, rather than a full refinancing. A-to-E transactions have two phases, as the name implies. The first is an amendment in which at least 50.1% of the bank group approves the issuer’s ability to roll some or all existing loans into longer-dated paper. The second phase is the conversion, in which lenders can exchange existing loans for new loans. In the end, the issuer is left with two tranches: (1) the legacy paper at the initial price and maturity and (2) the new facility at a wider spread.

Arranger fee. The fee paid by the issuer to the arranger for arranging and underwriting a loan.

Asset sales prepayment. The prepayment required as a result of the net proceeds of asset sales, normally excluding receivables or inventories. The typical percentage required is 100%.

Assignment minimum. The amount that the lender can assign to a different lender. It ranges from €1 million to €5 million.

Axe sheets. These are sheets with lists of secondary bids and offers for loans that dealers send to accounts. Axes are simply price indications.

Bank book (information memo). This document, prepared by the arranging bank, describes the transaction’s terms. The bank book, or IM, typically will include an executive summary, investment considerations, a list of terms and conditions, an industry overview, and a financial model. Because loans are not securities, this will be a confidential offering made only to qualified banks and accredited investors.

Break price. Price on the facility at the moment it goes free to trade in the secondary market once allocations are made or how much investors are willing to pay for this deal if they would like to hold it. When the market is strong and the transaction is well received, the break price generally will be above par.

Buyback. In a buyback, a sponsor or company will opportunistically buy back the company’s debt out of the secondary market, typically taking advantage of depressed secondary prices. The issuer might use surplus cash off its balance sheet or the sponsor might use its own equity to purchase the debt. Loan Market Association guidelines suggest the company should tender for its debt via a transparent auction process, as well as suggesting measures to reduce the risk of a conflict of interests resulting from the sponsor owning debt and equity. Although buybacks reduce the company’s debt burden, they are often contentious, especially if done using surplus cash rather than equity, and in some cases lenders refuse to sign waivers to give their permission.

BWIC. An acronym for “bids wanted in competition.” It’s really just a fancy way of describing a secondary auction of loans or bonds. Typically an account will offer up a portfolio of facilities via a dealer. The dealer will then put out a BWIC, asking potential buyers to submit for individual names or the entire portfolio. The dealer will then collate the bids and award each facility to the highest bidder.

Circled. When a loan or bond is full subscribed at a given price it is said to be circled. After that, the loan or bond moves to allocation and funding.

Club deal. A smaller loan (usually €50-150 million, but as high as €300 million) that is premarketed to a group of relationship lenders. The arranger is generally a first among equals, and each lender gets a full cut, or nearly a full cut, of the fees. Club deals are traditionally rare from the perspective of transactions syndicated across regions, but they are common regional plays in Europe, where regional banks provide the funding.

Commitment fee. A fee paid on unused portion of the facility that ranges from 50 to 75 bps. For example, the company might have a €100 million revolving credit, but it only needs to draw €20 million; it must pay a fee on the remaining €80 million to compensate the lenders for keeping this money available.

Corporate LBO. A buyout of a company by a private equity firm from a corporation. It’s also called corporate divestiture.

Covenant-lite. Loans that have bond-like financial incurrence covenants rather than traditional maintenance covenants that are normally part and parcel of a loan agreement.

Cover bid. The level that a dealer agrees to essentially underwrite a BWIC or an auction. The dealer, to win the business, may give an
account a cover bid, effectively putting a floor on the auction price.

**Credit statistics.** Financial ratios, such as leverage ratio, interest coverage ratio, etc.

**Cross border.** A transaction syndicated to both U.S. and European investors.

**Deal size.** Total amount of bank debt raised for the transaction.

**Default rate.** Calculated by either number of loans or principal amount. The formula is similar. For default rate by number of loans: the number of loans that default over a given 12-month period divided by the number of loans outstanding at the beginning of that period. For default rate by principal amount: the amount of loans that default over a 12-month period divided by the total amount outstanding at the beginning of the period. Standard & Poor’s defines a default for the purposes of calculating default rates as a loan that is either:
- Rated ‘D’ by Standard & Poor’s,
- Made to an issuer that has filed for bankruptcy,
- In payment default on interest or principal, or
- Restructured in such a way as to create a material loss to the lender.

**Default.** There are two primary types of loan defaults, technical defaults and the much more serious payment defaults. Technical defaults occur when the issuer violates a provision of the loan agreement. For instance, if an issuer doesn’t meet a financial covenant test or fails to provide lenders with financial information or some other violation that doesn’t involve payments. A payment default, as the name implies, happens when a company misses either an interest or principal payment. There is often a preset period, say 30 days, during which an issuer can cure a default [the “cure” or “grace” period]. After that, the lenders can take appropriate action, up to and including accelerating, or calling, the loan.

**Disintermediation.** Disintermediation refers to the process whereby banks are replaced [or disintermediated] by institutional investors.

**Distressed loans.** In the loan market, loans traded at less than 80 cents on the dollar were traditionally considered distressed, although in 2007–2008 some performing loans traded in the 80s and below due to technical rather than fundamental weakness. In the bond market, the common definition is a spread of 1,000 bps or more. In the loan market, however, calculating spreads is an elusive art [see above] and therefore a more pedestrian price measure is used.

**EBITDA.** Earnings before interest, taxes, depreciation, and amortization. This is often used as a proxy for cash flow.

**Equity contribution.** How much money the sponsor put in to finance the transaction. Calculated as the sponsor’s equity amount divided by total transaction amount.

**Equity cure.** These provisions allow issuers to fix a covenant violation—exceeding the maximum debt to EBITDA test for instance—by making an equity contribution. These provisions are generally found in private equity-backed deals, giving the sponsor the right, but not the obligation, to inject equity and cure a violation without having to request a waiver or amendment. Some agreements do not limit the number of equity cures, while others cap the number to, maybe one per year or two over the life of the loan, with the exact details negotiated for each deal. Bull markets tend to bring more generous equity cures as part of looser overall documentation, while in bear markets documentation is tighter and equity cures are less easily available.

**Equity issuance prepayment.** The prepayment required as a result of the net proceeds of equity issuance. The typical percentage required is 50% to 100%.

**Excess cash flow prepayment.** The prepayment required as a result of excess cash flow which is typically defined as cash flow after all cash expenses, required dividends, debt repayments, capital expenditures and changes in working capital. The typical percentage required is 50% to 75%.

**Financial covenant.** Financial covenants enforce minimum financial performance measures against the borrower, for instance to maintain a higher level of current assets than current liabilities. As a borrower’s risk increases, these covenants become more restrictive and extensive.

**First-lien debt.** Senior debt that holds the first priority on security.

**Flex.** Margin flex language allows the arranger to change spreads during syndication to adjust pricing to current liquidity levels. To entice more investors into buying the credit, spreads will be raised, or “flexed up.” When liquidity is high and demand outstrips supply, the spread will be decreased, or “reverse flexed.” A structural flex occurs when the arranger adjusts the size of tranches during syndication to reflect current liquidity levels.
As a result, during highly liquid times, an arranger may move debt from the more expensive tranches, such as mezzanine, to cheaper tranches, such as second lien or first lien.

**Forward calendar.** A list of loans or bonds that have been announced but not yet launched via a general syndication bank meeting. In the U.S., this is a list of loans or bonds that have been announced but not yet closed, including both instruments that are yet to come to market as well as those that are actively being sold but have yet to be circled.

**Haircut.** In relationship to financial covenants, this refers to the looser maintenance covenants set for mezzanine tranches compared with senior credit.

**Implied ratings** [credit estimates or shadow rating]. Credit opinions that are not available publicly on Standard & Poor’s RatingsDirect and other public sources. Implied ratings are not backed by the borrowers. CLO arrangers request the ratings agencies to issue an implied rating to ensure that the portfolio maintains certain agreed standards. For example, a CLO should not have more than 5% of rated debt in the ‘CCC’ category.

**Institutional facilities.** These tranches are sold primarily to institutional investors. They traditionally have had a bullet repayment with no amortization, a maturity of eight to nine years, and a spread of Euribor + 250 to 325. The TLb can have a pricing grid with fewer step downs than pro rata. The TLc usually does not have a pricing grid.

**Interest coverage.** EBITDA to interest.

**LBO** [European version]. Any transaction in which the issuer is owned by a private equity firm [sponsor]. It includes a buyout of a company by a sponsor, a follow-on acquisition, a dividend to the sponsor, refinancing, etc.

**LBO** [U.S. version]. A subset of the above, but includes only buyouts of a company by a sponsor. Excludes recapcs, refinancings, and follow-on acquisitions.

LevX/LCDX. LevX Senior is an index of 40 senior LCDS obligations that participants can trade. The U.S. equivalent is LCDX. The indices provide a straightforward way for participants to take long or short positions on a broad basket of loans as well as to hedge their exposure to the market.

**Leverage ratio or debt/EBITDA.** Many bank books use net debt to EBITDA, which is [debt minus cash] to EBITDA.

**Leveraged loans.** Defining a leveraged loan is a discussion of long standing in the loan market. Some participants use a spread cut-off: i.e., any loan with a spread of Euribor + 125 or Euribor + 150 or higher qualifies. Others use rating criteria: i.e., any loan rated ‘BB+’ or lower qualifies. But what of loans that are not rated? At Standard & Poor’s Leveraged Commentary & Data, we have developed a more complex definition. We include a loan in the leveraged universe if it is rated ‘BB+’ or lower or it is not rated or rated ‘BBB-’ or higher but has (1) a spread of Euribor + 125 or higher and (2) is secured by a first or second lien. Under this definition, a loan rated ‘BB+’ that has a spread of Euribor + 75 would qualify, but a nonrated loan with the same spread would not. It is hardly a perfect definition, but one that Standard & Poor’s thinks best captures the spirit of loan market participants when they talk about leveraged loans.

**LIBOR/Euribor floors.** A floor under the base rate for a loan. For example, if a loan has a 3% LIBOR floor and three-month LIBOR falls below this level, the base rate for any resets default to 3%.

**Loan credit default swaps** [LCDS]. Standard derivatives that have secured loans as reference instruments.

**Loss given default.** A measure of how much creditors lose when an issuer defaults. The loss will vary depending on creditor class and the enterprise value of the business when it defaults. Naturally, all things being equal, secured creditors will lose less than unsecured creditors. Likewise, senior creditors will loss less than subordinated creditors. Calculating loss given default is tricky business. Some practitioners express loss as a nominal percentage of principal or a percentage of principal plus accrued interest. Others use a present value calculation using an estimated discount rate, typically 15% to 25%, demanded by distressed investors. This can also be expressed as (1–Recovery Rate).

**Maintenance capex.** The minimum amount the company has to spend to keep its assets in shape. If the company cannot maintain its assets, those assets will not continue generating the same level of revenues.

**Mandatory prepayment.** Leveraged loans usually require a borrower to prepay the loans with proceeds of excess cash flow, asset sales, debt issuance, or equity issuance.

**Mezzanine.** A subordinated instrument that carries second-ranking security or, if the capital structure also includes second lien, third-ranking security.


**Mulligan.** A clause that essentially allows the borrower a “do-over” on the covenant tests. If, for example, a sponsor does not comply with its covenants for one quarter but is back in line the following quarter, the previous quarter is disregarded as if it never happened.

**Original issue discount (OID).** A way of remunerating primary lenders, usually institutional investors, by offering them a discount to par. Varies according to demand for the deal.

**Non-call.** During the non-call period, borrowers are obligated to pay a fee to lenders if they repay the debt during the stated non-call period. Generally, the fee is 2% in the first year and 1% in subsequent years.

**OWIC.** This stands for “offers wanted in competition” and is effectively a BWIC in reverse. Instead of seeking bids, a dealer is asked to buy a portfolio of paper and solicits potential sellers for the best offer.

**P2P [public to private].** A buyout of a publicly listed company by a private equity firm resulting in its delisting from the stock exchange.

**Par amount outstanding.** This is the amount of institutional bank loans issued previously and still outstanding at the particular point in time and is tracked by the U.S. and European leveraged loan indexes.

**Prepayment fee.** Fees paid by the issuer if the debt is repaid before maturity.

**Pricing grid [aka margin ratchet].** A set of financial measures that allows the issuer to pay lower interest on the facilities. For example, if the issuer’s debt to EBITDA is less than 3x, pricing is Euribor + 275; if such ratio decreases to 2.5x, pricing is Euribor + 250.

**Primary price [institutional].** Reflects how much investors pay for a facility if they buy it in the primary syndication. Primary price is par unless accompanied by an upfront fee. When the market is strong, institutional paper is issued without upfront fees.

**Printing a deal.** Refers to the price or spread at which the deal syndicates.

**Pro forma financials.** Financials that include “side effects” of the current transaction. For example, in case of an acquisition, pro forma EBITDA will reflect the combined EBITDA of the two companies plus synergies from their merger. For an LBO, pro forma EBITDA could include cost savings generated by headcount reductions. Often pro forma financials covers the last 12 months. We also track “estimated” (full fiscal current year) and “projected year one” (first full year after the current year).

**Pro rata.** Facilities sold to banks (revolving credit, TL, acquisition facility, capex facility). These tranches generally have a gradual amortization until maturity [except for the revolver] and a maturity of six to seven years. They will usually carry a spread of Euribor + 200 and greater and might have two to four step-downs based on a pricing grid.

