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HIGH YIELD OUTLOOK 2021: THE PHOENIX RISING

Leveraged finance markets, and the European high yield bond market in particular, have entered 2021 on fire with 25 issuances amounting to €12.63 billion during the first month of the year. This burn looks poised to continue as positive momentum coming out of a challenging and volatile year continues to build in 2021.

After a strong start of the year, with 30 high yield bonds issued in January 2020 alone, the world ground to a halt in March 2020 as successive governments around the world started imposing lockdowns to curb the spread of COVID-19. The resulting economic shock was as brutal as it was unexpected. Markets collapsed and deal activity dried up completely. American and European companies rushed to secure liquidity and strengthen their balance sheets, drawing down almost $124 billion from their credit lines in just three weeks, thereby raising concerns of a potential liquidity crunch. To avert an economic catastrophe, governments and central banks acted swiftly.

On the fiscal front, governments set out rescue packages on a scale that exceeded even the financial crisis of 2008. European governments extended loan guarantees, tax cuts, payment holidays, bailouts and generous furlough packages worth billions of euro. In America, Congress approved a $2 trillion stimulus package earlier in Spring 2020, followed by an additional $900 billion stimulus bill in late December.

On the monetary front, the response was even more consequential. To alleviate the strain on the plumbing of the global financial system caused by a desperate rush for cash on both sides of the Atlantic, the United States Federal Reserve System (the "Fed") unleashed a huge amount of liquidity. Other foreign central banks, including the European Central Bank, the Bank of England and the Bank of Japan quickly joined in. They cut interest rates and rolled out a sweeping bond-buying program of approximately $5 trillion (two-and-half times as much as during the peak of the 2008 financial crisis).

Investor confidence quickly returned in the late Spring of 2020 and the floodgates opened to the raising of fresh corporate debt. What followed was the largest corporate borrowing spree on record, which companies used to plug the hole in their earnings left by the shutdown of the global economy and to keep businesses alive. The burst of activity in the global financial markets that took place on Q3 and Q4 of 2020 was further electrified by the announcement of a vaccine at the end of the year. At the close of 2020, the world's non-financial companies had raised a striking $3.6 trillion from public markets. The issuance of both investment-grade bonds and high-yield bonds set records of $2.4 trillion and $426 billion, respectively. Between June and October (excluding the holiday-month of August), high yield bond issuances in

Key issues

- The European high-yield bond market outlook for 2021 is positive.
- The roll-out of the COVID-19 vaccine and continued support from central banks all but guarantee that many deals will come to market this year.
- Despite increased competition from private markets, 2021 will likely see numerous refinancing transactions and a larger portion of acquisition-finance deals than in 2020.
- The hunt for yield prompted by historically low interest rates will likely result in issuer-friendly covenant evolution as well as a growing number of lower-grade companies accessing the European high yield bond market.

Europe recorded double-digit volume totals in billion euro, a record run for that market. So did the $538 billion in secondary stock sales by large listed companies, an increase of 70% from last year, which essentially reversed a recent trend to buy back shares rather than issue new ones. This unprecedented volume of activity resulted in historically high fees for investment banks, which reported over $124.5 billion in fees related to debt and equity issuances in 2020.

THE EUROPEAN HIGH YIELD MARKET IN 2020

similar bumpy ride in 2020. A strong start to a year was suddenly knocked off course by the onset of COVID-19 (with only 10 bonds issued between March and May), and followed by a robust recovery. By the end of the year, 2020 had recorded the second largest full-year volumes since 2006.

With central banks in Europe and America back-stopping bonds (now both investment grade and high yield) and pledging not to raise interest rate, investors were mostly happy to overlook decimated financials provided the companies still had access to liquidity and a business model that could function in a world impacted by COVID-19.

Investor appetite allowed a wide array of credits to come to market in 2020, largely for opportunistic reasons. But despite rising new-yields, many companies did so to refinance debt, with refinancings accounting for almost two-thirds of the total global high-yield volume in 2020 (ahead of the 52% average share on that measure for the 2006-2019 period).

In contrast, 20% of the volume was used to support M&A or LBO financings, compared to an average share of 28% in the 2006-2019 period; the lowest since 2013. Fewer M&A deals at a time of heightened uncertainty also resulted in fewer private debt deals. There were 140 deals in the first half of 2020 compared to 197 in the same period in 2019.

In line with previous years, the double-B issuer base dominated proceedings, accounting for 63% of the volume and 57% of the bond count in Q3. However, as a consequence of the pandemic, companies have overwhelmingly opted for short-dated paper, with 26 five-year bonds issued in Q3 2020 (the highest quarterly tally since Q2 2014, which counted 28).

However robust the rebound in the high yield bond market, the challenging economic environment, particularly for swaths of companies in the transport, leisure, hospitality, retail and energy sectors, resulted in 78 credit downgrades between April and June. In Q3, Standard and Poor's and Moody's reported 27 bond-related defaults in Europe; missed interest payment and distressed exchange were the most frequent reason for default.

