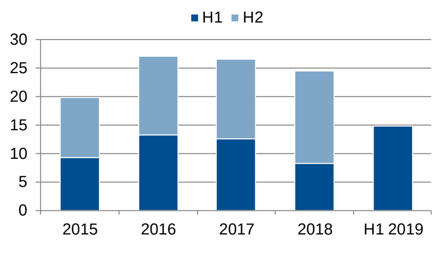
Schuldschein: pricing edge sharpens as volumes, internationalisation grow
Placements set to exceed EUR 25B in 2019

Low yields on recent Schuldschein (SSD) issues show that the specialist private-debt market is to some extent substituting for Europe's corporate bond market judging by how investors ignored the segment's typical illiquidity risk premium in recent pricing. The phenomenon as a sign of how robust the private financing segment has become, enhancing a reputation for lower volatility than public capital markets. Such a pricing differential is little cause for concern if we assume the issuer has a rock-solid credit profile offering investors a likely 'hold-to-maturity' investment.

On the other hand, for companies with borderline investment-grade credit ratings and explicitly non-investment grade corporates, such bias may turn out to be a problem. Long term, SSD pricing needs to reflect the credit and liquidity risk of buy-to-hold securities, not just the former. Recent pricing anomalies could continue for the next few quarters as issuers and investors seek safety amid the uncertain financial-market and economic outlook.

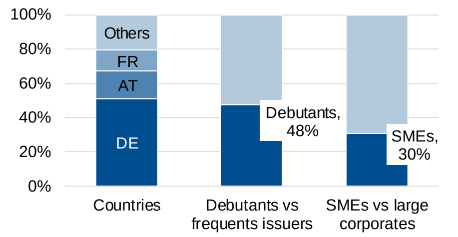
Schuldschein placement volumes picked up strongly in H1 2019 compared with H1 2018, with more than 80 transactions closing more than EUR 14.8bn, significantly more than the first-half volume in the record years of 2016 and 2017. The internationalisation of the segment continues apace, with issuance from non-German corporates making up around half of total first-half volumes for the first time. Larger, listed companies which also more often carry a public rating were also more active issuers, while there was comparatively less issuance from small and medium-sized enterprises.

Figure 1: SSD placements (EUR bn)*



* based on closing dates Source: Bloomberg, Scope

Figure 2: Structural features in H1 2019



Source: Scope

The standout H1 2019 feature was the superior pricing on SSD issues from a wide range of companies – from unrated German conglomerate BayWa to French dependency-care provider Orpea, auto maker Peugeot and Spanish construction firm Sacyr – compared with comparable corporate bonds. Most impressively, Germany's Bilfinger, an industrial services company, priced a 5.5-year Euro-SSD tranche in April at just 250-270 basis points above Euribor – the benchmark rate has hovered either side of zero for much of 2019 – compared with a 5-year bond at 4.5% placed in June.

Outlook: Volumes set to exceed EUR 25bn by end-2019

We are confident that issuance volume will rise this year to more than EUR 25bn, thereby confirming our view at the beginning of the year. An impressive early-summer issuance pipeline of more than EUR 2bn includes deals from Porsche, Acciona, Gewobag, Buzzi Unicem, RHI Magnesita, as arrangers and issuers take advantage of favourable market conditions. They include the SSD's current pricing advantage over corporate bond markets and the termination of European Central Bank net purchases of corporate-sector bonds, under the bank's corporate sector purchase programme (CSPP), in January 2019.

