8 January 2020 **Corporates**

Schuldschein private-debt market breaks records in 2019
Down-cycle risk aversion weighs on outlook

Investor aversion in 2020 to cyclical and disrupted industries risks pegging back growth in the buoyant Schuldschein private-debt market after a record issuance of at least EUR 28.7bn in 2019, up 15% from the year before.

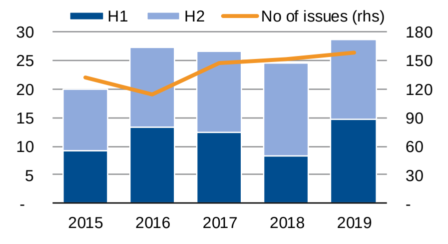
Healthy investor demand and attractive pricing led to around 160 Schuldschein (SSD) transactions last year, up from around 150 in 2018. A strong first-quarter pipeline and refinancing of old SSD tranches promise robust deal flow in early 2020.

Such favourable conditions are unlikely to endure in a context of a slowing global economy, which is why we expect relatively subdued issuance of EUR 20bn-25bn for the full year.

Greater investor discernment regarding debt issued by companies in cyclical and economically sensitive sectors is set to push coupons up to levels at which corporate treasurers will be less enthusiastic about tapping the 'buy to hold' private-debt segment. Recent financial troubles at German cable and wiring supplier Leoni AG, a frequent SSD issuer and auto-sector supplier, and credit events at a handful of other issuers should have reminded investors of the need to focus on solid investment-grade borrowers and/or demand adequate risk-adjusted coupons to compensate for the lack of liquidity inherent to the private-debt market.

While SSDs tend to be robust compared to public debt when markets turn sour, such a shift in sentiment is significant for the SSD market, considering cyclical and sensitive sectors have respectively made up 35% and 42% of placed SSD volumes over the past seven years. Companies in the automotive (manufacturers and auto suppliers), construction (construction and construction materials) and industrial (including industrial services and transportation) sectors have been active issuers.

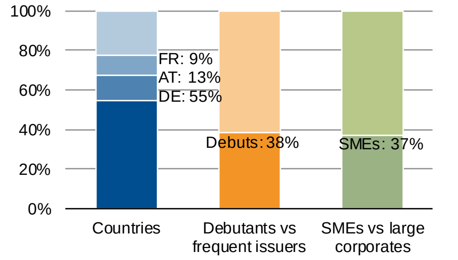
Figure 1: SSD placements (EUR bn)*



* based on closing dates

Source: Bloomberg, Scope data

Figure 2: Structural features in 2019



Source: Scope

Investors will be more reluctant to take part in new deals or demand higher spreads in such sectors – as signalled in a survey of 30 SSD investors conducted by Bloomberg in November 2019 regarding new automotive-sector issues – while arrangers are likely to focus on more defensive sectors to minimise the risk of not being able to place SSD deals. The market will likely shift back toward more highly rated – i.e. larger, more diversified companies – or seasoned issuers of private debt.

Underlying market conditions will still be far from poor, mirroring Europe's buoyant public debt markets following the ECB's rate cuts in September, though the central bank's new corporate sector purchase programme (CSPP) may encourage public rather than private bond issuance. Average SSD pricing remained broadly stable through 2019, with a median spread above mid-swap for five-year euro-SSD tranches of about 110 bps (median from 90 SSD deals based on the spreads of five-year SSD tranches).

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Troubles at Leoni are reminder of SSD liquidity risk

Some issuers were able to place SSD paper competitively thanks to the pricing in corporate-bond markets in 2019, such as Belgian steel-wire supplier Bekaert SA, German property company DIC Asset AG, healthcare firm Fresenius SE and DIY chain Hornbach Baumarkt AG as well as Spanish auto parts supplier Gestamp Automoción. However, the difficulties confronting investors in Leoni's SSD debt in terms of reducing their exposure at anything other than a significant discount is a reminder of the illiquidity risk inherent to a 'hold to maturity' market such as the private-debt segment.

The internationalisation of the once German-dominated SSD issuance took a breather in the second half of 2019, though French companies were increasingly active. With issuers eager to meet growing investor appetite for sustainable financial products across capital markets, 'green' SSD issuance accelerated last year and looks set to remain a trend in 2020.

