Previously published in the European Credit Alpha
25 October 2019

Default risk: the party keeps going, for now

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Default rates continue to be low for European HY corporates: the trailing 12m rate for HY bonds is 1.1% and zero for loans. Given the low maturity wall ahead, ongoing relatively easy credit conditions but a slight increase in the number of bonds trading in distress, we estimate the default rate for HY bonds will increase but remain low at 2.5-3.5% in 2020. Similarly, given the maturity wall is even lower for loans, we expect a default rate of 1-2% next year. We caution that risks are to the downside, however, given deteriorating growth globally, but particularly in the euro area.

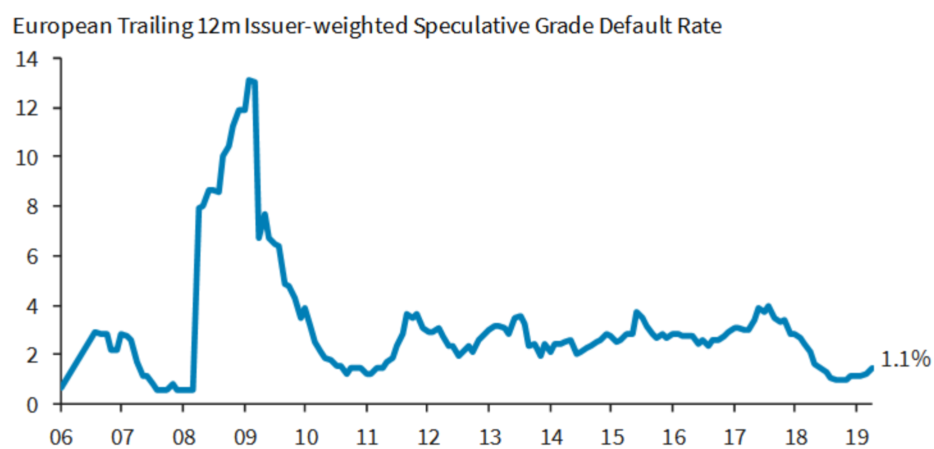
2019 HY default backdrop

Only eight bonds have defaulted YTD (Figure 2), compared to 12 YTD this time last year. At just 1.1%, the trailing 12m default rate for European HY is at the lowest level observed since 2008, despite the deterioration in growth globally, but particularly in the euro area (*Time to play defense*, 26 September 2019).

We think this is in part due to the low maturity wall of €29.5bn for Pan-Europe HY (€19.3bn excluding financials) in 2019 (Figure 3).This was on the lower end of the range since late-2013 on a 12m forward-looking basis. In addition, coupon rates, which averaged 4.5% this year, are at historical lows (Figure 4), while low yields which have supported the rally we saw in credit spreads this year has also meant that the refinancing rate has been attractive to issuers for most of this year.

While corporate macro leverage is rising in France and Germany (see *Rising Stars and Fallen Angels*, 18 October 2019), we note that new issue leverage for European HY, albeit still high at 5.0x is not rising (Figure 5). As Figure 6 shows, bonds rated as in distress (CAA1 and below) has risen from 6% this time last year to 9% currently as more bonds have been downgraded this year (*Fundamental Matters*, 20 September 2019). Indeed, the rate of bonds trading at distressed level (cash price < 70) has risen from c.1.5% this time last year to about 3.3% currently (PE HY ex-fin).

FIGURE 1
12m trailing default rate in European HY is the lowest since 2008



Source: Moody's, Barclays Research

FIGURE 2

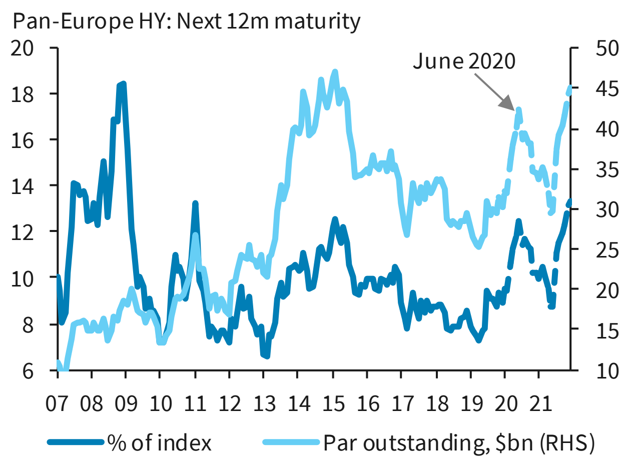
S&P's YTD 2019 European bond defaults list – only two names were trading at distress level this time last year (New Look & Galapagos)

