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Innovation fuels Europe's high-yield market

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The new issue European high-yield bond market surged in 2004, continuing the strong growth that it experienced the previous year. In 2004, European issuers issued \$27.1 billion equivalent of new high-yield bonds. These bonds were sold in 101 separate issues. That smashed the previous record of \$19 billion of high-yield bonds issued in 2003. By comparison, in 2002, European companies issued only \$5.3 billion in 25 issues.

2005 is already off to a strong start. The first two months have witnessed record high-yield issuance in Europe.

This record number of issuances has been driven by the eye-opening performance of European high-yield bonds. After losing money for three consecutive years (2000 to 2002), an index of European high-yield bonds returned an astonishing 30.89% in 2003. That pace moderated in 2004, with the same index growing a respectable 13.82%, making European high-yield one of the best performing asset classes over the last two years.

The strong performance of the European high-yield market enabled it to grow faster than the US and global high-yield markets. In 2004, the European high-yield market's share of global high-yield issuance was 13%, up from about only 6% in 2001. Some observers believe that it could approach 25% of total global issuance in 2005.

European buyouts soon to overtake US buyouts

Sponsor-driven leveraged buyouts, or LBOs, were little known in Europe until the mid-1990s – a decade after they became a regular feature in the US M&A market. However, since the mid-1990s, the number and size of European LBOs has grown quickly and steadily as European private equity funds have grown in size and as US private equity funds have set up shop in Europe and have raised funds dedicated to European acquisitions.

Private equity firms have a strong inter-

est in Europe because they believe that Europe presents greater opportunities for buyouts than the US, where much of the low-hanging fruit has been picked over the last 15 years. Europe is viewed as a treasure trove by private equity capitalists who see many opportunities to buy and break up bureaucratic European conglomerates and to squeeze costs out of formerly state-run enterprises.

As a result, Europe is slowly but surely catching up with the US in the size and number of leveraged acquisitions. While the aggregate value of European buyouts continues to lag the aggregate value of US buyouts, in 2004 for the first time there were more buyouts completed in Europe than in the US.

As leveraged buyouts grow in number and size in Europe, private equity firms will require large amounts of acquisition financing. The European high-yield market provided most of the subordinated financing for the largest leveraged acquisitions in Europe in 2004, such as the buyouts of Dynamit Nobel, Vendex, VNU World Directories, Grohe and ATU. It will continue to do so in 2005.

Secondary or pass-the-parcel buyouts

With the continued weakness in equity markets, sponsors have been less able to

rely on the IPO markets to provide them with exits from their investments. As an alternative to IPOs, sponsors have been selling their investments to each other at higher and higher prices in secondary buyouts.

These secondary buyouts usually need to be completely refinanced with new acquisition financing. These buyouts not only provide investors with additional opportunities to invest in high-yielding debt instruments, but also frequently provide a bonanza for high-yield investors, because the existing high-yield bonds at the target often have to be repurchased in tender offers at a so-called make-whole premium.

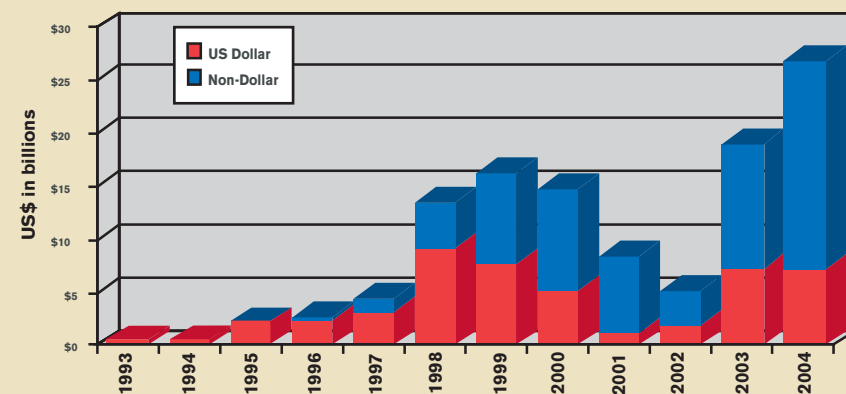
Holdco PIKs

In addition to financing primary and secondary buyouts, the European high-yield market has been willing to refinance the equity of sponsors by funding holding company pay-in-kind (PIK) bonds, the proceeds of which are used to pay a dividend or distribution to shareholders.

