9 January 2019 Corporates

Schuldschein set for growth in 2019: Private-debt issuance to exceed EUR 25bn amid investor demand, volatile public markets

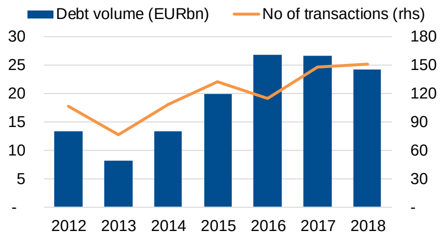
The Schuldschein private-debt market is set for at least EUR 25bn in issuance this year, continuing a H2 2018 comeback helped by closer, confidence-building investor scrutiny of new issues and volatility on public debt markets.

The more demanding approach of investors amid likely continued volatility on public debt markets, particularly given the end to the ECB's bond-buying programme, should ensure SSD issuance this year will end up not far from the value of debt raised in 2017.

Other factors should also underpin growth, from the greater use of digital platforms, which offer a speedier and cheaper way to place issues, to the market's growing appeal for issuers and arrangers outside Germany.

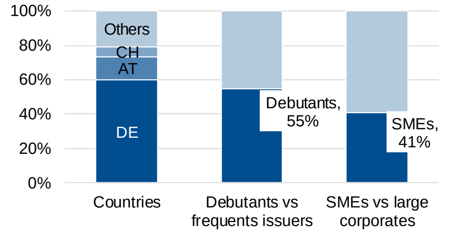
The Schuldschein market proved its resilience in 2018 as a debt-funding source amid often turbulent capital markets and the high-profile defaults of two borrowers a year ago, followed by a number of other debt restructurings. After meagre placement activities in H1 2018 in the corporate SSD market (~EUR 8bn), the segment has accelerated strongly during H2 2018, comfortably surpassing the EUR 20bn mark, thanks to the year-end placement of a few jumbo deals: EUR 700m from France's Faurecia, EUR 500m from Switzerland's Emil Frey Gruppe, EUR 500m from Germany's Lidl and EUR 500m from Switzerland-based LafargeHolcim. Scope has tracked SSD with an overall volume of at least EUR 24.5bn (down by 10% yoy) from at least 150 different transactions[1], unchanged YoY.

Figure 1: SSD placements (EUR bn)



Source: Bloomberg, Scope

Figure 2: Structural features in 2018



Source: Scope

2019 Outlook

For 2019 Scope expects again a market expansion to a volume above EUR 25bn, not far from the record issuance in 2016 and 2017. Investors seem to be back in the driver's seat, making it hard for companies without strong balance sheets or sturdy business models to tap the SSD market. That said, important internal and external factors are setting the segment up for further growth:

- Shaky public bond market sentiment and the end of ECB's quantitative easing and bond-purchasing programme;
- Growing ease of placement through digital platforms, thereby increasing placement frequency and making it even more attractive for smaller borrowers and returning SSD issuers for refinancing;
- Further Scandinavian, French and Italian arrangers entering the market, bringing with them their corporate - mostly domestic – clients;
- Continuous deal flow from refinancing needs for 3y, 5y and 7y tranches from 2016, 2014 and 2012 - all of them strong years of SSD issuance.

[1] Data is based on closing dates. SSDs issued in different currencies are treated as one deal.

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Taking the rough with the smooth: The Schuldschein market is growing up

The default of Carillion and selective default of Steinhoff, two high-profile issuers of SSD debt in 2017, rattled market sentiment in early 2018. The resulting loss of confidence in the market proved short-lived but had the salutary effect of reminding investors that as the segment grows and diversifies by type of issuer—by industry, geography and financial profile—credit events become a fact of life. There are likely to be more issuers whose creditworthiness will be tested in the months ahead, particularly if the economic slowdown proves more severe than expected amid less advantageous refinancing conditions. At the same time, the very same conditions may lure issuers and investors to the SSD segment, given its reputation for stability at times of financial stress.

Defaults and selective defaults become a new reality

Further warnings in the market following Carillion and Steinhoff

Let's start with the bad news: We reiterate our thesis that the SSD segment has come to a maturity phase where it mirrors a true credit cycle where defaults and selective defaults belong to the reality among the issuers of SSDs. The past year or more left a bitter taste with the default of Carillion, the special case of Steinhoff, but also the debt restructuring (selective defaults) of Germany's Gerry Weber (prolongation of debt maturities) and Greece's Folli Follie (selective default on certain debt instruments) most recently. While troubled German fashion company Tom Tailor managed to repay its last remaining tranche from its 2013 SSD, the re-capitalisation of UK construction and support services firm Kier (emergency rescue rights issue to pay debts) and Swiss food company Aryzta (presumably for compliance with financial covenants) show that credit quality among SSD issuers can be rather diverse and has to be monitored diligently.

