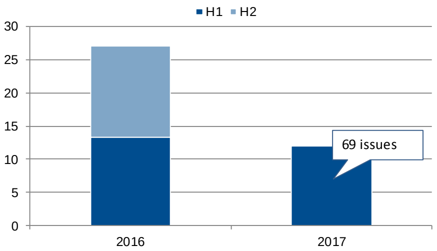
Corporate Schuldschein Market Has Pricing Reached the Floor?

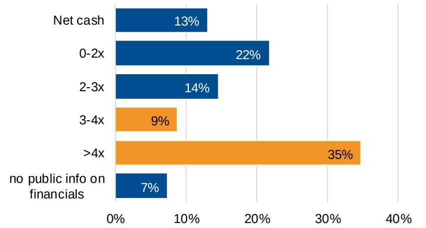
Following a rather slow start into 2017, the corporate Schuldschein (SSD) market has strongly gained momentum in Q2 leading to a volume of more than EUR 12bn from almost 70 deals. While volumes for this half-year fell short of H1 2016 levels because of the lack of jumbo deals, it was the busiest half-year in terms of transactions. This was strongly driven by non-German issuers, which, for the first time, contributed half of the deals. Even though publicly unrated corporates dominate the market, the median leverage of 2.7x in H1 2017 still suggests that the market is in good health. However, with more than 30% of issuers in H1 2017 exhibiting a leverage of more than 4.0x – commensurate with a high-yield credit quality – the record low average pricing may not reflect the full risk involved in some cases. Scope has established that, in particular, SMEs and non-German issuers are benefiting from strong sentiment despite their leverage often indicating non-investment grade financial metrics.

Figure 1: SSD volumes and transaction numbers (EUR bn)[1]



Source: Bloomberg, Scope

Figure 2: LTM SaD/EBITDA of SSD issuers in H1 2017



Source: Companies' latest annual reports, Scope

More than half issued by non-German corporates

Treasurers across the continent are increasingly eyeing alternative debt financing. For the first time, half of SSDs in H1 2017 were closed by non-German corporates. This was not only driven by increased activity on the part of Austrian and Swiss companies; French companies placed an amount of about EUR 1bn, similar to the H1 2017 volume of Euro-PPs. Moreover, Scope points out that the market is spreading eastwards with the first issuers from Poland, Russia, the Czech Republic (Amrest, International Investment Bank, O2 Czech Republic) and Hungary (MOL Group currently marketing its debut SSD). Such increasing outreach is also reflected by the growing number of multi-currency deals, which amounted to around 20% of all transactions in H1 2017.

Pricing tightened further

Scope highlights the further tightening of spreads on SSD issues, contrary to the expectations of many market participants. Median spreads on a five-year euro tranche have narrowed to 118bps against a median of 138bps in FY 2016. The range in pricing is, however, considerable, from 55bps up to 300bps. While German issuers were offering a median coupon of 103 bps for such tranches, non-German corporates were obliged to entice investors with a median coupon of 130bps. Scope questions whether this fully reflects the illiquidity premium and average credit quality in the sector as indicated by the issuers' leverage measures, particularly with regard to the ever growing number of – often private and less transparent – newcomers to the capital markets. The median Scope-adjusted leverage across more than 60 issuers, for which financial data is publicly available, stands at 2.7x, which is still commensurate with a financial risk profile indicating a low investment grade, according to Scope's rating methodology. However, more than 40% of issuers, particularly SMEs and also non-German issuers, exhibit a leverage of more than 3.0x, which points to a high-yield financial risk profile.

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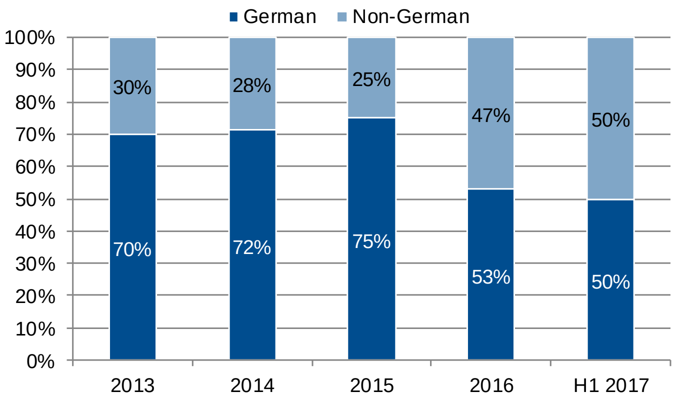
[1] The actual issuance volume may even be higher as some transactions are reported with some time delay in this highly non-transparent market. Numbers based on closing dates of the deals.

