



Corporate Debt

Newsletter Q3 2022

Corporate Debt Markets in Q3 2022 – Overview

- > In the second quarter of 2022, European corporate bond markets were severely affected by economic uncertainty due to the war in Ukraine and the tightening of the monetary policy. As a result, activity levels declined and yields rose for new transactions.
- > According to PwC, 35 high yield deals and approximately EUR 13bn were issued in Q2 2022, compared to 46 deals and approximately EUR 24bn in Q1 2022. As a result, no corporate bonds with a credit rating below B- were issued.
- > Driven by four large financial sector issuances: Barclays plc, BPER Banca SpA, Ibercaja Banco SAU and Eurobank SA, Financials market share increased by 12%-points compared to the previous quarter, up to 44% in Q2 2022.
- > Despite unfavorable economic conditions, there was strong activity in the German senior debt and unitranche market with 44 transactions in Q2 2022 (QoQ: +14%). This remains a significant development given the global headwinds such as rising interest rates and supply chain issues.
- > The economic outlook and banks’ decreased risk tolerance had a strong impact on tightening of the credit standards. On the other side, firms’ report increased demand for credits due to financing needs for working capital related to increased production input prices and high energy prices.

European Sub-IG Market

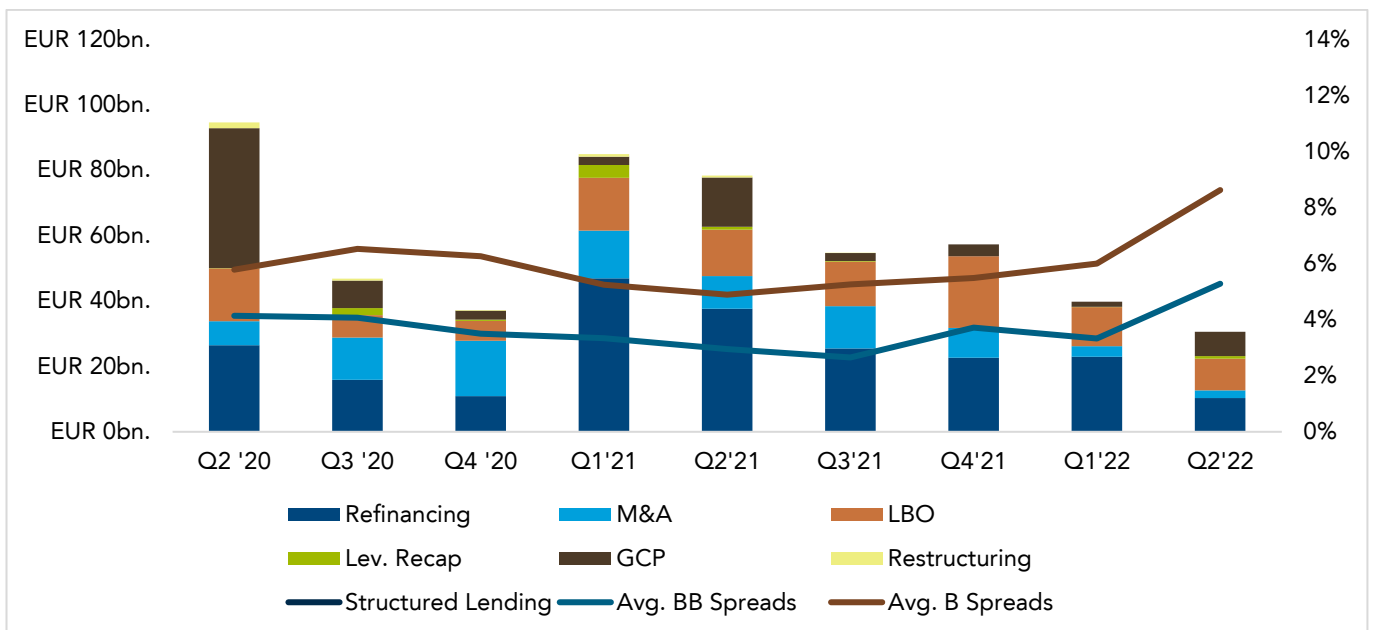


Figure 1: Volume of Sub-IG European debt markets (incl. leveraged loans and bonds) and average spreads.
Source: White & Case (Debt Explorer), PwC Debt Watch Europe Q2 2022