How will weaker SSD issuer, particularly in more volatile industries, perform in a weaker market environment

What is striking is that these SSD issuers have run into trouble even under rather buoyant market and credit conditions. The acid test for the segment will come with the expected slowdown of the current economic super-cycle, potentially leading to higher refinancing costs and disruptions in some industries, such as non-luxury fashion, aviation, machinery or construction and some automotive suppliers. While we believe that defaults and selective defaults will remain the exception than the rule, it remains to be seen how the companies with clear high-yield or even cross-over credit quality—which have tended to come to the SSD market since 2015—will perform if overall economic activity cools and long-running bull market ends. Scope's analysis had shown earlier (see Scope's studies: 'Schuldschein debt issuance rebounds after nervous first quarter' from July 2018 and 'Has Pricing Reached the Floor?' from July 2017) that a significant portion of highly indebted companies have tapped the SSD market. Elevated leverage in itself only isn't a problem if the SSD issuer in question operates in a niche market with high barriers to entry or a sector which can normally bear higher leverage such as real estate or regulated infrastructure.

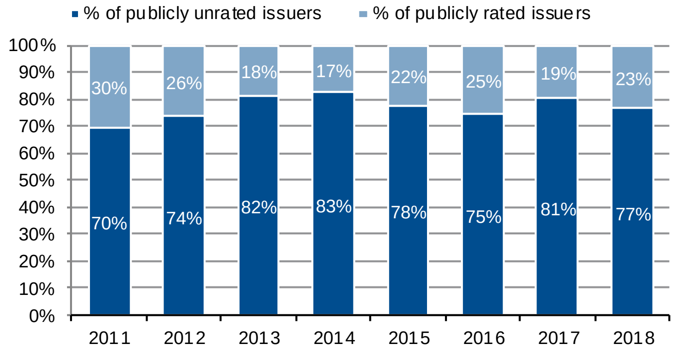
Investors still need to be wary about taking at face value the internal credit assessments of SSD issuers (more than 3/4 of the market remains publicly unrated – see figure 4), provided by the accompanying banks. The arrangers and advising banks both have conflicts of interest, from Scope's perspective.

Figure 3: Troubled SSD issuers in 2018

Issuer	Event	Size of SSD	SSD issued in …
Steinhoff	Fraud allegations and Selective Default	EUR 730m	2017
Carillion	Default	GBP 112m	2017
Folli Follie	Selective Default	EUR 51m	2017
Gerry Weber	Selective Default	EUR 75m	2013
		EUR 140m	2015
Kier	Recapitalisation	GBP 81m	2016
Aryzta	Recapitalisation	EUR 386m	2016

Source: Market information, Scope

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



Source: Scope

Shadow or internal credit assessments from arrangers can be tricky

Credit Research departments of some Scandinavian banks have been fined by ESMA for issuing credit assessments, known as ‘shadow ratings,’ without ESMA authorisation to such issue ratings or credit opinions. From Scope’s perspective, internal credit assessments of SSD arrangers are not much different. Apart from Steinhoff, all troubled SSD issuers have been publicly unrated.

Cancellations and coupon adjustments underpinning increased power of investors

In this context, greater scrutiny on the part of investors and arrangers for more solid SSD issuers and better risk-adjusted pricing is welcome. The cancellation of SSD issues of Ledvance, Austriacard, Adva Optical in the beginning of the year and Agfa-Gevaert more recently are signs of growing risk awareness or perceived inappropriateness of such companies for the SSD market. Moreover, the coupon adjustments during the placement phase at Freenet or ADO Properties (some more examples) have hinted at an increased risk perception.

