Europe Appears A Safer Haven

EUROPEAN CORPORATE CREDIT OUTLOOK

Q3, 2015

STANDARD & POOR'S RATINGS SERVICES

McGRAW HILL FINANCIAL

CORPORATE CREDIT OUTLOOK

SUMMARY

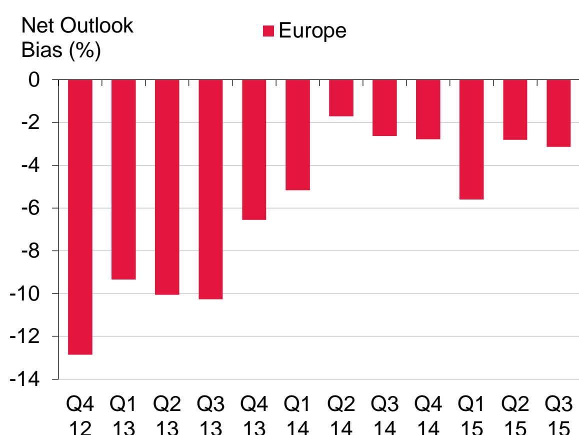
- The slowdown in emerging and developing markets, the turn in the U.S rate cycle and growing tension in the currency markets point to Europe as a relative corporate safe haven now that the preoccupation with Greece has dissipated
- Corporate credit quality remains quite stable for the majority of industrial sectors. Prospective earnings growth for European companies compares favorably to their U.S. peers apart from energy and materials
- Shareholder friendly actions remain a risk factor to monitor, but we do not view them as a material near-term concern

Europe Appears To Be A Safer Haven

The preoccupation with the Greece problem in recent months has distracted attention from other more demanding business and financial challenges facing European companies globally. Two of the most pressing are the shifting patterns of global trade and the imminent decoupling of interest rates as the business and credit cycles diverge between the U.S. and Europe, with Asian economies, particularly China, now an integral part of the mix. The unexpected devaluation of the Renminbi –albeit modest so far –speaks to the underlying economic pressures that are building in China, with the growing risk that volatility in the FX market will pick up further in coming months.

While corporate credit quality remains broadly stable for European industrial rated companies (see Chart 1) and near term default rates likely to remain below 3% (see pages 11-14), these shifts in the international business environment are set to reduce confidence in the earnings contribution from international operations and favor more European-based activity.

CHART 1 | EUROPEAN NON-FINANCIAL CORPORATE RATINGS NET OUTLOOK BIAS TREND



Source: S&P Capital IQ, S&P Ratings. Q3 15 – as of end-July 2015

Navigating Growth Trends Globally

Despite different regions operating in different phases of the credit cycle, overall the global economy continues to develop in a positive direction. Our latest forecasts anticipate global growth picking up from 3.4% in 2015 to 3.9% in 2016. The US economic recovery appears well entrenched, with short term rates expected to be raised imminently. The U.K. recovery lags the U.S., but with unemployment low, higher rates are moving into sight. The overall euroarea economy is starting to make some headway, heavily supported by the ECB's aggressive quantitative easing (QE) programme, the weak euro and low commodity input prices. Domestic demand is the key contributor to European growth led by the consumer with some indications that the long awaited pickup in investment may be materializing in many sectors[1]. But the variation in the strength of recovery amongst euroarea countries remains a concern.

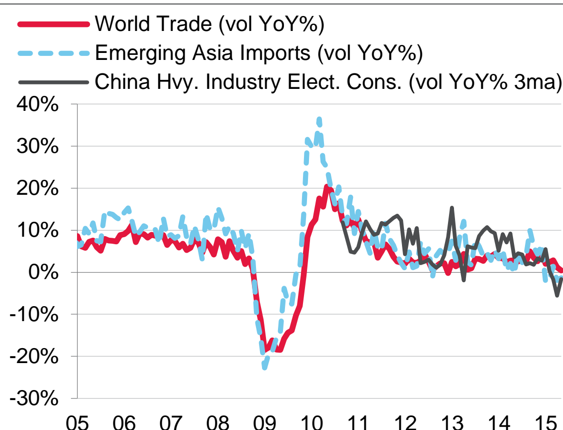
In contrast, the economic outlook for many leading emerging markets presents greater challenges from a corporate perspective. Russia and Brazil are two important countries that for different reasons are expected to remain in a slump through 2016. Russia is suffering from low hydrocarbon prices and Western sanctions, while Brazil, where business and consumer confidence is low as the government tries to resolve the Petrobras corruption scandal, grapples with high inflation and a weak fiscal position. In Asia-Pacific, although still the strongest region of the world, economic prospects are somewhat subdued. We expect growth in China to slide from 6.8% this year to 6.3% in 2017, but growing uncertainty in the depth and duration of the slowdown is undoubtedly damaging for business confidence and investment in the region. Construction and infrastructure investment will continue to be curtailed, implying little prospect of a turnaround in the fortunes of many commodity producers (iron ore and copper in particular). Concerns in the U.S. and Europe over cheap steel imports from China, Korea and Taiwan are only likely to increase. The latest managed devaluations of the Renminbi only exacerbate these concerns, in our view.

[1] See 'Global Corporate Capex Survey 2015' (August 3, 2015 on Global Credit Portal)

These changing patterns of trade and diverging monetary policy has potential ramifications for multi-national companies' business strategy and source of earnings.

Firstly, the strength of global trade has continued to disappoint in recent quarters. The annual growth in the volume of world trade has slipped to only 0.4% in the year to end May 2015, according to the CPB World Trade Monitor. This compares with a compound growth rate of 1.8% over the last four years and is way down from 7.2% experienced in the four year lead up to the financial crisis in mid-2008. With about 7% of the euroarea's merchandise trade exports (by value) going to China and growth of exports to China having contributed over 16% to extra-EU export growth since 2007, China is unlikely to remain the growth market for European exporters that we have seen in recent years.

CHART 2 | CHINA LEADING SLOWDOWN IN GLOBAL TRADE



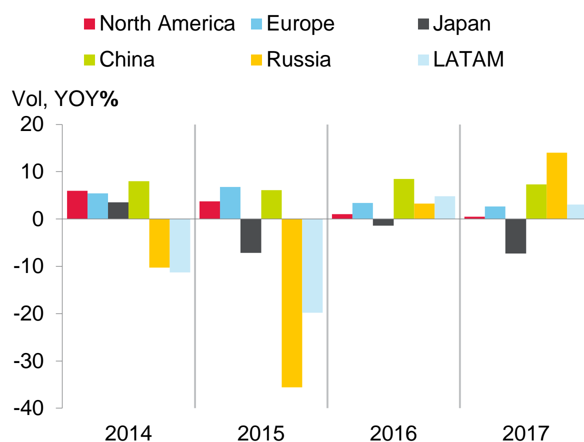
Source: CPB World Trade Monitor, NEA China, Thomson Reuters Datastream

Chart 1 highlights the close correlation between the growth of world trade and imports into emerging Asia, which is almost 50% weighted towards China. This chart also details the growth rate in volume of electricity demand for heavy industry in China, which is also closely correlated to growth in China. Therefore, by extension, the weakness in electricity demand on a year-on-year basis does not bode well for a pickup in international trade.

If this persists, it has potential implications for the contribution to overseas sales and earnings of European companies. Among the sectors most obviously impacted:

- Commodity producers, notably high cost producers of iron ore and other bulk commodities in the mining industry have been put under intense pressure by falling prices to reduce expenditure to limit negative free operating cash flow. Weak commodity currencies will act as a partial mitigant given costs are largely in local currency.
- Consumer product sales growth has not just been impacted by slower growth in leading emerging economies such as China and Russia, but suffered a double blow in the case of China from the anti-corruption drive by President Xi Jinping that has strongly discouraged conspicuous consumption. This has hit quite hard premium brand producers such as Diageo, Burberry, Louis Vuitton and even, to a lesser extent, marque auto brands. The recent depreciation in the Renminbi is likely to exacerbate this trend as Chinese tourists' discretionary spending contracts.
- Auto manufacturers have seen light vehicle sales fall quite dramatically in Russia and Latam in 2015 with sales volumes also weak in Japan (see Chart 3).