Competitive pricing, shorter placement periods, less onerous documentation, lower associated transaction costs – all increasingly facilitated by digital platforms – should further bolster the appeal of the debt instrument across Europe and selectively to non-European corporate issuers in 2020.

The 2020 outlook

Reduced SSD volume forecasted for 2020 vs 2019

We forecast the SSD segment will struggle to match the record level issuance in 2019, though a placement volume of EUR 20bn-25bn looks realistic for 2020.

We highlight the following positive and negative trends for the private-debt segment:

- (+) spill-over from the 2019 deal pipeline: arrangers talk of good placement volumes in the first quarter after investors reached lending limits for 2019
- (+) faster marketing through a growing use of digital platforms; growing appeal of SSD issuance across Europe, with further increase in non-German debut issues
- (+) refinancing of three-year tranches from 2017, five-year tranches from 2015, seven-year tranches from 2013 and 10-year tranches from 2010, with an overall refinancing volume in 2020 of at least EUR 6bn
- (-) higher scrutiny on issuers from more cyclical and sensitive sectors such as automotive, construction, industrials and chemicals – historically strong sectors in the SSD segment –, manifesting in difficulty in placing such debt and/or higher risk premiums being necessary to place it
- (-) the ECB's newly launched ECB CSPP will lure more potential issuers to the public bond market

Acid test for the segment

Credit events of smaller SSD issuers did not upset overall placement activity in 2019

We expect 2020 to prove crucial for the SSD segment and to burnish its credentials as a market which can flourish through the economic cycle. After the short-lived disruption in 2018 from the financial troubles of some high-profile issuers during the end of 2017 (Carillion and Steinhoff), a series of smaller credit events among SSD issuers in 2019 failed to rattle the market, given the smaller amount of debt involved and the involvement of fewer investors in potential SSD restructurings.

2020 to provide more clarity about true intrinsic credit quality through the cycle

However, a pronounced cyclical downturn or slowing economic growth which weighed on several sectors – such as basic resources and chemicals, construction, and discretionary consumer goods as well as on industries undergoing disruptive changes such as retail and automotive – could lead to more frequent credit events in 2020 and beyond. This would provide a test of the true credit quality through the cycle of the still widely unrated SSD market.

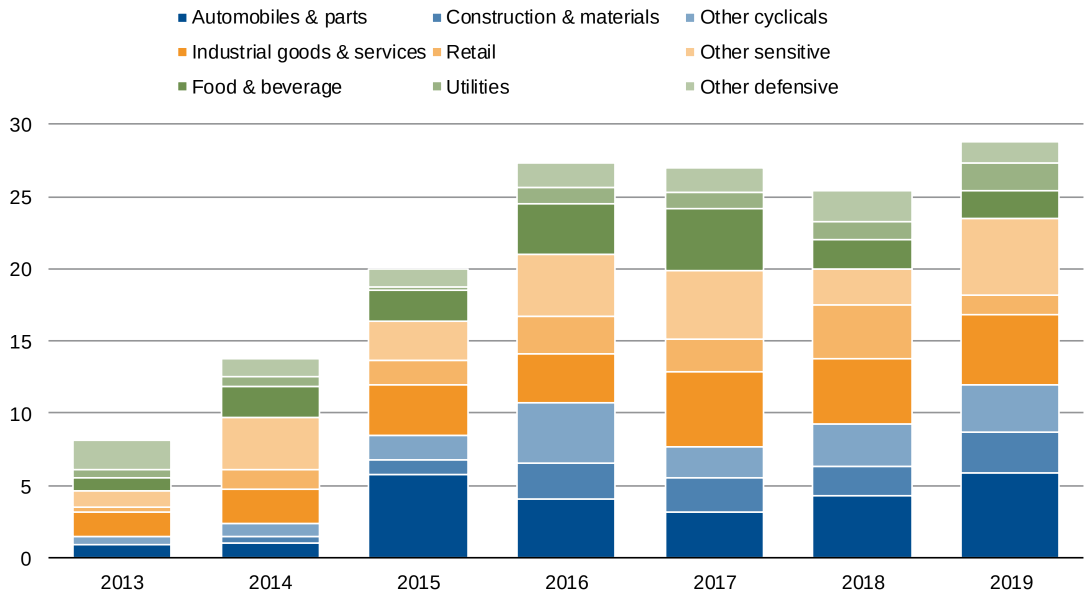
Debtor	iBoxx market sector	Credit event	SSD size	Placed in …
Gerry Weber International AG	Retail & personal goods	Default (Q1)	EUR 215m EUR 140m	2013 2015
Folli Follie SA	Retail & personal goods	Financial restructuring (Q1-Q4)	EUR 100m	2017
SANOCHEMIA Pharmazeutika AG	Healthcare	Default (Q4)	EUR 7m	2016
Nanogate SE	Technology	Covenant breach (Q4)	EUR 50m	2018
Euromicron AG	Technology	Default (Q4)	EUR 20m[1]	2014
Leoni AG	Automotive parts	IDW S6 and recapitalisation needs (Q4)	EUR 250m EUR 25m EUR 45m EUR 223m EUR 331m	2012 2013 2014 2015 2018

