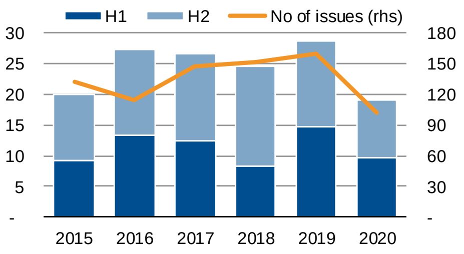
Schuldschein debt market catches cold
Return to form likely in 2021: refinancing, international issuers, new deals spur volumes

The Schuldschein private debt market has proven itself a robust source of corporate funding during crises and market turmoil, but the Covid-19 pandemic has set back issuance, with placement volumes falling 33% in 2020 from the previous year. Overall volume last year amounted to about EUR 19bn from around 110 deals. Whereas the fourth quarter showed some recovery, overall volumes fell slightly short of expectations. Hopes of a stronger rebound in H2 2020 were too optimistic, primarily due to the slow return of issuers outside of Germany, historically the main source of Schuldschein fund raising, and a lack of market debutants. For 2021, we expect the market to return to growth, with placement volume of more than EUR 20bn driven by more debutant and non-German issuers and significant refinancing.

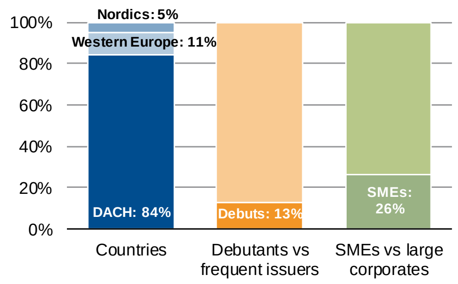
Figure 1: SSD placements (EUR bn)*



* based on closing dates

Source: Bloomberg, Scope data

Figure 2: Structural features in 2020



Source: Scope

Covid-19 crisis plays out differently for debt segment than GFC

Schuldschein, or SSD, debt has proven itself as a reliable funding instrument during turbulent times, particularly for experienced large cap issuers. The market functioned well during the great financial crisis.

The experience of the pandemic has been slightly different. The SSD segment received no extra boost as it did in 2008/09 when the subprime mortgage crisis led to a loss of confidence in banks and the financial system. Last year, conventional debt funding channels - the public bond market and companies' committed credit facilities - remained open, with the record amounts of debt issued in the European public bond market including the hybrid-bond segment.

The ECB among other central banks worked hard to maximise near- and medium-term liquidity in financial markets in 2020 through emergency monetary support, including the extension of the corporate sector purchase programme (CSPP) and the introduction of the pandemic emergency purchase programme (PEPP). They have increased the ECB's overall exposure to corporate bonds by around 50% to around EUR 270bn. The ECB's measures have surely lured some potential Schuldschein issuers to the public bond market. Few corporate treasurers were brave enough to tap a new funding channel in 2020, with a record poor showing of SSD market debutants at just 15% of total deals.

Some SSD investors have scaled back their exposure to the debt segment due to capacity constraints and a refocus on larger-scale debt segments, but we believe that investors' confidence in the niche market remains high. Many deals were heavily oversubscribed such as those by Asklepios Kliniken GmbH, Barry Callebaut Services NV, Clariant AG, DFS Deutsche Flugsicherung GmbH, Freudenberg SE, Gerresheimer AG, Robert Bosch GmbH, Sartorius AG. In each case, placement volumes ended up at least twice as large as the initial launch size.

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Post-pandemic balance sheets will test SSD credit quality

Delayed full impact of Covid-19 crisis will be test in 2021-22

The reputation of the market will be tested again in 2021/22 when companies are likely to experience the full impact of the pandemic on their balance sheets from weaker operating performance and countermeasures such as cost reductions, investment cutbacks, and lowered shareholder remuneration. This will primarily affect companies in more cyclical sectors – both those more vulnerable to the business cycle and those whose performance tends to lag it.

Premium on through-the-cycle credit assessment

We saw signs of this trend in 2020, with companies in such sectors showing little appetite for SSD issuance – as did small and mid-sized enterprises – a trend that we expect to persist, though to a lesser degree than last year. Investors will need to pay even more attention to through-the-cycle credit assessment and continuous monitoring, particularly compared with the recent boom years for the Schuldschein segment when the market's good reputation was seen as representative of the credit quality of many market entrants.