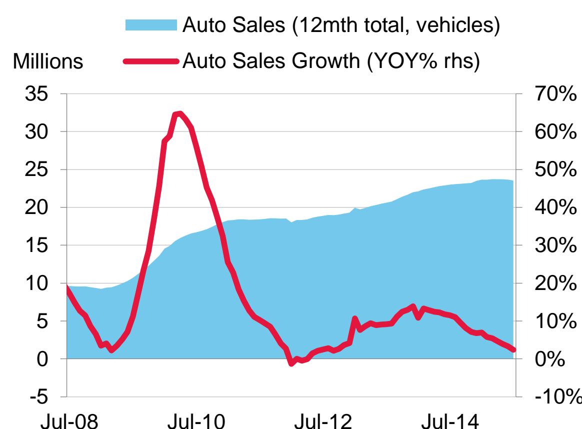
CHART 3 | LIGHT VEHICLE SALES SOFT IN JAPAN AND EMERGING MARKETS



Source: LMCA Q2 2015

Even in China, still seen as a strong growth market for automobiles given the relatively low penetration of only 10% of the adult population, passenger vehicle sales have slowed to an annual rate of only 2.7% in the first half of 2015. This is well below the high single digit percentage expected for the full year (see Chart 4). Furthermore, this masks a shift away from foreign models towards Chinese brands with Sports Utility Vehicles (SUVs) and Multi-Purpose Vehicles (MPVs) experiencing the most rapid growth.

CHART 4 | AUTOMOBILE SALES IN CHINA STALLING



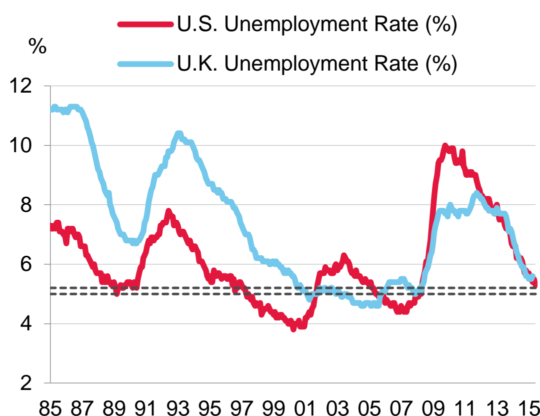
Source: CAAM July 2015; Thomson Reuters Datastream

U.S. and Europe on Diverging Paths

The second forthcoming challenge from a strategic corporate viewpoint is how to navigate the imminent turn in the rates cycle in the U.S. (and potentially in the U.K.) that is likely to fuel further U.S. Dollar strength in the process.

Our base case remains that the Federal Reserve is most likely to make its first move on the road to normalizing the level of short-term interest rates at their Sept. 16-17th meeting. On balance, we think the strength of the economy no longer warrants rates at emergency low levels despite inflation remaining low and limited signs of wage inflation so far. The unemployment rate at 5.3% is very close to the FOMC's latest assessment of the longer-run normal rate of unemployment at around 5.0-5.2% (dotted lines).

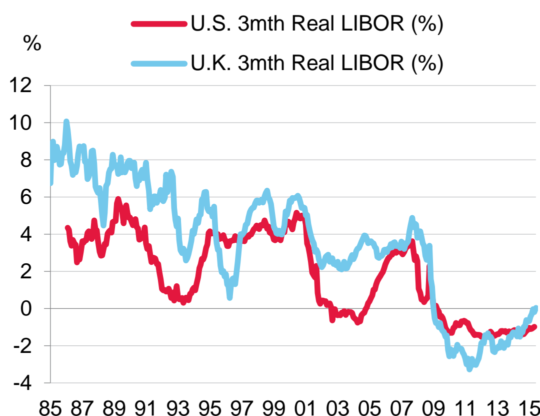
CHART 5 | U.S. AND U.K. APPROACHING FULL EMPLOYMENT



Source: Thomson Reuters Datastream

Money market rates remain extraordinarily low in the U.S. in real terms (see Chart 6), supporting our view that the time is right for the Fed to start moving to a more neutral stance. Indeed as Charts 5 and 6 highlight, the U.K. economy is in a very similar situation suggesting that U.K. rate rises may not be so far away.

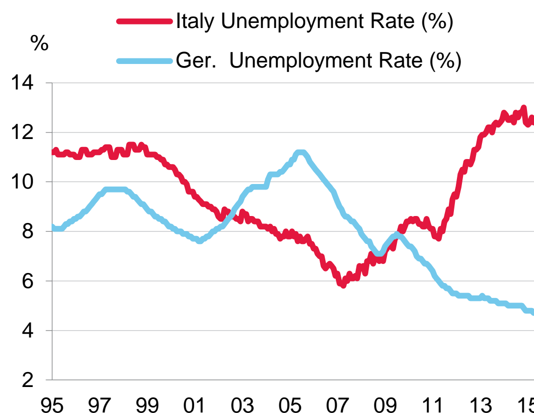
CHART 6 | REAL SHORT RATES TO BE RESTORED



Source: Thomson Reuters Datastream; Inflation measures ex. food and energy

In contrast, the situation in the euroarea is entirely different as monetary policy remains a critical support for the weaker regions where recovery has been slow to take hold since the financial crisis. The diverging unemployment trends between Italy and Germany illustrate the internal tensions that exist within the euroarea (see Chart 7).

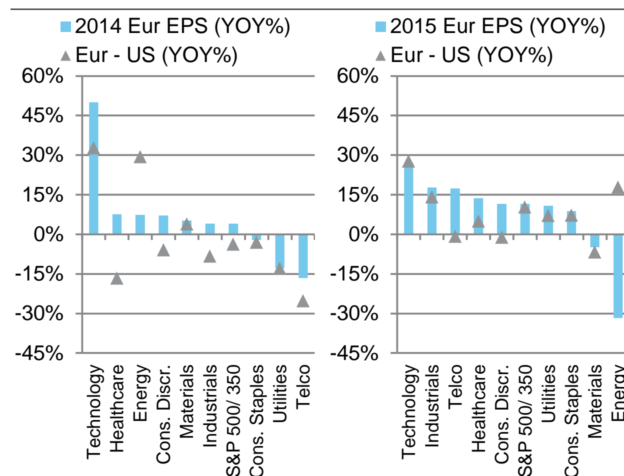
CHART 7 | DIVERGING TRENDS INSIDE THE EUROZONE



Source: Thomson Reuters Datastream

Nonetheless, in comparison to the mature growth story in the U.S., and reduced confidence in emerging market prospects, the euroarea is looking more attractive for European industrial companies. A continued highly supportive monetary policy, a soft euro, and weak commodity prices are all positive factors. Chart 8 details the anticipated improvement in European corporate earnings at the sector level in 2015. Beside energy and materials, all European industries (bar technology) are expected to perform more strongly in 2015 than in 2014 according to these forecasts. Earnings growth is also expected to be higher in Europe in most sectors as well, in contrast to 2014. This prospect should provide some support to credit quality for non-commodity related sectors in Europe.

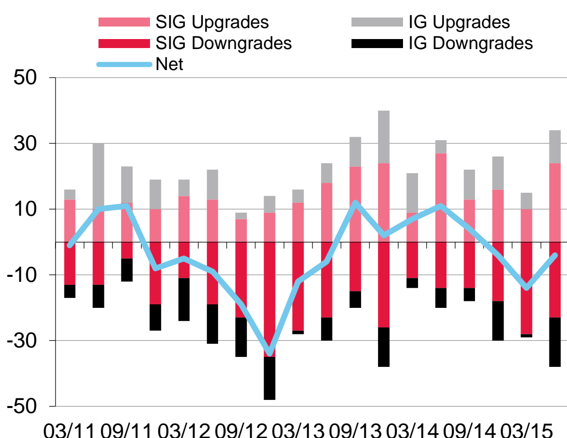
CHART 8 | 2014 v 2015 EPS GROWTH BY SECTOR – EUR v U.S.