Source: Scope

Issuers from cyclical and sensitive industries – ones to watch

A look at the vulnerability of different sectors to the overall economic cycle reveals that debtors in more cyclical and sensitive sectors have been active SSD issuers, using iBoxx market-sector categories[2] as a simple guide. Of the placed SSD volumes over the past seven years (see Figure 3), companies in cyclical sectors made up 35% and those in sensitive sectors 42%, with automotive (OEMs and auto suppliers), construction (construction and construction materials) and industrial (including industrial services and transportation) companies among the most frequent issuers.

Figure 3: SSD placement volume (EUR bn) per sector measured by iBoxx market sector classifications



Source: Scope

[1] The variable tranche of the EUR 20m SSD issued in 2014 which was originally due in 2019 had been prolonged in April 2018 through a conversion into a maturity loan with a new maturity in 2021.

[2] Using iBoxx level 2 sector definitions we classify the following

- Cyclical: automobiles & parts, basic resources, chemicals, construction & materials, travel & leisure
- Sensitive: industrial goods & services, oil & gas, personal & household goods, real estate, financial services, retail, technology, media
- Defensive: food & beverage, healthcare, telecommunications, utilities

This is just a broad classification as the vulnerability of subindustries to the cycle can differ significantly, e.g. retail for consumer staples and consumer discretionary or generation, supply and grid operations in the utilities sector.

Risk aversion may prove a theme for 2020

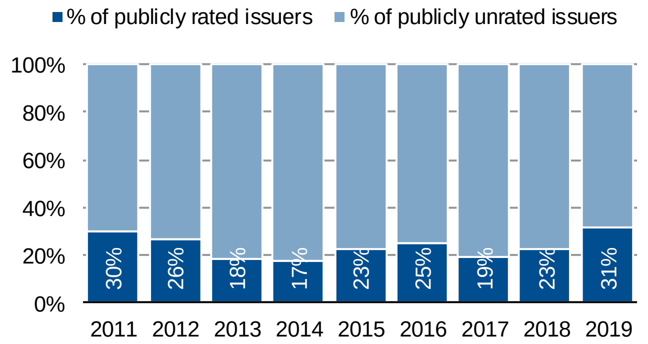
Growing concerns among investors over lending to companies in these more vulnerable industries could result in the following:

- Investors tend to be more reluctant to take part in new deals or demand higher spreads in such sectors, as signalled in a survey of 30 SSD investors conducted by Bloomberg in November 2019 regarding new automotive-sector issues.
- Arrangers will focus on more defensive sectors to minimise the risk of not being able to place SSD deals, typically what happened between 2008 and 2010.
- The market will likely shift back toward more highly rated – i.e. larger, more diversified companies – or seasoned issuers of private debt.

How will high-yield and non-rated SSD issuers perform in 2020?

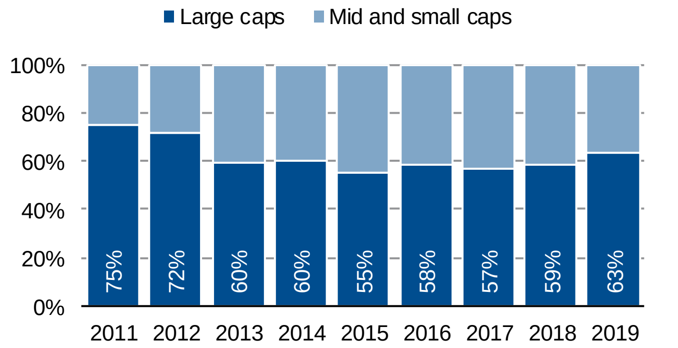
While around 50 issuers which placed an SSD over the last seven years explicitly carried a public non-investment grade rating, the vast majority have been unrated (more than 600 during the same period). We reiterate our thesis from one of our first SSD research papers from June 2015, 'German market for corporate 'Schuldschein' opens up to non-investment grade issuers', that a significant portion of publicly unrated issuers are likely to have a non-investment grade credit rating. Hence, we are particularly curious about how well SSDs issued during 2013-2016 will perform in 2020.