Rate of credit events set to rise this year

Overall, we expect a higher frequency of reported credit events in 2021, particularly on potential debt restructurings, once government support schemes such as short-time work end, extra funding from emergency debt programmes – such as that from German state-owned lender KfW – runs dry, or political and regulatory issues make government bailouts of troubled companies more difficult to undertake. We expect potential credit events from companies in pandemic-sensitive and cyclical sectors.

Outlook for 2021: expect a rebound in placement, deal volumes

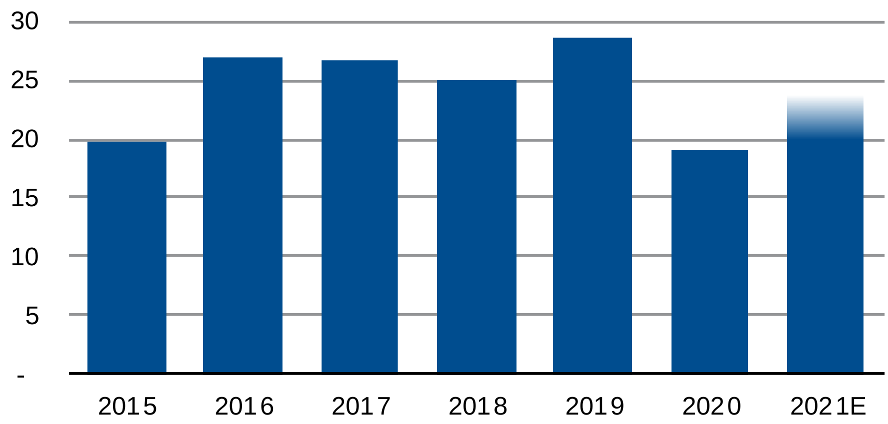
Market activity to pick up again in 2021

We forecast the market's return to growth in placement and deal volumes this year. Overall, we expect a placement volume above EUR 20bn from more than 100 transactions. This should be fostered by a return of international issuers, a continued compelling placement environment with average coupons remaining at comparatively low levels and a record volume of refinancing needs that stands at more than EUR 10bn for 2021. We also strongly believe that the ESG/green issues will gain further traction, which, for the SSD segment, could see volumes account for up to 20% of all issues.

Uneven post-pandemic recovery will create uncertainty

Nevertheless, uncertainties remain around the placement activities of issuers from cyclical and pandemic-sensitive industries - unless issuers are willing to reward investors with wider spreads - particularly when the market will experience some prominent defaults or debt restructurings. We see some scope of for jumbo placements related to a possible pick up in larger M&A deals in Europe in 2021.

Figure 3: 2021 SSD volumes expected to grow again (EUR bn)



Source: Scope

Internationalisation and debuts came to a temporary halt

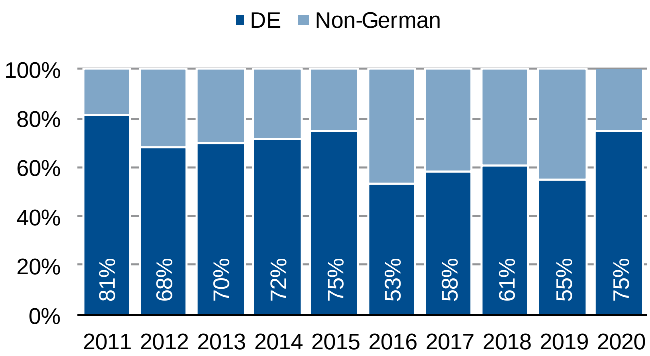
Just about 25 non-German issuers

The further internationalisation of the pool of SSD issuers beyond Germany, historically the primary source of borrowers, went into reverse in 2020. The share of non-German issuers among 2020 SSD issuers dropped to just 25% - a level that we haven't seen since 2015 when the internationalisation of the market accelerated.