Date	Ticker	Parent company	Subsector	Country	Reason
31/01/2019	NEWLOK	New Look Retail Group Ltd.	Retail/restaurants	U.K.	Distressed exchange
21/02/2019	NOVASP	Novasep Holding S.A.S.	Health care	France	Distressed exchange
20/03/2019	NYRBB	Nyrstar N.V.	Metals, mining, and steel	Belgium	Missed interest payments
04/04/2019	DEBLN	Debenhams PLC	Retail/restaurants	U.K.	Distressed exchange
02/05/2019	SENGR	Senvion Holding GmbH (Suzlon Energy Ltd.)	Capital goods	Germany	Missed interest payments
21/06/2019	GALAPG	Galapagos Holding S.A.	Capital goods	Luxembourg	Missed interest payments
02/07/2019	WFT	Weatherford International PLC	Oil and gas	Ireland	Chapter 11
24/09/2019	TCGLN	Thomas Cook Group PLC	Media and entertainment	U.K.	Chapter 15

Source: S&P, Barclays Research

FIGURE 3

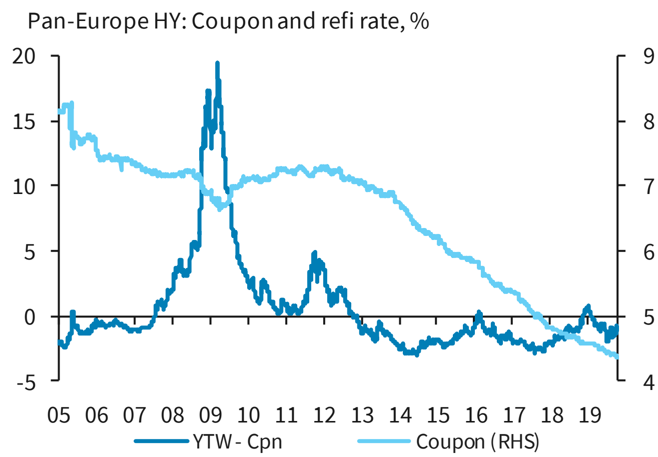
12m forward maturity wall, to peak at 12.5% of index in 2020, currently at c.9%



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 4

Coupon rate is at historical lows while the refinancing rate has been attractive most of this year



Source: Bloomberg Barclays Indices, Barclays Research

2020 HY bond default forecast: 2.5-3.5%

Top-down forecast

In this report, we model the historical 12-month trailing default rates using a multi-linear regression on a number of macro indicators that have previously been significant in explaining the development of default rates historically, to see what current indicators are telling us.

Top-down HY bond default model – nuts and bolts

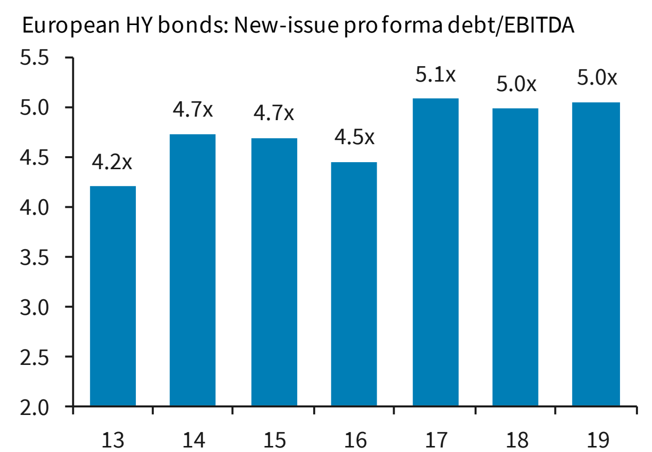
This framework model uses three key factors to forecast the 12-month issuer-weighted default rate since 2006:

- The ECB's bank lending survey (Figure 8), which shows the net percentage of business respondents reporting tighter (looser) lending conditions as a positive (negative) number. This measure captures the difficulty (or ease) with which borrowers can access financing from banks. We find the best fit for this factor when we apply a time lag of 12 months: historically, it has taken about one year from the tightening of lending standards before defaults occurs.
- The percentage of the Bloomberg Barclays Pan European High Yield Index (excl. Financials) that the market currently views as at risk of default: we define this as bonds trading with a cash price below 70 (Figure 9). We apply a time lag of six months to this factor, which reflects the average time it takes for an issuer to migrate from stress to outright default.
- Maturity wall, here we use the 12m forward maturity wall for Pan-Europe HY bonds (Figure 3), using the historical constituents of the Bloomberg Barclays PE HY bonds that have not matured, been called or upgraded as a Rising Star that would be due in the next 12 month. The higher this rate is (as a % of the market size), the higher the default rate is likely to be. Historically, this has also fitted best with a 12m lag.