Source: S&P Capital IQ, Actual and forecast earnings per share (EPS) growth for S&P 500 / S&P 350 constituents. Data as of 12 August 2015

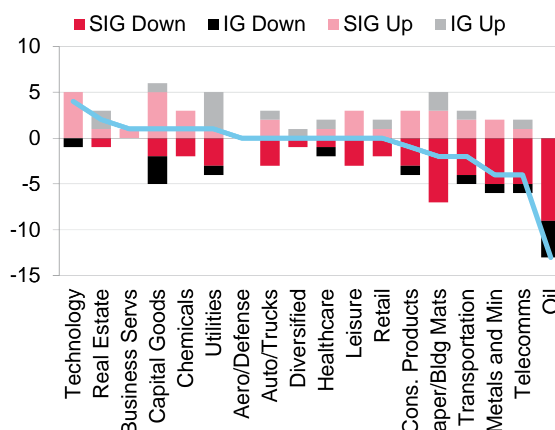
Credit Quality Relatively Stable Overall

CHART 9 | EUROPEAN RATING ACTIONS SLIGHTLY NEGATIVE



Source: S&P Ratings. European – EU28 plus Switz., Norway and Iceland.

CHART 10 | EUROPEAN SECTOR RATING ACTIONS - H1 2015

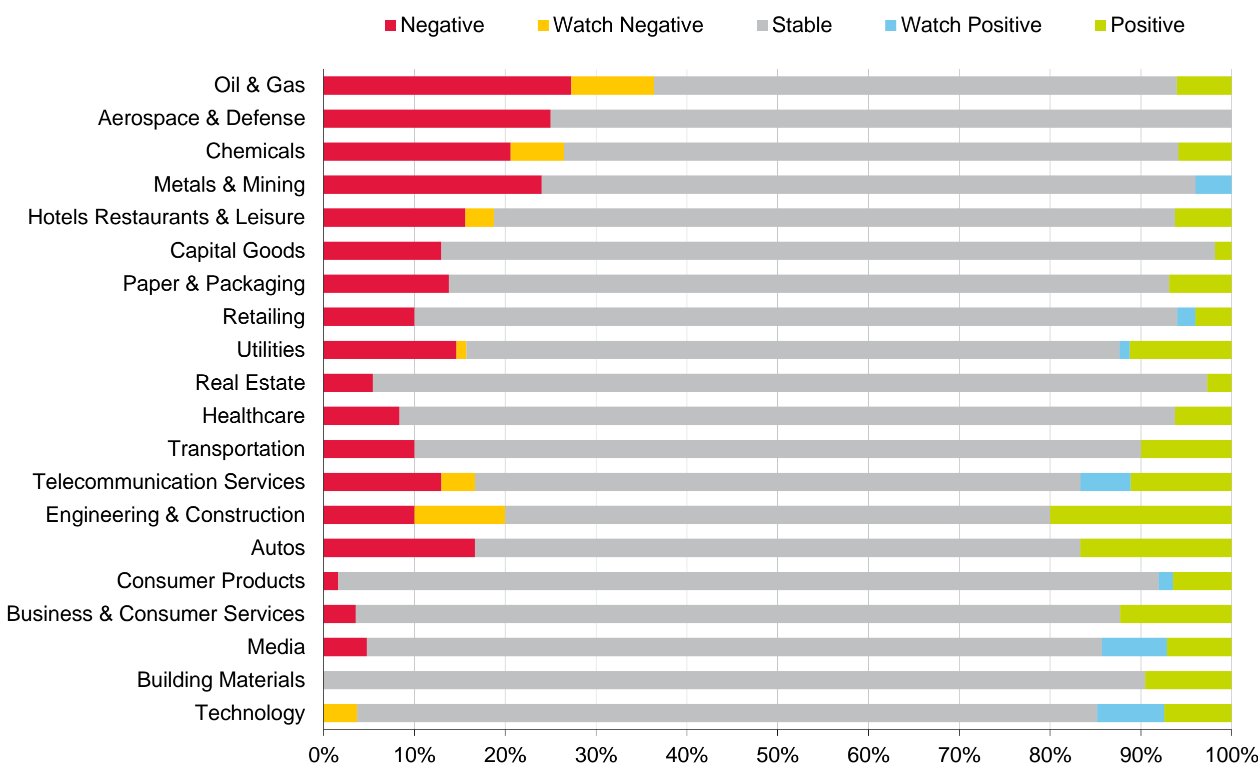


Source: S&P Ratings. European – EU28 plus Switz., Norway and Iceland.

In terms of credit quality for European corporates, in the majority of sectors we expect the ratings outlook to remain quite stable (see Appendix: Table 1) as the regional economy chugs along, benefitting from the strength of domestic demand as employment gains spread across the region, the benefits of Quantitative Easing (QE), and lower energy costs, which supports consumers. This is reflected in the balanced number of rating actions that we took in the second quarter (see Chart 9).

There were some substantial differences between sectors as material-related industries bore the brunt of downgrades in the first half of 2015 (see Chart 10). Business conditions remain challenging for commodity producers as they adapt their cost base to the lower price environment to shore up cash flow. Telecoms suffered a number of downgrades partly due to two ratings actions taken on Hellenic Telecom as well as a downgrade for Cable and Wireless Communications as a result of a material debt-financed acquisition.

CHART 11 | EUROPEAN RATINGS OUTLOOK DISTRIBUTION BY INDUSTRY (RANKED BY ASCENDING NET OUTLOOK BIAS)



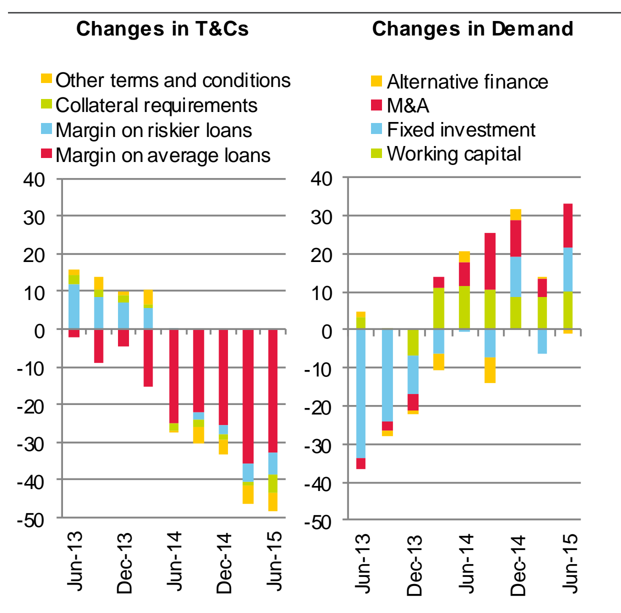
Source: S&P Ratings. Data as of end-July, 2015.

Financial Policy Remains Key Risk to Monitor

Given the prospect of continued monetary accommodation in Europe, financial policy is one key risk to credit quality that we continue to monitor carefully. Our concern, based on historical experience, is that availability of cheap debt financing often stimulates greater risk taking behavior either through more aggressive debt funded acquisitions or rapid growth in dividend payments or share buybacks.

Easing credit conditions are evident in the most recent July 2015 ECB bank lending survey. Terms and conditions for loans to private non-financial companies continue to ease as competition among the banks caused margins to erode. Demand for loans also increased for the purpose of capital investment as well as a pick-up in debt funded M&A (see Chart 11). A further increase in loan demand is expected in the third quarter.

