Schuldschein shaken up by Covid-19…
… but robust fundamentals assure rebound

The Schuldschein private debt market is set to bounce back in the second half of the year from a difficult first six months in which Covid-19 set new issuance back and put severe financial pressure on several issuers. We forecast full-year issuance of around EUR 20bn, compared to almost EUR 30bn in 2019. That would still represent a good second-half performance, however, given that first-half volumes fell by 35% year-on-year to around EUR 9.5bn.

The recession triggered by pandemic-related supply-chain disruptions, lockdowns and other healthcare protocols has weighed heavily on the willingness of issuers to tap the Schuldschein (SSD) market – and on investor appetite for private debt, particularly in vulnerable sectors such as aviation, automotive, travel and leisure.

SSD issuers facing financial difficulty include Deutsche Lufthansa (government bailout), Nanogate and 1.FC Kaiserslautern (insolvency proceedings), Benteler (ongoing debt restructuring) and Schlemmer Group (default).

New issuance from companies outside German-speaking Europe fell sharply as did issuance from companies new to the private debt market: 85% of first-half deals came from existing SSD issuers.

We expect this ‘safety first’ trend to be short-lived, however, and it should reverse through the second half of the year as the European economy starts to recover – assuming further easing of lockdowns, renewed market confidence and no alarming resurgence of Covid-19 cases.

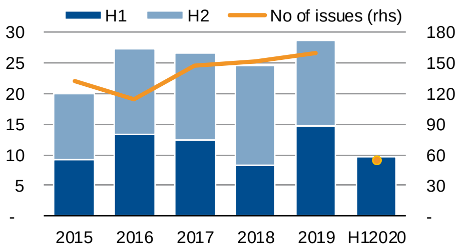
While first-half risk premiums rose – by about 20bp for five-year tranches against comparable deals in 2019 – the increase was modest in context of the collapse in economic activity in the first half of the year. Heavy over-subscription of recent new deals from financially solid names such as Bosch, Wacker Chemie, Voith and Clariant clearly shows underlying investor confidence in the SSD market. A significant number of experienced SSD issuers tested the waters with short-dated deals via digital platforms, which underscores the appeal of the SSD market for supplementing short-term liquidity.

In addition, investor demand for sustainability-linked debt issuance continues to extend into the SSD market, representing 15% of H1 deals compared with around 10% in 2019.

Covid-19 triggers slump H1 deal making; Bosch issue boosts Q2

Around 55 issuers raised at least EUR 9.5bn in the first half of the year in the SSD market, though volume was boosted by the EUR 2bn deal brought by Bosch in June. Activity was well below H1 last year, when companies raised roughly EUR 15bn from more than 80 deals.

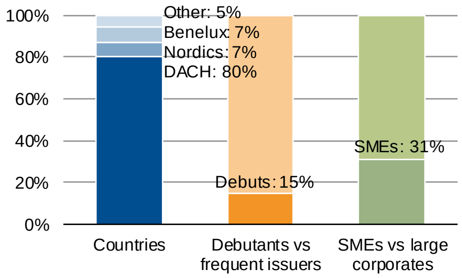
Figure 1: SSD placements (EUR bn)*



* based on closing dates

Source: Bloomberg, Scope data

Figure 2: Structural features in H1 2020



Source: Scope

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Covid-19 related lockdowns, production standstills and the impact on short and medium-term economic growth impeded troubled SSD issuers from stabilising their finances or succeeding with refinancing. Some SSD investors were not as lucky as those who lent to troubled automotive supplier Leoni, which succeeded in refinancing SSD issuance through bank debt in February right before the Covid-19 crisis intensified in Europe. The same is true for frequent SSD issuer Lufthansa, whose SSD investors will have been relieved that a nerve-wrecking bailout by the German State was finalised last month.

Recently defaulted SSD issuers already troubled before Covid-19 lockdowns

We do not consider recent default proceedings of SSD issuers Schlemmer Group, Nanogate or 1. FCK as entirely related to Covid-19 as these companies had been struggling in recent years. We are waiting for the outcome of likely financial restructuring of struggling automotive supplier Benteler, which also might involve SSD investors. Similarly, we will have to see whether experienced SSD issuer Tönnies – a German meat-processing company that has made headlines with a Covid-19 related scandal recently amid production shutdowns – can stabilise its finances in the months ahead.