**Pro rata spread.** Average spread of revolving credit and TL tranches [which are usually the same].

**Public ratings.** Ratings that are available publicly on RatingsDirect and other public sources.

**Purchase price multiple.** Purchase price paid to acquire the company divided by its EBITDA.

**Recap/dividend.** Capital structure shift in which additional debt is raised to finance a cash payment to the owners [sponsor, in case of a private company and general public, in case of a listed company]. Some part of the new debt may also be used to refinance existing debt.

**Recap/equity infusion.** Capital structure shift in which the sponsor injects new equity into the company, usually to refinance existing debt.

**Recap/stock repurchase.** Capital structure shift in which additional debt is raised to re-purchase shares from the owners [sponsor, in case of a private company and general public, in case of a listed company]. Stock repurchase can be in the form of shareholder loan repayment. Some part of the new debt may also be used to refinance existing debt. For research purposes, dividend and stock repurchase are considered the same thing because both reflect a payment to the sponsor.

**Recapitalization.** A shift in the issuer’s capital structure between debt and equity. Types of recap include: dividend, stock repurchase, equity infusion.

**Recovery.** Recovery is the opposite of loss given default—it is the amount a creditor recovers, rather than loses, in a given default.

**Refinancing.** A transaction in which new debt replaces existing debt of the company and only the debt portion of the capital structure is affected.

**Relative value.** This can refer to the relative return or spread between [1] various instruments of the same issuer, comparing for instance the loan spread with that of a bond; [2] loans or bonds of issuers that are similarly rated and/or in the same sector, comparing for instance the loan spread of one ‘BB’ rated healthcare company with that of another; and [3] spreads between markets, comparing...
for instance the spread on offer in the loan market with that of high-yield or corporate bonds. Relative value is a way of uncovering undervalued, or overvalued, assets.

**Reverse-flex.** Spread decrease during syndication when facilities are oversubscribed to the point where a spread reduction will not damage the arranger’s ability to syndicate the facilities. A sign of demand outstripping supply.

**Revolving credit.** A facility that allows borrowers to draw down, repay, and reborrow as often as necessary. The facility acts much like a corporate credit card, except that borrowers are charged an annual commitment fee on unused amounts, which drives up the overall cost of borrowing [the facility fee].

**Rich/cheap.** A loan that is “rich” is trading at a spread that is low compared with other similarly rated loans in the same sector. Conversely, something that is “cheap” means it is trading at a spread that is high compared with its peer group. That is, you can buy it relatively cheaply.

**Rollover equity.** Reinvesting funds contributed to the company under previous ownership into a “new” company under new ownership.

**Running the books** (or bookrunner). Generally the loan arranger is said to be “running the books,” i.e., preparing documentation and syndicating and administering the loan.

**Second lien.** Loan that has second-priority interest on security. Subordinated to senior loans [TLa, TLb, TLa, etc.], but senior to mezzanine, high-yield, PIK notes, and equity. They are floating-rate-instrument-like senior loans, priced at roughly 200 to 300 bps higher than senior loans. Second liens are more expensive to prepay than senior debt since many second liens have prepayment penalties in the first two years. Their maturity is usually one-half to one year longer than the TLc.

**Secondary LBO.** A buy-out of a company by one private equity firm from another private equity firm.

**Senior leverage ratio [senior debt to EBITDA].** Many bank books use net senior debt to EBITDA, which is [senior debt minus cash] to EBITDA.

**Senior loans.** These loans have the highest seniority in the issuer’s capital structure, i.e., obligations are contractually paid before subordinated securities. They have a stated maturity of six to nine years, but are fully prepayable at any time and prepayment penalties are rare. They are floating rate and priced based on a spread over Euribor or LIBOR. They have maintenance-based financial covenants, usually calculated quarterly, and there is no equity kicker to debtholders.

**Shareholder loan.** Sponsors’ frequently contribute equity in the form of a deeply discounted bond that pays paid-in-kind interest. An equity-like instrument that is subordinate to senior and subordinated debt.

**Sources of proceeds.** Sources used to finance the transaction [i.e., bank debt, mezzanine, high yield, and equity].

**Split rating.** When a loan is rated differently by Moody’s and Standard & Poor’s such that the rating comes out as a “three B” or a “five B”. “Three B” means ‘B’ (‘B-’, ‘B’, or ‘B+’) by one agency and ‘BB’ (‘BB-’, ‘BB’, or ‘BB+’) by another (if you count all the B’s you’ll get three). “Five B” means ‘BB’ by one agency and ‘BBB’ by another.

**Sponsored (volume, issuance, etc.).** Any type of transaction whereby a private equity group owns the issuer. Same thing as the European definition of LBO.

**Spread.** Interest paid on top of a “risk-free” rate, i.e., Euribor (for Euro deals) or LIBOR (for U.S. dollar- or sterling-denominated deals).

**Spread to maturity/spread to call.** The spread to maturity adjusts the value of the spread over base rate for any nonpar price, over the life of the loan. The spread to call calculates the same, except that the time horizon is a more realistic estimation of the actual life of these instruments, which are usually fully prepayable without penalty at any time.

**Staple financing.** Staple financing—or staple-on financing—is a financing agreement “stapled on” to an acquisition, typically by the MBA advisor. So, if a private equity firm is working with an investment bank to acquire an asset, that bank, or a group of banks, may provide a staple financing to ensure that the firm has the wherewithal to complete the deal. Because the staple financing provides guidelines on both structure and leverage, it typically forms the basis for the eventual financing that is negotiated by the auction winner, and the staple provider will usually serve as one of the arrangers of the financing, along with the lenders that were backing the buyer.

**Subordinated debt.** Debt that has subordinated claim on security and payments behind senior debt or has no security at all. Types of subordinated debt are mezzanine, public high yield, and PIK notes [which have certain quasi-equity characteristics].
**Glossary**

**Term loan.** This facility is simply an installment loan, such as a loan one would use to buy a car. The borrower may draw on the loan during a short commitment period and repays it based on either a scheduled series of payments or a one-time lump-sum payment at maturity (bullet payment).

**Toggle facilities.** This feature provides issuers with a “pay if you want” feature that allows them to switch off any cash-pay element and convert all spread to PIK without consulting the lending group.

**Total rate of return swaps (TRS).** Under a TRS program, a participant buys the income stream created by a loan from a counterparty on margin. Then the participant receives the spread of the loan less the financial cost plus base rate on its collateral account. If the reference loan defaults, the participant is obligated to buy it at par or cash settle the loss based on a mark-to-market price or an auction price.

**Transaction size.** Total amount of all debt and all equity raised for the transaction.

**Transferable recapitalization.** Buy-out in which the sponsor has the right to sell the targeted acquisition to another sponsor without triggering a change of control.

**Upfront fee.** Fee paid by the arranger to lenders joining the syndicate, tiered so that larger commitments earn larger fees.

**Vendor note (aka seller note).** A type of financing provided by the seller of the company. An equity-like instrument that is subordinate to senior and subordinated debt.

**Volume.** Sum of all leveraged loans raised [first and second lien] within the given period; new debt raised only. Therefore, if a deal is an amendment to the previous credit and no new debt is raised, this will be excluded. All amounts are converted to Euros using the exchange rate either [1] provided in the bank book, or [2] spot rate on the date of the deal’s bank meeting [our proxy for a launch date].

**Warrants (on mezzanine).** Gives the mezzanine lenders the right to purchase equity from the issuer at a specific price. Warrants potentially provide unlimited upside to lenders if the company does really well. However, deals that carry warrants have lower pricing.

**Weighted average institutional spread.** Average spread of TLb and TLc tranches weighted by the size of each tranche, i.e. $[\text{TLb spread times TLb size} / (\text{TLb plus TLc size})] + [\text{TLc spread times TLc size} / (\text{TLb plus TLl size})]$.

**Weighted average bid.** A price at which an investor is willing to buy a loan, weighted by the par amount outstanding. By definition, larger deals will have a stronger influence on the average.

**Yank The Bank.** This clause provides for the replacement of a minority nonconsenting lender where the majority of lenders are in agreement.

**You Snooze, You Lose.** This clause excludes from the final calculation any lender who fails to reply in a timely fashion to an amendment request.
Primary loan issuance sprang back to life as Autumn 2013 got underway, with a batch of launches designed to make the most of healthy liquidity among institutional investors, raising €3.8 billion during September.

The new deals included leveraged buy-outs (LBO) for Campbell Soup Co., Chesapeake, OGF Holding, and Skrill, refinancings for Oberthur and Tunstall, and dividend recaps for Card Factory and M7.

But the biggest kid on the block was undoubtedly Dell. Dell brought a jumbo LBO financing to the U.S. and European markets, in a mix of loans and bonds, and unlike the jumbo H.J. Heinz buyout from the first quarter, a portion of the debt did remain in euros.

Indeed the euro-denominated loan was upsized from €500 million to €700 million after the company decided to abandon a dollar-denominated second-lien notes tranche in favour of more senior debt. The euro response raised a heavy oversubscription as investors jumped at a rare chance to book ‘BB’ rated LBO paper in a brand new name.

Cross-border deals have loomed large over the third quarter, aside from Dell. Four out of the five largest merger and acquisition (M&A)-related institutional tranches belonged to deals sold into both the U.S. and Europe (BMC Software, Dell, Springer, and Gardner Denver), accounting for €2.5 billion of volume. Including purely domestic transactions, M&A-related loan volume totaled €6.9 billion in the third quarter, down slightly from €7.4 billion in the prior three months.

Even so, despite the home crop and the cross-border effort, European third-quarter new issue loan volume fell short of the two previous quarters, at €14.5 billion compared with €16.1 billion in the first quarter and €24 billion in the second.

This is perhaps disappointing given that conditions were favourable for borrowers, but all together the first nine months of the year have churned out €54.6 billion of new issuance from 146 deals, so Europe is set to more than double the 2012 total of €28.5 billion from 105 deals. Within this, sponsor-backed transactions amounted to €36.2 billion, exceeding all annual figures since 2008.

High-yield primary issuance also bounced back to health in September after a near-silent August, generating €7.1 billion of new issuance. As with loans, the third quarter was the thinnest of the year at €15.2 billion, but the year to date total of €54.9 billion, almost exactly in step with the loan market, is already 24% ahead of 2010, the previous biggest year.

A chunk of September’s primary activity came from crossover credits such as Continental and Lafarge, which shot out of the blocks at the start of the month, along with auto companies Peugeot, Renault, and Fiat. Further on through the month came a handful of much smaller deals, with a notable sterling bias, such as Soho House, Jerrold, and Study Group. The missing bit in the middle—benchmark-sized, true high-yield credits—meant investors were left feeling a bit short-changed despite the decent volume.

High-yield investors have also had their nerves tested, as expectations that the

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Slower Third Quarter New Issuance Boosts Investor Demand In Run To Year’s End
Federal Reserve would begin to scale back its monthly bond buying programme were turned on their head. The “taper,” which was widely assumed to be on the cards, has been postponed to an unknown point in the future, allowing more time for high-yield issuers to take advantage of the low-yield environment before bonds begin to get more expensive.

As October began, the near-term pipelines in loans and high-yield looked decidedly patchy, opening up the possibility of a rather faded end to an otherwise strong year. The bid is certainly there, on both fronts, but loan arrangers were talking of a pause of several weeks until new deals launched, potentially right up to the last few weeks of the year. The high-yield pipeline seems to be in better shape, and includes a number of debut borrowers—something many loan investors dream of. But these debut issuers are typically highly sensitive to market conditions and may want to wait for calm macro conditions—including a resolution to the U.S. government shutdown and debt ceiling—to be sure of getting the best possible execution.

Looking ahead through the fourth quarter and beyond, some market players anticipate that the overall volume of high-yield issuance could shrink, even if the number of issues remains strong. The thinking here is that many large, high-profile companies with bonds and/or loans outstanding have already tapped the market to refinance with high-yield, and will not need to come back to the market soon. Those that are yet to refinance may be smaller, and may in some cases be trickier credits, meaning slimmer overall volume and potentially more challenging deals.

Whether or not this is the case, arrangers and investors are as eager as ever to see new M&A-driven deals come to market, to satisfy the calls for fresh product—this being equally true in loans and bonds.

Arrangers, particularly those who have flourishing high-yield businesses, and that can comfortably syndicate cross-border, are

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**Chart 1 | Leveraged Loan New-Issue Volume**

- 1st, 2nd, 3rd quarters
- 4th quarter

(Bil €)

![Chart 1](chart1.png)


**Chart 2 | European High-Yield Bond Volume**

- Secured
- Unsecured
- Subordinated

(Bil €)

![Chart 2](chart2.png)

especially bullish about the availability of financing. "The debt markets are very buoyant. The loan market is robust. Collaterized Loan Obligations (CLOs) and credit funds have appetite, banks are reasonably active. The high-yield market is red-hot," says a banker.

The hope—and it’s not a new one—is that brighter economic conditions in Europe will gradually filter through into corporate and eventually leveraged M&A activity. "M&A will pick up slowly, firstly because of the improving economy, and secondly because it can’t be any worse," says an arranger.

Trading Up

As the taper-related volatility experienced in the second quarter eased off, and appetite for yield gained the upper hand once again, the third quarter saw secondary loan and bond prices rising steadily.