CHART 12 | LOAN SUPPLY & DEMAND FROM EUROAREA ENTERPRISES IMPROVING*

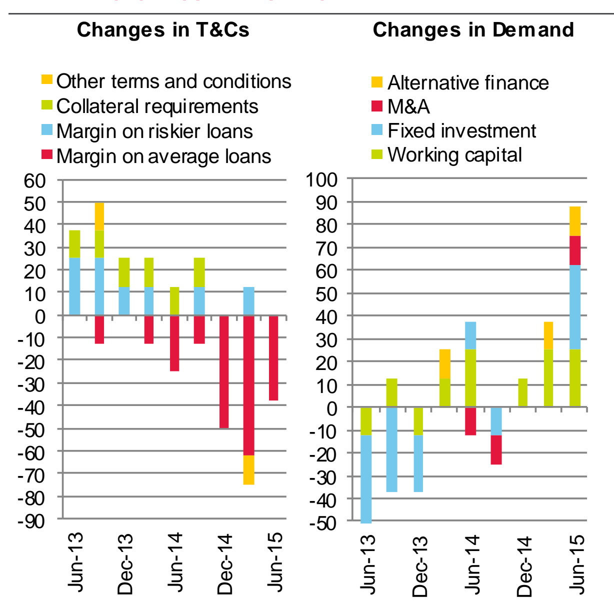


Source: ECB Bank Lending Survey July 2015, Thomson Reuters Datastream.

*-- net percentage of banks reporting tightening terms and conditions (T&C) and reporting positive demand including contributory factors

Interestingly, this pattern of improving supply and demand conditions is not limited just to core countries. Results from the Italian bank lending survey also indicate that lending standards continue to ease for manufacturing firms, most notably for medium-sized and larger enterprises (see Chart 12). They remain unfavorable for construction companies. More striking is the recent improvement in corporate loan demand which, according to the Bank of Italy, largely reflects some recovery in fixed investment, an increase in working capital financing, and the stimulus afforded by low interest rates. Indeed, overall bank lending to the manufacturing sector has now started to expand, increasing by 0.7% in the twelve months to the end of May.

CHART 13 | LOAN SUPPLY & DEMAND FROM ITALIAN ENTERPRISES ALSO IMPROVING*

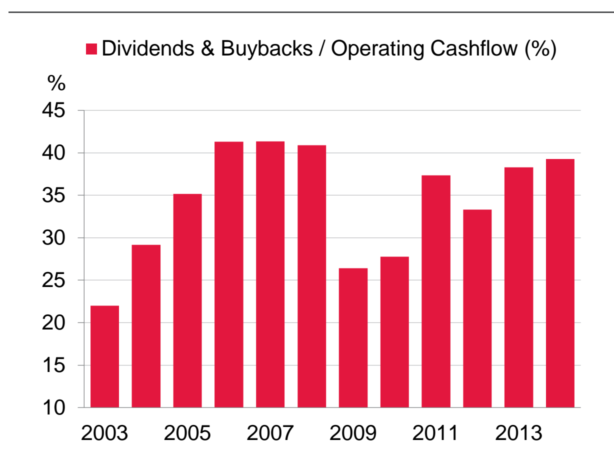


Source: ECB Bank Lending Survey June 2015, Thomson Reuters Datastream.

*-- net percentage of banks reporting tightening terms and conditions (T&C) and reporting positive demand including contributory factors

In this context, the elements appear to be falling into place tempting companies to ratchet up their financial risk profiles through shareholder-friendly actions. Dividend and share repurchases through to the end of 2014 absorbed almost 40% of operating cashflow (see Chart 13). And as discussed on pages 9-10, we are seeing a moderate increase in the proportion of M&A transactions being debt financed.

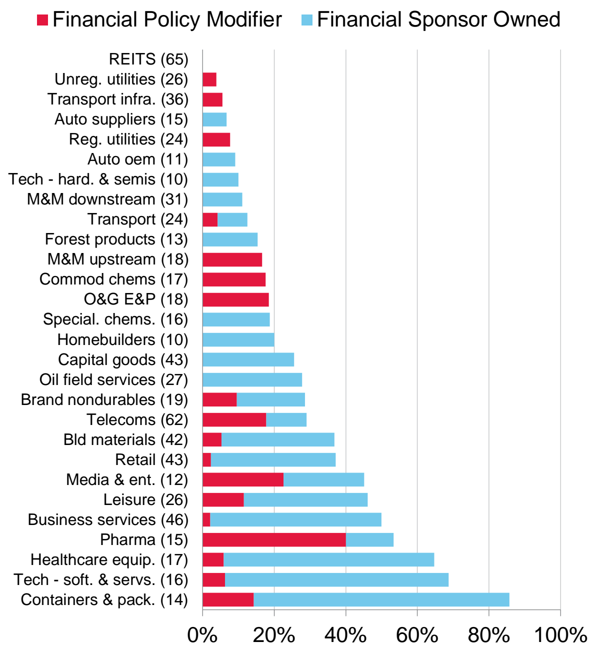
CHART 14 | W. EUROPEAN CORPORATE SHAREHOLDER PAYMENTS APPROACHING 2006-08 LEVELS



Source: Thomson Datastream; W. European companies in Global CAPEX

From a ratings standpoint, there are a number of sectors where financial policy is acting to constrain ratings. For instance, the pharma, media and leisure and the more upstream commodity sectors have a relatively proportion subject to negative financial policy rating modifiers (see Chart 14).

CHART 15 | CORPORATE SECTORS MOST CONSTRAINED BY NEGATIVE FINANCIAL POLICY ASSESSMENT



Source: S&P Ratings

There are also several sectors where the proportion of rated companies owned by financial sponsors (where an aggressive financial policy is usually a characteristic of their business model) is greater than 30%. These sectors include containers & packaging, technology (software and services), healthcare equipment, business services, retail, leisure and building materials.

However, while this is a risk factor that we continue to watch carefully, we do not view this as a widespread concern at this point in Europe. Indeed, if anything, caution ahead of the expected turn in the U.S. rate cycle, the renewed focus on China's growth and debt challenges and the pressures developing in the foreign exchange market suggests that continuation of a considered approach to financial policy remains appropriate.

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APPENDIX: TABLE 1 | EUROPEAN CORPORATE CREDIT CONDITIONS SURVEY – JULY 2015

Sector / Question	1. Current Business Conditions	2. Business Outlook Over Next 12 Months	3. Free Operating Cash Flow Over Next 12 Months	4. Capital Expenditure Over Next 12 Months	5. Sector Outlook Over Next 12 Months
Oil & gas – Upstream	Very Weak	Weaker	Substantial Decrease	Substantial Decrease	Negative
Transportation IFR – Rail	Weak	No Change	No Change	No Change	Negative
Utilities - Unregulated	Weak	Moderately Weaker	No Change	Decrease	Negative
Capital goods	Satisfactory	No Change	No Change	No Change	Stable to Negative
Chemicals	Satisfactory	No Change	No Change	No Change	Stable to Negative
Mining	Very Weak	Weaker	Decrease	Decrease	Stable to Negative
Oil & gas - Downstream	Strong	Moderately Weaker	No Change	No Change	Stable to Negative
Retail	Weak	No Change	No Change	No Change	Stable to Negative
Aerospace & Defence	Satisfactory	No Change	Increase	No Change	Stable
Autos – Manufacturers	Satisfactory	No Change	No Change	No Change	Stable
Autos – Suppliers	Satisfactory	No Change	No Change	No Change	Stable
Building Materials	Weak	No Change	No Change	No Change	Stable
Consumer Goods	Satisfactory	No Change	No Change	No Change	Stable
Forest Products	Satisfactory	No Change	No Change	Increase	Stable
Leisure	Satisfactory	No Change	No Change	No Change	Stable
Media	Satisfactory	No Change	No Change	No Change	Stable
Packaging	Satisfactory	No Change	No Change	No Change	Stable
Pharma & Healthcare	Satisfactory	No Change	No Change	No Change	Stable
Real Estate	Satisfactory	No Change	No Change	No Change	Stable
Service Companies	Satisfactory	No Change	No Change	No Change	Stable
Steel	Weak	No Change	No Change	No Change	Stable
Technology	Satisfactory	No Change	Increase	No Change	Stable
Telecoms – HY	Satisfactory	No Change	No Change	No Change	Stable
Telecoms – IG	Weak	Moderately Stronger	No Change	No Change	Stable
Transportation IFR – Airports	Strong	No Change	No Change	No Change	Stable
Transportation IFR - Toll Roads	Satisfactory	No Change	No Change	No Change	Stable
Transportation – Airlines	Strong	Moderately Stronger	Increase	No Change	Stable
Transportation – Shipping	Weak	Moderately Stronger	No Change	No Change	Stable
Utilities – Regulated	Satisfactory	No Change	No Change	No Change	Stable