WHAT TO EXPECT IN 2021?

There is a wide spectrum of European high-yield supply forecasts for 2021 from bank research reports, ranging from €47 billion of expected gross supply according to BNP Paribas to €120 billion according to J.P. Morgan. But despite this discrepancy, and the inherent risk of trying to predict the future, it is clear that absent another back swan event like COVID-19, the European high yield bond market is likely to remain strong and vibrant during 2021 owing primarily to an improved post-COVID-19 macroeconomic environment and the continued support of the European Central Bank and central banks globally. As a result, we expect historically low interest rates and corporate liquidity needs to result in a large number of refinancing transactions, greater access to the market by lower grade companies, a robust M&A market

supporting a flurry of acquisition-finance deals, issuer-friendly covenant evolution and an increasing focus on ESG.

Liquidity Needs

For one thing, the world is not yet quite back to normal, and further lockdowns and restrained economic activity is expected to continue during the first half of the year. This means that companies will still be in need of liquidity to make up the loss in revenue during this period and avoid distress. We believe that many companies are increasingly likely to raise needed funds in the public markets in 2021, which, thanks to COVID-related economic stimulus, have become less costly.

This is in line with a global trend where bond markets are taking over the lending market. The stock of tradable bonds in 2020 was $20.5 trillion (close to America's GDP). Bonds now account for well over half of the global debt.

Demand for high quality credits

There will continue to be a lot of demand for issuers that have a compelling credit story, more than sufficient liquidity, and where investors feel like they are being well compensated for the risk. 2021 will probably see a number of tightly-priced double-B refinancings too, pushing the hunt for yield down the rating spectrum (as discussed below).

Hunt for Yield

Lower credits are also likely to access the high-yield bond markets in larger numbers than in 2020. Historically low Treasury rates and central bank monetary easing have pushed real rates of interest on securities below zero and increased the attractiveness of other assets. This has set out a hunt for yield with a fading focus on credit quality. Money is likely to flow into high-yield funds and drag yields on the lower rungs of the rating ladder down. In December, AssuredPartners, sold CCC-rated unsecured bonds in the United States at a yield of 5.6%, the tightest pricing ever for eight-year notes of such a low rating.

Covenant Evolution

This hunt for yield will probably contribute to the issuance of bonds with riskier financing structures in the coming year, such as PIK and PIK-toggle bonds. It will also test investors' appetite for looser covenant packages. Indeed, in the current low interest rate environment, investors are likely to continue trading contractual protections for higher yield. Issuers and buyout firms argue that minimal covenants give them the freedom they need to engineer a turnaround after things go south. The risk, of course, as seen in recent years at companies such as Neiman Marcus, is that loose covenants may allow owners to extract value ahead of creditors. Yet, in 2020, despite a few early instances of investor pushback (such as the revision of various terms in Thyssenkrupp's covenant package back in June), most investors prioritized yield over covenant protections; a trend that is likely to continue in 2021.

Notable examples of this trend include Ancestry's upending of the long-held principle known as “one bond, one vote” that provides investors with voting power proportionate to their holdings by capping voting rights to 20%. This directly affects the ability of holders to declare an Event of Default, which normally sets the threshold at 30%. By making it more difficult for creditors to call a default, out-of-the-money equity owners can hang on much longer.

Loser protections, especially in the leveraged loan market, is already causing a civil war among lenders. In October 2017, the private equity firm Centerbridge Partners bought TriMark, a distributor of restaurant equipment and supplies, for about $1.2 billion. It incurred $795 million of bank debt that was then sold by the banks that underwrote it to investors. When TriMark ran into financial trouble in 2020 because of the COVID-19 pandemic, it obtained a new $120 million loan from a group of hedge funds led by Oaktree Capital and Ares Management. In making the new loan to TriMark, Oaktree and Ares were able to "prime" the existing lenders, placing the new loan more senior to them in the capital structure and giving the new loan protections the old lenders had previously bargained away. The value of the original loan fell to 20 cents on the dollar (80% in a matter of days). A similar dynamic occurred with a recent $200 million loan for mattress maker Serta Simmons, owned by Advent.

M&A and LBO Financing

Challenged companies looking to pay down their debt or streamline their balance sheets will likely dispose of non-core assets during 2021. As the post-pandemic economy takes shape, spinoffs and consolidation forces in a variety of sectors, including renewable energy and TMT, may further add to the list of assets available in the market.

The competition for these assets, however, is likely to be fierce. The balance sheets of high-grade public companies are brimming with liquidity following the borrowing spree of 2020 and asset managers are sitting on $2.6 trillion of dry powder, money they have raised to invest in leveraged buyouts, private debt, real estate, infrastructure and natural resources. That figure is double the level that had been raised just six years ago. Therefore, a significant amount of money will be chasing relatively few high-quality assets. All of this is likely to produce an active and competitive M&A market in 2021, which may in turn result in a larger number of high yield bonds used to finance these acquisitions.