Holding company PIK notes are issued on a structurally subordinated basis by a company sitting above the original credit group. Typically, they are unsecured and have no credit support from any members of the credit group. Because existing credit facilities and bonds generally restrict the payment of dividends to the holding company, the bonds are structured so they pay interest only through the issuance of additional bonds for the life of the bonds.

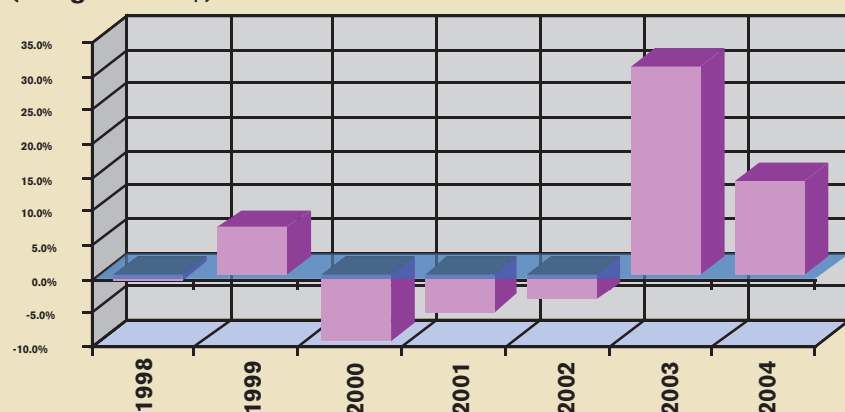
A good example is the December 2004 offering by Kabel Deutschland (KDG). Apax, Providence and Goldman PIA acquired KDG in March 2003 for €663 million (\$865.7 million). In July 2004, KDG was able to pay its shareholders a €475 million dividend from the proceeds of a €750 million high-yield notes offer-

New issue high-yield bonds by European issuers: 1993 to 2004

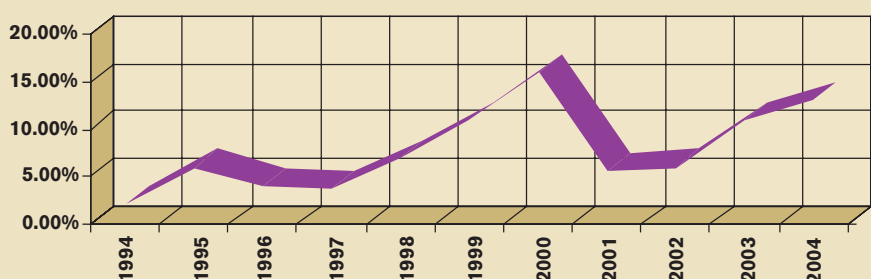


Annual total return: 1998 to 2004

CSFB Western European High Yield Index (Hedged in US\$)

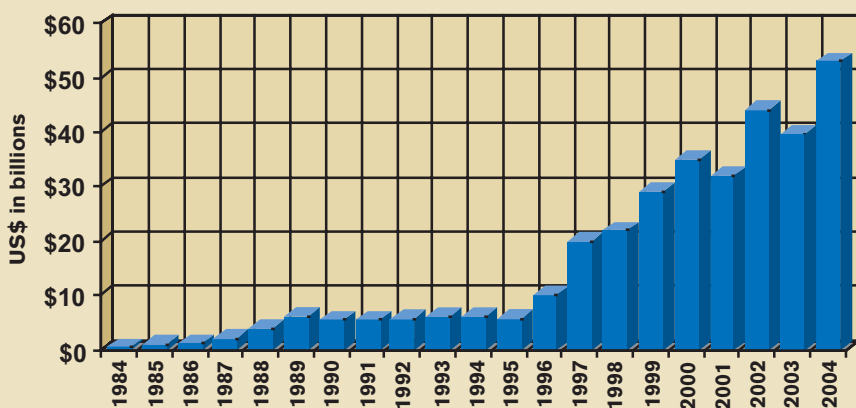


European high-yield issuance as percentage of global high-yield issuance (1994 to 2004)



Source: CSFB High Yield Research

European buyouts by aggregate value (1984 to 2004)



Source: CMBOR/Barclays Private Equity/Deloitte

ing. The sponsors relied on a carve-out that allowed a €475 million dividend if none of three designated acquisitions occurred, after an offer to bondholders to repurchase bonds at par.