Corporate Debt Market Europe

European Debt Market

According to the overall issuance of Debtwire, the transaction values of high yield bonds and leveraged loans amounted EUR 30.7bn in the second quarter of 2022. In comparison to the previous quarter with an issuance of EUR 40.4bn the volume decreased (QoQ: -24%). This decrease was driven by the heavily impacted European corporate bond markets due to the consequences of the war in Ukraine and tightening monetary policy. Regarding the economic uncertainty, corporates had to pay a premium to raise debt in a rising interest rate environment. The refinancing activity decreased from EUR 21.8bn in Q1 2022 to EUR 10.3bn in Q2 2022 (QoQ: -53%). Moreover M&A activity also decreased (QoQ: -25%) from EUR 3.1bn in Q1 2022 to EUR 2.3bn in Q2 2022 and LBO financing decreased to EUR 9.8bn in Q2 2022 (QoQ: -14%). However, in line with extended Capex financing needs of corporates, the general corporate financing increased heavily from EUR 1.4bn in Q1 2022 to EUR 7.5bn in Q2 2022 (QoQ: +423%). Furthermore, over the last twelve months, refinancing still remains the dominant use of debt with EUR 80.2bn, followed by LBO financing with EUR 56.7bn, M&A with EUR 27.3bn, general corporate financing with EUR 14.9bn, and leveraged recapitalisation with EUR 1.1bn.

Euro area banks reported in the ECB lending survey that they continued to significantly tighten their credit standards for corporate loans in Q2 2022. This is the result of an increased risk awareness related to the economic outlook and industry- or company-specific situations. On the other hand, net corporate credit demand continued to increase, reflected by corporate financing needs for working capital. This development is likely related to higher prices for production inputs in the context of ongoing supply chain disruptions and high energy prices.

According to S&P, average margins on new issued loans in Q2 2022 are E+448 basis points with an average yield of 5.14%, compared to E+413 basis points and 4.36% in the previous quarter. However, given the small size of the sample it is difficult to forecast if the margins need to widen further, should issuance volumes normalize in the following quarter.

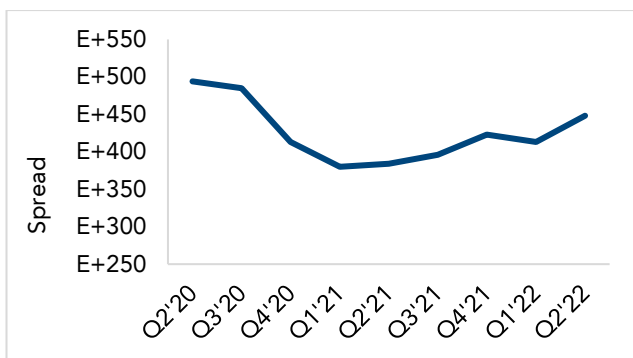


Figure 2: European new issue loan spreads
Source: S&P Global Market Intelligence

European unitranche financing activity was very strong in Europe in Q2 2022. A total of 130 transactions were financed (QoQ: +25%). These developments are remarkable especially in view of the countervailing macroeconomic developments such as the rise in interest

rates to curb high inflation as well as rising energy costs, the war in Ukraine and global supply chain issues.

According to PWC, 35 high-yield transactions were executed and EUR 13bn were raised in Q2 2022, compared to 46 high-yield transactions and EUR 24bn in the previous quarter. The delta of issuance yields between B and BB increased from 2.5% in Q1 2022 to 3.3% in Q2 2022, reflecting the decline in supply. On the other hand, investors have reduced their demand for riskier bonds due to high liquidity, rising interest rates and uncertainty about the economic outlook. It is also possible that the creditworthiness of issuers is changing due to increased refinancing costs.