ESG

ESG is gaining momentum in high yield markets. It is no longer a vague philosophical notion to aspire to, but rather it has become a concrete tool, which is likely to take important steps forward in 2021.

While green bonds still represent a sliver of the overall debt market, they are an increasingly popular tool for companies to fund operations that are more environmentally friendly. Thirty of the world's biggest asset managers, which collectively oversee $9 trillion, have set a goal of achieving net zero carbon emissions across their investment portfolios by 2050. This will likely fuel a significant number of green issuances in the coming years.

Governments and companies are expected to issue $500 billion in green debt in 2021, nearly half the total that has been raised since the asset class's inception, according to a projection from Swedish bank SEB (compared to $270 billion in 2020 and $180 billion in 2019).

Demographics will also play a big role in the near future development of ESG standards and green financing. An estimated $4 trillion is expected to be passed down within a generation in the UK and North America alone. It is set to be one of the biggest intergenerational wealth transfers in history. When baby boomers, who are now in their 60s and 70s, pass their money on to younger family members, millennials will be large beneficiaries. A paper by Credit Suisse last year identified millennial values as one of the main drivers

of investment themes in the coming years, with sustainability and clean energy expected to gain even more importance for investors as a result. As private bankers and fund managers adjust their offer to meet this demand, we are likely to see an increased focus on "impact investing" and the formation of "interest" funds.

Private Debt and Direct Lending

A key questions during 2021 is the extent to which private cash will compete with public markets. Today, the upper end of middle market companies financed by direct lenders overlaps with access to broadly syndicated loan markets. As such, private credit has replaced traditional leveraged finance solutions in some cases. As direct lending continues to grow, it is reasonable to expect that the overlap with other areas of the leveraged finance market will increase.

Medium-sized businesses have for years raised debt from so-called direct lenders, which often sit within larger private equity groups. But a rush of inflows from deep-pocketed investors such as Middle Eastern sovereign wealth funds is now giving some investment firms the firepower to lend to larger companies. The COVID-19 pandemic, which upended corporate balance sheets, has accelerated the shift.

In 2021, asset managers are seeking to raise almost $300 billion (up from $192 in 2019) to plough into private lending deals with groups such as Goldman Sachs and Oaktree hoping to lure investors away from frothy public markets. It is therefore reasonable to expect significant competition between private and public markets in 2021, although the current low interest rate environment is likely to push private lending back to the mid-market segment.

Conclusions

The European high-yield bond market outlook for 2021 is positive. The roll-out of the COVID-19 vaccine and continued support from central banks all but guarantee that many deals will come to market this year. Despite increased competition from private markets, 2021 will likely see numerous refinancing transactions and a larger portion of acquisition-finance deals than in 2020. The hunt for yield prompted by historically low interest rates will likely result in issuer-friendly covenant evolution as well as a growing number of lower-grade companies accessing the European high yield bond market.

There is, however, still uncertainty around when the pandemic will be over, which ultimately depends on the effectiveness and pace with which the vaccine is rolled out around the globe. It is also unclear what the global economy will look like in a post-COVID-19 world. The pandemic has caused over one million deaths and a huge global recession that has hit countries, economic sectors, social classes and ethnic groups unequally. For example, the European Central Bank estimate that GDP for the euro region shrunk by 7.3% in 2020 and real GDP will recover only gradually to reach 2019 pre-pandemic levels by mid-2022.

The structure of economies will be permanently changed and they will be saddled with an unprecedented level of public and corporate debt. The role of government has been significantly expanded with unprecedented interventions by fiscal and monetary authorities in peacetime that will bring about higher taxes in the long run and difficult spending cuts.

But there are also more immediate issues that will shape the European high yield bond market this year. First, the recovery has already been priced in.

Any unexpected economic bumps during the year or deviations from expectations may have a significant effect on asset prices. It is also unclear what is the actual financial health of companies. During the pandemic it's been more difficult for auditors to do their jobs as they could not go on site to audit companies. Finally, Government schemes have put many companies on life support, potentially masking underlying issues.

The challenges of 2020 showcased the resilience of the high yield bond market, which emerged from the shortest-lived recession in recent memory stronger than ever. As the year unfolds and the dust settles, the traits of our post-pandemic world will begin to take shape, and with it, the financial markets that will be needed to fund its economy. In the words of Ming-Dao Deng, "whether we remain the ash or become the Phoenix is up to us".

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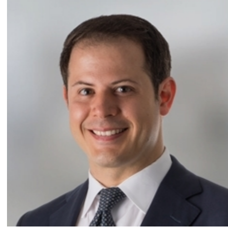

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