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The vanishing SSD illiquidity premium

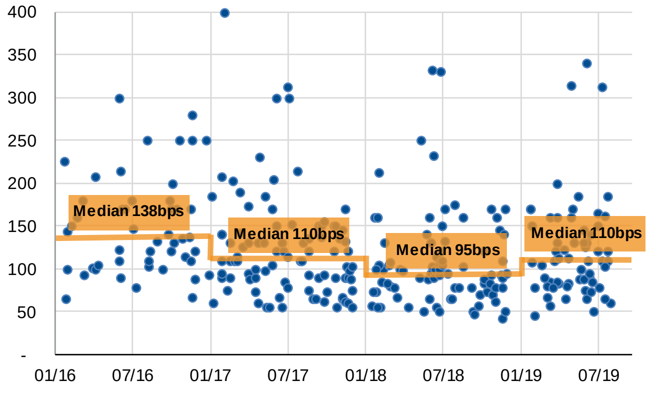
BayWa, Bilfinger, Peugeot, Telefonica Deutschland benefit from aggressive pricing

Competitive pricing is the latest attribute of the SSD segment that is attracting issuers, adding to the benefits of shorter placement periods, less onerous documentation, lower associated transaction costs, increasingly facilitated by the use of digital platforms.

Despite the pickup of average spreads – measured by the median spread above mid-swap for 5-year-Euro-SSD tranches – which increased by 16% against the median in 2018[1] (see Figure 3), pricing turned out to be a major pull factor. The pricing shift has proved more appealing for several individual cases, showing increasing arbitrage between private and public debt markets. A number of first-half SSD issues showed no sign of an illiquidity premium which would typically be expected for an illiquid debt instrument. Several SSD issues (see figure 4) displayed not just tighter pricing compared with a bond placement with similar features but a significant pricing advantage in some instances.

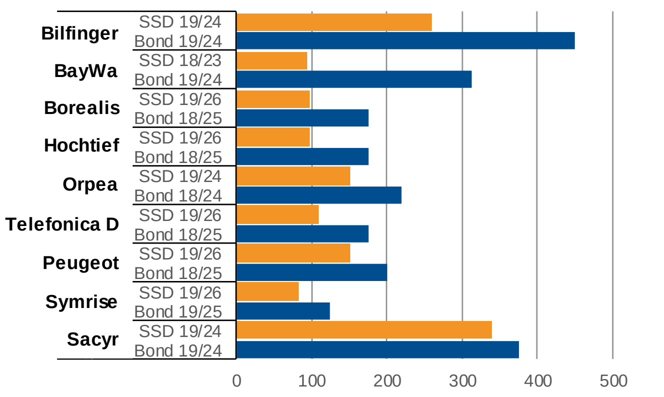
- German industrial services provider Bilfinger priced a 5.5-year Euro SSD tranche in April at just 250-270 basis points above Euribor – the benchmark rate has hovered either side of zero for much of 2019 – compared with a 5-year bond at 4.5% placed in June.
- Germany's BayWa, an unrated industrial conglomerate, issued a 5-year bond in June 2019 priced more than 200 basis points higher than a comparable 5-year-SSD placed in November 2018.
- Other examples such as Orpea, Symrise, Peugeot, Sacyr, Hochtief, Telefonica Deutschland, Borealis all marketed SSD debt with significantly lower spreads compared with a bond with the same/similar maturity and similar placement period.
- Switzerland's Barry Callebaut is said that to have pulled a bond and opted for an SSD issue instead.

Figure 3: Spreads on 5Y-EUR-tranches of SSD debt in bps



Source: Bloomberg, market info, Scope

Figure 4: Spread differential between SSD and bond with same/similar maturity and similar placement period[2]



Source: Bloomberg, market info, Scope

Lack of illiquidity premium may turn out as a problem for investors in crossover and HY SSD issuers

We interpret this phenomenon as a sign of how robust the private financing segment has become, enhancing a reputation for lower volatility than public capital markets. Such a pricing differential is little cause for concern assuming the issuer has a rock-solid credit profile offering investors a likely 'hold-to-maturity' investment. On the other hand, for

[1] Median spreads in H1 2019 derived from spread information for 48 SSD issues with a 5-year-Euro tranche vs spread information for 102 SSD issues with a 5-year-Euro tranche in 2018.