DACH Debt Market

According to the European Central Bank lending survey, banks continued to tighten their lending standards in Q2 2022. Credit standards were tightened more for loans to large enterprises than for loans to SMEs and more for long-term loans than for short-term loans. The tightening took place due to uncertain economic outlook and industry- or sector-specific risks. Monetary policy is less expansionary, so banks are reporting higher refinancing costs, which affect credit standards for corporate loans.

With 44 transactions in the second quarter of 2022, the transaction volume in the German senior and unitranche debt market was significantly higher than the transaction volume in the first quarter of 2022 (QoQ: +14%). This strong performance is remarkable, as the macroeconomic circumstances are not favourable. The increased transaction volume was served by banks and debt funds. Banks in particular were able to regain significant market share in the second quarter of 2022. Nevertheless, debt funds are ahead of banks, accounting for 52% of financings in Q2 2022, and even more strongly for the first half of 2022, with 57% market share. In contrast to the past performance, the technology sector failed to increase its market share in H1 2022 with 28% compared to 36% in H1 2021. On the other hand, in H1 2022 the consumer goods sector recorded a market share of 11% and the services sector 6%. Regarding the purpose of financing, refinancing in particular increased its market share in Q2 2022. According to Houlihan Lokey, this is mainly due to the German LBO market for medium-sized companies' is very resilient and less volatile compared to the liquid market.

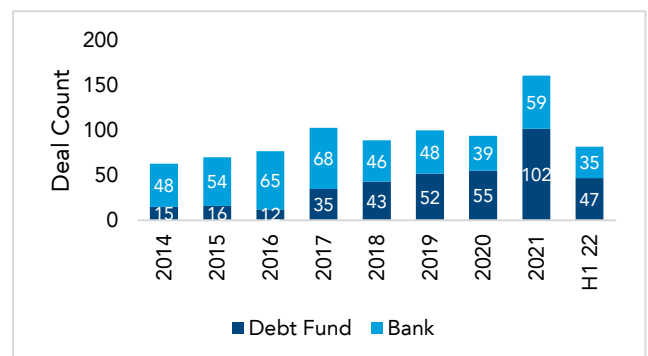


Figure 3: German mid-market financings 2022
Source: Houlihan Lokey MidCap Monitor Q2 2022

Senior and unitranche debt fund financings remain the financing form with a higher market share in the first half of the year 2022. In total, 47 debt fund financings with a

market share of 57% and 35 bank financings with a market share of 43% were completed. Overall, LBO banks and regional banks are more conservative but still ready for transactions and have proven their strength compared to debt funds.

Looking at the European market as a whole, Germany is the second most active region for unitranche financing with 101 transactions in Q2 2022, followed by France with 97 transactions in Q2 2022. The most active region is the UK with 168 transactions in Q2 2022.

Financing Conditions

The Bank of England expects inflation to remain above 9% over the next few months, rising to 11% by October this year. For this reason, the base rate was increased by 0.25% in May and by 0.25% in June to a total of 1.25%. To curb inflation, the European Central Bank also increased interest rates by 0.5% in July, even more aggressive than the expected increase of 0.25%. This is the first raise of interest rates in 11 years. Regarding the Federal Reserve, they increased the interest rate by 0.75% in June, the largest interest hike in over 25 years.

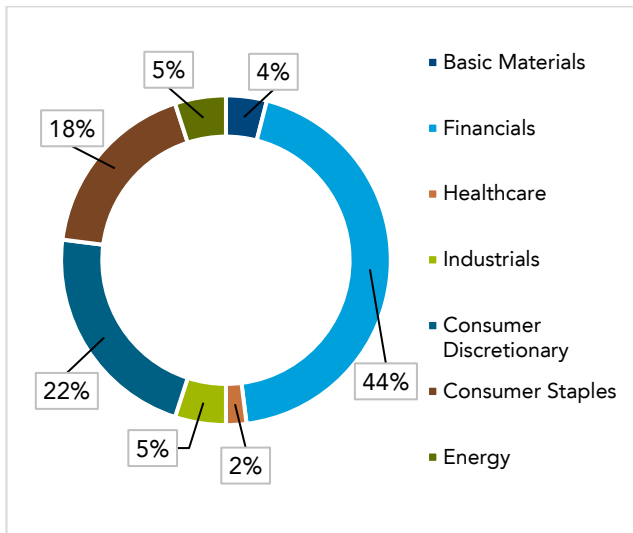


Figure 4: High Yield Volume Europe, Q2 2022 Sectoral Split
Source: PwC Debt Watch Europe Q2 2022