The good news

And now the good news: There are multiple reason for why 2019 is likely to become a strong year again for the SSD market. We see a stimulus for further growth from different directions:

1) Private debt segment expected to be robust in shaky markets

First, Scope believes that the general market environment is well fitted for a good 2019 SSD market:

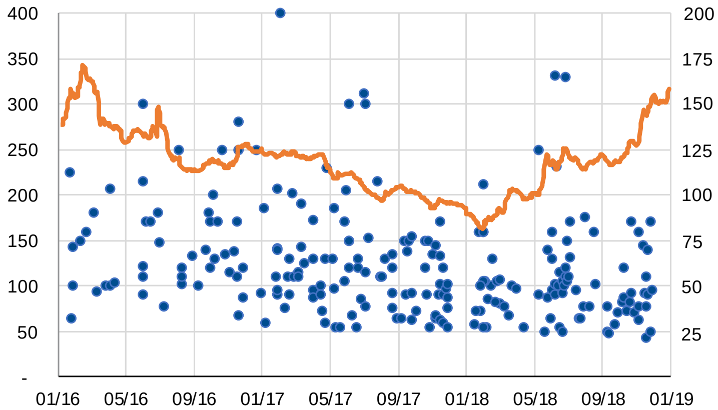
Shaky markets entice issuer to private placement segments

- Usually the private debt segments receive more attention from debt issuers when markets turn sour. The growing attraction of a private placement over a public bond issue could mostly be applicable to high-yield issuers and cross-over corporates, particularly when rising interest rates and rising spreads for bonds improve the relative appeal of private debt. The superior performance of SSD-issued debt compared with public-market debt is evident in figure 5.

End of ECB’s bond purchasing programme

- The ending of the ECB’s quantitative easing and bond-purchase programme will reduce the attractiveness of issuing bonds by rated large caps, thereby opening more room for private debt products such as the SSD.

Figure 5: Premium pricing: Spreads on 5Y-tranches of SSD debt in bps above reference rate (blue dots, lhs) compared with average corporate bond spread in bps measured by Barclays Pan European Aggregate Corporate Average OAS (orange line, rhs)



Source: Bloomberg, Scope

Continued dealflow from frequent issuers

- In light of the maturity of the SSD market, Scope expects a continuous deal flow for refinancing which overall provides a solid basis for new SSD issues. As around 50% of SSD issuers over the past few years have been repeat users of the debt segment, we assume that experienced SSD issuers are likely to return in 2019, either seeking new financing or refinancing of old issues. In 2019, the 3y, 5y and 7y tranches from 2016, 2014 and 2012 - all of them strong SSD years – will require refinancing, among them from SSD issuers like Enercon, Sartorius, Agrana, AKKA Technologies, Zech Group, AGCO Corporation, Acciona, Nordex, Otto Bock, Salzgitter, SEB.

Flow of M&A-related jumbo deals remains uncertainty

- Uncertainty remains regarding the strength of the M&A market in 2019. M&A surveys for 2019 look sobering in light of rising geopolitical risks. Hence, the potential for some jumbo SSDs which serve as a common funding source for M&A transactions could prove more limited than in the recent past.

2) Digital platforms expected to provide extra impetus for market growth

Platforms provide strong potential to increase placement frequency

Scope remains very bullish on the role of digital platforms for the expansion and placement frequency of the SSD market as such platforms make the lean debt product even leaner and most importantly cheaper. With the digitalization of the arrangement, placement and ticket allocation the platforms are offering a new competitive edge to the private debt product as a bilateral or better multilateral loan in reducing placement periods by an estimated two thirds and transaction costs by a significant amount[2].

Different platform approaches

While well-known German and Austrian SSD arrangers have either developed their own platform or have joined an open platform, it remains to be seen which strategy will be followed by French, BeneLux, Italian and Scandinavian arrangers. There are different approaches:

- Arranger-specific platforms such as **Synd-X** (HSBC) and the **permissioned blockchain platform** of Erste Bank;
- Platforms which are open for a number of participating arranging banks such as **vc trade** (with 7 different arrangers, among them Helaba, BayernLB, RBI),

[2] Not many reference points public yet: Austrian utility Verbund claimed it saved around 40% of transaction costs for its EUR 100m SSD issue placed by vc trade compared with a non-digitalised transaction. Finpair claims that transaction costs via the platform are around 50% less than compared with a classic placement on an SSD.

DEBTVISION (initiated by LBBW and Börse Stuttgart) and **FinPair** (initiated by NordLB);

- Bank-independent platforms such as **CredX, firstwire** and **FinnestPro.**

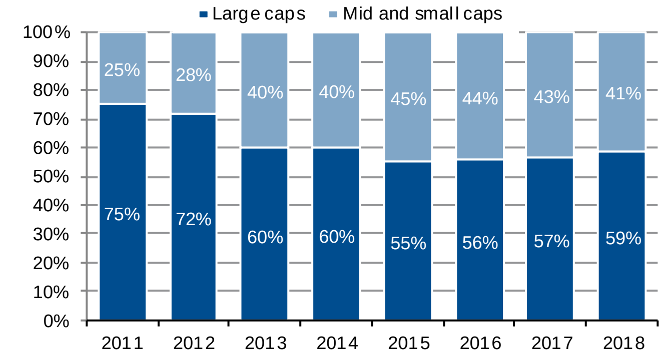
In the long-run, Scope believes that those platforms with the best contacts with investors or the coverage of a niche will stay a nose ahead of the competition.