S&P Ratings Services - European Corporate Credit Conditions Survey Questions

Change indicators

Weaker since March 2015

Stronger since March 2015

Question	Definitions
1. Current Business Conditions	Very strong/very weak = sharply above/below conditions unusual; Strong/weak = above/below average conditions
2. Business Outlook Over Next 12 Months	Stronger/weaker = more than 5% improvement/deterioration; Moderately stronger/weaker = up to 5% improvement/deterioration
3. Free Operating Cash Flow Over Next 12 Months	Substantial increase/decrease unusual for the industry historically; Increase/decrease
4. Capital Expenditure Over Next 12 Months	Substantial increase/decrease unusual for the industry historically; Increase/decrease
5. Sector Outlook Over Next 12 Months	Positive/negative = material number of potential upgrades/downgrades; Positive to stable /negative to stable = modest number of potential rating and outlook changes

Source: S&P Ratings. S&P Ratings Services' corporate analysts are surveyed quarterly as part of the S&P Credit Conditions Committee process. The survey is conducted with additional sub-industry categories than the industry classification used for this report.

See "Credit Conditions: Despite The Turmoil In Greece, Europe's Fragile Growth Continues " (July 14, 2015 on RatingsDirect) for our full European Credit Conditions Update

MERGERS & ACQUISITIONS

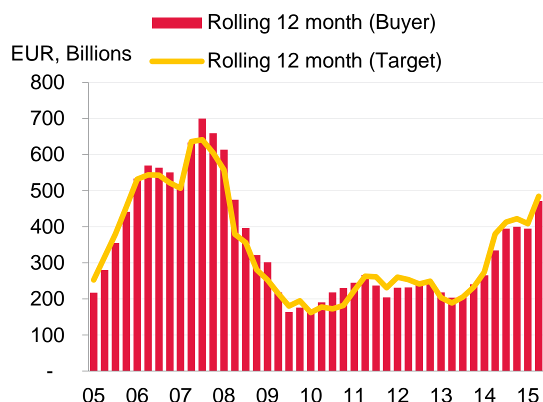
SUMMARY

- Globally M&A is on a trajectory to break records in 2015, although European companies still lag their North American counterparts in the cycle in terms of both deal flow and acquisition-related negative credit implications.
- Firms in Europe continue to stay financially conservative with smaller bolt on acquisitions – deals of €1bn or greater in size comprised only 19% of European acquisitions in 2015, compared to 26% of North American acquisitions in the same time frame.
- European industry and geography trends remain consistent with 2014 thus far, with buyers continuing to seek growth from U.S. companies in the IT and healthcare sectors.

Europe Steps Cautiously

Merger and acquisition (M&A) transactions have spiked in both North America and Europe, with activity building steadily over the past two years. But North America is ahead in the cycle. On a rolling 12-month basis, North American deals by value are exceeding 2007 levels from the last M&A boom (see charts 16 and 17).

CHART 16 | EUROPEAN M&A - ROLLING FOUR QUARTER ACTIVITY BY VALUE IN EUROPE

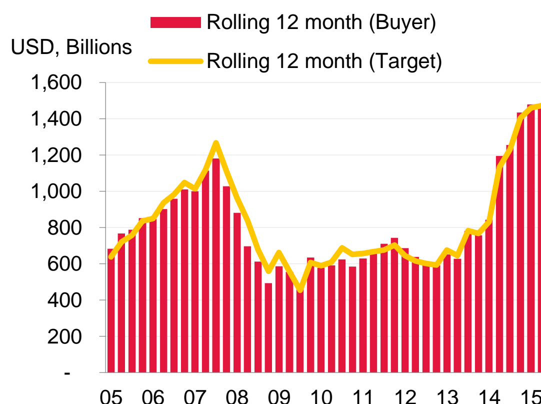


Source: S&P Capital IQ, Standard & Poor's Calculations. Shows rolling four-quarter sum of deal value by European buyer (EU31, Switzerland, Iceland and Norway) with European and North American target.

As of end-June, the total value of transactions from European buyers reached almost €300bn and was on track to top the €400bn of total deal value in 2014. But while firms in the U.S. have become more aggressive in terms of using debt for M&A transactions––particularly in the pharmaceuticals sector—those in Europe have so far remained more cautious in applying a mix of financing to transactions. Rather, European firms have tended toward smaller bolt-on acquisitions that don't require debt funding. As a result, European purchases have remained smaller, with only 19% of deals at greater than €1bn in size in 2015, compared to 26% for North American purchases.

Out of 28 announced deals from rated European buyers purchasing both European and North American companies in the first half of 2015, there were two instances where rated borrowers' announced transactions resulted in us placing them on CreditWatch with negative implications (Royal Dutch Shell PLC and Mylan N.V.; see table 2). There was one downgrade from Swiss travel retailer Dufry AG's purchase of World Duty Free, but also one upgrade. Standard & Poor's raised the rating on technology company Nokia to 'BB+' from 'BB' due to its better-than-expected 2014 results and the fact that we view the proposed merger with Alcatel-Lucent as potentially credit-positive in the medium term due to its all-share structure. This contrasts with the sample of 12 major U.S. transactions that we've examined, half of which resulted in a revision of the rating outlook to negative or a placement of the rating on CreditWatch with negative implications.

CHART 17 | NORTH AMERICAN M&A - ROLLING FOUR QUARTER ACTIVITY BY VALUE IN U.S. AND CANADA

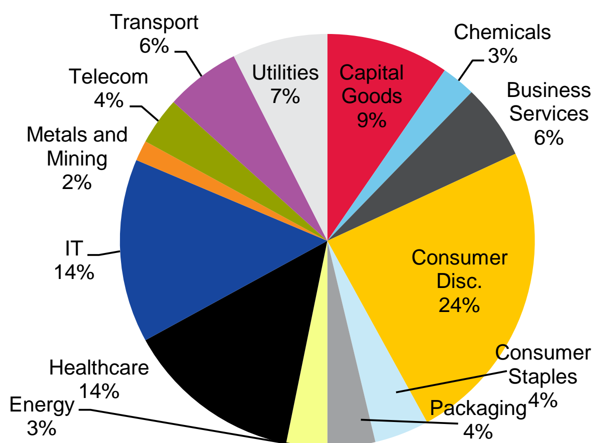


Source: S&P Capital IQ, Standard & Poor's Calculations. Shows rolling four-quarter sum of deal value by North American buyer with European (EU31, Switzerland, Iceland and Norway) and North American target.

More Of The Same?

By industry, the distribution of deals with European targets to the end of the second quarter of 2015 looks similar to last year, with consumer discretionary, IT and healthcare leading the way for deal flow by count (see chart 18). But when the data is split by deal value, energy (25%) and chemicals (13%) make up a much higher percentage due to Shell's BG Group transaction and Monsanto's potential acquisition of Swiss pesticide company Syngenta.