On the loan side, the bid was partly driven by managers ramping CLOs, and part from non-CLO buyers stocking up. Arrangers’ confidence in the technical bid is strong, especially in light of large repayments such as Avio and Molnlycke, although some fear the arrival of a few large deals would quickly soak up the liquidity.

Secondary loan prices reflected a recovery in confidence and appetite. The average bid of LCD’s flow names, based on Bloomberg data, climbed from 99.65 at end-June to 103.63 at end-September, bringing the yield just inside 6% at 5.94%.

High-yield funds have enjoyed a return to inflows during the third quarter, after losing €2.4 billion in June, based on J.P. Morgan’s

Sidebar 1  |  Steadier State

From a macroeconomic perspective, Europe continued its gradual shift from recession to stability during the third quarter—and by September there were early signs of growth across the region.

Flash Eurozone PMI numbers released in mid-September were encouraging, and the data "adds to growing signs that the region is recovering", according to Markit’s chief economist, Chris Williamson. "New orders increased for the second successive month in September, growing at the fastest rate since June 2011," the report said, going on to show that not only were Germany and to a lesser extent France seeing more business activity, but that this activity grew across the rest of the Eurozone "at the steepest rate since April 2011."

A robust recovery is a long way off, says a report from Standard & Poor’s Ratings Services, so it’s too early to get excited about healthy business growth in the near term. There are several good reasons to be cautious about the strength of Europe’s economy, and interest rates are predicted to remain very low until the picture changes convincingly.

Market players from the buy- and sell-side mostly dismiss the impact on their business of this macro stabilisation. They argue it is almost entirely technicals that are controlling the leveraged market and that have driven the uptick in primary activity and the rise in secondary market prices.

True as this is, a steadier macroeconomic frame in continental Europe, especially one that produces signs of growth in the peripheries as well as the core countries—as is suggested by some economic indicators—can only be helpful in enticing institutional investors to shift into leveraged loans.

The default picture within the European loan market helps the cause. LCD data through the end of August showed a continuing decline in the 12-month lagging default rate during the second quarter, as tracked by the S&P European Leveraged Loan Index (ELLi). By volume, the default rate dipped to 4.2% at the end of August, from 5.3% at the end of June. This is a good step down from the 6.6% level recorded at the end of 2012.
Slower Third Quarter New Issuance Boosts Investor Demand In Run To Year’s End

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weekly analysis of European funds. September saw provisional inflow of €674 million, following on from €577 million and €1.07 billion inflows in August and July. Unless some larger primary deals come to light, as investors hope will be the case, the technical bid will weigh heavily on the market during the fourth quarter, putting pressure on yields.

On the subject of investor appetite, it’s also worth touching on bank liquidity on the loan side. Some bank investors say they are protesting vehemently against what they see as an unacceptable erosion in credit quality, but a number of banks have rediscovered their hunger for loans during the year, and are keen to take a look at what’s on offer.

Banks’ natural caution still prevails, but some firms have seen the size of their loan books reduce so sharply and are under strong political pressure to show that they are lending, and are finding the returns on offer from leveraged loans increasingly appealing. Some Japanese banks, some Nordic banks, and others from the continent are keenly hunting for assets, sources say, without necessarily needing their names in lights on the arranger line-up.

“We are seeing a lot of run-off, to the high-yield market particularly, but the portfolio is just beginning to increase,” says a banker. “The driver to invest is the internal pressure to make budget, but the economic outlook helps. But we won’t do any deal—we still won’t do a Spanish deal, for example.”

CLOs Rush, Then Rest

Bolstering investor demand in Europe on the loan side, a rush of CLOs joined the 2.0 revival early in the third quarter, as some of the larger managers active in Europe came forward.
GoldenTree priced via Morgan Stanley in early July, followed by new vehicles for managers CSAM, ICG, Ares, 3i, Blackstone-GSO. The pace then slowed down with only Carlyle pricing in September.

Third quarter issuance volume of €2.1 billion takes the year-to-date total to €4.5 billion from 13 vehicles. As a point of comparison, the U.S. has seen $57.4 billion of CLO issuance this year, from 118 vehicles.

The threat that the Federal Reserve would start to reduce its bond buying programme in September raised the question of whether appetite for CLO ‘AAA’ paper, and hence the arbitrage, would suffer as a result. But even without this, conditions for new CLO issuance became more challenging, with limited ‘AAA’ appetite and ‘AAA’ spreads widening and paper being discounted, unlike in the early part of the year.

As of the end of September, the pipeline included ICG, NIBC Bank, CQS, Pinebridge, Avoca, CVC, Permira and Pramerica, of which a handful are said to be actively marketing and therefore should price before the end of the year. Other managers may opt to wait for clarity around the 122a compliance requirements, and until ‘AAA’ buyers’ budgets are refreshed at the start of the new year.

Although the Fed’s decision not to taper ostensibly extends the timeframe for banks and funds to re-establish the CLO market under the same macro picture, the slow pace of fresh LBO issuance continues to make it difficult to build a portfolio at a pace that will satisfy the requirements of the warehousing bank, sources say. Managers can find other ways to source assets—from secondary, from old vehicles, from other one-off opportunities—but primary syndication remains the missing link that would really enable CLO issuance to step up.

Fundraising for non-CLO institutional money continues to roll, although the pace is slow and steady rather than anything more exciting. The combination of macro stabilisation, fiscal uncertainty in the U.S., and low European defaults gives managers who are out on the road fundraising some good arguments. Although European interest rates aren’t likely to rise anytime soon, a shift toward greater exposure to floating—rate instruments makes good sense, sources say.

“A lot of unlevered funds are focusing on loans again as a good, low-volatility asset class that doesn’t have the tail risk on interest rates or inflation. As the economy improves, we will get better fundamentals [supporting loans] without the associated risk on the yield side,” a fund manager says.

After the mid-September announcement that the Fed would not yet start tapering its bond-buying programme, a manager of a global loan fund commented, “High-yield has had a bit of a reprieve. But everyone knows rates are going to rise. Now here’s the chance to switch into loans.”

Opportunistic Deals Flourish

The slow pace of LBOs during 2013, combined with a strong technical bid, has resulted in the sight of the volume of opportunistic transactions overtaking that of traditional buyout activity for the first time since LCD began tracking the market 15 years ago. Refis and recaps (including nondividend-related) took a 49% share of overall sponsored volume, compared with 46% for buyouts.
Opportunistic transactions, such as dividend recaps, were particularly prevalent during the third quarter. Private equity-owned borrowers, such as Card Factory, took out €1.6 billion of leveraged loans to fund a dividend between July and September, the same amount as the first two quarters combined. As a result, dividend recaps accounted for 14% of all sponsored loan issuance, up from just 7% in the first half of the year.

In the year to Sept. 30, €4.2 billion of loans funded a dividend recap, up from €1.7 billion last year and the highest reading than any full year tally since 2007. Relative to the overall sponsored volume, these deals represented a 11% share, up from 7% last year and a post-crunch high.

Moreover, after a three-month hiatus, dividend-related high-yield bond issuance reappeared in September, from two sponsored borrowers, Study Group and Phone 4U. In the year through September, 14 issuers tapped the bond market to make a sponsor payout, raising €4.6 billion.

As a result, private equity firms extracted €5.3 billion of dividends from their portfolio companies either via the bond or the loan market, up from €1.9 billion last year and the highest reading since €10 billion in 2007. Regardless of how the issuer funded the dividend, the recap took place 3.4 years after the initial buyout and the sponsor took 46% of its original equity contribution off the table, on average.

Investors anticipate more opportunistic deals, especially while the M&A pipeline is so slim. “There will be more sweating of existing assets, more dividend recaps,” says a manager.

In addition to recaps, private equity sponsors used the borrower-friendly market conditions to manage debt maturities, with refinancings accounting for 34% of sponsored loan volume, a record high, up from 28% in 2012. The institutional loan maturity wall, based on the ELLI, shows the impact of this activity, combined with repayments and A-to-E transactions. Maturities through the end of 2015 shrank by 56% in the year to the end of August, and by 49% through the end of 2016.

Via a mix of recaps and refinancing, including those done via amendments, European borrowers continued to push down spreads, although the pace slowed versus the previous quarter. €2.5 billion of institutional paper was repriced between July and September, down from €4.9 billion between April and June, bringing the year-to-date total to €9.8 billion. This is considerably higher than the €6.2 billion seen in 2011 and 2012 combined.

Cross-border deals led the way, with a few domestic deals following suit. For example, Douglas, the German retailer that an Advent-led group took private last year, completed the repricing of its €830 million senior buyout loan in September. The move takes 75 bps from Douglas’ term loan A and 100 bps from its term loan B, leaving the tranches paying EURIBOR (E)+425 and E+450, respectively.

![Chart 6 | Average TLB Primary Spread And YTM](chart)

Based on the TLB spread at launch, the OID and EURIBOR floor (if any).

Source: S&P Capital IQ LCD.
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For the year overall, repricings reduced term loan B yield to maturity by over a point, from the original 5.91% to the current 4.84%. Borrowers achieved interest savings via both lower contractual spreads, at E+448 vs E+500, and lower EURIBOR floor, at 105 bps versus 121 bps.

Price Discipline?
Looking at loan pricing on all institutional new issues, spreads spent most of 2013 tightening in bit by bit from a peak of E+536 in July 2012, and the second quarter of 2013 saw spreads dipping down below E+410. But the third quarter brought a widening, despite good investor appetite, with the rolling-three month reading sitting at E+462 in September.

New issues were also placed with a larger discount to par. For the previous four quarters the average discount was in the 99.3-99.45 range—but in third-quarter 2013 that widened to 98.64. This helped boost the average yield to maturity for term loan Bs to 5.56% for the third quarter, from 5.01% at the end of June.

With a patchy pipeline and keen buyside appetite, the question is whether there will be enough of an imbalance to push margins down again in the fourth quarter, and how far they might go. On this point, market players’ views are broadly aligned: because of the type of liquidity available, there is limited scope for a sharp reduction in pricing, sources say.

Given that CLOs need to clear certain hurdles to make their arbitrage work, and many managed accounts and other non-CLO funds also need spreads to stay steady to make their proffered returns, so the institutional investor universe has shown a consistent level of discipline on pricing.

"I don’t really think spreads will tighten. There is a fair amount of discipline," says an arranger. "It will be selective, with some reverse flexes, but not a material shift."

The third quarter saw reverse flex outnumbering upward price flex by roughly two to one, as 21% of institutional tranches flexed down and 9% flexed up.

There is more willingness to accept lower pricing from hot money such as hedge funds, as borrowers have grown more confident in their ability to be competitive in the market.

Sidebar 2  |  The Yields In High-Yield Widen

In the high-yield market, the average primary yield to maturity widened across all ratings categories in the third quarter, albeit more severely on the lower quality names. ‘BB’ rated bonds priced to yield 4.72%, on average, up 23 bps over June levels but roughly one-half a point tighter than 5.28% in the first quarter. At the same time, the average primary yield to maturity of ‘B’ rated bonds widened to 8.71%, the highest level since the first quarter of 2012 and 132 bps wider of levels seen three months ago.

As yields widened, the share of borrowers tapping the high-yield bond market to term out bank debt retreated to 18% in the third quarter based on €2.8 billion of issuance, from 26% in the first half of the year [€10.5 billion]. Recent examples include the €115 million secured notes for Soho House, which will move the company to an all-bond capital structure. Including other bonds that replace other types of debt, refinancing-related transactions accounted for 56% of third quarter’s volume, up slightly from 51% in the first half of 2013.

At the same time, borrowing for general corporate purposes increased to 26% of overall activity between July and September, with many crossover names falling into this category. In contrast, the share stood at 18% between January and June.

After the volatility over the summer, the hunt for yield continues into the autumn, and investors looking for liquid, ‘B’ names have had thin pickings of late, further sharpening their appetite. “Smaller risker high-yield deals are getting done. The hunger for yield rides over fear. Investors are focused on coupon, not on the credit and the structure,” says an investor.

In fact, only 21% of September issuance was rated ‘B’, compared with 53% in July, and many of these deals were small. During that month, 24% of high-yield bonds rated ‘B’ or lower by at least one ratings agency was sized below €200 million (excluding taps) in the third quarter, up from 18% in the second quarter. At the same time, the share of €500 million-plus deals retreated to just 4%, from 12%.
but less from core liquidity providers, sources say. That’s not to say spreads won’t succumb to downwards pressure at some point, if investors get really desperate for product, but a marked reduction isn’t widely expected in the fourth quarter.

On the arranger side, competition for mandates is as aggressive as ever, perhaps even more so on pure European loan-only deals where European banks that are not generating income via high-yield teams have an opportunity to earn some fees. Since pricing is seen as having something of a floor under it, it will be term sheets that suffer in the fourth quarter, sources predict.

This will be a continuation of what has been going on through the year, as arrangers get bolder about putting in clauses that were banished in the few years after the financial crisis. These include the ability to make dividend payments, add new lines, and repay subordinated debt before senior, typically below a certain leverage multiple trigger point. Some investors say they are getting more uneasy about these features since they undermine or interrupt the process of deleveraging, but others are comfortable as long as they like the credit itself.

In terms of headline leverage, there is no indication of deals quickly becoming more aggressive. Leverage multiples have been pretty steady this quarter, ending at 4.57x total on a rolling three-month basis, from 4.52x in the second quarter.