Figure 4: Share of publicly non-rated issuers (measured in number of transactions)



Source: Scope

Figure 5: SMEs vs large caps (measured in number of transactions)



Source: Scope

Pricing advantage over public bonds

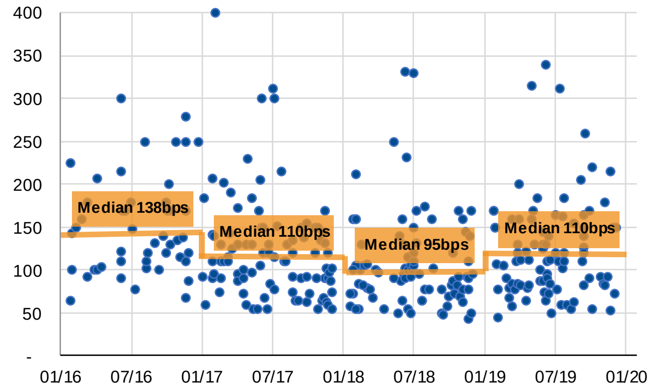
Stable spread development throughout 2019

Average pricing has remained broadly stable throughout 2019, with a median spread above mid-swap for five-year euro-SSD tranches of about 110 bps (median from 90 SSD deals with information of the spread of a five-year SSD tranche), despite the ECB's rate cuts in September and the start of a new round of bond purchases in November 2019. While we believe that quantitative easing and rate cuts directly trigger more favourable conditions for bonds issued by solidly rated companies, they also indirectly stimulate the private-debt market, where sentiment is usually driven by the public market.

Illiquidity premium still missing for some SSD issuers

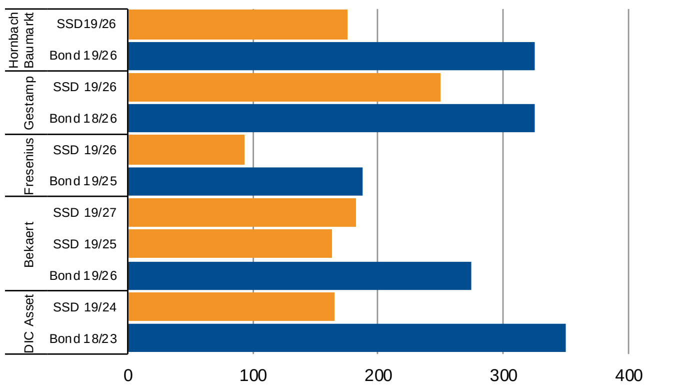
We maintain our view from our July 2019 SSD update ('Schuldschein private debt-market: Pricing edge sharpens as volumes, internationalisation grow') that the superior pricing of SSD tranches compared with that of similar public bonds remains a major attraction for many issuers. During H2 2019 we again observed that some SSD issuers, such as DIC Asset, Bekaert, Fresenius, Gestamp or Hornbach, were able to arbitrage differences in the spreads between newly placed SSD tranches and similarly configured corporate bonds. It can be more appealing for a potential issuer to go for an SSD rather than tap the public bond market – though the SSD segment has risks of its own.

Figure 6: Spreads on 5Y EUR tranches of SSD debt in bps



Source: Bloomberg, market info, Scope

Figure 7: Spread differential between SSDs and bonds with same/similar maturity and similar placement period[3]



Source: Bloomberg, market info, Scope

Lessons from Leoni

The recent case of German auto supplier Leoni clearly demonstrates that it remains difficult for an issuer to reduce an SSD exposure at anything other than a significant discount. Demanding an illiquidity premium for the private-debt instrument should be a pre-requisite for investors attracted by a 'hold to maturity' market such as the SSD, particularly for issuers with high-yield, cross-over credit profiles or from riskier industries which could turn out to be so-called 'fallen angels'.