In the second quarter of 2022, the financial sector gained a further 12%-points market share to reach a total market share of 44% in Q2 2022. In contrast, the telecommunication sector recorded the largest decline in market share from 25% in Q1 2022 to 0% in Q2 2022. In addition to the financial sector, the consumer goods sector in particular increased its market share. Both Consumer Discretionary with 22% market share (QoQ: +15%) and Consumer Staples with 18% market share (QoQ: +18%) are in the top 3 sectors this quarter.

Upcoming Recession on the horizon?

Currently, there is a lot of pressure on living standards. Real incomes are falling as much as they have not since the early 1980s oil shock. Even now, an oil shock is adding to the strain, with energy prices rising by about 80% in most parts of the world. Moreover, food prices are also rising at high single-digit to low double-digit rates. In response, retailers are trying to introduce cheaper product lines, but as these trends continue, people will adjust their spending in light of their declining standard of living.

The expected growth of real GDP in the euro area is revised downwards. Growth is expected to slow from 5.4% in 2021 to 2.5% in 2022 and 1.2% in 2023. Mainly driven by inflation due to energy prices and Russia's decision to use gas supplies as a tool to manipulate the European economy. As a consequence, this could send Europe into a recession. This affects individual countries to varying degrees. For example, the agreed partial oil embargo will affect the industry and private households mainly in Germany and Italy. These two countries each get a quarter of their energy from Russia.

The European Central Bank has been reluctant to raise interest rates for a long time. In July, the ECB raised key interest rates by 0.5%, more than the expected 0.25%. This rate hike is the first in 11 years and still well behind the Bank of England's 0.25% rate hike in May and 0.25% in June to a total of 1.25%. Despite this, the ECB felt that the rate hike should be delayed to avoid weakening the economy. The later and now more aggressive approach results in a stronger weakening of the economy. In addition, governments can impose unpopular measures that reduce demand, such as tax increases and fiscal tightening to curb inflation rates. However overall, their range of instruments is very limited compared to the ECB.

With regard to countries outside Europe, some show particularly high risks. China, for example, has a major problem with its zero-covid policy. Due to the implementation of this policy, the economy is suffering and China is currently contributing very little to global economic growth. However, China is expected to abandon this policy over the course of the year. Also in the USA, the economic effects are currently being felt. According to PwC, US Treasury yields are inverted at the beginning of July 2022. Yields on 2-year Treasury bonds rose above yields on 10-year Treasury bonds, a strong sign of a potential recession ahead.

According to data compiled by Bloomberg, more than three times the amount of bond deals were postponed in Europe, the Middle East and Africa. At the same time, the Bank of England plans to reduce its bond portfolio and the European Central Bank is ending its bond-buying program. Companies used this opportunity mainly to raise cheap debt capital with a volume of USD 1.2 trillion in 2021. Due to the discontinuation of the ECB support, shakier borrowers in particular may run into difficulties. In other words, the credit rating of bond issuers may change and with it their ability to refinance their debt. This development is also reflected in the fact that not a single corporate bond with a rating below B- was issued in Q2 2022.

The probability of a recession at the end of this year or the beginning of next year is relatively high, in the order of 35% according to Schroders' July 2022 assessment. However, at the moment investors are not really pricing the recession into the markets, although serious thoughts are beginning to emerge.

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Our corporate debt team has accompanied and executed transaction in excess of EUR 700m. Our Private Debt Team additionally invests into Aviation Debt, Infrastructure Debt and Real Estate Debt. We expect significant further growth in these areas, which provide attractive risk-adjusted returns to our investors.

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- > Managed accounts and funds with investment expertise in various jurisdictions and markets
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