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Lessons Learned in the German SME Bond Market

Special comment

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Since the inception of the German SME bond market in 2010, Scope Ratings has counted 26 corporate defaults and four selective defaults impacting 34 corporate bonds in total with a total debt volume of EUR 1bn. This translates into a default rate of 17%. Outstanding refinancing risks point to a serious likelihood of further corporate defaults in the market.

While all market participants are working on re-establishing the credibility of the German SME bonds market, it is important to incorporate the lessons learned from the past. Scope Ratings ("Scope") has analysed the reason for the high number of defaults and points out measures aimed at reducing them in future. The lessons learned can serve as guidance to other European markets, helping them to establish transparent and credible bonds markets in their respective country.

Eclectic reasons for high default rate

Scope sees diverse reasons for the high default rate in the German SME bond market, namely:

- structural problems in a particular industry with strong debt issuance activity, such as the renewable energy market;
- fraud allegations;
- financing of unduly risky investments with proceeds of bonds issuance;
- lack of strict financial covenants limiting the ability of creditor-friendly debt protection measures.

Often the SME bond market was seen as the last resort of financing for weaker debt issuers. This trend was further accelerated by the expansive monetary policy of the European Central Bank, catalysing the provision of capital through private placements or the traditional banking system.

The average credit ratings assigned at issuance indicated a low investment-grade or high non-investment grade credit quality of the segment, while the actual default rate suggests an average credit quality of mid sub-investment-grade in this market.

Lessons learned

Some market participants have drawn their conclusions and have adjusted to these circumstances. For instance:

- debt advisors are examining new issuances with more scrutiny, which has led to several cancellations of new bond issues
- issuers are offering improved creditors protection by means of provision of tangible collateral or stricter covenants;
- bond exchanges have heightened transparency requirements for a listing;
- rating agencies have adapted rating methodologies with a more focussed approach on future cash flow generation and liquidity;
- investors are conducting more thorough reviews on their investments, recognising the need for in-depth credit analysis of an international standard;
- issuers are pursuing other financing options with alternative financial instruments such as private debt placements or the issuance of hybrid bonds.

Outlook

Although successful issuance volumes for German SME bonds dropped significantly in 2014 and 2015 YTD, the market will likely overcome these birth pangs. However it may take time for a complete recovery of investors' confidence. Scope believes that with the execution of measures listed above, the market will regain its importance and provide an improved credit protection to investors looking for high yields.

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Related Research

Refinancing Risk Emerging in the German SME Bond Market

Covenants - A Study of the German SME Bond Market

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German SME bond market: Fact & Figures

	No of issuers	No of issues	Emission volume (EUR bn)	Placed volume (EUR bn)
Issues	149	194	8.5	7
Defaults	30	34	1.5	1

	2010	2011	2012	2013	2014	2015 YTD	Total
Bond issues	21	46	43	49	30	5	194
Average Coupon (%)	6.50	7.25	7.25	7.88	7.25	7.00	7.25
Defaults	0	1	5	9	13	2	30

Source: Scope Ratings

High default rate

High default rate and low recoveries in the SME bond market

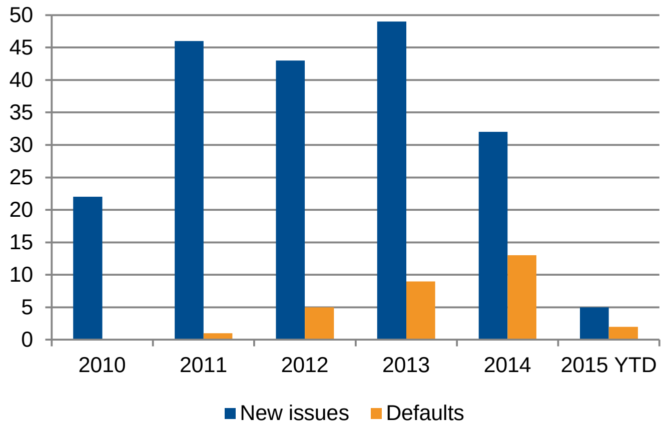
Since the creation of the German SME bond market, the segment has suffered many defaults. Between Q12010 and Q12015 Scope Ratings counted 30 corporate defaults and selective defaults on bond issues respectively. That is 34 bonds with a volume of almost EUR 1bn out of a total invested volume of nearly EUR 7bn. Even more sobering is the very low determined or market-price induced recovery rate of such bonds, averaging below 15%.

The default quote of 17% relating to the total number of bond issues (15% relating to bond volume) is very high compared to other high-yield bond segments such as the European high-yield bond market. This is surprising as interest spreads – as indicators of market and idiosyncratic risk – have been comparable in both bond markets, ranging between 5% and 7% over the last four years.