Repeating our view of the need for greater investor scrutiny on issuers in cyclical and sensitive industries, we expect that investors will likely demand higher spreads in 2020 to reflect the intrinsic industry and corporate credit risks plus compensation for the SSD market's limited liquidity. The quid pro quo for the market's improved credit quality in 2020 would be a corresponding drop-off in placement volumes.

Green and ESG-linked SSD deals providing stimulus to overall demand

Sustainability becoming an increasingly popular topic for SSDs

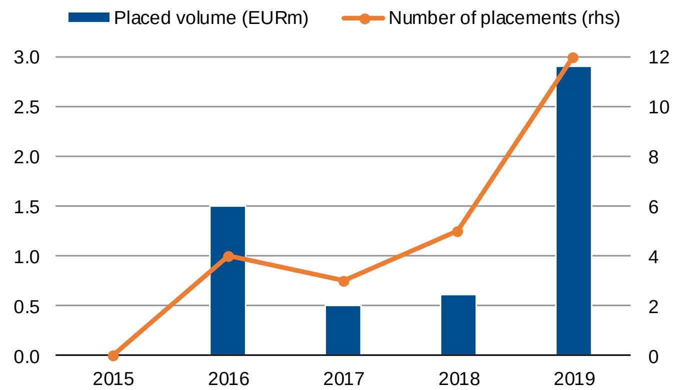
The green-labelling of securities is a broad phenomenon. In line with other debt classes such as bonds, hybrids or credit facilities, issuance of sustainable SSDs accelerated in 2019, compared with a handful of such transactions in earlier years. Such debt contributed around EUR 2.9bn of placements from 12 deals[4].

Figure 8: Green and ESG-linked SSDs from various industries

* SSD debt issued by Spanish solar project – solar farm Guillena-Salteras – in Luxcara's portfolio

Source: Scope

Figure 9: Number and placement of green and ESG-linked SSDs



Source: Scope

[3] Spread above mid-swap (Euribor) for SSDs and fixed-rate coupon for public corporate bonds

[4] The EUR 600m SSD from Barry Callebaut has been accounted for two-thirds, which were earmarked to finance sustainability projects.

The flexibility of the SSD instrument is perfectly suited for incorporating features linked to environmental, social and governance (ESG) factors such as interest payments tied to ESG ratios or an ESG score similar to a financial covenant.

Applicable to debt placements in many sectors

In the context of the overall SSD market, ESG-linked volumes remain fairly low (8% of deals and 10% of placement volume in 2019). However, the wide range of companies from different industries (see Figure 8) – outside of the classic utilities sector, which is predestined for green and ESG debt instruments – demonstrates that the green label is likely to play an increasing role.

Attracting a broader investor base

While we believe that labelling a loan as green or ESG-related does not change much regarding both the terms – most importantly the coupon – and the perceived creditworthiness compared with a 'normal' SSD, it certainly attracts a broader investor base by including investors dedicated to environmentally or socially responsible investments. As such, growing demand for green or ESG-linked debt issues could also provide an extra stimulus for the private-debt segment's overall growth.

SSD continues to grow in appeal across Europe

Around 40 SSD debutants from outside Germany

After the rapid growth of SSD issuance from outside of the market's German heartland in H1 2019 (50% of new issues from non-German debtors), the market again concentrated on German issuers in H2 2019, leading to 45% of non-German issuers overall. New issues from Nordic countries (five transactions) – particularly Finland – but also Switzerland (six transactions) and Eastern Europe (three transactions) lagged behind our expectations from the beginning of the year, with only a few deals in H2 2019 particularly. Nevertheless, of the 72 non-German issuers, around 60% have tapped the market for the first time, demonstrating the SSD's growing attraction outside of Germany.

French issuers gained third position

French issuers in particular remained active users of the market: numbering 16 last year, they have become the most active after German and Austrian companies, with several first-time market participants and some jumbo deals such as EUR 500m from telecoms operator Iliad, EUR 328m from healthcare company Orpea, EUR 522m from automaker PSA and EUR 548m from car parts supplier Valeo. With the establishment of French debt arrangers like BNP, SocGen and Natixis in the SSD segment, this trend should solidify further in 2020 (see also Scope's special comment 'French corporates take German's Schuldschein private-debt market increasingly to heart', July 2019).

