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Axel Potthof Discusses the European Market for High Yield Bonds



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Dr. Potthof is a Senior Vice President and a portfolio manager for PIMCO Fixed Income Portfolio Management in Munich. He is a member of PIMCO's Global High Yield team where he is responsible for European High Yield and Bank Loan portfolios. Dr. Potthof joined the group in 1998, previously working as an assistant researcher at the University of Hagen and for Deutsche Bank AG. He published several fixed income articles and contributed a paper on Fundamental Credit Research to a Handbook of Portfolio Management. Dr. Potthof has fifteen years of experience, holds a Master's degree in Business Administration from the University of Mannheim, Germany, and a Ph.D. (summa cum laude) from the University of Hagen, Germany.

The European market for high yield bonds rated BB or lower has matured in the last few years and has become very popular with investors. In the interview below portfolio manager Axel Potthof gives an overview of the high yield market in Europe and the latest trends in this market segment.

Q: In the past few years the European high yield market impressed with a very good performance. What made Europe's high yield segment so successful?

Potthof: The performance of the European high yield market has indeed been remarkable. In 2006 the market achieved a performance of around 10 percent, similar to the U.S. market. In 2004 and 2005 it was even able to outperform its U.S. counterpart. This strong performance of high yield is, among other factors, due to sustained economic growth worldwide, high liquidity in the high yield market and big demand for this asset class in Europe. For a long time Europe also benefited from lower default rates than the U.S. and growing expectations of a slowdown in the U.S. economy, while growth in Europe continued.

However, the valuation of European and U.S. high yield markets is now more or less at the same level. Spreads (i.e. the difference in yield versus government bonds) show no considerable difference anymore, at least not in the case of bonds with a B rating. To compare the two markets we have to adjust nominal spreads for the different durations, though. The shorter duration in the European market justifies the narrower spreads.

In the slightly higher quality segment of BB ratings, spreads in Europe are and have been narrower, even adjusted for duration. This is due to the low number of companies in this sector. In addition, most of these companies are already on their way back to the investment grade class of ratings of BBB and above.

Q: Why are issues with BB ratings so rare in Europe?

Potthof: This is due to the market structure. The rating quality of companies in Europe tends to be higher than in the U.S. European companies often aim for an investment grade rating. The majority of BB-rated companies that we have in Europe are so-called

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fallen angels, which the rating agencies downgraded from investment grade to high yield during the difficult years between 2001 and 2003. These companies have recovered and the market has priced in further rating improvements. Examples for such companies are Ahold or Alcatel, whose bonds are already trading at very narrow spread levels.

Q: What influence have company takeovers through private equity and leveraged buyout investors had on the European high yield market?

Potthof: Takeovers are a driving force behind the volume of issuance in the high yield market, in the U.S. as well as in Europe. About 65 percent of high yield bonds in Europe currently stem from leveraged buyout financings where bonds are issued to finance a takeover by private equity

Q: You mentioned the low default rates in Europe. How do European default rates compare globally?

Potthof: Default rates in the global high yield markets have hit historic lows. According to Moody's only 1.75 percent of companies in the high yield market have gone bankrupt over the past twelve months. This is the lowest year-end figure since 1996 and is thus markedly below the long-term average of 4.5 percent. If we break this global figure down between Europe and the U.S., we get a similar picture. In both markets, the default rate is slightly below 2 percent.

Q: What are the reasons for these low default rates for corporate bonds in Europe?

Potthof: The low default rates are a result of the good economic environment on the one hand and high demand for high yield bonds on the other hand. The still-low interest rates and a certain willingness by creditors to take risk, currently allows even financially weaker companies relatively easy access to credit. Thus it is easy for companies to extend existing debt so that no liquidity problems and payment difficulties arise. Consequently there are very few bankruptcies at the moment. Moreover, in the difficult years of 2001-2002 many weak companies went bankrupt and disappeared. Thus the sector is quite healthy at the moment.

Q: How long do you expect these low default rates in the high yield market to remain?