This model provides an appealing fit, with the three explanatory variables capable of explaining 77% of the variation in default rates.

FIGURE 5

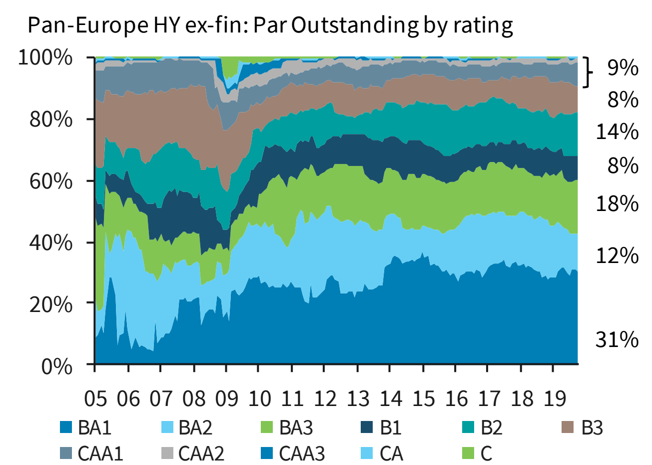
Leverage is relatively high but not increasing



Source: S&P LCD, Barclays Research

FIGURE 6

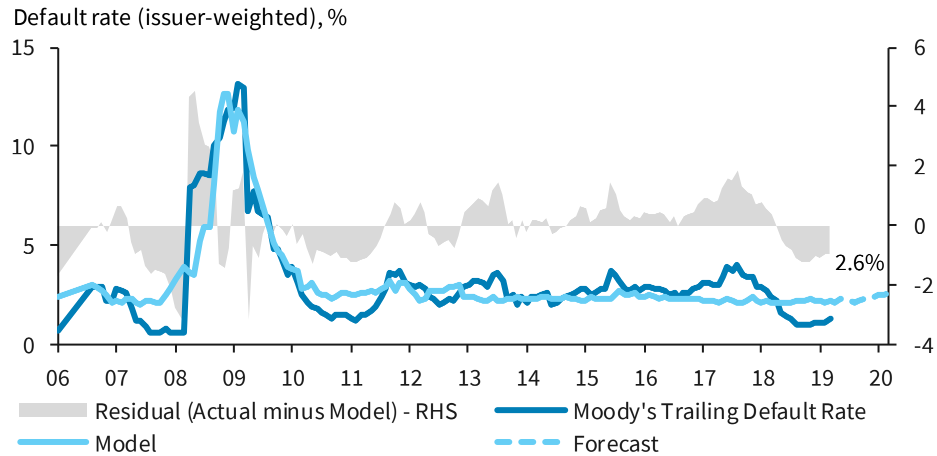
Distress rated bonds (CAA1 & below) has risen from 6% of the index this time last year to 9% currently



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 7

Pan-Europe HY ex-fin: Model implied forecast: 2.6%



Source: Bloomberg Barclays Indices, Moody's, ECB, Bloomberg, Barclays Research

This year, given the current levels of the three variables, the model estimates a default rate of 2.6% in the next 12 months. We also note that the 12m forward-looking maturity wall looks highest around June next year, when almost €30bn of non-fin HY bonds (€42bn including fins) come due in a 12-month horizon. All else being equal, with a maturity wall of that magnitude, the model estimates a default rate of 3.0%. Assuming a highly unlikely scenario that all the non-fin bonds due next year are unable to refinance, the default rate would be 6.3%.

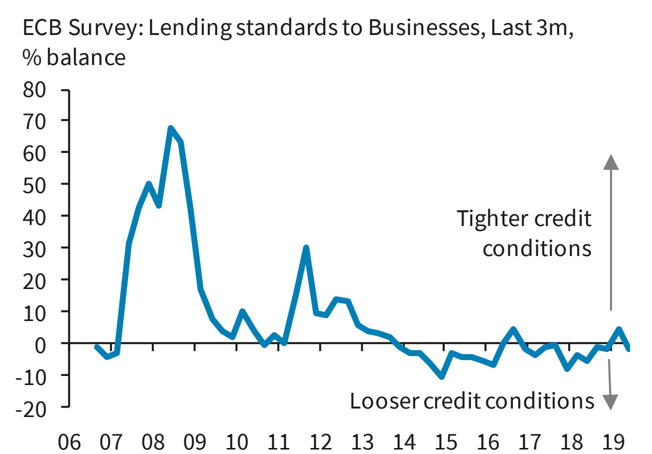
Bottom-up forecast

Complementing the top-down forecast, we tally the bonds in the PE HY index that currently trade below 70 in price terms. If we assume all these names will default in 2020, as a percentage of the size of the PE HY ex-fin index, this would imply a default rate of 3.2%.