Healthy half-year with many non-German SSD debutants

Average deal size down to EUR 100m without major outliers

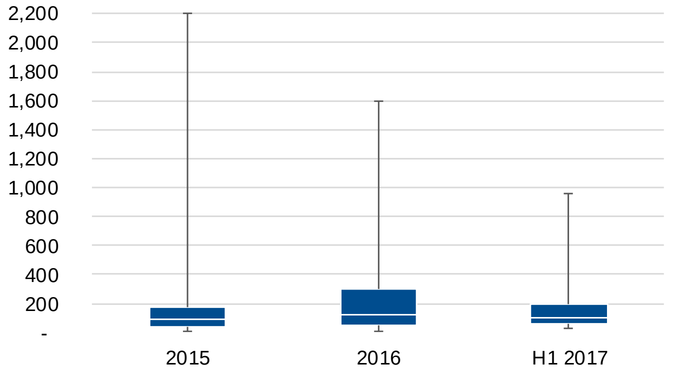
While the first half of 2016 was distinguished by a handful of jumbo transactions (over EUR 500m each), such transactions were barely in evidence in H1 2017. Only three deals (KION, Axel Springer and Volkswagen Financial Services) exceeded the threshold of EUR 500m. H1 2017 was clearly dominated by smaller ticket sizes, driving down the average (median) deal size to EUR 100m compared to EUR 120m in 2016. Scope highlights that transactions were boosted by first-time non-German issuers testing out acceptance for this debt instrument with smaller ticket sizes.

Figure 3: German vs non-German issuers



Source: Scope

Figure 4: No major outliers from jumbo transactions in H1 2017 (EUR m) as signalled by boxplots



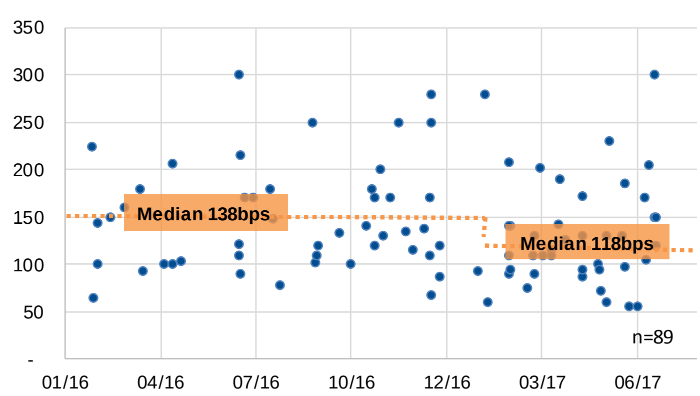
Source: Scope

Pricing vs leverage

Large pricing difference between German and non-German issuers

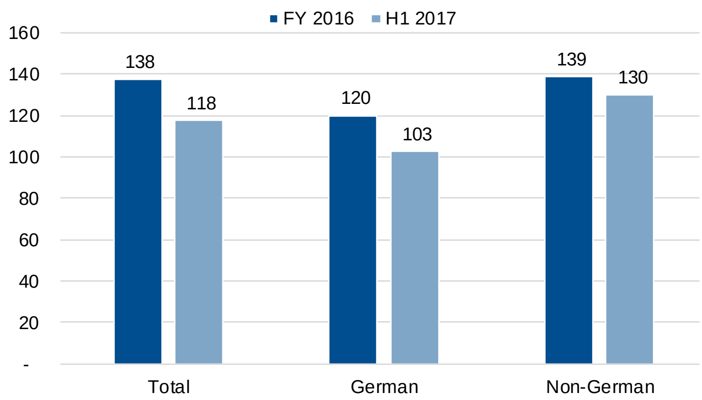
The median spread for five-year euro SSD tranches[2] placed in H1 2017 – which Scope has compiled from 42 transactions – stands at just 118bps. It is striking that non-German issuers are required to pay a somewhat higher risk premium. There is a remarkable difference between coupons from German issuers and non-German issuers (see Figure 6), which is fully justified according to their average financial risk profiles – measured as Scope-adjusted debt/EBITDA – which are on average significantly weaker than those of German issuers (see page 3). Moreover, with the first sobering news from a handful of SSD issuers[3], the market should eventually find a pricing floor and return to more risk-adequate risk premiums.

