European High Yield:

The Issuers Mix is Changing!

Following the recent downgrade of significant Brazilian and Russian issuers, the weight of emerging market credits has grown in widely used European High Yield indices. We believe this poses important considerations for investors.

The European High Yield market may not be old, but it has certainly had an exciting life.

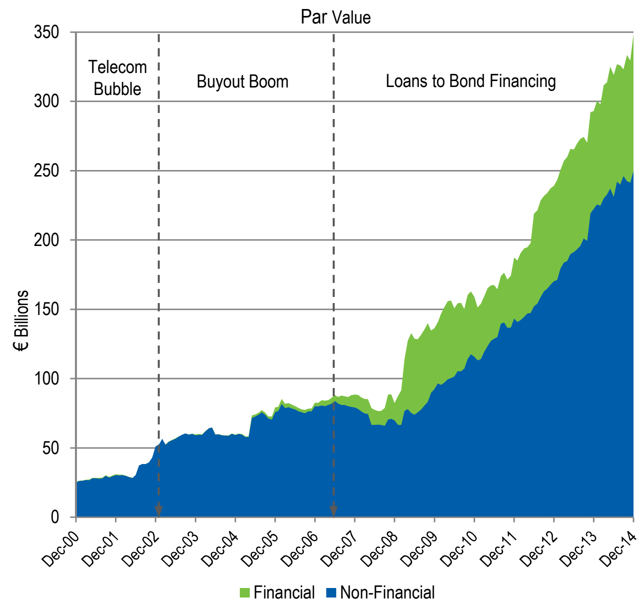
It was born in the telecom bubble in the late 1990s. The first few years of growth ended badly as the telecom sector became overleveraged in an environment of intense competition, leading many companies to default on their debt.

The years following were spent emulating the US leveraged buy-out boom when the European High Yield market grew in size from €52.7 billion as of March 2003, to €84.1 billion four years later. This was driven, as in the US, by private equity companies using leverage to undertake acquisitions during the boom years prior to 2007. It came to end when the global financial crisis caused the new issue market to close for a while in 2008.

Since then, the market's vigorous youth during the last seven years or so has been characterised by extraordinary growth as a result of European corporations refinancing bank debt in the capital markets. In the four years following 2008, the ex-financials market grew by €100 billion reaching a size of €170 billion in 2012.

In the past two years, Financials added another €100 billion to the size of the market, although given that subordinated bonds issued by financial sector companies, predominantly banks, are very different in nature to that issued by corporates, managers often exclude the financial sector from their benchmark.

Evolution of the European High Yield market



As of 31 December 2014
Source: BofA Merrill Lynch
Benchmark: BofA Merrill Lynch European Currency High Yield Index, BofA Merrill Lynch European Currency Non-Financial High Yield 2%, Constrained Index (HPIC EUR Hedged)

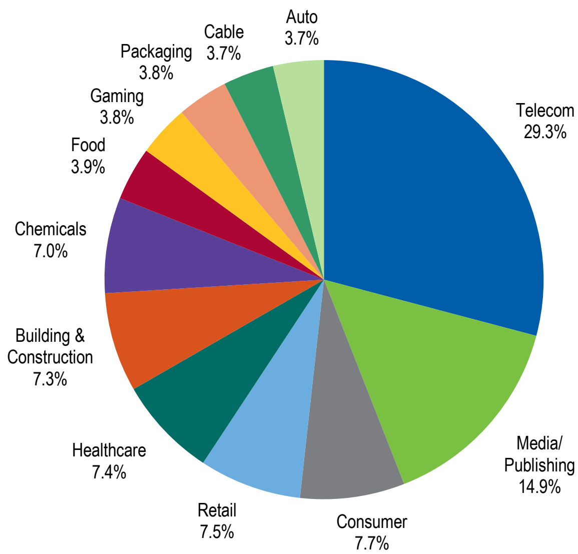
Along with growth of the market, came another transformation. In less than two decades, the European High Yield market has grown from a small, highly focussed asset class with a market capitalisation of €5.2 billion at the end of 1998, when the top 3 sectors accounted for 52% of market cap, to a much more diversified market approaching €250 billion in size at the end of 2014, with the top 3 sectors accounting for just 32%.