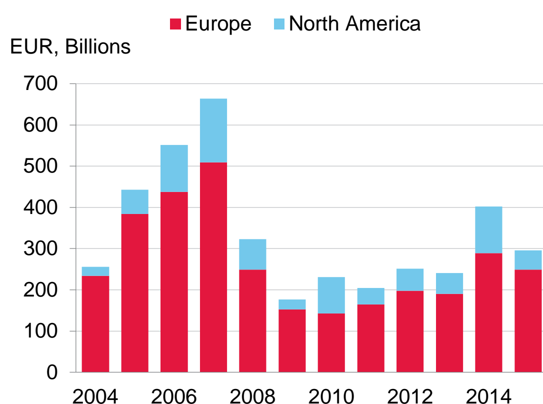
CHART 18 | EUROPEAN M&A TARGET ACTIVITY BY VOLUME SPLIT BY INDUSTRY Q1 2015



Source: S&P Capital IQ, Standard & Poor's Calculations. Target is EU31, Switzerland, Iceland and Norway with buyer from Europe or North America.

Another ongoing trend is European firms' focus on acquisitions in the U.S., although this activity has slowed on a relative basis, with cross-Atlantic deals by value accounting for 15% of the total at mid-2015, compared with 28% for 2014 as a whole (see chart 19).

CHART 19 | EUROPEAN M&A BUYER ACTIVITY SPLIT BY TARGET REGION



Source: S&P Capital IQ, Standard & Poor's Calculations. Shows deal value by European buyer (EU31, Switzerland, Iceland and Norway) with European and North American target.

Now that some of the market nervousness created by the Greece situation has passed, we expect the pressure to buy growth through M&A will continue in Europe and using debt to fund these acquisitions will become a bigger downside credit risk. Nonetheless, we anticipate that there may be some reticence in Europe towards aggressively structured transactions due both to US lending guidelines but also some expectation that the European authorities are tracking market developments carefully with a view to taking macro-prudential measures should they be warranted.

TABLE 2 | CREDIT IMPACT OF MAJOR Q2 2015 M&A TRANSACTIONS

M&A Transaction	Rating Action/Outlook Change	Rationale
Royal Dutch Shell PLC's purchase of BG Group PLC	Negative outlook	The negative outlook reflects the potential for a one-notch downgrade if the BG Group acquisition is finalized and further depresses credit metrics compared with our base case.
Ireland-based Endo International PLC is acquiring U.S. Par Pharmaceutical Cos. Inc.	'B+' rating affirmed	While leverage will be higher than our current base-case scenario, it does not meet our downgrade trigger for the rating.
Merger of food retailers Ahold and Delhaize	'BBB' rating affirmed	Notwithstanding the integration costs and some degree of execution risk, this merger will moderately strengthen Ahold Delhaize's 'satisfactory' business risk profile, while we will likely maintain the financial risk profile at 'intermediate'. The stable outlook reflects our expectation of continued free cash flow generation and a prudent financial policy.
EDF is becoming the controlling shareholder of AREVA NP to ensure the competitiveness of France's nuclear industry and AREVA's viability	No revision to ratings or outlooks	While Standard & Poor's Ratings Services is closely following developments, so far we have not revised our ratings or outlooks on the two companies because the plan is still under discussion, and subject to changes and conditions. We will reassess our ratings on AREVA and EdF once discussions are more advanced, and after we review AREVA's financing plan.
Mylan N.V. is pursuing Perrigo Co. in a debt-and-equity funded acquisition	We have revised our CreditWatch implications, including our BBB- corporate credit rating for Mylan to negative from developing	Depending on the ultimate price and financing mix of the potential acquisition of Perrigo, and the de-levering plans post-acquisition, we could lower the ratings on Mylan based on the deterioration in credit measures.

Source: S&P Ratings.

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DEFAULTS AND RECOVERY

SUMMARY

- We now forecast the overall annual corporate default rate for March 2016 at 2.7%. This compares to 3.5% for the 12 months to end December 2015 in our previous forecast
- Excluding credit estimates, our default forecast for rated companies is only 2.2%, compared with our prior forecast of 2.7% for the 12 months to December 2015
- These low forecasts reflect signs of improvement in the corporate credit cycle in Europe, the majority of companies operating in the larger, more stable countries , as well as limited concentrations of risk by sector
- The European corporate default rate has fallen to the lowest level since 2007, with only four defaults in the first quarter and 17 over the last 12 months. This puts the overall default rate by volume at 2.4% from 2.7% at end December 2014
- By value, the overall default rate fell to 1.8% from 2.0% at end 2014, and ticked higher to 1.0% from 0.6% for just publicly rated corporates.

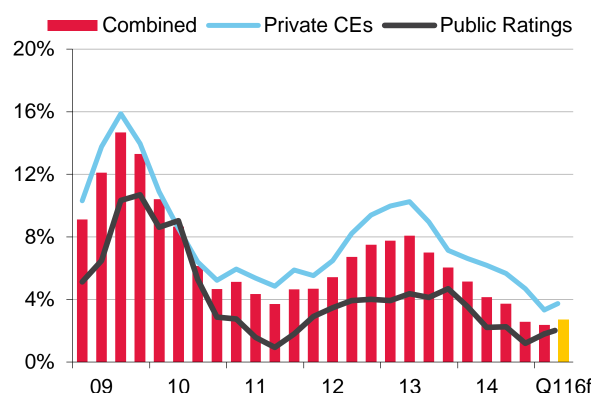
Financial Cycle Bears Down on Defaults

The incidence of corporate defaults in Europe has fallen sharply over the past year against the backdrop of a gradually improving economic environment in Europe, the 10% fall in the effective euro exchange rate over the past year, and the establishment of the European Central Bank's (ECB's) €60 billion per month quantitative easing (QE) program.

In the first quarter of this year, there were only four corporate defaults in Europe, carrying a total €3.4 billion of debt. This compares with three defaults in the fourth quarter of 2014 on €3.0 billion of debt. As a result, the overall default rate by number (combining public speculative-grade corporate ratings plus private credit estimates) fell to 2.4% from 2.7% at year-end (see chart 20). By value, the equivalent default rate fell to only 1.8% from 2.0% at the end of 2014. This is the lowest default rate by number we have seen since 2007, while the default rate by value did briefly touch 1.8% in Q2 2011 by our estimation.

Taking only rated non-financial corporates (NFC) into account, the default rate picked up from a three-year low of 1.2% at the end of December 2014 to 1.8% at the end of March 2015. This remains well below the long-term annual average of 3.3% since the start of this study in 2003. With no credit estimate defaults in the first quarter, the credit estimate default rate fell sharply to 3.5% from 5.1% at the end of December 2014 (see table 4).

CHART 20 | EU SIG CORP. DEFAULT RATE BY VOLUME



Source: S&P Ratings. SIG – sub-investment grade

This strong overall performance is, in part, skewed by the concentration of entities in the larger European markets that have suffered least from recession. U.K., German, French, and Dutch domiciled companies comprise 62% of our European speculative grade corporate universe. In fact, the proportion is higher because many Luxembourg-registered companies (10% of the total dataset) belong to groups based in these four countries.

Our datasets are also not reflective of bank credit exposure to NFCs more broadly across Europe. For instance, in Italy, bank bad loans to NFCs amounted to €136.4 billion or 16.9% of the corporate loan book at end-April 2015, according to the Bank of Italy. Bad debts have increased by an annual rate of 13% in the first four months of 2015.

In Spain, while there are signs of modest improvement, nonperforming loans (NPLs) remain significant. NPLs for NFCs (excluding real estate and construction) fell modestly to 14% of the loan book at end-December 2014 from 14.7% one year earlier. Another 4.5% of corporate loans

that have been restructured or refinanced are still viewed as nonperforming, according to the Bank of Spain.