Senior leverage has crept up over the course of the year from around the 3.5x in the first quarter to close to 4x, but there have been steps forward and back along the way, rather than a relentless march. Year-to-date, at 4.65x, 2013 is showing a very small increase in total leverage over 2012, following on with the broad trend at work since 2009 of a gradual rise.

“As the economy improves, bringing more visibility on future cash flows, leverage will creep up a bit. But it’s constrained by ratings. It’s all very well feeling that forecasts show a company can withstand higher leverage, but that’s no good if you don’t get the desired rating,” an arranger notes.
Standard & Poor’s Ratings Services’ latest quarterly analysis of the default rate for European speculative-grade companies (that is, those rated ‘BB+’ and below) shows that it has risen above 7% for the first time since the second quarter of 2010. Within recent reported defaults [particularly private defaults] are a high proportion of companies defaulting for a second and even a third time. In the absence of a material improvement in the economic outlook for the region, the still-weak credit quality of our private credit estimates portfolio, together with a less tolerant approach toward borrower-friendly amend-to-extend [A-2-E] transactions, suggests to us that this trend is likely to continue. We note that lenders’ attitude toward forbearance is already hardening in certain countries, resulting in rising defaults in France and The Netherlands in particular. (Watch the related CreditMatters TV video “Serial Defaulters Keep Pressure On Corporate Default Rate in Europe,” dated Sept. 11, 2013.)

European Default Update:
Serial Defaulters Pressure Europe’s Corporate Sector

Overview

- Ten EU-30 speculative-grade corporates [including private credit estimates] defaulted in the second quarter of 2013 on total debt of €8.7 billion, compared with 12 corporates and €2.4 billion in the first quarter.
- Over the past 12 months, 52 EU-30 speculative-grade companies have defaulted [11 publicly rated; 41 private credit estimates] carrying €31 billion of debt.
- The trailing-12-month speculative-grade default rate by number in the second quarter of 2013 was 7.5% [combining public and private portfolios] compared with an upwardly revised 7.6% for the first quarter.
- The default rate by value rose to 3.7% at the end of June 2013, from a revised 3.1% at the end of March 2013.
- Our 12-month default rate forecast [by number] to September 2014 of 6.5% is heavily influenced by the still-weak credit quality of a significant proportion of the credit estimates cohort.
Credit Estimates Dominate The Default Rate By Number

There were 10 corporate defaults in the second quarter of 2013, resulting in a trailing-12-month (TTM) EU-30 speculative-grade corporate default rate (combining our public rating and private credit estimate portfolios) of 7.5%. This rate is in line with our upwardly revised 7.6% default rate from the first quarter and continues to reflect a steady stream of credit estimate defaults, some of which have been slow to report (see table 1 and chart 1).

The default rate is heavily influenced by the low credit quality of our private credit estimates portfolio, of which 55.4% sits at the ‘b-/ccc’ level. This is either because credit estimates at this level remain vulnerable after restructuring for various reasons (including still-stretched balance sheets) or are continuing on probation. Other, highly leveraged, credits are still hoping that business conditions might pick up sufficiently to facilitate a refinancing on reasonable terms before their debt matures in 2013-2014.

Of the 10 defaults in the second quarter, three were publicly rated entities that missed making an interest payment. They comprise Netherlands-based integrated logistics services provider CEVA Group PLC (CEVA), which defaulted for the second time; Netherlands-based telecoms holding company Magyar Telecom B.V.; and Spain-based gaming company Codere S.A. There was also a default by a confidentially rated Greek shipping company. The six private credit estimate defaults were all pre-2008 transactions, of which three had previously defaulted.

We note that since the start of 2011, only eight of the 106 defaults have been investments or transactions where new public ratings or credit estimates were assigned from

*Data cover period from Jan. 1, 2003, to June 30, 2013. §Average no. of entities in database over period. TTM—Trailing 12 months. Europe—EU-27 + Iceland, Norway, and Switzerland.

Source: Standard & Poor’s.
the beginning of 2009. Of these eight, only three are private credit estimates, and none of the other five public defaulters had credit estimates prior to obtaining public ratings. The key takeaway is that more than 90% of defaults in the past two-and-a-half years relate to transactions originated at the height of the 2006-2008 bull market.

Serial defaulters stretch the default cycle
A notable feature of recent defaults is the high proportion of companies defaulting for a second or third time. Since the start of 2011, 44% of all the corporate speculative-grade defaults in this dataset are repeat defaults, with three defaulting for a third time. This is a key reason why the current default cycle is proving to be so protracted, and, in the absence of a material improvement in the economic outlook, the increasing frequency of A-2-E transactions suggests that this trend is likely to continue. A repeat default occurs when an entity’s corporate credit rating or private credit estimate is raised from ‘D/SD’ [Default/Selective Default] after a default or restructuring then suffers another default. Our default definition covers failure to pay; bankruptcy filings; and financial restructurings that we consider to be distressed exchanges, including some A-2-E transactions.

Default Rate By Value Ticks Up To 3.7%
By value, the €8.7 billion debt exposed by the 10 defaults in the second quarter was slightly above the quarterly average experienced since 2009, reflecting three large defaults with outstanding debt of more than €1 billion (CEVA €2.6 billion; and two large French credit estimate defaults). The average amount of debt held by defaulting entities was a material €980 million and €790 million, respectively, for public speculative-grade and private credit estimates defaulters. In aggregate, the TTM default rate by value ticked up to 3.7% from a revised 3.1% at the end of the first quarter of 2013 (see table 2), but is still well below the 4.9% average over the last cycle that started in 2008. Despite a gradual erosion in the number of private credit estimates in our portfolio as loan issuers refinance and investors in collateralized loan obligations slowly run down their portfolios, outstanding debt held by EU-30 private credit estimate corporate issuers remains significant at €218 billion. Of this amount, comprising both senior and junior funded debt, about €76 billion is held by companies with ‘b-/ccc’ credit estimates at the end of June 2013, of which 45% or €34 billion resides in the ‘ccc’ categories. Within the most vulnerable ‘ccc’ category, 40% of the outstanding debt is held by Spanish companies, much of which remains real estate-related. French companies are next in line, holding 25%, followed by German companies with 17%. Only 10% was held by U.K. companies at the end of June 2013.

Chart 1 | European Speculative-Grade Default Rate 2003–2014*

Trailing 12 months

Transportation Defaults Spike At 18%

The business environment continues to test the transport industry and two of the second-quarter defaults arose in the shipping (a confidential rating) and transport logistics segments (CEVA). These defaults mean that the TTM default rate in the transportation industry rose to a record 18.2% for the speculative-grade corporate portfolio that we track (see table 3).

Overcapacity continues to dog the shipping sector as new ships are delivered, and this, combined with slower-than-anticipated growth in global trade and high bunker fuel costs, is playing havoc with the industry’s economies.

CEVA’s default was triggered by missed interest payments just prior to a major restructuring in the second quarter of 2013. The company’s financial performance has been weakened significantly by the global supply chain industry’s volume shift to [cheaper] oceanic transport from air transport, and by its exposure to the weak southern European economies in its contract logistics business.

In the media and entertainment sector, the 10.6% default rate remains well-above average, led by print publishing firms (including those in the Yellow Pages segment) suffering from the structural shift toward digital media. Spain-based gaming company Codere was a high-profile public default in the second quarter caused by a missed payment.

The company is wrestling with an unsustainable capital structure, weak operational performance in Argentina and Mexico, and the effect of higher gaming taxes in Italy.

The retail sector, an early casualty of the recession, is struggling against rising unemployment, declining real disposable incomes, and depressed consumer expenditure—notably in the peripheral countries of Europe. The most recent quarter saw two French retail defaults, further highlighting the current deterioration in the economic environment in Europe’s soft core. These, together with a

Table 2  European Public And Private Speculative-Grade Default Rate (By Value) 2008–2013*

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Defaults</th>
<th>Value (bil. €)</th>
<th>TTM default rate (%)</th>
<th>No. of Defaults</th>
<th>Value (bil. €)</th>
<th>TTM default rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 2008</td>
<td>1</td>
<td>3.02</td>
<td>0.00</td>
<td>0</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Q2 2008</td>
<td>5</td>
<td>0.71</td>
<td>0.00</td>
<td>0</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Q3 2008</td>
<td>1</td>
<td>0.97</td>
<td>0.00</td>
<td>0</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Q4 2008</td>
<td>2</td>
<td>7.45</td>
<td>3.4</td>
<td>4</td>
<td>19.98</td>
<td>5.6</td>
</tr>
<tr>
<td>Q1 2009</td>
<td>26</td>
<td>14.21</td>
<td>6.6</td>
<td>4</td>
<td>3.35</td>
<td>6.5</td>
</tr>
<tr>
<td>Q2 2009</td>
<td>24</td>
<td>11.98</td>
<td>9.8</td>
<td>2</td>
<td>8.23</td>
<td>8.8</td>
</tr>
<tr>
<td>Q3 2009</td>
<td>22</td>
<td>9.27</td>
<td>12.1</td>
<td>6</td>
<td>5.10</td>
<td>10.1</td>
</tr>
<tr>
<td>Q4 2009</td>
<td>15</td>
<td>5.46</td>
<td>8.2</td>
<td>4</td>
<td>4.89</td>
<td>10.1</td>
</tr>
<tr>
<td>Q1 2010</td>
<td>10</td>
<td>0.69</td>
<td>8.2</td>
<td>1</td>
<td>0.00</td>
<td>5.0</td>
</tr>
<tr>
<td>Q2 2010</td>
<td>9</td>
<td>9.25</td>
<td>7.9</td>
<td>3</td>
<td>2.47</td>
<td>3.4</td>
</tr>
<tr>
<td>Q3 2010</td>
<td>7</td>
<td>2.79</td>
<td>6.2</td>
<td>1</td>
<td>2.17</td>
<td>2.6</td>
</tr>
<tr>
<td>Q4 2010</td>
<td>7</td>
<td>1.39</td>
<td>5.2</td>
<td>0</td>
<td>0.00</td>
<td>1.2</td>
</tr>
<tr>
<td>Q1 2011</td>
<td>8</td>
<td>2.96</td>
<td>8.2</td>
<td>1</td>
<td>0.37</td>
<td>1.3</td>
</tr>
<tr>
<td>Q2 2011</td>
<td>5</td>
<td>1.77</td>
<td>3.6</td>
<td>1</td>
<td>0.41</td>
<td>0.8</td>
</tr>
<tr>
<td>Q3 2011</td>
<td>4</td>
<td>5.96</td>
<td>4.9</td>
<td>0</td>
<td>0.00</td>
<td>0.2</td>
</tr>
<tr>
<td>Q4 2011</td>
<td>12</td>
<td>4.92</td>
<td>6.3</td>
<td>2</td>
<td>3.17</td>
<td>0.9</td>
</tr>
<tr>
<td>Q1 2012</td>
<td>12</td>
<td>4.65</td>
<td>7.1</td>
<td>3</td>
<td>10.52</td>
<td>2.8</td>
</tr>
<tr>
<td>Q2 2012</td>
<td>12</td>
<td>1.37</td>
<td>3.8</td>
<td>3</td>
<td>1.93</td>
<td>2.8</td>
</tr>
<tr>
<td>Q3 2012</td>
<td>12</td>
<td>5.52</td>
<td>6.6</td>
<td>12</td>
<td>0.48</td>
<td>2.6</td>
</tr>
<tr>
<td>Q4 2012</td>
<td>15</td>
<td>6.12</td>
<td>7.2</td>
<td>2</td>
<td>4.14</td>
<td>3.1</td>
</tr>
<tr>
<td>Q1 2013</td>
<td>8</td>
<td>1.67</td>
<td>6.2</td>
<td>4</td>
<td>4.37</td>
<td>1.9</td>
</tr>
<tr>
<td>Q2 2013</td>
<td>6</td>
<td>4.76</td>
<td>8.3</td>
<td>4</td>
<td>3.91</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Source: Standard & Poor’s.
credit estimate default by an Italian food service business, pushed the TTM default rate for the sector to 9.9% from 4.0% in 2012.

**LBO Defaults Rise Sharply In France And The Netherlands**

From a country perspective, the default rate in France and The Netherlands has risen most sharply over the past 12 months. Recessionary conditions in the soft core of Europe have undoubtedly played a part. However, another factor that we believe is playing out, particularly in France, is that lenders appear to be pushing back to a greater extent on A-2-E transactions than they were in 2010 and 2011.

In 2010 and 2011, it was noticeable that lenders to French companies were sympathetic to the practice of forbearance. This enabled debt maturities to be extended to buy time to enable companies to grow back into their balance sheets. The practice also protected lenders from getting caught up in protracted legal proceedings that in France are relatively favorable to debtors.

Now this trend appears to have reversed, with France and The Netherlands experiencing a rapid acceleration in the TTM default rate to 11.1% and 9.5%, respectively, from 8.7% and 5.6% in 2012; [see chart 3].