Figure 5: Spread (bps) of five-year euro SSD tranches



Source: Bloomberg, Scope

Figure 6: Spread difference between German and non-German SSD issuers for five-year euro tranches (bps)



Source: Bloomberg, Scope

[2] Measured as either as the announced spread at closing or the mid-point of price range during the marketing phase.
[3] Sobering news from SSD issuers such as Tom Tailor with a covenant reset after disappointing financial performance, Premier Oil with complete debt restructuring or Sanochemia, Axpo and DEMIRE with disappointing figures for the last twelve months.

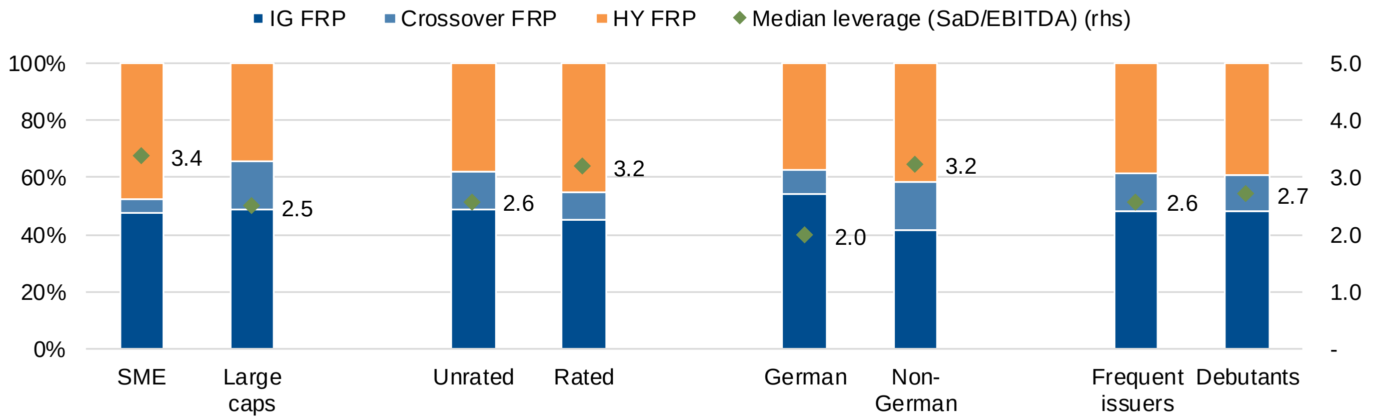
In order to partially assess the SSD issuers' credit quality with regard to their financial risk profiles, Scope has compiled the balance sheet data for more 60 corporates which have closed an SSD during H1 2017 (more than 90% of issuers). Financial data refers to either the issuing company or the ultimate parent company which is likely to guarantee the debt issued by the subsidiary. Leverage data refers to the latest available balance sheet date, which was mainly 2016 but, in some cases, is still 2015. Financial data for the remaining SSD issuers was mainly related to non-German SMEs.

Scope has grouped issuers according to their leverage as measured by SaD/EBITDA as per Scope's corporate rating methodology. Firstly, issuers with a leverage commensurate with an investment-grade financial risk profile (leverage 2.5x and better), secondly, issuers with a crossover financial risk profile exhibiting a leverage of between 2.5x and 3.5x and thirdly, issuers with a high-yield financial risk profile with a leverage of above 3.5x.