Platforms most suitable for certain SSD issuers

Pointing to the additional benefits coming from digital platforms, Scope believes that the usage of digital platforms makes most sense for the following SSD issuers:

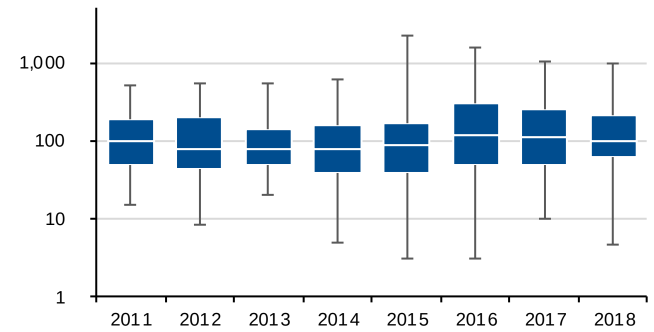
- Enabling smaller corporates for a lean placement of a smaller ticket below EUR 100m;
- Platforms could be good for refinancing measures of returning SSD issuers.

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



Source: Scope

Figure 7: Range of ticket sizes in EUR m (box plots)* – Logarithmic axis



* Largest deals in 2015 and 2016 at EUR 2.2bn and EUR 1.6bn

Source: Scope

Greatest relative advantage for smaller SSD transactions

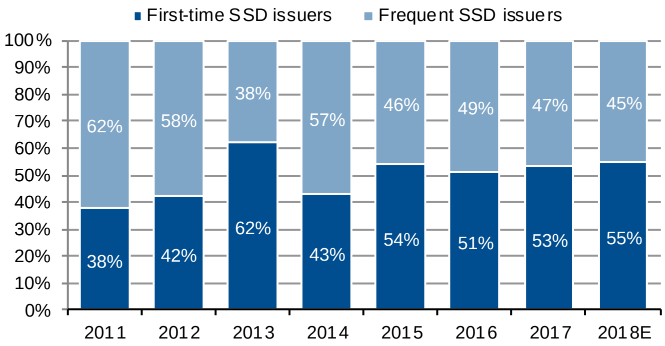
While such platforms are suitable for all sorts of deals, regardless of the deal size—ranging from jumbo transactions as the EUR 700m of Faurecia to mini transactions as the EUR 20m of ASFINAG and EUR 40m of W. Classen—the most benefit it is for smaller ticket sizes, which are usually issued by smaller corporates given the relative amount of transaction costs that can be saved. Pointing to the persistently strong inflow of SSD deals from small and medium sized corporates[3] (around 40% in 2018 – see figure 6) and the median transaction size of an SSD deal remains rather small (median of EUR 100m in 2018 – see figure 7), Scope argues that such corporates could mostly be enticed to conduct a placement via a platform.

Frequent and experienced issuers do not need extensive service of arrangers, particularly for refinancing

Secondly, frequent issuers are more likely to use the platform. With a track record of SSD issuance, they usually do not need as much support from arrangers— particularly when it comes to refinancing of old SSDs—leaving them well placed to exploit the benefits of the platforms. Such issuers would include GrenkeLeasing, BayWa, Deutsche Telekom, CHG-Meridian, Hornbach W. Classen or Entega.

[3] In this context Scope defines small and medium sized corporates as corporates with an annual revenue of less than EUR 1bn.

Figure 8: Frequent issuers vs. market debutants (measured in number of transactions)