Likelihood for further defaults remains high

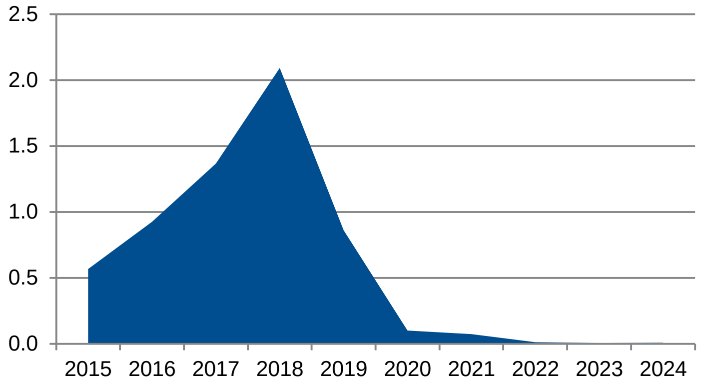
Scope believes the likelihood of further corporate and bond defaults remains high, especially given the size of refinancing needs for issuers with a volume of EUR 1.4bn in 2017 and a current peak of EUR 2.1bn to be refinanced in 2018. With the increase in credit spreads for very low rated issuers over the last 12 months, there is a question whether all issuers can succeed in refinancing. Refinancing is likely to become even more difficult for the lower-rated entities (see figure 2 and related research piece: Refinancing Risk Merging in the German SME Bond Market).

Figure 1: Decreasing number of new bond issues with increasing number of defaults



Source: Scope Ratings

Figure 2: Refinancing wave (EUR bn)



Source: Scope Ratings

Following the stressed situation for new SME bond issues, bond transactions fell sharply in 2014 and Q12015: -53% in terms of placed volume and -39% in terms of number of issues, (from 2013 to 2014 YOY). While the supply from issuers is still strong, many issues had to be cancelled during the conception of a bond or during the issuance phase.

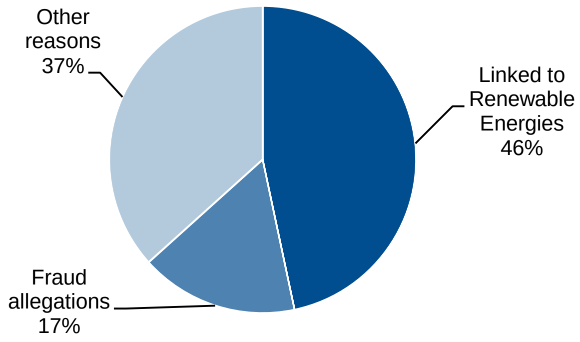
Eclectic reasons for high default rate

Scope sees diverse reasons for the high default rate in the German SME bond market, which relate either to the issuers or market setup. A diligent differentiation is needed to draw conclusions about future market developments.

Half of defaults related to structural issues

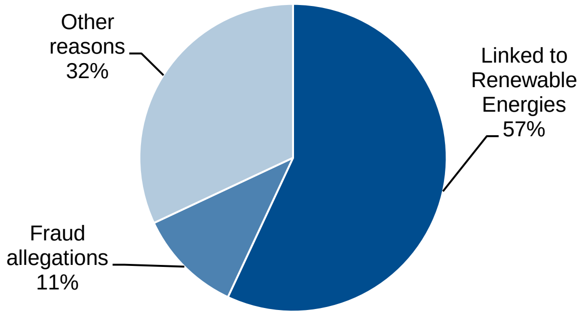
Almost one half of the issuer defaults and more than half of the bond volumes have been related to sector-specific developments in the renewable energy market – an industry that has been distressed since 2009. Component or equipment suppliers in the solar and wind industry such as 3W Power S.A., Rena GmbH or SIAG Schaaf Industrie AG have been exposed to severe pricing pressures, resulting in several corporate defaults. Moreover, project developers in the renewable energy industry such as CarpeVigo AG, BKN biostrom AG face ongoing regulatory changes, which jeopardised their business models.

Figure 3: Various industry and company-specific reasons for defaults (number)



Source: Scope Ratings

Figure 4: Various industry and company-specific reasons for defaults (bond volume)



Source: Scope Ratings

Serious fraud allegations

While the remaining half of corporate or bond defaults are linked to other corporate or industry developments, there have also been serious fraud allegations against some of the defaulted issuers regarding misrepresentation of financial accounts (e.g. MIFA Mitteldeutsche Fahrradwerke AG or Penell GmbH) and embezzlement (getgoods.de AG).

Bond market lender of last resort

Scope notes that the credit quality of many issuers was already weak at the time of issuance. For some entities the issuance of an SME bond was the last resort to receive external financing as banks had already rejected financing requests.

Moreover, Scope notes that many issuers did not use proceeds from bond issues as a substitute for a bank loan, but as a substitute for mezzanine or equity capital in order to finance risky investment projects, or to avoid short-term bankruptcy.