Record low of debutants

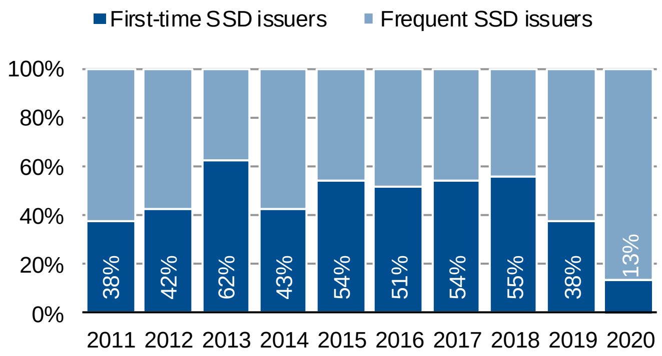
Also missing was an influx of new issuers, another source of the SSD segment's growth in recent years, with only 15 companies – corresponding to just 13% of overall deals – tapping Schuldschein debt for the first time - such as Sweden's Vattenfall AB and Klövern AB, Germany's MTU Aero Engines AG and France's privately held Auchan Holding SA – to diversify their funding.

Figure 4: 2020 split of SSD transactions (measured in number of transactions)



Source: Scope

Figure 5: 2020 split of SSD transactions (measured in number of transactions)



Source: Scope

Pandemic-related uncertainty, ECB programmes curb SSD issues - temporarily

Massively liquid public markets provide stiff competition

We expect SSD placement volumes, out of sync with the record in issuance of public debt markets in 2020, to rebound in 2021 given the exceptional circumstances of the Covid-19 crisis which clearly deterred issuers, particularly those unfamiliar with the segment, from testing the market. Instead, corporate treasurers tended to refocus on sources of funding with which they were familiar, using undrawn committed credit lines or issuing other bonds under existing EMTN programmes, particularly for raising liquidity quickly during the first wave of the pandemic. Loading up on new debt from conventional funding channels limited some appetite for tapping the Schuldschein market.

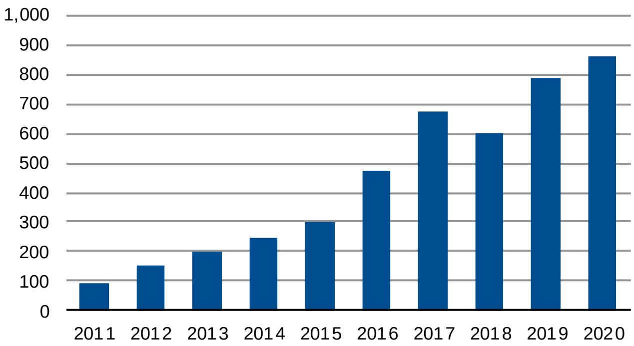
ECB's APP programmes provide ample liquidity, narrow spreads

Borrowers also fund they had access to ample liquidity in public bond markets with the massively accommodative monetary policy from the ECB, including its enlarged bond-buying programme: the renewed and extended asset-purchase programmes including the CSPP and the new PEPP which also relates to the ECB's purchases of non-financial corporate bonds. The ECB impressively increased asset purchases relating to corporate bonds equivalent to an expansion of about EUR 85bn during 2020. We are convinced that some rated investment grade firms have likely favoured APP-eligible bonds over a private placement.

More "normal" market dynamics likely in 2021

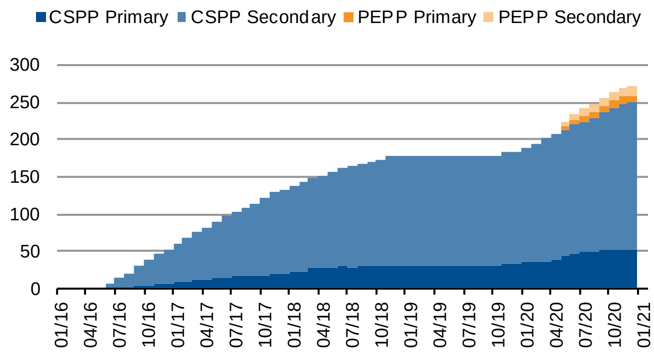
The SSD segment should revert to "more normal" market dynamics this year, in line with trends visible in 2017-2019, with the return of non-German SSD issuers and more debutants. We expect less pressure for short-term funding as economic growth recovers this year assuming accelerating vaccination programmes bring the pandemic under control. One encouraging sign is EUR 75m first-time SSD placement by Trafigura, the Netherlands-headquartered Singaporean commodities firm, earlier this month.