The Default Rate For Mid-Market Companies Is Also Low

Delving into the default detail a little further, it is also interesting to investigate whether we see any divergence in the default experience for mid-market or smaller companies. Applying our mid-market definition of no more than €1.5 billion in revenues and less than €500 million in outstanding debt (below €250 million for LBOs), we had 287 companies in our dataset at the beginning of 2014. Of these, 78% were LBOs and 22% corporates.

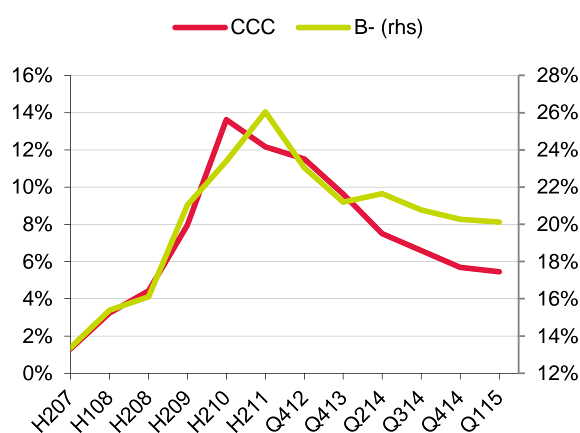
In terms of defaults, seven mid-market companies defaulted in 2014 out of the total 18 speculative grade companies defaulting in that year. This translates to a 2.4% default rate for 2014. Although slightly below the 2.7% overall (combined) default rate (as detailed in table 4), we would caution against drawing any broader conclusions due to the very limited data available at this point.

Near-Term Default Prospects Remain Benign

In this context, looking at our base case over the next 12 months, we see the economic environment for the larger European economies as gradually improving, with monetary policy-setting remaining highly supportive from a default perspective. We anticipate that the lending environment will likely become more competitive as bank lenders, institutional investors including CLO funds, and alternative direct lenders seek to deploy capital.

While absolute debt levels remain quite high, low interest rates, the meaningful extension in debt maturities in recent years, and growing tolerance for issuer-friendly terms within loan documents suggest that the near-term outlook for defaults will remain benign.

CHART 21 | EU SIG CORP. PORTFOLIO WEIGHTS



Source: S&P Ratings. SIG – sub-investment grade

Credit quality of the existing combined portfolio is continuing to improve, with 20.1% and 5.4% currently standing at 'B-' and 'CCC', respectively, as of March 2015 (see chart 21). This compares with 22% and 8.7% a year earlier.

In addition, we see little concentration of risk now that transactions (originated before the financial crisis) have been refinanced in one form or another. From a sectoral viewpoint, concentration of risk is not of great concern either at this point. For instance, in the commodity area, speculative-grade companies in the energy and metals and mining sectors comprise 9.1% of our dataset by number at end-March 2015. This is very similar to the BoA Merrill Lynch Euro High-Yield Index (excluding financials), where the energy and metals and mining (incl. steel) sectors have a combined weight of 9.4% by volume. This is a low percentage compared to the equivalent 24.1% weight in the Merrill Lynch U.S. High-Yield Master II Index.

In addition, with the corporate credit cycle in Europe showing early signs of improvement, supported by the ECB's QE program, we judge it appropriate to apply a slightly lower default stress in estimating the default rate over the next 12 months.

As detailed in table 3 below, our forecast for the trailing 12-month rated corporate default rate by end-March 2016 is 2.2%. This is lower than our previous 2.7% forecast for the 12 months to end-December 2015. At the same time, it is a slight increase from the actual 1.8% run rate that we currently have through to end-March 2015 (see table 4).

TABLE 3 | EU NON-FINANCIAL CORPORATE DEFAULT PROJECTIONS TO MARCH 2016

Ratings / Credit Estimates (% per annum)	Default Assumptions	
	Base Case	Downside Case
>B+	**0.3**	0.5
B+	**1.4**	1.7
B	**2.2**	3.1
B-	**3.5**	5.0
CCC / CC	**16.5**	19.9
Default Rates		
Public Ratings	**2.2**	2.9
No. of Defaults	**11**	15
Credit Estimates	3.9	5.1
No. of Defaults	8	10
Overall		
No. of Defaults	2.7	3.5

Source: S&P Ratings

We expect the default rate within the private credit estimate contingent that now numbers less than 200, to remain significantly higher, as almost 26% were categorized as 'b-' or 'ccc' at the end of March 2015. But at 3.9% for end-March 2016, this would place 2015 and 2016 as the only years since the financial crisis that we have seen the private credit estimate default rate print below 4%.

Greek Corporates Are Vulnerable to a Grexit

Should Greece depart from the eurozone, which we currently consider less than a one-in-three probability, corporate credit quality for almost all Greek companies would become significantly impaired, with those dependent on the Greek economy being most vulnerable to default. The transmission channels would be various, extending from a seizing up of bank and other sources of liquidity, redenomination of local law debt into new domestic currency, reduced ability to service foreign currency (e.g. euro)-denominated debt after a likely substantial depreciation in their currency, as well as the heightened economic uncertainty in the local economy that would result.

Nonetheless, given that we only rate seven Greek corporates, several of which have low country risk exposure to Greece and therefore potentially have the ability to continue to service their debt obligations on a timely basis, the direct impact on our European corporate default rate would be limited.

Lowest Level of Defaults Since Financial Crisis

With only 4 (all non-LBO) defaults experienced in the first quarter of 2015, taking the twelve month total to only 17, this is the lowest annual total since late in 2008. Notably, for the first time since the start of the financial crisis, we did not record a single credit estimate default.

TABLE 4 | EUROPEAN DEFAULT RATE VOLUME

	Private Credit Estimates			Public Ratings			Combined
	No. of entities*	Defaults	Default rate (%)	No. of entities*	Defaults	Default rate (%)	Default rate (%)
Q1 09	578	26	10.4	176	4	5.1	9.2
Q2 09	568	24	13.9	170	2	6.5	12.2
Q3 09	581	22	16.4	163	7	10.5	15.1
Q4 09	594	15	14.6	155	4	11.0	13.9
Q1 10	576	6	11.6	158	1	8.9	11.0
Q2 10	558	9	9.3	160	3	9.4	9.3
Q3 10	556	7	6.7	158	1	5.7	6.4
Q4 10	541	7	5.4	170	0	2.9	4.8
Q1 11	521	9	6.1	178	1	2.8	5.3
Q2 11	513	5	5.5	187	1	1.6	4.4
Q3 11	501	4	5.0	211	0	0.9	3.8
Q4 11	503	12	6.0	223	2	1.8	4.7
Q1 12	498	7	5.6	240	4	2.9	4.7
Q2 12	468	8	6.6	253	3	3.6	5.5
Q3 12	452	12	8.6	246	1	4.1	7.0
Q4 12	427	16	10.1	249	2	4.0	7.8
Q1 13	416	8	10.6	254	4	3.9	8.1
Q2 13	407	8	10.8	254	4	4.3	8.3
Q3 13	399	6	9.5	291	2	4.1	7.2
Q4 13	367	6	7.6	318	5	4.7	6.3
Q1 14	339	4	7.1	335	1	3.6	5.3
Q2 14	314	5	6.7	355	0	2.3	4.3
Q3 14	274	2	6.2	394	3	2.3	3.9
Q4 14	255	2	5.1	419	1	1.2	2.7
Q1 15	254	0	3.5	445	4	1.8	2.4

Source: S&P Ratings. *Number in database one year prior

Rated High-Yield Credits Drive Defaults

The European corporate default rate by value, combining both public and private defaults, fell to 1.8% in the first quarter (see table 5). Even though all the defaults in Q1 2015 were on rated companies, totaling €3.4 billion, the rated corporate default rate by value only picked up to 1.0%.