Median leverage at 2.7x

Median leverage among over 60 issuers stands at 2.7x which indicates a financial risk profile in the crossover area. When identifying structural differences among the SSD issuers' leverage Scope makes the following observations:

Figure 7: Leverage distribution of SSD issuers in H1 2017



Source: Scope

Smaller SSD issuers carry higher leverage

Most strikingly, Scope highlights a significant difference between SME issuers[4] and larger corporates in terms of leverage. While almost 50% of SSD issuers in H1 2017 classified as SMEs show a debt level (median 3.4x), which clearly suggest a financial risk profile in the high-yield rating categories, only 30% of larger issuers exhibit debt levels of above 3.5x. Scope notes that SMEs, which have issued an SSD, often attain a strong position in their respective niche markets, thereby indicating a stronger business risk profile. However, it would be difficult for a company with debt levels of above 4.0x to achieve an investment grade rating unless it is active in a special industry such as real estate or utilities.

Are non-German issuers further diluting average credit quality?

Moreover, non-German issuers are, on average, more heavily indebted than German SSD issuers, which fully explains the aforementioned difference regarding the pricing of five-year SSD tranches. While the average German SSD issuer displays a leverage of 2.0x only (34 SSD issuers for which financial data is publicly available), the average non-German issuer is indebted with a median leverage of 3.2x (based on 29 non-German issuers for which financial data was publicly available). In light of the pricing gap of about 30 bsp, this remarkable divergence in leverage raises the question of whether non-German SSD issuers benefit from the strong market sentiment.

[4] Defined by Scope as corporates with an annual revenue of below EUR 1bn.

Unrated issuers not necessarily indebted than rated issuers

Surprisingly, Scope finds out that unrated SSD issuers do not necessarily demonstrate higher leverage on average than rated ones. While more than 40% of publicly unrated issuers display a leverage which is clearly commensurate with a high-yield financial risk profile, more than 50% of rated SSD issuers show comparatively weak leverage. However, it should be noted that only 15% of SSD issuers in H1 2017 carried a public rating – the lowest number over the past six years.

Challenges for investors in the SSD market

Scope understands investors' large appetite for SSDs given their long list of advantages, which often make them more appealing than investments in other European private-debt markets (i.e. Euro-PP). After analysing several SSD issuers and following discussions with SSD arrangers and investors at conferences, Scope considers the main challenges for investors in the SSD market to be:

Going down the credit curve

Confirmation that investors need to go down the credit curve or demand longer maturities in order to achieve the required yields. While many investors apply a rating floor at the BB rating category, many others are in 'risk-mode' as market fundamentals for most industries and countries are supportive. However, it remains to be seen how investors will view coupons once market fundamentals and the financial performance of issuers deteriorate and the SSD market has experience one full cycle.

No pressure to obtain a public rating

Currently there is no pressure on issuers to obtain a rating due to the favourable environment; it would, however, prove a great benefit to investors, particularly insurances and pension funds, as well as non-European investors. Frequently, the short placement phases (often less than three weeks) and oversubscription make it impossible to opt for an external rating. While a public rating may be supportive for strong issuers, thereby leading to lower spreads and increasing their investor base, it could actually be detrimental for crossover candidates or issuers whose financials clearly indicate a high-yield character as this might lead to higher risk premiums for the transactions.

Non-European investors facing extra challenges

Particularly for foreign, e.g. Asian, investors SSD instruments are very appealing as they provide exposure to private European corporates which are not active in the public bond market. Moreover, banks investing in SSDs may increase the likelihood of cross-selling activities if they participate in an SSD issue made by a market debutant. However, it is often difficult for such non-European investors to fully assess the issuers' credit quality as this requires analysts with a knowledge of local European markets. This is a particularly important factor in view of the growing number of unknown SSD debutants in niche markets which have never issued public debt.

Lean documentation could prove problematic in a workout

The lean documentation for a new SSD issue, which in some cases comprises less than 10 pages, could prove problematic if a workout becomes necessary, particularly when many investors are involved. So far this has not caused any major difficulties as investors have only had to cope with a small number of insolvent SSD issuers or debt restructurings. However, considering the growing number of more strongly indebted SSD issuers this situation may change in the future.

Outlook 2017

In light of H1 2017 activities, Scope reiterates its expectation that the market volume in 2017 is likely to exceed the threshold of EUR 20bn. The placement of jumbo transactions will largely determine whether or not this volume will approach the record 2016 levels of EUR 26bn. With regard to pricing, however, Scope doubts that it is possible for the market to go any deeper.

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