Figure 6: Record in European public bond market (EUR bn)



Source: Bloomberg, Scope

Figure 7: Strong boost of ECB's APP (asset purchase programme) through CSPP and PEPP: ECB's cumulative corporate bond purchases (EUR bn)



Source: ECB, Scope

Safety first: economic impact of Covid-19 may linger this year and next

Condition of post-Covid balance sheets critical

The next two years will still be a test for the SSD segment, amid lingering pressure on corporate revenue and earnings often coupled with increased debt from short-term liquidity funding on corporate balance sheets. Overall, we expect the impact to be modest, given most SSD issuers have investment-grade quality balance sheets.

Will pandemic-related credit pressures be temporary or not?

SSD issuers which defaulted and selectively defaulted during 2020 typically faced financial pressures before the outbreak of the pandemic. However, financial performance and the pace of an economic recovery, which is expected to be uneven across industries, will take their toll on corporate credit metrics in the medium term. For solid investment grade issuers, a temporary deterioration of credit metrics will unlikely cause problems in contrast with crossover names and issuers perceived as high-yield companies.

Frequency of credit events expected to increase

We expect a higher frequency of reported credit events in 2021, particularly involving potential debt restructuring, once government support schemes such as short-time work schemes or emergency government funding come to end.

Figure 8: Distressed SSD issuers seeking creditor protection, state bailout and restructuring

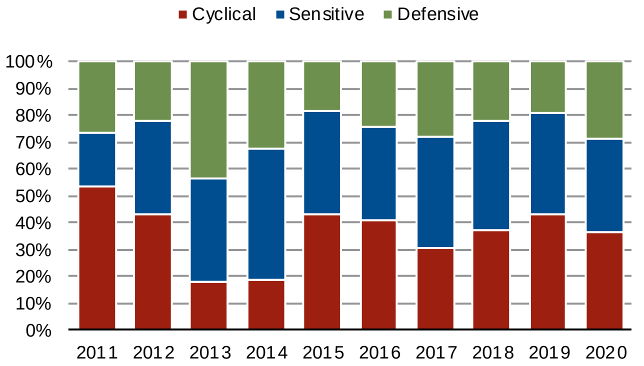
Defaults/Selective defaults	State bailouts	Debt and balance sheet restructurings, required recapitalisations or covenant resets
nanogate, Schlemmer, Eterna, pressmetall	TUI, Lufthansa	Benteler, Grillo, AmRest, FACC, Aryzta, Regus

Source: Scope

Danger of credit events, particularly among cyclicals

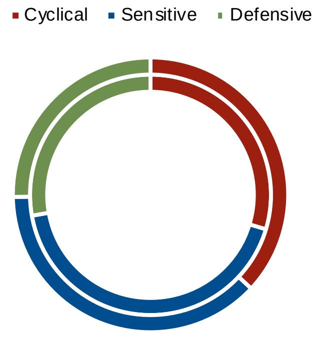
The greater vulnerability of some sectors – notably aviation, automotive, non-food retailing, leisure and entertainment – to the lockdowns and other restrictions put in place to contain the pandemic has been clearly visible in the past nine months, including in the distribution of new SSD deals by sector.

Figure 9: Split by industry[1]
(measured in number of transactions)



Source: Scope

Figure 10: Sector split in 2020[1]
(Inner circle: measured by number of transactions; Outer circle: measured by placement volume)



Source: Scope

Inevitable caution among investors, arrangers

Investors have shown little enthusiasm for placements from cyclical or pandemic-sensitive borrowers while arrangers have been similarly reluctant to bring such companies to market, judging by the decline in the amounts of SSD debt placed during the year.

- Surprisingly large volumes from automotive companies. However, most of them large caps and publicly rated such as Daimler AG, BMW AG, Freudenberg SE, Schaeffler AG, Robert Bosch AG.
- Strong reduction of deals and debt volume placed by industrial and capital goods, construction, and cyclical consumer goods and retail companies.