Solid investment-grade issuers should not be severely hit by adverse economic growth, but the Covid-19 crisis is likely to accelerate financial distress of some high-yield and crossover names that have tapped the SSD market over the past few years. The spotlight remains on issuers from vulnerable industries, notably the automotive and travel and leisure companies.

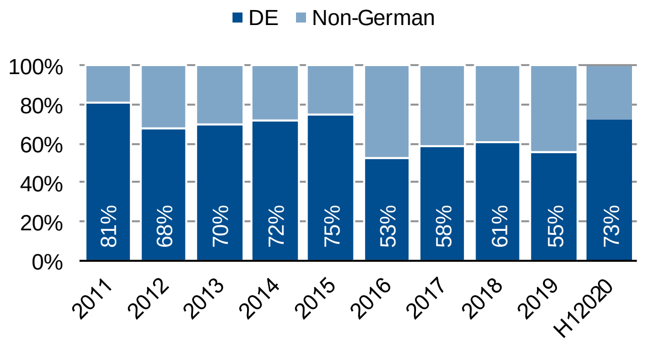
Downer on internationalisation and debutants … but this is just temporary

Covid-19 delays funding decisions

Some non-DACH and non-European corporates were lining up to tap the SSD market in early 2020, in line with the recent trend of the private debt-market's internationalisation. Covid-19 uncertainty seems to have delayed numerous fund-raising decisions. We still believe that SSDs are a good instrument in a treasurer's toolkit in turbulent times, but this is maybe not the right moment to test a new market. Apart from established SSD issuers such as Huhtamaki, Jacquet Metal Services, Cargolux, Port of Rotterdam and Trelleborg, few non-DACH corporates (such as Swedish Klovern and Vattenfall) have risked trying out anything new.

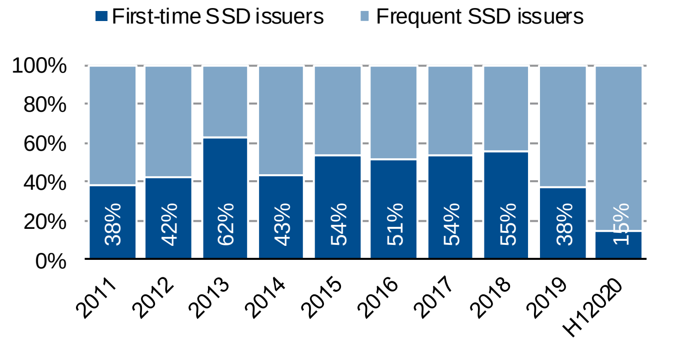
We believe that the lack of debut and international issuers in the first half is temporary. French retailer Auchan is about to kick off H2 deals with a debut SSD. We also point to the constraints facing arrangers to present deals and investors to screen debut issuers given other short-term priorities in the middle of Covid-19 lockdowns. As business returns to normal through 2020, we expect the SSD market to refocus on placements from newcomers.

Figure 3: German versus non-German SSD issuers (measured in number of transactions)



Source: Scope

Figure 4: Debutants vs frequent issuers (measured in number of transactions)



Source: Scope

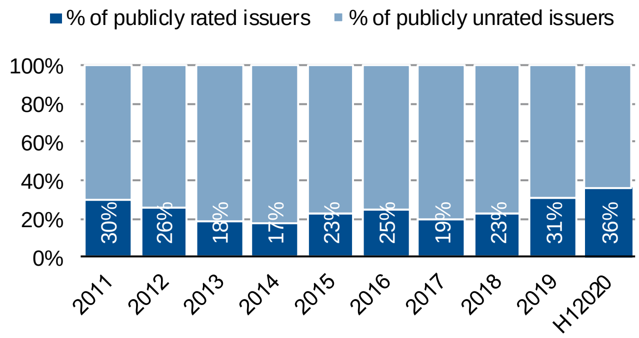
Safety first: buy what you know in uncertain times

Covid-19 frightens off debutant issuers in H1 2020

As we would expect in turbulent times, 'safety first' was the priority for issuers, arrangers and investors in the SSD segment in the first half, illustrated by several trends.