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

companies with borderline investment-grade credit ratings and explicitly non-investment grade corporates, such bias may turn out to be a problem for investors. In the longer term, pricing in the SSD segment needs to reflect credit and liquidity risk, not just the former. We expect the recent pricing anomalies to continue for the next few quarters as issuers and investors seek safety amid the uncertain financial-market and economic outlook of falling or negative central-bank lending rates, soaring asset prices, tensions related to global trade and geopolitics.

Carillion's ghost: expect more selected defaults, SSD restructurings

Gerry Weber default in Q1 2019

It has been a good signal that we have recently seen little issuances from niche apparel companies which are facing significant industry disruptions. While investors in the 6y-SSD tranche from German fashion brand Tom Tailor had a narrow escape in 2018 with the early redemption of its SSD issue before the company ran into deeper financial trouble, investors in SSD issuer Gerry Weber were less lucky: the company declared insolvency in January 2019. The fashion company's financial position looked solid at the time of the issuance of the first Schuldschein loan (Scope adjusted leverage – measured as Scope-adjusted debt/EBITDA – of below 2.0x), but it deteriorated quickly after an ill-timed acquisition as trading conditions across the bricks-and-mortar retail-clothing sector worsened amid the consumer shift to online shopping. Given the limited liquidity of the "buy-and-hold" loan market, investors have to constantly monitor an SSD issuer's sector fundamentals and financial performance.

Cyclicals not best suited to Schuldschein

Recent history suggests companies operating in other cyclical like construction and unpredictable sectors like sports clubs are not well suited to the segment from our perspective. German football club Hamburger SV (HSV Fußball AG), relegated to the second division last year, and UK contractor Kier both issued SSD paper in 2016 – as did Kier's larger, defunct UK rival Carillion – and are facing continued financial difficulties. And 1. FC Kaiserslautern – another German football club which had been relegated to the third division last season and faces constant financial distress is said to have placed an SSD in some kind of rescue plan.

2020-2022 expected to be crucial years

While these are current examples of companies not perfectly suited for the SSD segment, they are extremes. The years – 2020-2022 – are set to be a crucial test for unrated SSD issuers and potentially some fallen angels among rated SSD issuers which tapped the market between 2014 and 2017.

Non-German issuers almost outnumber German issuers

50% of placements and debt volume from non-German corporates

Schuldschein issuers from outside Germany, as we have expected, continue to provide much of the impetus for growth in the segment. Our research puts the share of non-German SSD issuer at around 50% during H1 2019 for the first time in the Schuldschein market's history. Foreign issuers placed more than EUR 8.1bn including jumbo issues from Barry Callebaut (EUR 600m) and three French issuers: auto maker Peugeot (EUR 522m), telecoms firm Iliad (EUR 500m), and car-parts supplier Valeo (EUR 500m). A similar picture prevails for those deals which are currently in the marketing phase.