**Table 3 | European Speculative-Grade Corporate Default Rate By Industry Sector 2008–2013**

<table>
<thead>
<tr>
<th>Industry Sector</th>
<th>No. of entities</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>LTM Q2 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transportation</td>
<td>39</td>
<td>4.9</td>
<td>7.5</td>
<td>4.8</td>
<td>7.4</td>
<td>10.5</td>
<td>18.2</td>
</tr>
<tr>
<td>Business services</td>
<td>47</td>
<td>1.4</td>
<td>13.3</td>
<td>4.5</td>
<td>1.7</td>
<td>16.4</td>
<td>13.2</td>
</tr>
<tr>
<td>Media and entertainment</td>
<td>104</td>
<td>4.5</td>
<td>14.3</td>
<td>6.7</td>
<td>6.4</td>
<td>8.5</td>
<td>10.6</td>
</tr>
<tr>
<td>Retail/restaurants</td>
<td>71</td>
<td>5.1</td>
<td>22.7</td>
<td>2.6</td>
<td>7.0</td>
<td>4.0</td>
<td>9.9</td>
</tr>
<tr>
<td>Chemicals, packaging, and environmental services</td>
<td>45</td>
<td>10.8</td>
<td>19.0</td>
<td>1.7</td>
<td>3.9</td>
<td>13.5</td>
<td>9.4</td>
</tr>
<tr>
<td>Homebuilders/real estate</td>
<td>51</td>
<td>11.3</td>
<td>22.6</td>
<td>0.0</td>
<td>3.9</td>
<td>2.0</td>
<td>5.9</td>
</tr>
<tr>
<td>Automotive</td>
<td>34</td>
<td>9.5</td>
<td>23.7</td>
<td>2.5</td>
<td>4.9</td>
<td>2.6</td>
<td>5.8</td>
</tr>
<tr>
<td>Consumer products</td>
<td>51</td>
<td>7.1</td>
<td>13.0</td>
<td>1.6</td>
<td>6.4</td>
<td>13.2</td>
<td>5.7</td>
</tr>
<tr>
<td>Capital goods</td>
<td>43</td>
<td>1.7</td>
<td>10.0</td>
<td>3.8</td>
<td>7.0</td>
<td>4.7</td>
<td>4.8</td>
</tr>
<tr>
<td>Forest products</td>
<td>30</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>3.5</td>
</tr>
<tr>
<td>Health care</td>
<td>64</td>
<td>3.2</td>
<td>3.3</td>
<td>3.2</td>
<td>3.3</td>
<td>5.0</td>
<td>3.4</td>
</tr>
<tr>
<td>Technology</td>
<td>21</td>
<td>5.0</td>
<td>22.2</td>
<td>9.5</td>
<td>0.0</td>
<td>4.7</td>
<td>0.0</td>
</tr>
<tr>
<td>Oil and gas</td>
<td>21</td>
<td>0.0</td>
<td>0.0</td>
<td>4.5</td>
<td>0.0</td>
<td>4.1</td>
<td>0.0</td>
</tr>
</tbody>
</table>

due both to upcoming debt maturities in many cases as well as reduced appetite of existing bank and institutional lenders to roll over their loan commitments.

To reflect the different position in the liquidity cycle of the two portfolios, this quarter we have applied higher stress factors in our one-year default forecast to the credit estimate dataset. We believe this also aligns with EU regulators’ intention to move toward a more consistent classification of A-2-E transactions, which we anticipate will increase the likelihood of some of these vulnerable private companies being restructured.

Consequently, under our base case we now project the TTM default rate to increase slightly to 6.5% [see table 4] by the end of September 2014 from our previous forecast of 6.3% for the end of June 2014. This assumes that the default rate for credit estimates will remain above 9% over the next 12 months due to the weak credit quality of our credit estimates portfolio, with 55.4% at ‘b-’ or below—slightly higher than the March figure of 52.6%. Nonetheless, we continue to see the number of (legacy) credit estimates being whittled away through refinancing, conversion to public ratings, or repayment of the loans.

Our overall base-case forecast is somewhat lower than the latest actual 7.5% default rate by number as we work through the default cycle and transition away from

---

**Chart 2 | European Public And Private Speculative-Grade Cumulative Default Volume 2008–2013* **

- Private credit estimates
- Public speculative-grade ratings

(12-month volume; bil. €)

*Data cover period from the fourth quarter of 2008 to the second quarter of 2013. €urozone = EU-27 plus Iceland, Norway, and Switzerland. TTM—Trailing 12 months.

Source: Standard & Poor’s.

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**Chart 3 | European Speculative-Grade Corporate Default Rate By Country 2008–2013* **

- Spain
- France
- Italy
- The Netherlands
- U.K.
- Germany

(12-month volume; bil. €)

*Data cover period from Jan. 1, 2008, to June 30, 2013. §Data combines rated entities and private credit estimates. €urozone—EU-27 + Iceland, Norway, and Switzerland. LTM—Last 12 months.

Source: Standard & Poor’s.

© Standard & Poor’s.
Table 4 | European [EU-30] Speculative-Grade Default Projections To September 2014

One-year default assumptions for ratings/credit estimates

<table>
<thead>
<tr>
<th>[ % per year ]</th>
<th>Public ratings</th>
<th>Credit estimates</th>
<th>Combined</th>
<th>Public ratings</th>
<th>Credit estimates</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>B+</td>
<td>0.6</td>
<td>0.7</td>
<td>0</td>
<td>0.9</td>
<td>1.0</td>
<td>1</td>
</tr>
<tr>
<td>B+</td>
<td>2.1</td>
<td>2.2</td>
<td>2.6</td>
<td>2.6</td>
<td>2.7</td>
<td>2.7</td>
</tr>
<tr>
<td>B</td>
<td>4.3</td>
<td>4.7</td>
<td>5.5</td>
<td>5.9</td>
<td>5.9</td>
<td>5.9</td>
</tr>
<tr>
<td>B-</td>
<td>6.7</td>
<td>7.4</td>
<td>8.9</td>
<td>8.9</td>
<td>9.6</td>
<td>9.6</td>
</tr>
<tr>
<td>CCC/CC</td>
<td>23.4</td>
<td>25.1</td>
<td>28.6</td>
<td>30.3</td>
<td>30.3</td>
<td>30.3</td>
</tr>
</tbody>
</table>

Default rates

| Percentage | 4.1  | 9.1  | 6.5  | 5.2  | 11.3 | 8.1  |
| No. of defaults | 15   | 29   | 43   | 18   | 36   | 54   |

Source: Standard & Poor’s.

Chart 4 | European [EU-30] Speculative-Grade Ratings Distribution 2005–2013*

*Data cover period from Jan. 1, 2005, to June 30, 2013. EU-30 = EU-27 + Iceland, Norway, and Switzerland.

© Standard & Poor’s 2013.


*Data cover period from Jan. 1, 2005, to June 30, 2013. EU-30 = EU-27 + Iceland, Norway, and Switzerland.

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private credit estimates. In addition, the unusually high number of defaults in the second half of 2012—which will be difficult to repeat in the second half of 2013—is likely to produce a modest easing in the headline default rate from the current level.

In our more severe downside scenario, where the European economy slumps into a more severe and extended recession accompanied by more difficult credit conditions in financial markets, we could see the default rate by number rise as high as 8.1%. We project that this scenario would be led by legacy 2006–2008 vintage LBOs, for which we envisage the default rate rising above 11%.

Chart 6 tracks the actual TTM default rate (by number) and compares to our base-case and downside forecasts since the end of 2009. The actual default rate has been about 1% above our base-case forecast in recent years, but well below our downside scenario. On closer scrutiny, the variation against our base-case forecast is solely due to the consistently higher default experience of our private credit estimate portfolio over this period.

This lends support to our revised approach in applying slightly harsher stress assumptions to the credit estimates portfolio to reflect the near-term liquidity risks to which many private credit estimates are still exposed.

Related Criteria And Research
All articles listed below are available on RatingsDirect.

- Mixed Signals Distort The Default Cycle In Europe, June 27, 2013
- Europe’s Senior Loan Market Continues To Deliver A Strong Recovery Performance, June 25, 2013
- European CLOs: Life After The Reinvestment Period, May 14, 2013

*A Data cover period from December 2009 to September 2014. EU-30 = EU-27 + Iceland, Norway, and Switzerland. 
**Forecast. 
Source: Standard & Poor’s. 
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N
early four years have passed since the peak in European default
Poor’s Ratings Services published its first empirical study on European
debt instruments that defaulted between 2003 and 2010 (“Europe’s
Senior Loan Market Delivers A Strong Recovery Performance Over Its
First Cycle”). This second empirical study includes data for 2011 and
2012 and covers 674 defaulted debt instruments (an increase of 269
over the 2012 study). Although our findings for this study remain
preliminary due to the large volume of interim recoveries, we believe
they accurately model investors’ experience over the first real cycle of
an expanded European leverage finance market.

Europe’s Senior Loan Market
Continues To Deliver A Strong
Recovery Performance

Overview
• First-lien secured debt recoveries have remained strong through the cycle, with a mean
nominal recovery rate of 78% between 2003 and 2012. This is marginally higher than the
76.0% in the previous study, and is broadly comparable with the nominal recovery rate of
83.6% for U.S. loan facilities.
• Senior unsecured debt (primarily speculative-grade bonds rated ‘BB+’ and below)
achieved recoveries of 48% between 2003 and 2012, which compares well with the U.S.
long-term empirical average of 51.0% for senior unsecured bonds or 45.7% for all bonds.
• Second-lien debt recoveries for 2003-2012 have improved to 37% from last year’s study
mean of 31%. Still, second-lien recoveries remain low and are little better than the
mezzanine loan recovery rate of 35%.
• However, we view the nominal European recovery rate with caution since it includes a
high volume (78%) of interim recoveries, which are generally debt exchanges.
• The number of defaulted credits in our study has expanded to 173 from 101, and the
number of instruments has grown to 674, an increase of 269.

The key findings that we’ve drawn from this expanded data set are consistent with last
year’s report. First-lien secured debt recover-
ies have stayed strong at 78% between 2003
and 2012, which is very close to the mean
nominal rate of 76% from the first study
mentioned above. Similarly, senior unsecured
debt recoveries, at 51%, are only marginally
higher than the 48% recorded last year.
Second-lien recoveries have improved slightly
to 37% from 31%, but this is still a low rate, and is little better than that for mezzanine—a more subordinate debt instrument—at 35%.

As in our first study, the results in this year’s report show there are similarities with U.S. first-lien recoveries, which have a mean nominal recovery rate of 83.6% between 1987 and 2012.

However, the nominal European recovery rate still contains a high volume (78%) of interim recoveries, which are mostly debt exchanges where there is a lack of reliable trading price information on the new securities. Currently, we assume that the new instrument is valued at par. As the instrument is redeemed, written off, or when it receives a reliable trading price, the recovery value will be updated to an ultimate recovery. Therefore, it is likely that ultimate recoveries may result in overall lower recoveries in the portfolio over time.

Defining The Dataset: Scope, Specifications, Qualifications, And Limitations

This second empirical study on European corporate recovery rates expands on the 2012 study, with 674 instruments included—an increase of 269. We’ve extended the time period by two years to include 2011 and 2012 (the 2012 study covered 2003 to 2010). This study includes 173 of 337 known defaults in the period, with the data still biased toward defaults that occurred after 2005. It includes the majority of publicly rated defaults and the largest by value.

The number of defaulted instruments has increased from 405 in the April 2012 study to 674. Of these, just 145, or 22%, have ultimate recoveries. The remainder are interim recoveries on defaulted instruments [mainly debt exchanges] where there is a lack of reliable trading price information on the new securities. This study therefore differs from the U.S. study, which only includes ultimate recoveries. We take the view that the inclusion of these interim recoveries provides more value than if they were excluded, although they may lead to higher estimates for recovery rates, as we discuss later.

In the event that the debtholder receives a portion of equity in exchange for a material write-down, we assume this equity has a zero value [as we do for all debt tranches] unless there is evidence to the contrary.

The methodology we use in this report is predominantly the same as that used for the Standard & Poor’s LossStats database. The refinements we have adopted for our study are detailed in the Appendix, along with key definitions from the LossStats Database User Guide.

European First-Lien Recoveries Remain Remarkably Stable, Despite The Expanded Dataset

Despite the huge increase in the number of data points [from 269 to 459], the first-lien recovery rate remains little-changed from last year’s report. The mean recovery rate has risen from 76% to 79%, the median rate from 89% to 100%, and the standard deviation from 28% to 27% [see chart 1 for the full distribution of recoveries and a comparison with the 2012 study]. These results are comparable with the long-term averages observed for U.S. loans, which have a mean
recovery for all senior loan facilities of 83.6%, a median of 100%, and a standard deviation of 36.6% [see “Recovery Study (U.S.): Most Nonfinancial Sectors Showed Distinctive Trends In Recovery Rates Over The Last 25 Years,” published Jan. 24, 2013].

We obtain similar results if we view the recoveries by number of instruments rather...
Europe's Senior Loan Market Continues To Deliver A Strong Recovery Performance

Chart 5 | European Publicly Rated Companies: Recovery % In First-Lien Debt By Value

- Amount of debt (1st publication)
- Amount of debt (2nd publication)

© Standard & Poor's 2013.

Chart 6 | European Publicly Rated Companies: Recovery % In First-Lien Debt By No. Of Instruments

- Number of cases (1st publication)
- Number of cases (2nd publication)

© Standard & Poor's 2013.

Chart 7 | European Credit Estimates: Recovery % In First-Lien By Value

- Amount of debt (1st publication)
- Amount of debt (2nd publication)

© Standard & Poor's 2013.
than by value (see chart 2), indicating that a small number of high-value defaults do not unduly skew the figures.

