

Spotlight on high yield

New supply, extreme valuations and late cycle dynamics

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- Latest new issue pricing highlights the difference in valuations between Euro and US high yield markets
- Several European issuers are trading at near-distressed levels having failed to achieve elevated expectations of company performance
- Idiosyncratic risk is rising across all sectors of the market, emphasising the importance of selectivity



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The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

A raft of new supply has hit the high yield market in recent weeks as issuance picks up again after the summer hiatus, with two large leveraged buyouts (LBOs) by private equity sponsors pricing high yield issues in euros and US dollars. The first of these debt offerings resulted from the \$17 billion partial spin-off of the finance and risk arm of Thomson Reuters (renamed as 'Refinitiv'), while the second was the €10 billion buyout of the specialty chemical business of Akzo Nobel.

The striking feature of both issues was that the euro tranches came at much higher spreads than the dollar tranches (please refer to the table) – and the difference would have been even wider if the euro cashflows were swapped back into dollars.

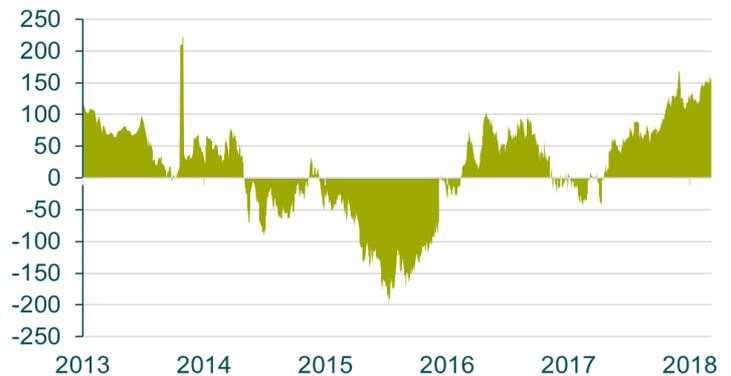
Euro tranches command higher spreads than dollar tranches

Refinitiv	US dollars	Euros	Difference
Senior tranche (B2 / B / BB+)			
Size	1.25 billion	860 million	
Coupon	6.25%	4.50%	
Spread to government	325 bps	445 bps	+120 bps
Subordinated tranche (Caa2 / B- / B+)			
Size	1.575 billion	365 million	
Coupon	8.25%	6.88%	
Spread to government	525 bps	664 bps	+139 bps
Akzo Nobel Speciality	US dollars	Euros	Difference
Senior notes (Caa1 / B- / B-)			
Size	605 million	485 million	
Coupon	8%	6.50%	
Spread to government	494 bps	625 bps	+131 bps

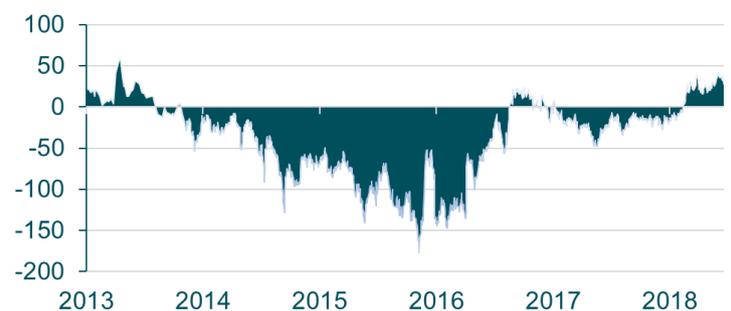
Source: M&G, Bloomberg, as at 24 September 2018

This highlights the difference in valuations between the European and US high yield markets. The following two charts show the difference between double-B and single-B spreads over the past five years, both of which are currently at extreme valuations.

Europe versus US single-B spread difference (bps)



Europe versus US double-B spread difference (bps)



Source: M&G, Bloomberg, ICE BofAML European and US high yield indices, as at 24 September 2018

The fact that the same markets trade at such big differentials suggests that it is not down to the make-up of the indices. The US high yield market has been a strong performer this year – spreads have tightened around 7%, while European high yield spreads have widened by 27%. This has been in an environment where US investment grade spreads are wider by 13% and European high yield spreads are 21% wider.

The rise of idiosyncratic risk

Another trend we have been observing is the significant price impairments hitting European high yield issuers as several names have failed to achieve elevated expectations of company performance. UK retail names including fashion retailer New Look and Debenhams, the department store chain, have been under pressure for a while now with their bond prices falling to near-distressed levels on the back of a series of profit warnings as tough trading conditions persist for the retail sector. The fact that other well-known names in the European market, not only retailers, have recently suffered steep price falls tells us that companies are increasingly vulnerable to earnings shocks and that an over-reliance on stability of earnings is being challenged.

It also suggests that we are starting to see idiosyncratic risk increase across all sectors of the market.

High yield names trading at near-distressed levels



Source: M&G, Bloomberg, as at 27 September 2018: DEBLN 5.25 07/15/2021, NEWLOK 6.5 07/01/2022, CMCRAV 6.0 02/15/2023, ASTIM 7.125 12/01/20, IKKSFR 6.75 07/15/2021, GALAPG 7.0 06/15/2022, NYRSTAR 6.875 03/15/2024, TAKKO 5.375 11/15/23

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