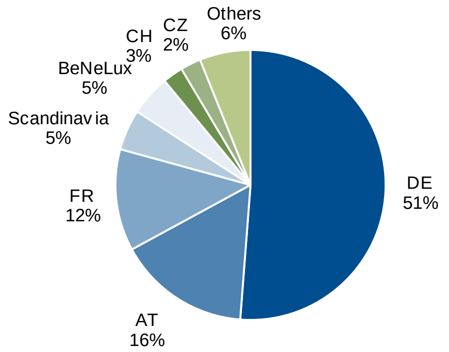
24 new non-German debutants

While it is the non-European issuers such as the EUR 405m deal from India-based Reliance Industries Ltd. or the EUR 200m of China's Tianjin Rail Transit Group which attracted plenty of attention with their debut Schuldschein, it is the continued inflow of Austrian corporates as well as the burgeoning deal flow from French and Scandinavian issuers which provide the volumes. Of the 40 non-German issuers, around 60% have tapped the market for the first time. Scandinavian issuers included Danish farming cooperative DLG Group and industrial-investment company Schouw & Co, Norway's Aker - another industrial investment company - and seafood supplier Mowi. Among other French corporates which tapped the market were dependency care provider Orpea and cement supplier Vicat. While Eastern European issuers were represented by a few Czech corporates such as EP Infrastructure, CPI Property, O2 Czech Republic, issuance from Italian, Iberian or British issuers remained scarce, if not to say inexistent. Spanish construction and concessions firms Acciona and Sacyr as well as Italy's Buzzi Unicem, a building materials supplier, are set to settle SSD debt in the second half of 2019. As the example of French users of the segment show – as a fairly mature source of SSD issuance judging by the more than 60 SSD deals over the past few years – it needs a few reference deals before a country's corporates consider the private-debt segment as a reliable source of funding. UK issuers like INEOS Group Holdings look set to remain an exception partly because they have other private debt-placement options such as the US-PP though the uncertainty over Brexit is souring investor sentiment toward British firms.

SMEs not yet prominent among nongermane/Austrian SSD issuers

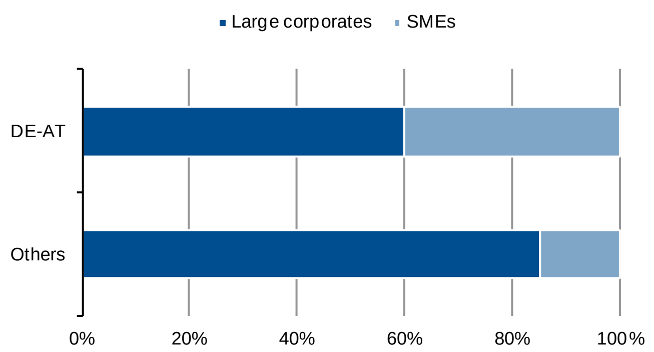
One striking feature is that among foreign SSD issuers, it is larger, publicly quoted companies with a recurring revenue of more than EUR 1bn and past experience with debt issuance programmes that have tapped the market. Among smaller companies, German and Austrian SMEs remain the most frequent users of SSD financing. We however believe that it is just a question of time before French, Dutch and Scandinavian SMEs follow.

Figure 5: H1 2019 split of SSD transactions (measured in number of transactions)



Source: Scope

Figure 6: Company size among German/Austrian and companies outside of the traditional SSD core markets



Source: Scope

Bigger fish swimming in the SSD sea

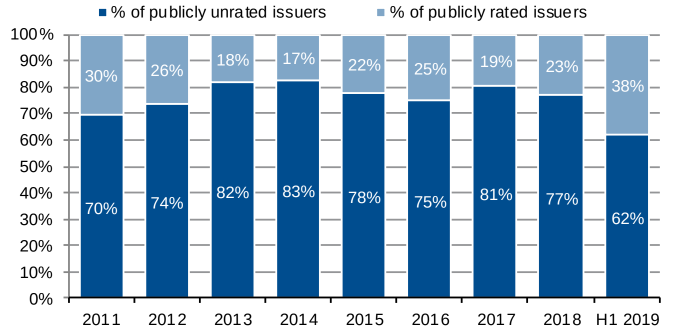
Larger corporates are the safer bets for new SSD countries

In H1 2019, we have observed a strong pick-up in SSD issuance from larger and more often rated[3] SSD issuers (see Figures 7 and 8) for two reasons:

- As the private debt segment becomes more popular, arrangers are concentrating on issuers with the best chances of quick and successful placements. They are typically larger, publicly rated and repeat SSD issuers, particularly when it comes to non-German/Austrian companies.
- Arrangers and investors are also more comfortable with larger and more diversified issuers. They are more likely to pull through current and future economic turbulence. After the experience of the financial trouble that some SSD issuers encountered in the past 18 months, the market seems keen to avoid the dilution of credit quality among SSD issuers in the 2014-2017 period.