Potthof: This depends, among other things, on the pace of economic growth, and in Europe, mainly on the impact the economic slowdown in the U.S. will have on Europe and the local corporate sector. There are several signs that the environment is similar to the mid-1990s. At that time, we were in a period of quite sustainable growth and relatively low default rates for several years.

The positive environment for high yield in Europe should last for some time. But investors will look closely to see if companies are tempted to take more risks, and if so, what implications this has for financial ratios.

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Q: Which are the biggest investors in the European high yield market?

Potthof: This can vary from one issue to the next. Basically, traditional high yield funds account for 50 percent to 60 percent of investments in the high yield sector. Hedge funds and so-called crossover investors, who originally only invested in investment grade and are now targeting high yield in the search for higher returns, will likely be among the biggest investors.

Q: How has demand for high yield bonds developed?

Potthof: Demand for high yield bonds is very high in Europe and new issues are frequently several times oversubscribed. This is due to the stable environment and to the low yields in the investment-grade sector. Consequently, many investors are approaching the high yield market looking for higher returns and are thus adding these bonds to their portfolios, so that demand is not likely to ebb away.

Q: Given the high demand, what trend do you expect for issue volumes?

Potthof: In the past few years, the volume of new issues has been rising continuously, contributing to the growth of the high yield market. After new issue volume of about €18 billion in 2005, issuance hit a new record with approximately €26 billion last year. These volumes have been absorbed by the market without difficulties. In the past, such an increase in new issue volume normally led to a short-term expansion of spreads in the secondary market. Investors became more cautious and positioned themselves more defensively to participate in the new issues. This was not the case in 2006, and if the environment does not change, demand will probably stay high.

Another factor that suggests high demand in 2007 are the imminent redemptions. Up to €8 billion in high yield bonds will probably mature this year. In addition, there are coupon payments amounting to about €5 billion to €6 billion, which are usually reinvested. If the new issue volume is again around €20 billion in 2007, the net amount of newly available bond volumes will not be that high. This means that portfolio managers are more or less forced to buy new issues in order to replace maturing bonds. This alone indicates that demand will not subside.

The redemptions might be even higher if we also take into account bonds with call options, which enable the issuer to repay the bond before maturity. Tender offers, where issuers offer to repurchase bonds at a premium outside of call options, are another possibility. On balance, the new issue volume might then be only slightly above the redemptions.

Q: Is it currently worthwhile for an issuer to repurchase or to refinance bonds?

Potthof: At the moment it is definitely cheaper to issue bonds now than when many of the existing bonds were issued. Spreads are markedly lower – and thus interest rates as well – than perhaps three or four years ago so that financing costs are lower overall. At the same time, the financial health of many issuers has improved due to debt

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reduction, so that investors demand lower risk premiums. There are various examples of companies that lowered their interest cost by 2 to 3 percent through refinancing.

Q: Could the favourable financing opportunities lead to an increase in corporate debt in Europe?

Potthof: We are not so much focused on absolute debt levels but more dynamic measures such as debt relative to cash flow or debt relative to ebitda (i.e. earnings before interest, taxes, depreciation and amortisation). Although European companies have increased debt in the past few years, ebitda growth has been even stronger. Thus, corporate leverage has dropped continuously, including in 2006.

However, many of the new corporate debt issuers differ from existing issuers. Often they tap the capital market after a leveraged buyout and are characterised by more risky financing and a higher degree of leverage. These new issuers are thus also increasing the risk for the market as a whole.

Q: That sounds like a two-class society among issuers in the high yield market.

Potthof: Exactly. On one side, we have the so-called "seasoned issuers" or existing issuers of corporate bonds. These have mostly had very good profit growth, which has contributed to the narrowing of spreads. On the other side, we have new names in the market with markedly higher debt, which makes us cautious. In some cases we watch the performance of these companies for several quarters and see whether they are able to reduce their debt, before we make an investment. These issuers have yet to prove themselves.

Q: What role do covenants play, i.e. clauses that oblige an issuer to meet certain conditions or balance-sheet ratios, in an environment of such high demand?