Stone Harbor Investment Partners

Industry diversification has increased signficantly

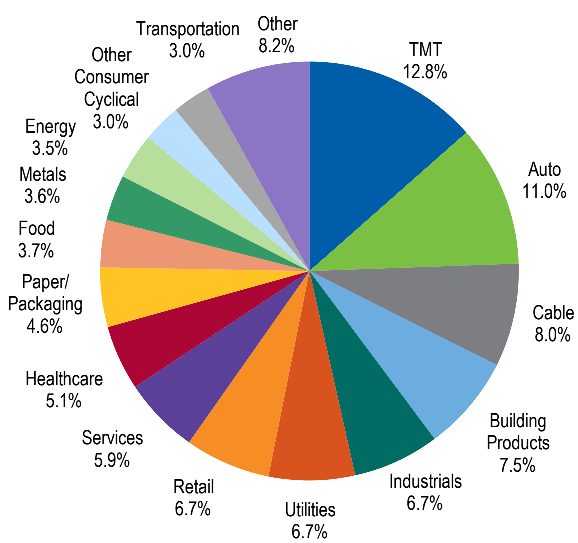
December 1998

- *Size: €5.2 bn*
- *# of issuers: 28*
- *Top 3 Industries, 52% of Market Value*



December 2014

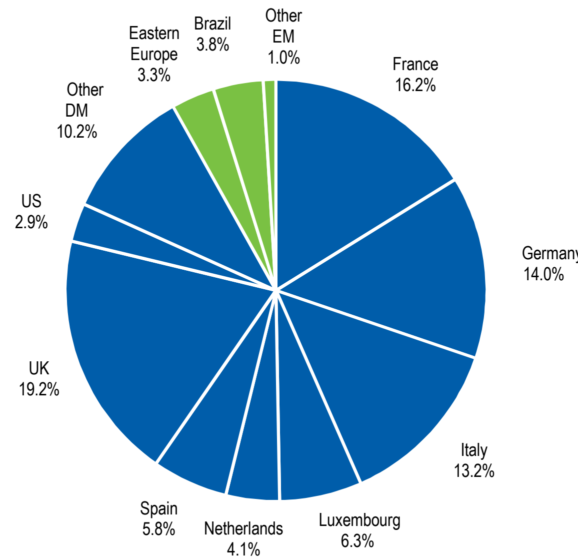
- *Size: €249.8 bn*
- *# of issuers: 297*
- *Top 3 Industries, 32% of Market Value*



As of 31 December 2014
Source: BofA Merrill Lynch
Benchmark: BofA Merrill Lynch European Currency Non-Financial High Yield 2%, Constrained Index (EUR Hedged)
Other includes: Technology, Finance, Consumer product and Textile.

Geographically the asset class has diversified as well. Back in 2010, 75% of the universe was represented by issuers from the UK, the US and the Netherlands; 60% from just the UK and the US. Today, it is more evenly represented by issuers from a host of European countries including France, Germany, Italy and the UK.

Country breakdown of issuers as of 2 March 2015



As of 2 March 2015
Source: BofA Merrill Lynch
Other Developed Markets (DM) includes Australia, Austria, Belgium, Canada, Denmark, Finland, Greece, Ireland, Japan, Norway, Portugal, Slovenia, Sweden and Switzerland.
Other Emerging Markets (EM) includes India, Mexico, and South Africa

A more recent transformation worth highlighting is the increasing presence of issuers from emerging markets. Historically, issuers from emerging markets have comprised no more than 5% of the European High Yield universe, with most issuers from Eastern European countries such as Poland, Czech Republic and Hungary. Since last year, and with the recent downgrade of Brazil state oil company Petrobras, this figure has risen to 8% and we expect it to rise further to 11% with the downgrade of Russian corporates such as Gazprom.

With borrowing costs in Euros currently at historic lows, there is great demand by institutional and retail investors for assets that can yield higher than the essentially zero and even negative rates of European government bonds. As a result, we believe overall growth in the European High Yield market is set to continue.

Investors should be aware of the growing exposure to emerging markets credits. Managers, particularly those who are benchmarked against the widely used BofA Merrill Lynch European High Yield indices, will be taking an active bet against benchmark weightings if they keep their emerging markets exposure below the expected 11%.

European High Yield market today

	Par Value	Duration	YTW	OAS
High Yield ex Financials (HPIC)	$270bn	3.40	4.00%	377
BB	60%	3.91	2.75%	254
B	35%	2.97	5.35%	525
CCC	5%	2.21	8.99%	900

Issuers in European High Yield ex Financials	
Number of Issuers	305
Top 10 Issuers (by MV)	20%
Top 25 issuers (by MV)	41%
Emerging Markets Issuers[1]	11%

As of 2 March 2015
Source: BofA Merrill Lynch
[1] Estimated with Gazprom, Gazprom Neft and Russian Railways entering index at 31 March 2015

These increased emerging markets exposures have some important implications for investors to consider, in our view. Firstly investors will want to assess their overall exposure to emerging markets credits if they also have separate emerging markets corporate debt mandates. Secondly, emerging markets corporate credits represent a different type of credit risk to developed market corporate credits. For investors who only want to have exposure to developed market credits in their European High Yield portfolios, it will be important to engage with their managers and consider different benchmarks or more bespoke portfolios.

Endnotes

The BofA Merrill Lynch European Currency Non-Financial High Yield 2% Constrained Index (HPIC) contains all non-Financial securities in The BofA Merrill Lynch European Currency High Yield Index but caps issuer exposure at 2%. Index constituents are capitalization-weighted, based on their current amount outstanding, provided the total allocation to an individual issuer does not exceed 2%.

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