**Does Vintage Matter?**

One of the most frequent requests that Standard & Poor’s received following the publication of last year’s recovery report was to provide data on recoveries by vintage, both by origination year and by default year. With the increase in the number of instruments to 674, we believe the current dataset can provide more meaningful statistics in this area.

The data suggests that vintage does not appear to have played a role in first-lien recoveries, with the possible exception of 2008. Specifically, the spike in default and recovery in 2009 did not result in a material drop in first-lien recoveries. The only material drop in recovery levels was in 2008, when they were 10% below the period average. It is difficult to argue, however, that this was due to the rise in the volume of defaults, seeing as 2009 had a much greater volume of defaults but was much closer to the average.

**Outliers Still Drag Down Recovery Rates For Publicly Rated Companies**

A comparison of recoveries on first-lien debt for publicly rated companies against our portfolio of credit estimates continues to show a markedly different outcome, which is unsurprising since there are only four new data points for publicly rated companies compared to the 2012 study. *(For further details on our credit estimates, see "What Are Credit Estimates And How Do They Differ From Ratings?" published April 6, 2011.)*

The mean recovery for publicly rated companies’ first-lien debt increased marginally from 62% to 63%, with the median remaining at 66% (see charts 5 and 6). For credit estimates, the mean increased slightly from 79% to 81%, and the median increased from 91% to 100% (see charts 7 and 8). The lower recoveries for publicly rated companies can be partly explained by a single large default, Lyondell Basell, which had recoveries in the 60%-70% range, and by Wind Hellas, which had recoveries in the 0%-10% range. Without these two cases, the mean for publicly rated companies would have been slightly higher at 66%.

**Investors’ Forbearance Keeps Interim Recovery Rates High**

Ultimate recovery—the value of the settlement a lender receives by holding an instrument throughout its emergence from default—represents the current estimate of a defaulted instrument’s value, based on the best information available *(see Appendix for more details).*

When we compare the 72 ultimate first-lien recoveries with the 387 interim recoveries, an interesting picture emerges. Specifically, the ultimate recoveries achieved are lower than the interim recoveries *(see table 1 and charts 9 and 10). We believe this is due to the high percentage of interim recoveries in which debt has been rolled over or extended. As we track these new instruments to ultimate recovery, the recovered value for original investors is likely to be lower. Despite the apparent turn in the

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**Chart 8**  
**European Credit Estimates: Recovery % In First-Lien Debt By No. Of Instruments**

© Standard & Poor’s 2013.
default cycle after the third quarter of 2009, it has always been our view that the default rate over the past two years was artificially depressed by the accommodating behavior of senior lenders, who we believe have been more interested in minimizing book losses while at the same time capitalizing on amendment fees and higher spreads. One might have expected this second study to result in lower overall recoveries as more interim recoveries migrate to ultimate recoveries. This has not happened, however, largely due to an almost 50% increase in interim recoveries in this second study. As these interim recoveries migrate to ultimate recoveries, the actual recovery rates may be lower.

### Table 1 | Statistical Breakdown Of Interim Recoveries Versus Ultimate Recoveries For First-Lien Debt In Europe 2003–2012

<table>
<thead>
<tr>
<th></th>
<th>Ultimate recoveries %</th>
<th>Interim recoveries %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>63.2</td>
<td>81.7</td>
</tr>
<tr>
<td>Median</td>
<td>66.4</td>
<td>100.0</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>34.5</td>
<td>24.1</td>
</tr>
</tbody>
</table>

### Chart 9 | European Corporates: Final versus Interim Recoveries On First-Lien Debt By Value 2003–2012

© Standard & Poor’s 2013.

### Chart 10 | European Corporates: final Versus Interim Recoveries On First-Lien Debt By Value 2003–2013

© Standard & Poor’s 2013.
As banks seek to comply with increased regulation and the need to reduce their risk-weighted assets, we believe senior bank lenders are increasingly likely to adopt a more robust stance in terms of disposing of non-core assets. We believe they are also more likely to take appropriate remedial action to address loan exposures where underperforming businesses with overleveraged balance sheets have approaching maturities. Increased regulation could therefore precipitate the process of interim recoveries migrating to ultimate recoveries.

Excluding Non-Defaulted Instruments Enhances Data Integrity

Many of the 173 company defaults covered in this study are what we deem “selective defaults” (that is, where only some of the issuer’s instruments defaulted). By definition, the recovery on the instruments that do not default is 100%, and the inclusion or exclusion of these instruments can affect the results. For example, among our 173 company defaults, there were 164 first-lien instruments that did not default. If we were to treat these instruments as having full (100%) recovery, the calculation of mean recovery on first-lien debt would rise to 84% from 79%, the median calculation would remain at 100%, and the standard deviation would dip slightly to 25% from 27%.

Throughout this report, therefore, we exclude these non-defaulted instruments from our calculations, which is consistent with Standard & Poor’s LossStats methodology.

First-Lien Recoveries Are Unaffected By Insolvency Regime

When reviewing recoveries by country, it is important to note that the sample size remains comparatively small. The 46 instruments in the Spanish jurisdiction, for example, represent just 14 companies. In the 2012 study, we highlighted the fact that recoveries for Spain and France were as good as, or better than, recoveries for the U.K. This remains the case, but the one notable feature is the material rise in the German recovery rates, off the back of an increase from 39 to 92 instruments in the latest study. This resulted in the mean increasing from 79% to 90% and the median increasing from 90% to 100%.

At this stage, however, we believe that in the context of the small size of the dataset, there is inadequate evidence of differences in recoveries among the main European jurisdictions. It will be interesting to view the development of these statistics as the dataset increases each year. Once we have experienced at least one economic cycle, the evidence may have a material impact on our existing jurisdiction-specific adjustments (see “Jurisdiction-Specific Adjustments to Recovery and Issue Ratings,” published June 20, 2008).

Second-Lien And Mezzanine Debt Recoveries Remain Significantly Lower Than Other Asset Classes

Perhaps the most unexpected result of our first recovery study was how similar (and how low) the second-lien and mezzanine recoveries were. We categorize debt as second-lien

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where it is secured but subordinated to the senior debt, and senior to an additional layer of secured debt defined as mezzanine debt. If there is only one layer of secured subordinated debt, we consider it to be mezzanine debt.

The number of second-lien and mezzanine instruments has increased to 166 (from 84 in the previous study), but the results remain remarkably similar, albeit with higher overall recoveries. Mezzanine mean recoveries increased slightly from 30% to 35%, with the standard deviation increasing from 43% to 45%. Second-lien recoveries increased from 31% to 37%, with the standard deviation increasing from 37% to 43%. Despite these increases, recoveries in both asset classes were heavily skewed toward either 100% or 0%, and the very high levels of negligible recoveries continue.

When second-lien debt was introduced in 2006, there was considerable debate among market participants about whether investors in second-lien debt were being compensated adequately for risk. This was referred to commonly in the market as whether such debt was "stretched senior" or "underpriced mezzanine." In other words, if the level of recoveries were to turn out to be nearer to those of senior secured debt, then the market might deem the debt "stretched senior," since investors were paid higher margins than for senior secured debt. On the other hand, if the recoveries were to turn out to be closer to traditional mezzanine recoveries, then the market might consider the debt to be "underpriced mezzanine," since investors were paid lower margins than on typical mezzanine debt.

Based on the 166 instruments that have defaulted (that is, all the secured but subordinated debt instruments we have recoveries for), the mean recovery of 37% on second-lien debt is slightly higher than recoveries on...
mezzanine debt. So our sample second-lien debt would appear to continue to behave more like underpriced mezzanine debt than stretched senior debt.

Over the ten years covered by our study, we observe 60 instances of second-lien debt defaulting. By value, we note that more than 82% of these instruments have a recovery of less than 10%. By number of instruments, this falls to 48%, but in our view the recovery rate at this level is extremely high.

One of the reasons that second-lien issues have demonstrated such low actual recoveries is because those tranches tend to form a relatively small proportion of the total debt issued by a given issuer. That means that the second liens are highly likely to achieve either full or zero recovery in a default scenario. This is because a small incremental difference in the enterprise value of a company at default can result in a large shift in the value available for a lower-lien debtholder.

For mezzanine tranches, actual recoveries are remarkably similar to those for second-lien debt. Of the 106 defaulted mezzanine instruments in our study, 75% received a value of less than 10%. The higher instance of 90%-100% recovery in this category (see charts 12 and 13) relates to instruments that had their interest converted to payment-in-kind (PIK), triggering a default, but an interim full recovery. As identified above, these interim recoveries may be overestimating ultimate recoveries.

In 45% of cases, we note that the second-lien debtholder often receives a portion of equity in exchange for a material write-down. For our analysis, we assume this equity has a zero value [as we do for all debt tranches] unless there is evidence to the contrary. Of the equity portions allocated to second-lien debt, 13% received less than 5% of the total equity of the restructured organization. In only 6% of cases did tranche holders receive more than 40% of the equity, generally where the company was small in size and the subordinated lenders took ownership of it. In this 6% of cases, we believe there is potential for a higher recovery level and we will continue to monitor the asset until final recovery.

In our opinion, it would be premature to assume that our study sample is representative of the entire second-lien debt class in Europe. It’s possible that these early defaulters, because they defaulted quite quickly, may be unrepresentative of the class as a whole.

Unsecured Recoveries Continue To Track Global Recoveries

Despite the still small sample of instruments [which have risen from 29 to 33], recoveries on senior unsecured debt, primarily speculative-grade bonds, remain close to the observed mean values from our much larger U.S. dataset. Eighty-seven percent of the defaulted European instruments that we categorize as senior unsecured debt are speculative-grade bonds. The mean recovery rate of these instruments over 2003-2012 is 48%, the median recovery rate is 38%, and the standard deviation is relatively high at almost 32%.

Despite the comparatively small sample size, these results are consistent with the findings of Standard & Poor’s Global Fixed Income Group for the U.S. This group has established nominal recovery rates of 51% [mean], 43% [median], and a 39% standard deviation for senior unsecured bonds that defaulted between 1987 and 2012. [For more details, see “Default, Transition, and Recovery: Recovery Study [U.S.]: Piecing Together The Performance Of Defaulted Instruments After The Recent Credit Cycle,” published Dec. 1, 2011.]

Results Deliver A More Complete Picture Of European Recovery

Although our findings for this study remain preliminary [an evaluation of 173 of 337 known company defaults, and 78% interim recoveries], we believe they accurately model investors experience over the first real cycle of an expanded European leverage finance market. In particular, the stability of the findings, despite a 50% increase in the number of data points from the 2012 study, indicates that the statistics may be a meaningful representation of the full market dataset.

While there are limits to the existing data, including the high percentage of companies that we consider to have interim recoveries, we have found that recovery rates on European first-lien debt have remained strong throughout the cycle. This experience mirrors recoveries on similar debt facilities from U.S. companies. We will continue to collect and analyze this data to obtain a fuller picture of the first cycle for the European leveraged finance market, about which data on actual recovery rates post-default has so far been limited.
Standard & Poor’s continues to compile data on the remaining 164 known defaults, and new defaults as they arise, to provide an annual update on this study.

Related Criteria And Research
All articles listed below are available on RatingsDirect, unless otherwise stated.
- European Corporate Defaults Likely To Rise In 2012 On Gloomy Business And Financing Prospects, Jan. 18, 2012
- Piecing Together The Performance Of Defaulted Instruments After The Recent Credit Cycle, Dec. 1, 2011
- What Are Credit Estimates And How Do They Differ From Ratings?, April 6, 2011
- Timeliness of Payments: Grace Periods, Guarantees, And Use Of ‘D’ And ‘SD’ Ratings, Dec. 23, 2010
- Criteria Guidelines For Recovery Ratings On Global Industrial Issuers’ Speculative-Grade Debt, Aug. 10, 2009
- Understanding Standard & Poor’s Rating Definitions, June 3, 2009
- Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009
- Update: Jurisdiction-Specific Adjustments To Recovery And Issue Ratings, June 20, 2008

Appendix: Definitions From LossStats Database User Guide

Interest rates
We define the effective interest rate as the prepetition rate at the time the last coupon was paid. For fixed-coupon instruments this is the fixed rate, and for floating-rate instruments it is the floating rate used at the time of default. Nominal recovery rates are also reported, which are the nondiscounted values received at settlement.

Interim recovery
Specifically for this study, Standard and Poor’s are using the concept of “interim recovery”. This is where the defaulted instrument has been converted or exchanged to a new instrument, with a new maturity date, but where there is no reliable trading price for that instrument. This situation is very common in Europe. We assume that this new instrument is valued at par. As the instrument is redeemed, written off or receives a reliable trading price, the Interim Recovery will be updated to an Ultimate Recovery.

Recovery
We define recovery as the ultimate recovery rates following emergence from three types of default: bankruptcy filings, distressed exchanges, and nonbankruptcy restructurings. Unless specified otherwise, we base recoveries at the instrument level. Recovery is the value creditors receive on defaulted debt. Companies that have defaulted and moved into bankruptcy will usually either emerge from the bankruptcy or will be liquidated. On emergence from bankruptcy, creditors often receive a cash settlement, new instruments (possibly debt or equity), assets or proceeds from sale of assets, or some combination.