In December 2004, KDG paid a further €400 million dividend to its shareholders through the issuance of 10-year floating rate PIK holding company notes. As a result, the sponsors have recovered 131% of their original investment – and still own 100% of the company.

Other recent European PIK bonds

include the €530 million offering of holding company PIK notes by Cognis Holding KG in January 2005, the €325 million senior notes offering by the parent of Jefferson Smurfit Group, the €100 million PIK notes offering in connection with the acquisition of VNU World Directories and the €250 million offering by the parent of Eco-Bat.

Why are investors willing to invest so much money at the riskiest end of the capital structure? In a low-interest environment, holding company PIK notes offer some of

the best yields around. The VNU holding company PIK note carried a fixed coupon of 13.75% and the KDG and Cognis holding company PIKs were priced at Euribor plus 850 and 900 basis points, respectively, for instance. And although they are the most junior layer of debt capital, they include incentives that make it likely that the sponsors will try to repay these instruments first, such as tight restrictions on dividends.

Second lien loans: an alternative to mezzanine debt

In May 2004, Cognis, the German chemicals company, completed a €2 billion leveraged recapitalization to fund a €330 million distribution to Permira and funds advised by Goldman Sachs, the owners of Cognis who retained 100% of their equity in the company. The recapitalization was made possible through an innovative three-tiered debt structure consisting of a traditionally syndicated €1.3 billion senior European credit facility on the top, €345 million of subordinated high-yield bonds on the bottom and in the middle €400 million of US-style second lien financing sold primarily to US hedge funds – the first ever such financing for a European borrower.

The second lien financing consisted of €235 million of Luxembourg-listed bonds and a loan consisting of a €62 million Euro tranche and a \$125 million US dollar tranche. The terms of the second lien financing were eye-opening: a nine-year maturity; a floating rate coupon of Euribor plus only 475 basis points; optional redemption at 104% after one year, at 102% after two years and at 100% after three years; and high-yield style incurrence covenants rather than financial maintenance covenants found in European mezzanine loans.

The sponsors found that both the terms and the amount of the second lien financing compared favourably to what was available at the time in the European mezzanine loan market.

What makes the US-style second lien product different from traditional European mezzanine loans? For one thing, the US hedge fund buyers of the second lien product require that the paper be contractually senior in right of payment. They are willing to give the banks priority with respect to proceeds from the joint collateral, but they are unwilling to accept general bankruptcy turnover provisions characteristic of contractual subordination. In return for this fairly nuanced improvement in insolvency rights, second lien lenders are willing to forgo warrants or other equity

kickers, lend at rates substantially below the benchmarks set by European mezzanine funds and live with incurrence rather than maintenance covenants.

Will second lien loans work in Europe?

Since Cognis, European companies such as Telewest and Waste Recycling have sold second lien loans and notes into the European market. While European second lien debt used many of the features of US second lien debt – that is, reliance on lien subordination rather than payment subordination – it has had to be adapted to make it acceptable to European senior bank syndicate and to make it workable within the various European bankruptcy regimes.

It is expected that the same market forces that have driven second lien debt to a prominent position in the US leveraged loan market will propel the European version of the second lien product to a similar position in Europe. Second lien debt provides an attractive alternative to European mezzanine debt. As hedge fund investors become more familiar, and more comfortable, with the European market and as sponsors and companies become more aware of the benefits of this product, it is predicted that there will be more second lien debt issued by European companies and sold to hedge fund investors.