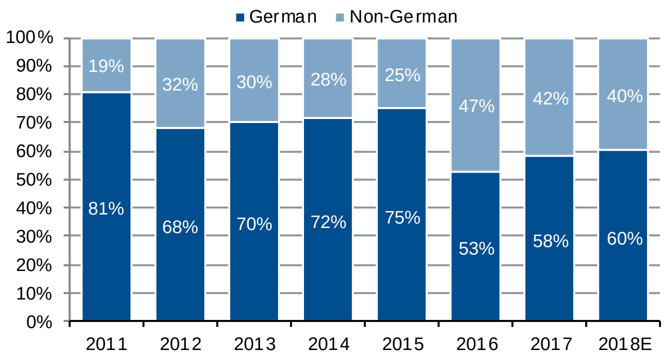
Source: Scope

3) Stimulus from the new arrangers outside the SSD core markets

Non-German SSD issuers returning

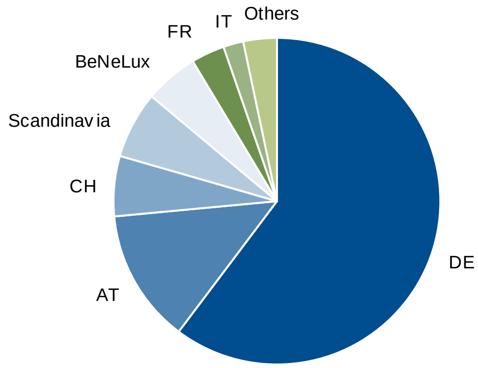
While non-German deals have been scarce in the first half of 2018, maybe still as a reflection of the defaults at Carillion and Steinhoff, the placement of SSDs from non-German issuers accelerated strongly in the second half of 2018, overall reaching 40% of the placements (against below 30% in H1 2018), among them very prominent SSD debutants such as France's Faurecia, Switzerland's Emil Frey Group and Liebherr, and Encevo from Luxembourg.

Figure 9: German versus non-German SSD issuers (measured in number of transactions)



Source: Scope

Figure 10: 2018 split of SSD transactions (measured in number of transactions)



Source: Scope

Enlarged pool of SSD arrangers

We observe the continued market entry of new arrangers which bring with them their corporate, primarily domestic, clients. And this stimulus comes from almost all directions.

Scandinavian arrangers joining the league

Most interestingly is the rapid expansion of the SSD product to Scandinavia. While the first Scandinavian deals of Huhtamäki, Amer Sports, Trelleborg or Hafslund were accompanied by non-Scandinavian arrangers, e.g. Helaba, Commerzbank, the new stimulus of Scandinavian debutants such as Meyer Turku, Elkem, Wihuri, Danish Crown, Marel, partly comes from Scandinavian arrangers such as Danske, SEB, Nordea. Scope believes that the Nordic region offers a wide array of companies with credit profiles suited to the SSD investor base, with 2018 potentially proving as the start of a longer-term trend, bolstered by the following:

- Scandinavian corporates show an above-average tendency to get capital-market based funding;
- Wide range of corporates, acting in niches which could well be suitable to the SSD product;
- Widespread interests among investors to get credit exposure to Scandinavian companies.

France and BeNeLux

Whereas some French and BeNeLux arrangers such as BNP, SocGen and ING, Rabobank are already well-known arrangers, we've seen new joiners such as ABN Amro and another placement by Natixis in 2018.

Southern and Eastern European issuer still a rare exception

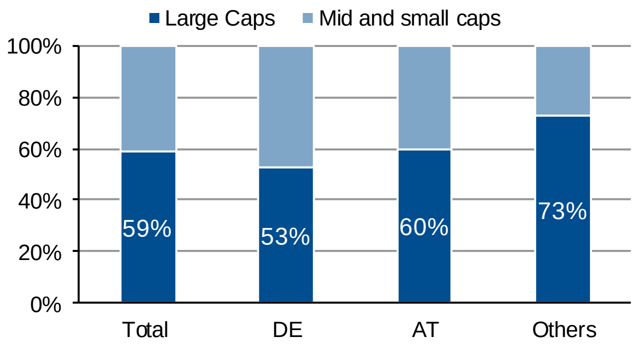
Italian, Spanish and Portuguese but also Eastern European corporates still remain an exception. Will they be next? Unicredit with vast experience with German and Austrian companies is most likely to accompany potential Italian SSD as recently with the second deal of Pirelli and the 2017 debut of Buzzi Unicem. But also other Italian arrangers such as Mediobanca and Unione di Banche Italiane are positioning themselves.

Scope believes that the creation of a new LMA (Loan Market Association) documentation standard should help by benefiting arrangers without previous experience of the SSD segment

Predominantly larger companies among non-German/Austrian SSD issuers

Most strikingly, Scope observes that SSD issuers outside of the traditional core markets Germany and Austria tend to be larger corporates (see figure 11) which are often stock-listed and have experience with debt issuance programmes. However, Scope believe that it is just question of time until the SSD product will be rolled out further to solid smaller and private corporates in France, Italy, Switzerland and Scandinavia.

Figure 11: More apparent dominance of larger corporates among non-German/Austrian SSD issuers in 2018



Source: Scope

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