Pandemic-sensitive, cyclical firms tapped public bond market

The development is striking when compared with the sector split in 2020 for public bond issuance. We continued to see large debt volumes placed by capital goods, oil & gas, automotive, transportation often as a means to raise near-term funds as cash flow evaporated in the initial phase of the pandemic. However, this mismatch is somewhat linked to liquidity – given the intrinsic illiquidity of the "buy-to-hold" SSD market.

In these circumstances, fundamental through-the-cycle assessment of an issuer's credit quality appears to be more important than ever: lingering uncertainty arising from lockdowns, lack of visibility on the pace of economic recovery and the effectiveness of short-term cost reductions and investment cutbacks across industries.

Large-cap issuers considered as "safe banks"

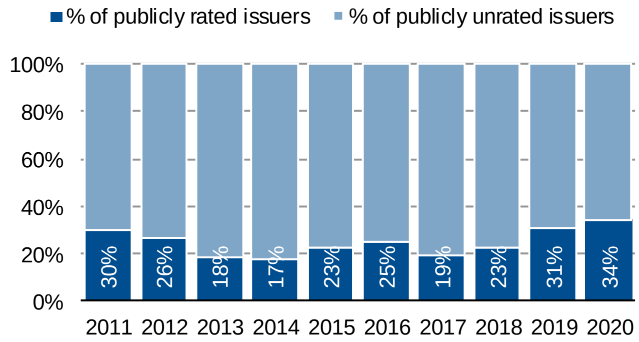
While remaining a largely publicly unrated market, it is not surprising that the share of publicly rated companies stood at a record of 34% in 2020. That said, this partly reflects the absence of small and mid-sized corporates in 2020, making up only around a quarter of SSD issuers. Another factor was the constrained capacity of investors who had to focus on existing credit portfolios and prioritise companies for which banks had committed credit facilities.

"Buy-and-hold" market requires through-the-cycle credit view

Nevertheless, Scope as a rating agency is certainly seeing the benefits, if not necessity, for issuers of having an external rating assessment which captures through-the-cycle credit quality to the fullest extent. This is particularly important for SSD issuers given the nature of the Schuldschein as a "buy-and-hold" debt investment. Over the past few months, Scope has experienced increased rating demand for publicly unrated corporates which intend to tap the SSD market.

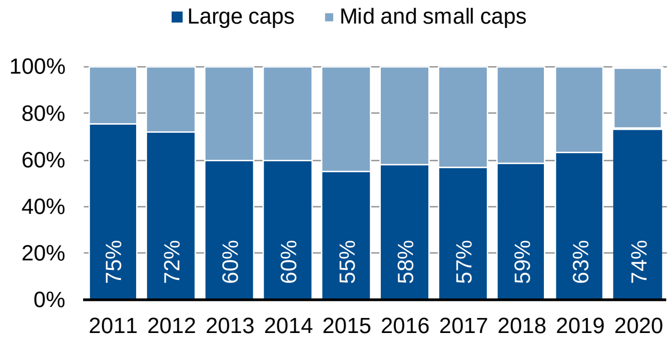
[1] Using iBoxx level 2 sector definitions we classify the following
• Cyclical: automobiles & parts, basic resources, chemicals, construction & materials, travel & leisure
• Sensitive: industrial goods & services, oil & gas, personal & household goods, real estate, financial services, retail, technology, media
• Defensive: food & beverage, healthcare, telecommunications, utilities

Figure 11: Share of publicly non-rated issuers (measured in number of transactions)



Source: Scope

Figure 12: SMEs[2] vs large caps (measured in number of transactions)



Source: Scope

Pandemic's market impact complicates assessment of SSD risk premium

Fewer reference points for judging segment risk

The interpretation of the market's risk assessment of the SSD segment signalled by how risk premiums evolved during the year has proved difficult. There were two issues:

- fewer reference points in 2020 from the overall lower deal volumes but also a greater variety of maturities with more short- and very long-dated tranches;
- significantly changed deal structures, with more publicly rated SSD issuers, fewer deals from cyclical corporates and a significantly higher proportion of large cap companies.