Mezzanine notes

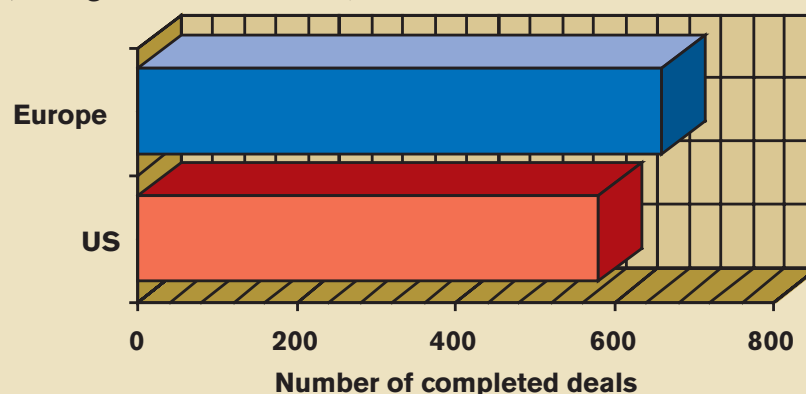
Another development in the European high-yield market was the offering by Focus Wickes of mezzanine notes in July 2003 and the offering by Baxi of mezzanine notes in March 2004.

The mezzanine notes were designed as a hybrid security, giving investors the credit support that traditional European mezzanine lenders enjoyed, together with the liquidity of a listed high-yield bond. They were the product of a lengthy negotiation with senior lenders.

The senior lenders in both Focus Wickes and Baxi agreed to a series of intercreditor concessions that allowed the mezzanine notes to go to market. For example, the senior lenders allowed the mezzanine notes to be secured by a second-ranking lien over all of the operating assets of the companies, but the collateral was held by a joint security trustee and the mezzanine noteholders agreed in return for this lien that they would allow the senior lenders to make all decisions regarding enforcement of remedies against the collateral. In that respect, mezzanine notes had fewer rights than traditional mezzanine lenders, who in most cases are allowed to initiate enforcement

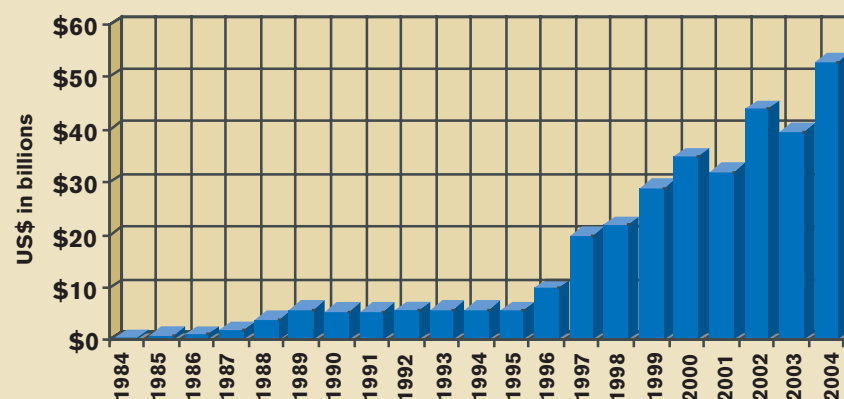
European buyouts versus US buyouts in 2004

By number of completed deals
(Through December 31 2004)



Source: Thomson Financial

Secondary pass-the-parcel European buyouts (1984 to 2004)



Source: CMBOR/Barclays Private Equity/Deloitte

action against the collateral after a specified standstill period.

The most controversial feature of the Focus Wickes and Baxi mezzanine notes for sponsors was the diluted call protection. If an exit event occurs (in general a trade sale or initial public offering), the mezzanine notes may be redeemed at 103% of accreted amount plus accrued interest in the second year, 102% of accreted amount plus accrued interest in the third year, 102% in the fourth year and 100% in the fifth year and thereafter.

There is considerable debate in the leveraged finance community about whether this diluted call protection will be accepted in other high-yield bond offerings. The high-yield investor community has been vocal in insisting upon traditional call protection, yet they willingly purchased the mezzanine notes because of the high coupon and strong credit support. In addition, European mezzanine lenders are now able to finance much larger transactions, deals of a size that previously had to be financed with high-yield bonds. Sponsors focussed on the price of traditional high-yield call pro-

tection might prefer to finance their transactions with mezzanine loans, with their higher interest rate and with maintenance covenants, rather than using high-yield bonds. This choice might preclude high-yield investors from investments in some of the better European credits.