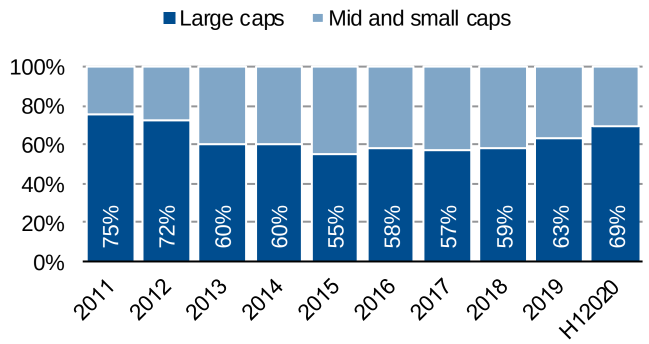
- Increased share of publicly rated issuers, with 40% of successful issuers showing an external – usually investment-grade – credit rating;
- Dominating share of large caps with recurring annual revenue of more than EUR 1bn;
- Most strikingly: a strong reduction in debut SSD issuers, with more than 85% of deals executed by experienced SSD issuers;
- Limited deals from cyclical sectors such as automotive and parts, basic resources, chemicals, construction and travel and leisure, at least when measured by the number of deals. However, placement volumes show a completely different picture, with strong placement volumes from the automotive, chemicals and industrials sectors thanks to large deals from Robert Bosch, Schaeffler, Wacker Chemie, Voith, SAF Holland, Wieland Werke.

Figure 5: Share of publicly non-rated issuers (measured in number of transactions)



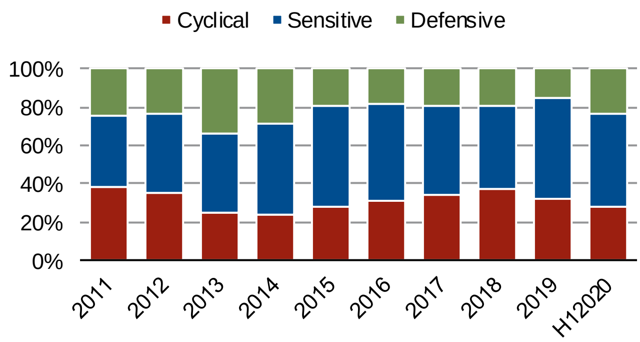
Source: Scope

Figure 6: SMEs vs large caps (measured in number of transactions)



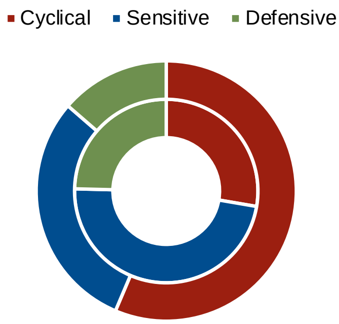
Source: Scope

Figure 7: Sector split[1] (measured in number of transactions)



Source: Scope

Figure 8: Sector split H1 2020[1] (Inner circle: measured by number of transactions; Outer circle: measured by placement volume)



Source: Scope

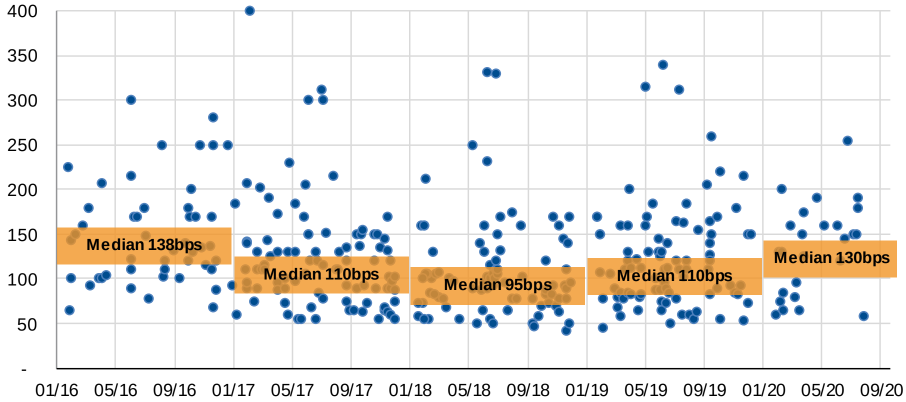
Investors rather than issuers were clearly in the driving seat in H1, with fewer deals marketed, a spike in market volatility, and rising risk premiums. Average risk premiums ticked up, with a median spread of around 130bp over the reference rate for five-year