TABLE 5 | EUROPEAN DEFAULT RATE – BY VALUE

	Private Credit Estimates			Public Ratings			Combined
	No. of defaults	Value (€, Billion)	Default rate (%)	No. of defaults	Value (€, Billion)	Default rate (%)	Default rate (%)
Q1 09	26	14.2	6.6	4	3.4	6.5	6.6
Q2 09	24	12.0	9.8	2	8.2	8.8	9.3
Q3 09	22	9.3	12.1	7	9.8	10.1	11.1
Q4 09	15	5.4	11.5	4	4.9	5.9	8.7
Q1 10	6	0.8	8.2	1	0.0	5.0	6.5
Q2 10	9	9.3	7.9	3	2.5	3.4	5.5
Q3 10	7	2.8	6.2	1	2.2	2.6	4.2
Q4 10	7	1.4	4.1	0	0.0	1.3	2.7
Q1 11	9	3.6	5.2	1	0.4	1.4	3.2
Q2 11	5	1.8	3.2	1	0.4	0.8	1.9
Q3 11	4	6.0	4.5	0	0.0	0.2	2.1
Q4 11	12	4.9	6.2	2	3.2	1.1	3.2
Q1 12	7	4.6	7.1	4	10.6	3.8	5.1
Q2 12	8	1.4	6.9	3	2.0	4.2	5.3
Q3 12	12	5.5	6.9	1	0.5	4.3	5.3
Q4 12	16	6.7	7.6	2	4.1	4.0	5.3
Q1 13	8	1.7	6.4	4	4.4	2.3	3.6
Q2 13	8	5.2	7.2	4	4.2	2.4	4.0
Q3 13	6	2.6	6.5	2	2.0	2.4	3.6
Q4 13	6	1.3	4.6	5	3.6	2.5	3.2
Q1 14	4	5.0	6.2	1	0.1	1.7	3.0
Q2 14	5	7.3	7.9	0	0.0	0.9	2.7
Q3 14	2	0.2	7.7	3	2.0	0.9	2.4
Q4 14	2	1.3	8.0	1	1.7	0.6	2.1
Q1 15	0	0.0	5.3	4	3.4	1.0	1.8

Source: S&P Ratings. Europe--EU-28 + Iceland, Norway, and Switzerland

Commodity-Related Sectors Are The Most Exposed

Although the frequency of defaults has fallen, the general pattern at this late stage in the default cycle broadly reflects underlying economic developments (see table 6). Local consumer-related industries are experiencing less pressure on financial performance as low inflation improves consumers' discretionary spending power (such as retail and consumer products). Intensive energy users (such as various transportation segments) have also enjoyed a windfall from the substantial fall in oil prices.

Conversely, commodity producers (such as oil and gas, metals and mining) and, highly relevant in this context, companies that supply the major producers find themselves heavily squeezed on pricing as well as new orders and contracts.

TABLE 6 | EU DEFAULT RATE BY INDUSTRY

		Default Rate* (%)							
	No. of Entities	2008	2009	2010	2011	2012	2013	2014	Q1 15
Metals/mining	30	0.0	27.3	10.0	0.0	0.0	0.0	7.1	6.7
Business services	42	1.6	11.1	8.6	1.5	17.0	11.5	7.3	4.8
Oil and gas	23	0.0	0.0	9.1	0.0	4.0	4.4	0.0	4.3
Retail/restaurants	73	5.2	22.1	2.7	6.4	5.4	7.7	6.9	4.1
Media and entertainment	108	4.4	13.5	6.8	6.4	8.3	12.2	2.8	3.7
Consumer products	58	7.1	13.4	3.0	6.5	13.0	0.0	3.6	3.4
Forest Products	31	0.0	12.5	0.0	0.0	0.0	6.7	0.0	3.2
Homebuilders/real estate	46	13.7	21.4	2.2	4.1	4.7	5.7	2.3	2.2
Health care	63	3.5	1.5	3.6	3.5	4.8	5.0	1.7	1.6
Transportation	40	5.3	7.9	5.7	8.3	13.5	7.3	2.4	0.0
Automotive	30	9.1	22.0	2.6	5.0	2.8	5.7	0.0	0.0
Chemicals, pckg.,envir.	45	9.5	15.5	2.0	3.4	14.3	4.9	0.0	0.0
Utilities	15	0.0	0.0	0.0	6.3	0.0	7.7	0.0	0.0
Telecommunications	40	2.6	5.3	8.7	4.6	3.2	6.1	0.0	0.0
Capital goods	44	2.3	11.3	6.8	6.3	7.7	0.0	0.0	0.0
Technology	23	5.0	21.7	11.8	0.0	4.2	0.0	0.0	0.0

Source: S&P Ratings *Data combine public and private ratings.
Europe – EU-28 and Iceland, Norway, and Switzerland

European Recovery Rates Are Slipping But Still Strong

In the latest update of our annual European recovery report[2], mean first-lien recoveries have slipped slightly, to 74% from 76%, but remain strong (see table 7).

Second-lien recoveries continue to mirror those for mezzanine debt, although this reflects the binary nature of these underlying recoveries that typically experience either full or zero recovery, as they represent only a small sliver of the overall capital structure.

The European first-lien results are lower than the nominal long-term average rate of 83% we've observed in the U.S. However, in the U.S. this is over a much longer period (from 1987 to 2014), comprises final recoveries only, and excludes bonds. A portion of the divergence likely reflects that, in Europe, unlike in the U.S., we don't impute any value to equity in our recovery calculations.

TABLE 7 | EUROPEAN CORPORATE RECOVERIES (2003-14)

Year	Number of instruments	Mean (%)	Median (%)	Standard Deviation (%)
First lien	669	74	83	29
Second lien*	75	36	10	42
Mezzanine*	136	36	2	44
Senior unsecured	47	46	38	35
Subordinated	23	23	0	36

Source: S&P Ratings

Looking forward, more than half of European institutional loan transactions have been cov-lite so far this year, versus 60% in the U.S. market. In Europe, we currently have no evidence to indicate whether or not cov-lite structures constrain credit quality and recoveries, but the companies that have been able to issue cov-lite debt have often been higher-rated entities. It remains to be seen whether this loosening in protections for senior lenders will result in a dilution of recoveries over time.

DEFAULT STUDY METHODOLOGY

Our default study covers the broadest investable universe for European institutional investors by including leveraged loans and high-yield bonds. Our universe comprises speculative-grade nonfinancial companies (that is, those with a public rating of 'BB+' or a private credit estimate of 'bb+' or lower) domiciled in Europe (EU-28 plus Iceland, Norway, and Switzerland).

The calculation of the denominator used to determine the default rates is the number of rated nonfinancial corporates and private credit estimates in our static pool at the start of the year rather than the average over the year.

This methodology is slightly different to that applied by Standard & Poor's Global Fixed Income Research (GFIR). GFIR tracks corporate defaults, including financial institutions and insurance companies, but only for rated entities (not credit estimates).

STANDARD & POOR'S DEFINITION OF DEFAULT

For rated companies, we record a default when a company fails to make a scheduled payment of principal or interest on any financial obligation, files for bankruptcy, or completes the restructuring of a financial obligation involving what we consider to be a distressed exchange offer. We recognize defaults on the date that we assign a 'D' (Default) or 'SD' (Selective Default) classification to a company.

For companies with a private credit estimate where a coupon or principal payment is not paid on time we then consider that default occurs on that date.

However, in the case of a debt restructuring, we recognize that a default has occurred either on the date a restructuring plan is implemented (if payments remain current) or on the date of the first missed payment, whichever occurs first.

Due to the time lag involved in receiving information relating to restructurings for private unrated companies, or to companies that defaulted after their ratings were withdrawn, it is not uncommon to revise default rates over time.

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[2] See 'Leveraged Finance:2014 European Empirical And Recovery Rating Performance Update Shows Continued Strong First-Lien Recoveries' (May 20, 2015 on Global Credit Portal)

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