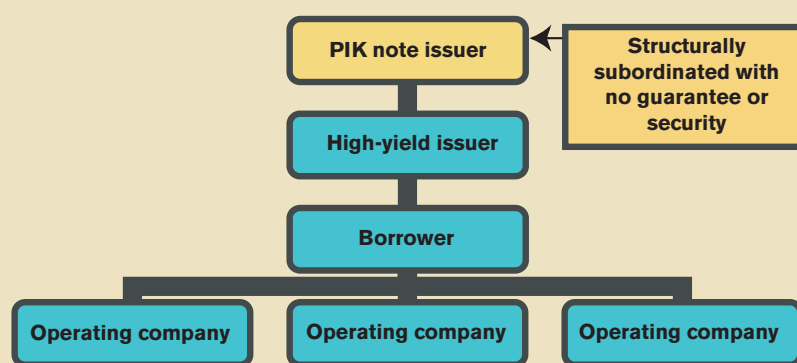
Fallen angels and crossover bonds

Another development in 2003 and 2004 was the willingness of European crossover credits to tap the European high-yield for refinancings and for long term financing. In 2003, a number of large European companies that formerly had investment grade ratings – companies such as Vivendi, Heidelberg Cement and Rhodia – issued high-yield bonds to refinance other debt that was coming due.

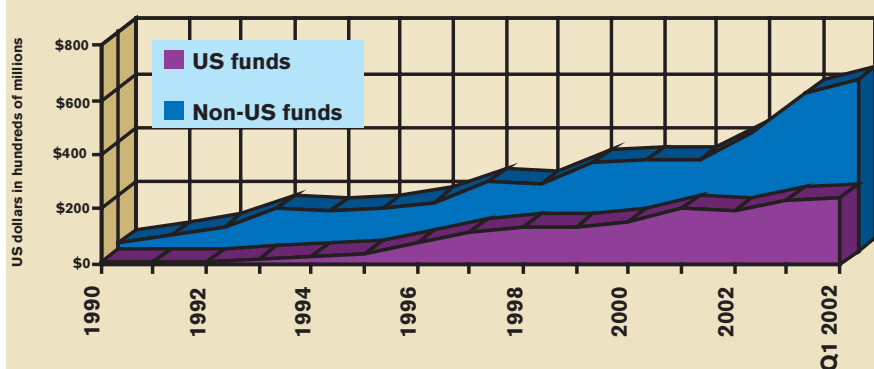
Several of these bonds, particularly the bonds issued by Vivendi, turned out to be spectacular investment successes. As these issuers executed their business plans and as their businesses improved, the bonds they had issued in early 2003 enjoyed significant appreciation in value.

This trend continued in 2004 with a

A basic Holdco PIK structure



Growth in non-US hedge funds



Source: Hedge Fund Research 2004 Industry Report

number of new large European companies issuing non-investment grade bonds. For example, TUI, Europe's largest tour operator with annual revenues exceeding €19 billion, raised over a billion euros in two highly oversubscribed offerings of bonds that introduced several innovative features to the European bond market.

The underwriters in the TUI offerings generated unexpected demand by designing hybrid bonds that were marketed and sold to disparate investor groups, including high-yield bond investors, investment grade bond investors and, for the first time in recent memory, individual investors. By tapping these various investor bases, the underwriters succeeded in generating a large order book during difficult weeks in the bond market and succeeded in pricing bonds with interest rates well below the interest rate assumptions made in the offering memoranda.

Did the boycott of the high-yield market work?

Prompted by the severe losses that European high-yield investors suffered

from the first generation of European high-yield bonds, and wiser after observing first-hand how weak their bargaining position had been in numerous European restructurings and reorganizations, a group of influential European high-yield investors in late 2002 organized themselves and demanded structural improvements in the rights and remedies available to investors in European high-yield bonds.

They threatened to boycott future high-yield offerings used to finance leveraged acquisitions until the traditional European leveraged structure, which they viewed as broken, was fixed. To avoid finding themselves in this same situation in the next round of restructurings, the bondholder group demanded upstream credit support in the form of guarantees from operating companies and better financial reporting from issuers.