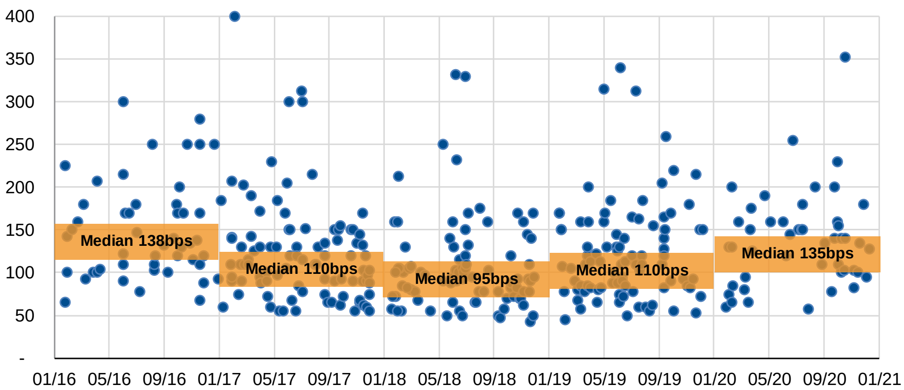
Judging by the median indicated from available spreads over the reference rate for five-year SSD tranches which on average picked up by 25 bps against the 2019 median, investors' risk reward just increased very modestly.

Risk premiums taking time to revert

SSD risk premia did not jump at strongly as compared with the public bond market, according to credit research from Landesbank Hessen-Thüringen (Helaba), one of the leading SSD arrangers. However, the reversion to the pre-crisis levels is also lagging behind the public bond market.

The widening of the ECB's APP continues to provide a compelling context for justifying low risk premiums for solid investment grade issuers of SSD paper which should encourage new deals and a return to growth in 2021.

Figure 13: Spreads on 5Y EUR tranches of SSD debt in bps



Source: Bloomberg, market info, Scope

[2] For this analysis we define SMEs as small and mid-sized corporates with annual recurring turnover of less than EUR 1.0bn.

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

Good year for green SSD deals

The earmarking of placement proceeds for projects remains a hot topic in the SSD segment. While the total number of placed ESG-related – or green - SSDs remained stable at 13, the placed volume developed in sync with the total SSD market at around EUR 2.3bn, down by around 20% from the previous year. As in 2019, we observed a broad spectrum of issuers, with largest deals from Aurubis AG, Voith AG, Schaeffler AG, Puma SE and Dürr AG.

Proportion of ESG-linked SSD higher than public bond market

Interestingly, the SSD segment's exposure to green and ESG-related deals (12% of total placement volume and deals) is two times the volumes that we have seen in the public bond market including hybrids (6%). We argue that the relative attractiveness of green/ESG-related Schuldschein deals should be seen in the context of the slimmer documentation and lower placement cost which partially offset the extra efforts (time and cost) needed for a dedicated ESG rating/certificate to justify a green/ESG label. Green or ESG-related deals also help companies broaden their investor and creditor base.

As such, we strongly believe that the ESG/green issues will gain further traction in 2021, which, for the SSD segment, could see volumes account for up to 20% of all issues. The EUR 400m sustainability-linked SSD placement by Volkswagen AG unit Traton earlier this month may be a harbinger of deals to come.

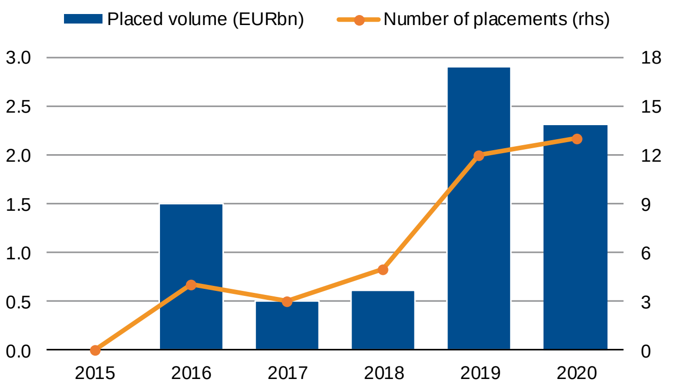
Figure 14: Wide range of ESG-linked SSDs

SARIA, Faber-Castell, Dräger, Schaeffler, EVN, Dürr*, Arcadis, Indus Holding AG, Puma, Verbundnetz Gas AG, Aurubis, Voith

* Dürr with two ESG-related SSD deal in 2020

Source: Scope

Figure 15: Number, placement of green, ESG-linked SSDs



Source: Scope

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