Ultimate recovery
Ultimate recovery is the value of the settlement a lender receives by holding an instrument through its emergence from default. The recovery is based on the amount received in the settlement divided by the principal default amount. Within Standard & Poor’s LossStats database, three recovery valuation methods are used to calculate ultimate recovery:
- Trading price at emergence. We can determine the recovery value of an instrument by using the trading price or market value of the prepetition debt instruments upon emergence from bankruptcy. Of the three methodologies, this one is the most readily available because most debt instruments continue to trade during bankruptcy.
- Settlement pricing. The settlement pricing includes the earliest public market values of the new instruments that a debtholder receives in exchange for the prepetition instruments. It is similar to the trading price method, except that it is applied to the new [settlement] instrument instead of the old [prepetition] instrument.
- Liquidity-event pricing. The liquidity event price is the final cash value of the new instruments or cash from the sale of assets that the lender acquires in exchange for the prepetition instrument.
Editor’s note: This article is part of a series examining the dynamics of debt in Europe and how this will shape the path to recovery.

The funding environment for mid-market companies in Europe is at a turning point. These enterprises, which are an engine for economic growth and employment, are increasingly seeking to diversify their funding sources as banks, their traditional lenders, embark on a deleveraging process that may take many years. At the same time, investors searching for yield increasingly want to diversify their investments into this new asset class. However, despite some progress on linking together mid-market companies with willing capital, a cohesive pan-European solution is still elusive. Most of the current funding alternatives to bank lending and capital markets fundraising are still dominated by large companies. Of the one-thousand nonfinancial companies that Standard & Poor’s rates in Europe, only a handful of them meet our definition of the mid-market.

Developing an efficient pan-European funding market for these companies will necessitate changes for both issuers and investors, in our view. For debt issuers, expanding outside of a long-term banking relationship can be a significant cultural shift. Companies also regard interest rates demanded by institutional investors in many cases to be too high. For investors, we believe that better access to timely financial information could go some way toward helping to diversify into this new asset class. There are also other challenges, including differing regulatory and accounting environments across Europe.
Underwriting The Recovery: Mid-Europe’s Market Seeks New Ways To Fund Growth

Chart 1 | Eurozone Nonfinancial Corporations Loan And Security Issuance

<table>
<thead>
<tr>
<th>NFC long-term net loan issuance</th>
<th>NFC long-term net security issuance</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Mil. €)</td>
<td></td>
</tr>
</tbody>
</table>

Sources: ECB; Loans up to end Dec 2012; Securities up to end Nov 2012; Long-term securities issuance includes all securities >1 yr excluding shares. © Standard & Poor’s 2013.

Chart 2 | Yearly Nominal Growth Of Bank Loans And Deposits For Nonfinancial Corporates By Country*

<table>
<thead>
<tr>
<th>Loans</th>
<th>Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>[% change]</td>
<td></td>
</tr>
</tbody>
</table>


Chart 3 | U.K. Private Nonfinancial Corporations Loan And Security Issuance

<table>
<thead>
<tr>
<th>PNFC net loan issuance</th>
<th>PNFC net security issuance</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Mil. €)</td>
<td></td>
</tr>
</tbody>
</table>

Sources: BOE; Loans and bonds up to end Dec 2012; Total net issues of all currency stand-alone and program bond issues by PNFCs. © Standard & Poor’s 2013.
A Hard-To-Define Asset Class

The mid-market is a critical engine for economic growth and employment in Europe. Across France, Germany, Italy, and the U.K., the mid-market generates about one-third of private sector revenue and employs a third of each country’s workforce, according to research from GE Capital, which is an active mid-market lender.

The middle market asset class is difficult to define in Europe because both government and private organizations in individual countries regard its scope differently. For example, France, Germany, and the U.K. define midsize companies in different ways [see Appendix table 1]. For the purpose of this report, we define mid-market companies as those with revenues between €100 million and €1.5 billion and outstanding debt between €50 million and €500 million. We also exclude financial firms, utilities, leveraged buyouts, and project finance.

Disintermediation Will Be A Multiyear Trend In Europe

Disintermediation—where bank lending is replaced by capital market funding—is likely to be incremental in Europe, in our view. Increasing regulatory pressure, particularly the effect of new capital requirements for banks under Basel III regulations, coupled with bank deleveraging in certain countries, means that financial institutions are narrowing their lending focus to major clients, mostly domestic companies with which they have strong relationships. They are also concentrating their deleveraging efforts on capital- and cost-intensive wholesale and international businesses. According to our research, this strategy is influenced by pressure from national governments to prioritize domestic lending and, in some cases, increase purchases of domestic government debt as foreign investors retreat [for more information, see “Global Banking Risks And Credit Trends Dominated By Fragile Economies, Evolving Regulations, And Government Support,” published on RatingsDirect on Jan. 17, 2013].

We believe bank balance-sheet deleveraging will be a slow process, with a gradual shift over many years as investors develop an appetite and the ability to increase their share of term lending. According to ECB figures, disintermediation is beginning to occur overall across the eurozone [European Economic and Monetary Union], with net loan issuance to eurozone nonfinancial corporates turning negative in 2012 [see chart 1]. But anecdotal research suggests that in certain regions—particularly France and Germany—mid-market companies still have relatively good access to bank credit. European Central Bank [ECB] data shows that deleveraging of bank balance-sheet loans is occurring at a much faster pace in countries such as Spain, Ireland, and Italy, while net lending from banks increased in Germany (0.2%) and decreased by only a very low percentage (-0.4%) in France in 2012 [see chart 2]. And Bank of England data shows a much more long-term contraction of bank lending beginning in 2009 through to 2012 [see chart 3].

Just how quickly and smoothly the process of disintermediation will occur in Europe will in our view depend on how the regulatory framework evolves as well as other various key questions: How fast will other sources of debt finance develop? What will happen to bank lending capacity—in particular to what degree can securitization be redeployed as a funding tool in Europe? And will demand for debt grow through investment, dividends, and mergers and acquisitions? There are also cultural considerations, such as how easily a deeply ingrained banking culture will be able to change.

Alternative Funding Is Nascent

The alternatives to bank funding for mid-market companies in Europe form a cluttered and incohesive landscape. In addition, most direct funding is still mainly aimed at companies larger than what we would consider to be the middle market. These include the developing loan fund market, the U.S. private placement market, the private placement market in Germany (the “Schuldschein” market), the very young private placement markets in the U.K. and France, and to some extent regional bond platforms on exchanges.

The non-bank lending market reawakens

Institutional lending by funds—as opposed to banking institutions—has been slow to develop in Europe, partially because of a lack of new deal flow since the global financial crisis of 2007–2009. Pre-2008 non-bank lending in Europe was dominated by collateralized loan obligation (CLO) funds,
mezzanine funds—which specifically lend subordinated debt to companies—and some nonleveraged loan fund managers, such as MGIG Investments. However, the financial crisis derailed new entrants to this market, particularly as stagnant buyout activity and the subsequent lack of new deal flow meant that it was difficult for new types of loan investors to raise capital to invest. However, over the past year there has been a resurgence in fund investors’ interest to lend to smaller companies in Europe. These include private equity and asset managers, such as Axa Private Equity, Ares Capital, and Amundi. More recently, press reports indicate that there are new CLO transactions under way—structured transactions that have not been seen since before the financial crisis—including one that has already been priced from Pramerica. These funds in Europe typically help fund private equity buyouts and a handful of small-to-midsize enterprises, and have indicated they may increase lending to these types of companies.

Private placement markets offer stability and simplicity

The U.S. private placement market is a unified and efficient market that mid-market and larger companies can use to access funding. In 2011, it was a $50 billion market, and in 2012 it expanded to $55 billion. The number of European companies tapping it is also growing (see chart 4). Although 39% ($43 billion) of issuance by volume came from European companies in the period 2010 to first-quarter 2013, only about 10% of French, German, and U.K. issuers fall within our definition of the mid-market (for more details see Appendix table 2).

In general, the U.S. private placement market is a private bond market available to both U.S.-based and non-U.S.-based companies. The market is flexible in terms of size: issuers can raise up to $1 billion. Private placement bonds are typically fixed-rated U.S. dollar-denominated tranches with maturities of between three and 15 years. Yet, issuance of floating-rate debt and in multiple currencies is all a possibility. Investors in the U.S. private placement market are typically insurance companies. They are long-term “buy and hold” investors and do their own rigorous due diligence, taking comfort from the fact that U.S. private placements typically have covenants similar to bank credit facilities as opposed to the usually looser bond covenants. From the company’s perspective, the market is seen as relatively stable (it was open throughout the period 2008-2009). Furthermore, the process is relatively simple, as no Securities and Exchange Commission (SEC) registration is required, and the lender base does not expect ancillary business, unlike in a banking relationship.

The most developed of the European private placement markets is the German Schuldschein corporate market, which is essentially a bilateral, unlisted, unregistered loan market, governed by German law. Both large multinationals as well as midsize domestic companies have historically tapped this market. Looking at companies for which there is publicly available issuance information, only a handful in 2010-2012 would fall...
into the mid-market group [for examples, see Appendix table 2]. In 2012, the market had a volume of €12.2 billion, and in 2011 there were 65 deals with a volume of €8 billion [see chart 5]. Companies typically borrow in sizes of €10 million to €500 million, with floating or fixed coupons and maturities of two to 10 years.

The main investors in the market are German banks, insurance companies, and to a lesser extent investment funds, including some for retail investors. Although Schuldschein loans cannot be listed on stock exchanges, there is a secondary market for the instruments, in which the original arrangers of the facilities act as market makers.

Although most users of the market are German, non-German corporates are increasingly using them to reach German investors. For example, the French textile and apparel mid-market company Etam Developpement S.A. completed a €40 million issue in 2011, and health care company Eurofins Scientific S.A. raised €170 million in 2011 [see Appendix table 2]. However, one type of Schuldschein investor, the German savings banks (“Sparkassen”) is not allowed to invest in foreign companies. Furthermore, foreign issuers must be willing to comply with German law.

In the U.K., the Association of Corporate Treasurers (ACT) is leading a working group exploring the development of a private placement market. The group released an interim report in December that says there is clear demand for this type of market, but that there are changes that need to be made to facilitate this in the U.K. These include the need for clear regulatory treatment for insurance company investors, standard documentation, readily available information about market activity, a track record of performance and defaults built up by individual investors, and investors that are prepared to set up internal resources to participate in the market. According to ACT, these obstacles can be overcome, but it will take time. It says the regulatory treatment for insurance company investors could be the most difficult obstacle, while standard documentation and information about market activity could be the barriers most easily resolved.

Currently, U.K. companies use the U.S. private placement market: 44% of the FTSE 350 and 40% of the FTSE 250 have issues outstanding, according to the Breedon Report, commissioned by the U.K.’s Department for Business Innovation and Skills (BIS). However, these tend not to be mid-market companies, according to our definition. For example, in 2012, energy utility SSE, Anglian Water, and Thames Water tapped the U.S. private placement market. Yet, these companies’ turnover place them well beyond our mid-market definition.

Until recently, most European private placements completed in France were also too big to fall within our mid-market definition. However, at the end of 2012 and in the first quarter of this year, there were six issues that fell within the mid-market (also see Appendix table 2). For comparison, 22 companies in total issued private placements in France in 2012. In addition, Société Générale and AXA Group last year established a joint venture that works like a private placement market for mid-market companies. Société Générale has credit expertise, but not an unlimited balance sheet. AXA, meanwhile, invests strongly in sovereign issues and is looking to diversify into more corporate lending. The partnership signed two transactions

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**Chart 5 | German Schuldschein Issuance 2007–2012**

(Bil. €)

- 2007
- 2008
- 2009
- 2010
- 2011
- 2012

Sources: BayernLB Research, CFO Insight, DZ Bank, © Standard & Poor’s 2013
in 2012. These included a €150 million fund-raising for Néopost, the postal service company, in September, which would be close in size to a mid-market financing.

**Bond platforms on exchanges are still in development**

Germany has also taken the lead in developing funding avenues for companies in Europe via exchanges. More than 55 companies have debt of approximately €3 billion that is actively traded across the three main stock exchanges in Germany: BondM on the Stuttgart Stock Exchange, Mittelstandsmarkt on the Düsseldorf Stock Exchange, and Entry Standard on the Frankfurt Stock Exchange.

These platforms allow retail investors and family offices the opportunity to invest, as well as some traditional institutional investors. In Germany the companies that tap these markets would be considered midsize. Indeed, 51 of the companies currently listed have revenues of below €500 million.

However, the markets are less developed in France and the U.K. In the U.K., the London Stock Exchange has set up ORB (the Orderbook for Retail Bonds) to allow private investors to buy into individual corporate bonds in small denominations. It mostly started with large companies such as Royal Bank of Scotland, Tesco Bank, and National Grid issuing. Yet, some mid-market companies are beginning to tap the market, such as International Personal Finance PLC. In France, NYSE-Euronext launched its bond market in 2012, which is open to retail investors. It has executed three transactions so far, from agricultural companies AggroGeneration S.A., family-owned property developer Capelli, and camping resort firm Homair Vacances.

In Italy, Borsa Italiana manages the bond exchange platform MOT. Borsa Italiana is owned by the London Exchange group, and is a regulated market, open to retail investors. Issuance on the market, however, is heavily dominated by bank funding. However, last year, the Monti government changed the law in a move that’s expected to open the bond market more broadly, including to midsize corporates, so we expect the market there may develop in the near term.