Retail market with limited creditor protection from covenants

In hindsight, the high proportion of retail investors in the German SME bond market who were impresssed by high coupons and seemingly safe issue offered by issuers with an established brand,overlooked the accompanying risks of such investments. Institutional investors – which Scope presumes to have invested in the SME bond market to a limited extent only (10-20% of overall invested debt volume) – have traditionally avoided such risky debt instruments.

Creditors' protection through meaningful covenant structures such as financial covenants were not established in the early stages of the market. Such covenant structures that are usually requested by professional institutional investors, and are a standard in other high-yield bond markets or in conventional loan contracts, were largely ignored. However, such covenants could have protected creditors against risky developments, as well as from the misuse and misinvestment of proceeds from the debt instruments.

Lessons learned and industry adjustments

All market participants adjusting to the new SME bond world

Given the loss of confidence in the bond market segment it will take time to regain its credibility and for the market's maturity to evolve. From Scope's perspective, all relevant market participants have already adjusted to these circumstances, either by amending investment behaviour or taking appropriate measures.

Investors and debt advisors: more selective

While Scope has seen a significantly lower number of new bond issues in 2014, Scope recognises that investors have become increasingly selective. Many planned bond issues were cancelled either during the conception stage of a new bond issue or due to a lack of investors' demand. Investors are conducting more thorough reviews on their investments, recognising the need for in-depth credit analysis of an international standard, even if this results in ratings well below the investment-grade threshold.

Successful new issues or tap issues tend to come from: (1) comparably large new issuers; (2) returning issuers which have already convinced the market with improving financial results; and (3) issuers from sectors with less industry-inherent credit risks such as real estate. Finally, recent successful bond placements are characterised by stronger creditor protection.

Stronger creditor protection through covenants and asset pledges

Scope believes the market has matured considerably in terms of creditor protection. The introduction of meaningful covenants – which have been the exception rather than the rule in the early stages of the market – is becoming the norm for new bond issues.

This can be seen in comprehensive covenant packages comprising the full range of common covenants such as negative pledge, pari passu, cross default, change of control clauses or payout or (des)investment restrictions. Financial covenants ensuring adherence to important debt protection measures, such as leverage or interest coverage, are still an exception in less than 10% of all outstanding bonds. Nevertheless, such financial covenants can be observed in the newer bond issues rather than issues seen at the early stages of the market.

Scope also notes a more frequent provision of recoverable assets as collateral. One third of all new bond issues in 2014 and 2015 YTD have provided collateral, against only 20% of bond issues in the earlier years. Such pledges in the form of real estate, inventories, brand rights, power plants or shares in other companies can be seen as measures designed to secure a successful placement of the bond issue, but which also put pressure on the management of the issuers to protect the company's asset base or brand value.

Issuers: Change of financing with other financing instruments

Issuers have opted for different financing alternatives to avoid the stressed market sentiment in public SME bonds. In particular, privately placed bonds with institutional investors have been favoured by midsized issuers such as Grand City Properties S.A., HELMA Eigenheimbau AG or Semper idem Underberg GmbH. The same trend has been seen in tap issues of existing public SME bonds (such as Metalcorp B.V. or Adler Real Estate) that directly address institutional investors.

Rating agencies: Adaption of rating approaches

Rating agencies focused on small and midsized corporates have reacted accordingly by amending their rating approaches and methodologies towards a more forward looking view. While in the early phases of the market, corporates were rated based predominantly on balance sheet ratios of past financial years, amended rating methodologies incorporate important cash flow and liquidity-based indicators. Such financial metrics focus on the future development of the rated entities, reflecting financial risks in a more accurate and realistic fashion.

Sector's rating migration from BB+ to B+ on average

In conjunction with the adjusted rating approach, the amended rating perspective is reflected in the rating migration after the assignment of an initial rating. Scope noted a strong tendency to rating adjustments with an average of 3 notches down with the average credit rating in the sector now standing at B+.

Exchanges: Best practice guide and stricter listing requirements

Bond exchanges have launched measures to steer against the battered image of the market segment. While 'Deutsche Börse' has published a best practice guide giving advice to issuers and intermediaries on bond listings, the specialised bond exchange 'Mittelstandsbörse Düsseldorf' has restructured its bond segment. The latter sharpened its listing requirements regarding transparency with the timely publication of interim reports and key financial metrics. While Scope interprets such guidances as soft laws to provide orientation and a more standardised approach, it may protect the segment from additional bond issues from issuers too weak or not yet mature enough to enter the capital markets.

Outlook

Overcoming of birth pangs

Although successful issuance volumes have dropped significantly in 2014 and 2015 YTD, the market segment for German SME bonds will likely overcome its birth pangs. It will take some time for investors' confidence to return. However, Scope believes that with the execution of appropriate measures the market will regain its importance and provide an improved credit protection to investors looking for high yields.

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