[1] 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.

tranches. However, we believe that the 20bp increase in risk premiums was modest considering the gloomy business climate and the stronger widening of euro-denominated credit spreads of European investment grade bond issuers which Bloomberg[2] determines at 49bp year-to-date compared to 2019. Heavy over-subscription of new deals from solid names such as Bosch, Wacker Chemie, Voith, Clariant and Barry Callebaut shows that the SSD segment has not lost its shine.

Figure 9: Spreads on 5Y-EUR-tranches of SSD debt in bps



Sources: Bloomberg, market data, Scope

Digitisation expected to get further push particularly for short-dated debt

Digital platforms facilitate short-term fund raising

While corporates' focus was on preserving and raising short-term liquidity in general over the past four months, we've seen that a significant number of experienced SSD issuers have tested the waters with short-dated deals. Deals or tranches with maturities of two years and below have been rare in recent years, but prominent issuers like MTU Aero Engines, Lufthansa Port of Rotterdam and Vattenfall all priced single-tranche 400-day deals this year; while Bosch and Clariant issued multi-tranche deals that had two-year tranches and Daimler priced a single-tranche two-year.

Prominent issuers tap SSD with 400-day deals

Raising short-dated debt is usually only available to issuers with CP programmes. The issuance of short-dated bonds would typically hardly justify associated transaction costs. Hence, we believe that the test placements from these issuers underscore the growing popularity of digital platforms, which help investment-grade companies access short-term liquidity at low cost even in times of economic turmoil.

Enthusiasm for green and ESG SSDs further getting traction

More ESG momentum

Investor enthusiasm for sustainability-linked SSD issuance continues to grow. Eight companies tapped the market with ESG-linked deals in the first half. Sustainability-linked SSD debt represented roughly 15% of the debt volume so far in 2020 compared with 10% in 2019.

The range of companies from different industries other than the utilities sector – typically, the leading issuer of such debt – that came to the SSD market with sustainability-linked placements suggests that the green label is likely to play an increasingly important role in the market's development.

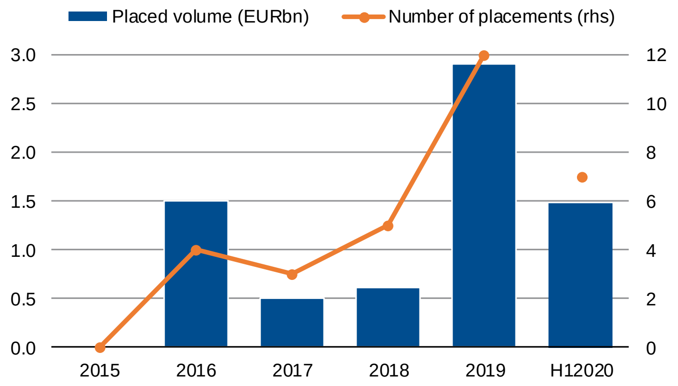
[2] Based on Bloomberg Barclays index

Figure 10: Green and ESG-linked SSDs from various industries

Utilities | **Other industries**

Source: Scope

Figure 11: Number and placement of Green and ESG-linked SSDs



Source: Scope

2020 Outlook

We are sticking to our view that 2020 Schuldschein volumes should reach EUR 20bn based on our expectations of a slow easing of lockdowns and restored confidence of potential – primarily international – issuers to seek alternative financing through Europe's leading private-debt market. The next jumbo deal is about to be closed soon with a deal from second-time issuer Barry Callebaut with a volume potentially exceeding EUR 600m.

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