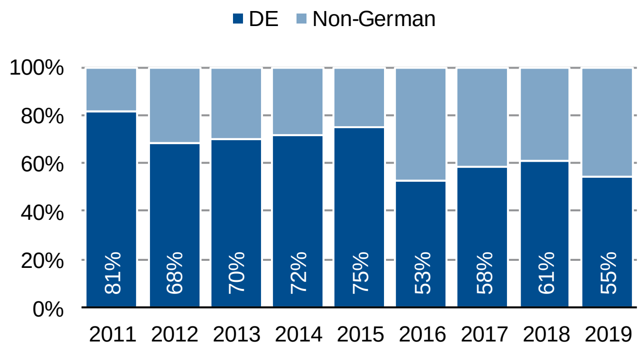
Southern European issuers gaining traction

Italian and Spanish issuers became more prominent in the SSD market, too, with larger deals last year from infrastructure company Acciona (EUR 155m), building-materials supplier Buzzi Unicem (EUR 200m), Gestamp Automoción (EUR 185m) and Telecom Italia (EUR 250m). Issuers from such countries are expected to gain further importance in 2020, with arrangers such as Unicredit, BekaFinance or BBVA (with its newly established digital platform) increasingly promoting SSD among their clients.

Further development of SSD segment continuously driven by non-German debutants

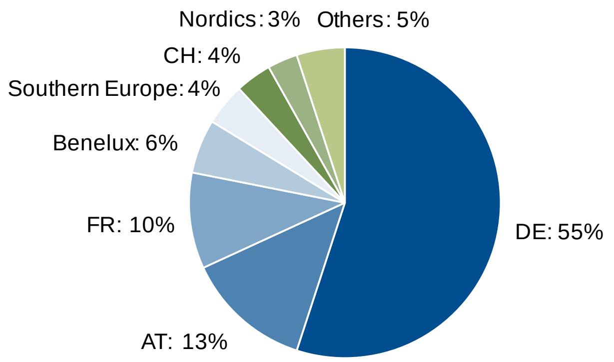
Overall, we reiterate our standpoint that competitive pricing, shorter placement periods, less onerous documentation, lower associated transaction costs and increasing facilitation by digital platforms should bolster the further roll-out of SSDs across Europe and selectively to non-European corporate issuers.

Figure 10: German versus non-German SSD issuers (measured in number of transactions)



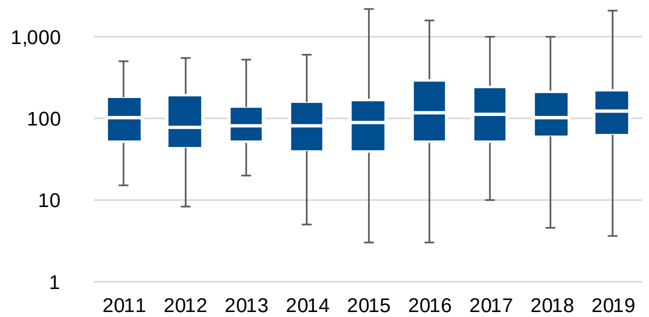
Source: Scope

Figure 11: 2019 split of SSD transactions (measured in number of transactions)



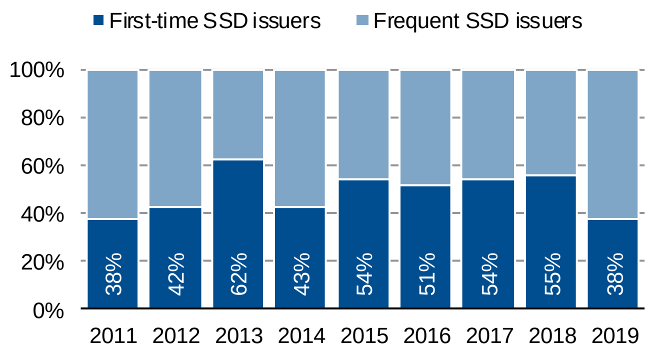
Source: Scope

Figure 12: Range of ticket sizes in EUR m (box plots) – logarithmic axis



Source: Scope

Figure 13: 2019 split of SSD transactions (measured in number of transactions)



Source: Scope

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