The seriousness of this threat became evident in the 2003 high-yield refinancing for the acquisition of LeGrand, the largest European leveraged buyout to that date. The acquisition closed with bridge financing, which was to be refi-

nanced through a high-yield offering. As a result of pressure from high-yield investors, the investment bankers and sponsors approached the senior lenders and sought modifications of the senior lending arrangements to allow the high-yield bondholders to get limited upstream guarantees from operating companies.

After much discussion and consideration, the senior lenders rejected this request, and the sponsors and the underwriters were forced to take to market a structurally subordinated high-yield bond using old-style European intercreditor arrangements. Many of the leading European high-yield investors boycotted the transaction because of the weak structure. To attract enough demand to get the deal done, the company was required increase the interest rate on the high-yield bonds by 100 to 150 basis points over what the coupon would have been if the desired structural protections had been obtained.

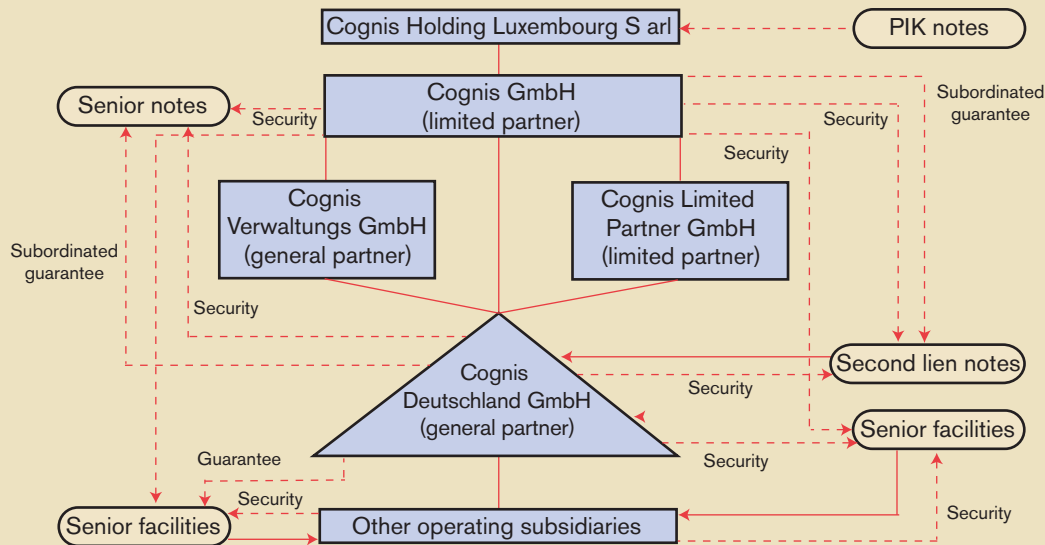
The LeGrand offering brought the structural debate to a head and, by demonstrating the cost to sponsors and issuers of a weak intercreditor structure, forced a serious re-evaluation, by all market participants, of the old-style European leverage structure.

After LeGrand, almost all European high-yield offerings (other than the holding company PIK notes discussed above) were structured to allow high-yield investors credit support, to the extent legally possible, from operating subsidiaries. And some deals, such as the second lien and mezzanine notes described above, have given holders second ranking security in operating assets.

The influence of hedge funds on European leveraged finance

Hedge funds developed into players in European leveraged finance in 2004. Hedge funds now have close to \$1 trillion in assets under management. As the Cognis recapitalization showed, by purchasing the second lien loans the hedge funds were providing funding that traditionally has been the domain of European mezzanine investors. All indications are that the hedge funds will continue to seek opportunities to invest in European leveraged acquisitions. Where and how they invest will have implications for traditional European mezzanine and high-yield investors as well as for the investment banks arranging such financing.

Cognis's refinancing



Hedge funds will continue to make large direct investments in both the equity and debt of European companies. Such investments might eliminate the need for an investment bank to arrange and structure such financing and to underwrite and distribute it.

There are several situations where financial sponsors and companies are negotiating directly with one or two hedge funds to obtain large amounts of debt financing on unusually good terms. Such financing will be provided without the services of an underwriter

or investment-banking firm as financial adviser. ■

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