Potthof: Covenants are a very important element in the high yield market. All in all, we observed in this environment that covenants have somewhat deteriorated. The thorough examination of the covenants of a bond has thus become increasingly important. The industry works with a so-called "standard high yield covenant package", and PIMCO's analysts check every bond to see whether the package is complete and how the covenants are worded.

The trend toward looser covenants is typical for the current positive market phase because, like spreads, covenants are subject to "pricing" in the market. The bigger the demand, the easier it is for issuers to formulate the covenants more loosely. With a weaker issuer where demand for a bond is low we find it easier as investors to work towards more stringent covenants.

Q: Has the deterioration of covenants deterred investors?

Potthof: The trend toward looser covenants is not that dramatic. But in an environment of low returns, high yield bonds are increasingly bought by investors who usually

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confine themselves to investment-grade bonds. These investors may not have the same experience in the high yield segment and are hence less critical about covenants. Traditional high yield investors like PIMCO have always taken covenants into account and will continue to do so.

Q: Do companies also use covenants in bond issues as a means of deterring takeovers?

Potthof: This is definitely the case in the high yield sector. A covenant that belongs to the standard package for high yield is the so-called “change of control put”, which in the event of a takeover allows a bond investor to sell the bond for a price of 101 to the issuer. This is an effective weapon particularly if the bond is trading below par, i.e. below 100. If the bond is at 105 or 110 the put is of course worthless. But it is often the case that a takeover leads to an unscheduled repayment of the bond, because outstanding bonds can stand in the way of restructuring the company.

Q: Are European high yield bonds still attractive in spite of the narrow spreads?

Potthof: From a strategic point of view, an allocation in high yield may make sense for investors. The market is now fully developed and well diversified. Four or five years ago the market was very concentrated, with only a few issues from a small number of sectors. However, as far as timing is concerned, the attractiveness of high yield depends on the assessment of future economic growth. We believe that the healthy fundamental trend in high yield may last for some time.

High yield has become more expensive but this applies to other sectors as well, so that, relatively speaking, we do not consider high yield to be overvalued. It is important to note that the default rates are very low at the moment and a strong rise in defaults is not on the horizon at present, so we still regard this sector as attractive.

Q: Where do you currently see the greatest risk in the high yield sector?

Potthof: We are keeping a close watch on the leverage I mentioned earlier and are therefore not investing in new issuers whose debt level is simply too high. In the high yield sector we are also working closely with PIMCO's credit research team. Our in-house analysts have visited all the companies we invest in and have conducted their own studies on these issuers.

Q: Do you favour any particular corporate sectors or segments in the high yield market?

Potthof: In keeping with our investment approach we are looking for companies that are not too heavily leveraged and that generate stable cash flows. A company should thus have a diversified group of regular customers and a business model largely independent of economic ups and downs so that a regular and on-schedule flow of income is possible. Apart from stable cash flows, we also focus on a healthy portfolio of assets. In Europe, these criteria lead us to telecommunications and cable network

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operators but also to a certain degree to the energy sector with utilities, as well as to so-called “directories” like the yellow pages.

Q: At first glance, the telecom sector seems to be a rather surprising candidate considering the financial difficulties these companies faced about five years ago.

Potthof: The point is that almost all the less stable telecommunications companies went bankrupt at that time. These companies didn't have any cash flow, but were based solely on business plans and issued bonds in order to finance them. Hence PIMCO mostly avoided these companies at the time. The telecommunications companies we see in the high yield market today have existing networks and regular customers who generate cash flow.

The situation is similar with cable network operators whose leverage was massively higher five years ago so that many went bankrupt. With today's leverage, investors still have to look closely since we are operating in the high yield sector, but the companies can carry the debt burden today, which was not the case five years ago.

Q: In which high- yield sector do you recommend caution?

Potthof: We are particularly cautious of everything connected to information technology (IT) and high tech due to the usually very high fluctuations in the cash flows of these companies. We are also cautious on the retail sector, where companies often have low assets and are dependent on fashion trends. Hence, volatility and the potential for losses in the retail sector are high.

Q: Thank you, Axel.

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