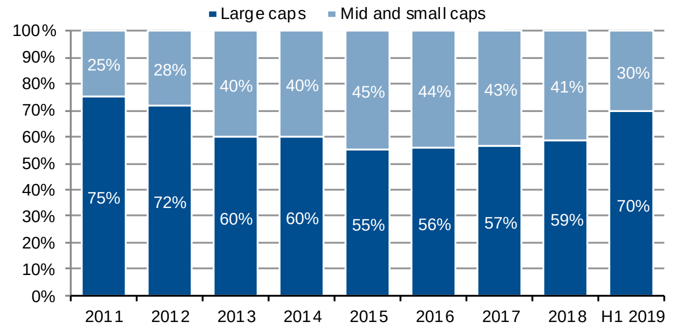
[3] Either being rated directly or carrying a rating on its ultimate parent.

Figure 7: Share of publicly non-rated issuers (measured in number of transactions)



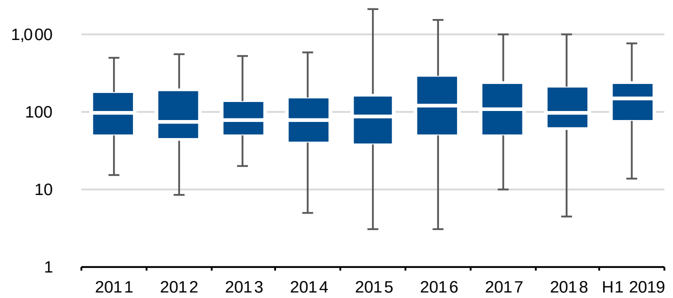
Source: Scope

Figure 8: SMEs vs large caps (measured in number of transactions)



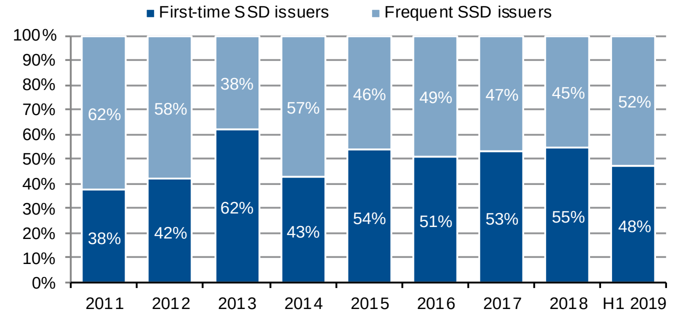
Source: Scope

Figure 9: Range of ticket sizes in EUR m (box plots) – Logarithmic axis



Source: Scope

Figure 10: Frequent issuers vs. market debutants (measured in number of transactions)



Source: Scope

Digital platforms already playing a vital role

New digital SSD platforms evolving

The growing importance of digital platforms for SSD placements seems uncontested, primarily for frequent SSD issuers or well-known listed companies. More digital platforms have launched during H1 2019: Finledger (DZ) and yellowe (Raiffeisen). We believe that more are to come over the next few months, particularly from non-German/Austrian arrangers. While is it clear that in the long-term not all of these platforms will remain in the market, we argue that there is a logic to mushrooming of new platforms in that they are a good test-bed for the digitalisation of other debt instruments.

Scope estimates that platforms play a role for 40-50% of all new transactions

Full or partial SSD placements via a dedicated digital platform have been prominent among the 100 SSD deals closed so far this year or which are currently in the marketing phase. We estimate that a digital platform was at least partially involved in the placement of 40-50% of all new transactions, with an even higher share for returning SSD issuers. This is a remarkable number considering that the first digital platform opened its doors just a year ago.

Better liquidity management particularly in time of negative carry

Operators of digital platforms remain rather opaque about the direct cost savings of a digitalised SSD transaction compared to a traditional deal. We found one element particularly convincing: The digitalisation can bring an indirect cost advantage referring to liquidity costs or costs of carry, given the assumed direct cost savings for smaller ticket transactions. By issuing more frequently at smaller ticket sizes through SSD placements, the segment could well become attractive for some corporates to better manage liquidity by avoiding paying interest on borrowed funds which they have not been able to deploy. We expect to see more repeated small SSD deals placed via digital platforms such as recent ones from German DIY-store chain Hornbach, car-rental firm Sixt and conglomerate BayWa.

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