In Spain, according to press reports, it is believed that the new Mercado Alternativo de Renta Fija—or Fixed Income Alternative Market (MARF)—will be ready before this summer. Companies expected to use the market to issue debt would have on average revenues of about €100 million. There is also the Sistema Electrónico de Negociación de Deuda (SEND) in Spain, which is an electronic fixed-income trading platform, aimed at retail investors.

**Obstacles To Overcome For Both Investors And Issuers**

Although the European market has made some progress in linking together mid-market companies with willing capital, a pan-European, cohesive solution is still elusive. We believe that issuers, for their part, can find expansion beyond a long-term banking relationship to be a significant cultural shift. This often coincides with a reluctance to disclose financials broadly.

In addition to the barrier of funding-rate expectations, other obstacles to the development of an efficient market include investors’ need for better access to company information, particularly if an investor is small and hasn’t had the means to build internal research and risk management capacities. Differing regulatory and accounting environments across Europe also make establishing a cohesive funding market an uphill struggle. Standard & Poor’s, through this series of funding articles, aims to help shed some light on the detail, as well as the larger themes and trends as this nascent market continues to develop in Europe.
Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Underwriting The Recovery: Internal Financing And Financial Discipline Keep European Companies On An Even Keel, April 4, 2013

Appendix

The authors would like to acknowledge the contribution of Silvia Platter and Julie Firino-Martell in the preparation of this article.

Table 1 | Examples Of Varying Midsize Company Classifications By Country And Institution

<table>
<thead>
<tr>
<th>Source of data</th>
<th>Country</th>
<th>Definition</th>
<th>No. of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>French article 51 of the Loi de modernisation de l’économie (2008)</td>
<td>France</td>
<td>Entreprise de taille intermédiare (ETI): Employees 250-4,999 and either revenue &lt; €1.5 bil. or balance sheet of &lt; €2 bil.</td>
<td>64,600</td>
</tr>
<tr>
<td>GE Capital</td>
<td>France</td>
<td>Revenue €10 mil.-€500 mil.</td>
<td>36,000</td>
</tr>
<tr>
<td>Department of Business Innovation &amp; Skills (BIS)</td>
<td>U.K.</td>
<td>Employees 50-249</td>
<td>30,475</td>
</tr>
<tr>
<td>Breedon Report</td>
<td>U.K.</td>
<td>Revenue £25 mil.-£500 mil.</td>
<td>30,475</td>
</tr>
<tr>
<td>GE Capital</td>
<td>U.K.</td>
<td>Revenue £20 mil.-£1 bil.</td>
<td>21,500</td>
</tr>
<tr>
<td>RPC Group plc</td>
<td>U.K.</td>
<td>Employees 2-499</td>
<td>30,475</td>
</tr>
<tr>
<td>GE Capital</td>
<td>U.K.</td>
<td>Revenue £20 mil.-£1 bil.</td>
<td>21,500</td>
</tr>
<tr>
<td>Ifm Bonn - Institut fur Mittelstandsforschung</td>
<td>Germany</td>
<td>Employees 10-500 and turnover of €1 mil.-€50 mil.</td>
<td>426,695</td>
</tr>
<tr>
<td>Hoppenstedt</td>
<td>Germany</td>
<td>Turnover between €24 mil. [-€30 mil.] and €397 [-€500 mil.]</td>
<td>4,200</td>
</tr>
<tr>
<td>GE Capital</td>
<td>Germany</td>
<td>Revenue €20 mil.-€1 bil.</td>
<td>4,200</td>
</tr>
<tr>
<td>EU Commission (Mittelstand)</td>
<td>Germany</td>
<td>Employees 50-249 and turnover of €10 mil. - €50 mil. and total balance sheet €2 mil.-€10 mil.</td>
<td>64,173</td>
</tr>
<tr>
<td>GE Capital</td>
<td>Italy</td>
<td>Revenue €5 mil.-€250 mil.</td>
<td>62,000</td>
</tr>
</tbody>
</table>

Table 2 | Examples Of Mid-Market European Companies Issuing Private Placements*

<table>
<thead>
<tr>
<th>Company</th>
<th>Market</th>
<th>Year of issuance</th>
<th>Industry</th>
<th>Country</th>
<th>Deal amount (mil. €)</th>
<th>Capital IQ Revenue (mil. €)¶</th>
<th>Capital IQ total balance sheet debt (mil. €)¶</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low &amp; Bonar</td>
<td>U.S. PP</td>
<td>2010</td>
<td>Manufacturing</td>
<td>U.K.</td>
<td>60</td>
<td>469</td>
<td>135</td>
</tr>
<tr>
<td>Filtrona plc</td>
<td>U.S. PP</td>
<td>2010</td>
<td>Manufacturing</td>
<td>U.K.</td>
<td>160</td>
<td>818</td>
<td>253</td>
</tr>
<tr>
<td>Mersen</td>
<td>U.S. PP</td>
<td>2011</td>
<td>Technical Services</td>
<td>France</td>
<td>100</td>
<td>811</td>
<td>270</td>
</tr>
<tr>
<td>Premier Farnell plc</td>
<td>U.S. PP</td>
<td>2011</td>
<td>Wholesale</td>
<td>U.K.</td>
<td>235</td>
<td>1,094</td>
<td>418</td>
</tr>
<tr>
<td>1887 Co Ltd</td>
<td>U.S. PP</td>
<td>2011</td>
<td>Beverages</td>
<td>U.K.</td>
<td>300</td>
<td>475</td>
<td>455</td>
</tr>
<tr>
<td>Maser</td>
<td>U.S. PP</td>
<td>2011</td>
<td>Manufacturing</td>
<td>France</td>
<td>150</td>
<td>598</td>
<td>293</td>
</tr>
<tr>
<td>Groupe Faiveley Transport</td>
<td>U.S. PP</td>
<td>2012</td>
<td>Transportation</td>
<td>France</td>
<td>175</td>
<td>901</td>
<td>380</td>
</tr>
<tr>
<td>Sage Group</td>
<td>U.S. PP</td>
<td>2013</td>
<td>Technology</td>
<td>U.K.</td>
<td>400</td>
<td>1,340</td>
<td>209</td>
</tr>
<tr>
<td>Etam Developpement SA</td>
<td>Schuldchein</td>
<td>2011</td>
<td>Consumer discretionary</td>
<td>France</td>
<td>40</td>
<td>1,184</td>
<td>273</td>
</tr>
<tr>
<td>Eurofins Scientific SA</td>
<td>Schuldchein</td>
<td>2011</td>
<td>Healthcare</td>
<td>France</td>
<td>170</td>
<td>1,044</td>
<td>455</td>
</tr>
<tr>
<td>envi Tec Biogas AG</td>
<td>Schuldchein</td>
<td>2012</td>
<td>Energy</td>
<td>Germany</td>
<td>100</td>
<td>72</td>
<td>77</td>
</tr>
<tr>
<td>Toux SCA</td>
<td>EU PP</td>
<td>2012</td>
<td>Industrials</td>
<td>France</td>
<td>10</td>
<td>358</td>
<td>492</td>
</tr>
<tr>
<td>Séché Environnement</td>
<td>EU PP</td>
<td>2012</td>
<td>Industrials</td>
<td>France</td>
<td>25</td>
<td>434</td>
<td>217</td>
</tr>
<tr>
<td>Ubisoft</td>
<td>EU PP</td>
<td>2012</td>
<td>Information technology</td>
<td>France</td>
<td>20</td>
<td>1,081</td>
<td>93</td>
</tr>
<tr>
<td>Testia</td>
<td>EU PP</td>
<td>2013</td>
<td>Information technology</td>
<td>France</td>
<td>20</td>
<td>262</td>
<td>34</td>
</tr>
<tr>
<td>Group Laurent-Perrier</td>
<td>EU PP</td>
<td>2013</td>
<td>Consumer Staples</td>
<td>France</td>
<td>15</td>
<td>219</td>
<td>292</td>
</tr>
<tr>
<td>Akka Technologies</td>
<td>EU PP</td>
<td>2013</td>
<td>Industrials</td>
<td>France</td>
<td>100</td>
<td>474</td>
<td>272</td>
</tr>
</tbody>
</table>

*As per Standard & Poor’s definition: from the U.K., France, and Germany, excluding financials and utilities, 2010-2012. ¶Latest available financial year-end. Sources: S&P Capital IQ, Standard & Poor’s
Standard & Poor’s Revises Credit Estimate Guidelines And Reaffirms Global Debt Issuance Limits For Private Ratings

Standard & Poor’s Ratings Services previously implemented guidelines worldwide for both credit estimates and private ratings. These guidelines are designed to improve transparency and clarity and to provide consistency across all jurisdictions.

Based on continually evolving conditions in the debt capital markets, we are reducing the required timeframe for when we provide a credit estimate after a transaction closes in the Americas and Asia-Pacific regions. We are also providing further guidance, on a globally applicable basis, on when we may provide a credit estimate when a borrower requests a lender to amend existing debt facilities. The revisions, outlined below, will become effective immediately.

For issuers with total debt facilities above the prescribed limits, we will assign public credit ratings upon request.

Debt Issuance Limits By Region

In the Americas (including Bermuda and the Caribbean), the following revised timeframe will become effective immediately:

- Credit estimates will be available when the total debt facilities (drawn and undrawn) of an issuer’s new transaction are less than US$200 million. Credit estimates may be provided before the transaction closes or during the syndication process.
- Credit estimates also will be available when the total facilities (drawn and undrawn) of an issuer’s new transaction are US$200 million or more but less than US$1 billion, provided the loan transaction has been closed for at least three months. In other words, credit estimates on facilities in this band will not be available before the transaction closes or during the syndication process.
- Private ratings will be available only when the issuer’s total debt facilities (drawn and undrawn) that have a private rating from Standard & Poor’s are less than US$1 billion.

In Asia-Pacific, the following revised timeframe will become effective immediately:

- Credit estimates will be available when the total debt facilities (drawn and undrawn) of an issuer’s new transaction are less than US$200 million. Credit estimates may be provided before the transaction closes or during the syndication process.
- Credit estimates also will be available when the total facilities (drawn and undrawn) of an issuer’s new transaction are US$200 million or more but less than US$1 billion, provided the loan transaction has been closed for at least three months. In other words, credit estimates on facilities in this band will not be available before the transaction closes or during the syndication process.
- Private ratings will be available only when the issuer’s total debt facilities (drawn and undrawn) that have a private rating from Standard & Poor’s are less than US$1 billion (or up to US$3 billion for syndicated bank loans).
In Europe, the Middle East, and Africa, the following guidelines continue to apply:

- Credit estimates are available when the total debt facilities (drawn and undrawn) of an issuer’s new transaction are less than €250 million.
- Private ratings will be available only when the issuer’s total debt facilities (drawn and undrawn) that have a private rating from Standard & Poor’s are less than €750 million.

Debt Limits For Amended Transactions

Standard & Poor’s has also updated its guidance on the provision of credit estimates when a borrower requests a lender to make amendments and/or extensions to its existing debt facilities.

To date, our determination of when we will maintain a credit estimate in amend-to-extend situations, versus when we will withdraw one, has been on a case-by-case basis. Although we will still view each transaction independently, we will now withdraw an existing credit estimate if the amendment includes material new debt facilities raised. This will now be determined by the lower of:

- US$100 million/€75 million or more new debt (or the foreign currency equivalent in Asia); or
- New debt at, or exceeding, 10% of the total original transaction size.

These levels apply when new debt results in the total debt facilities exceeding the current stated credit estimate limits.

Standard & Poor’s reserves the right not to provide credit estimates for issuers whose total debt issuance falls within the debt issuance limits but whose complexity is beyond the scope of analysis provided by a credit estimate. We review unique requests for credit estimates with consideration for specific elements germane to the underlying transaction or the intent of the stated guidelines.

Note: In all regions, we do not allow issuers to have a mix of private and public ratings.

So, if a privately rated issuer chooses to issue publicly rated debt, all ratings must be public. Public ratings are available for all issuers in all regions.

Standard & Poor’s also offers confidential ratings for issuers’ internal use, which cannot be disclosed to any third party other than issuers’ professional advisors. These ratings are communicated directly to the issuer. We generally provide issuer-level credit ratings as part of our confidential rating offering.

Credit Estimates And Private Ratings

A credit estimate is a confidential indication, provided solely at the request of a third party [other than the company or issuer of the obligations at issue] of the likely Standard & Poor’s credit rating on an unrated company or obligation primarily in the context of collateralized debt obligations (CDOs). Credit estimates are not ratings and are formulated from an abbreviated analysis and, generally, do not include all of the aspects of our standard ratings analysis.

A private rating is an interactive rating that the issuer wants to disclose, on a confidential basis, to a limited number of third parties. Up to 75 third-party institutions authorized by the issuer are able to access a private rating and related reports on a dedicated, password-protected Web site, currently IntraLinks.

Related Criteria And Research

- Standard & Poor’s Global Debt Issuance Limits For Credit Estimates And Private Ratings, July 21, 2011
- Standard & Poor’s Announces Private Ratings Distribution Via IntraLinks, May 18, 2011
- What Are Credit Estimates And How Do They Differ From Ratings?, April 6, 2011
- Final Planned Changes To The Provision Of Ratings And Credit Estimates In Europe’s Leveraged Finance Market, July 16, 2008
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