Tying those two observations together, and given the deteriorating macro growth outlook and corporate earnings next year, we bias our estimates up slightly to **forecast a default rate for Pan-European HY non-fin corporates of about 2.5-3.5% next year.**

FIGURE 8

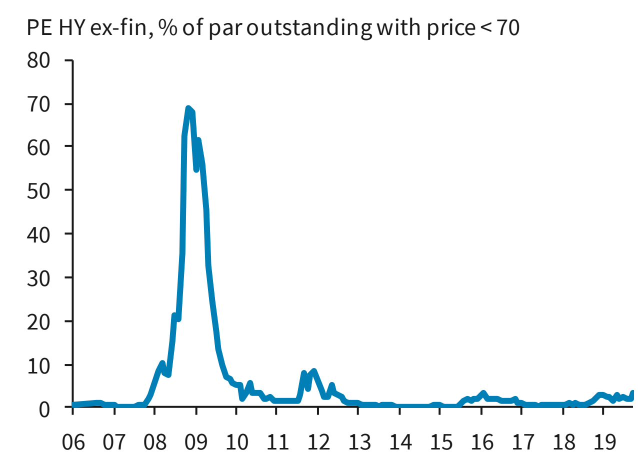
Lending standards are still relatively loose



Source: ECB, Bloomberg, Barclays Research

FIGURE 9

% of distressed bonds is not elevated compared to history



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 10

Issuers with bonds where cash price is less than 70: almost twice the number of bonds than this time last year

				Cash price <70			Total oustanding in PE HY index		
Sector	**Ticker**	**Issuer Name**	**Country**	**Average Price**	**# of bonds**	**Par Amount, $mn**	**Average Price**	**# of bonds**	**Par Amount, $mn**
Basic Industry	LECTA	LECTA SA	Spain	41.0	1	418	41.0	1	418
	STLNSW	SCHMOLZ+BICKEN LX FIN SA	Switzerland	68.0	1	390	68.0	1	390
	VKFP	VALLOUREC SA	France	67.8	1	557	79.3	3	1,615
Capital Goods	ALDESA	ALDESA FINANCIAL SERVCS	Spain	41.6	1	278	41.6	1	278
	KPERST	KLEOPATRA HOLDINGS 1 SCA	LU	55.7	1	503	55.7	1	503
	OFFMAC	OFFICINE MACCAFERRI SPA	Italy	57.7	1	212	57.7	1	212
	OHLSM	OBRASCON HUARTE LAIN SA	Spain	68.5	2	660	68.5	2	660
	PROGST	PRO-GEST SPA	Italy	49.2	1	278	49.2	1	278
Consumer Cyclical	ATALIA	LA FINAC ATALIAN SA	France	69.5	3	1,376	69.5	3	1,376
	HEMABV	HEMA BONDCO II BV	Netherlands	44.0	1	167	44.0	1	167
	INLOTG	INTRALOT CAPITAL LUX	GR	53.0	1	557	61.5	2	835
	PIZEXP	PIZZAEXPRESS FINANCING 1	UK	16.9	1	258	51.8	2	858
Consumer Non-Cyclical	BOPRLN	BOPARAN FINANCE PLC	UK	57.5	2	760	57.5	2	760
	DIASM	DIST INTER DE ALIMENTACI	Spain	47.1	1	334	61.8	2	668
	TEREOS	TEREOS FINANCE GROUPE I	France	67.3	1	668	67.3	1	668
Transportation	CMACG	CMA CGM SA	France	69.6	1	835	75.7	3	2,367
	MOBYIT	MOBY SPA	Italy	30.4	1	334	30.4	1	334

Source: Bloomberg Barclays Indices, Barclays Research

2020 European leverage loan default forecast: 1-2%

The trailing 12m default rate in European leveraged loans has been zero since the start of this year (Figure 15). This is not surprising, as we highlighted in *The longer the part, the bigger the hangover*, 19 October 2019, our default outlook note last year, there were hardly any loans coming due in 2019. Similarly this year, there are currently just €1.2bn of loans coming due in 2020 according to data from S&P LCD (Figure 11). We also think the rate of issuance with covenant-lite documents (Figure 12) which has been increasing since 2014 and is now at a historical high (85%), has also contributed to this low default rate by raising the bar to default (though when these companies do default, the concern is that recovery value would also be lower than otherwise).

While leverage is high (Figure 13) for loans at issuance, a trend in recent years, it has not risen further this year (5.4x) and more importantly, interest cover is still healthy at 4.3.x. We note however that the rate of loans trading at distressed levels (cash price < 80) has risen from c.2% this time last year to 4% currently (Figure 14).

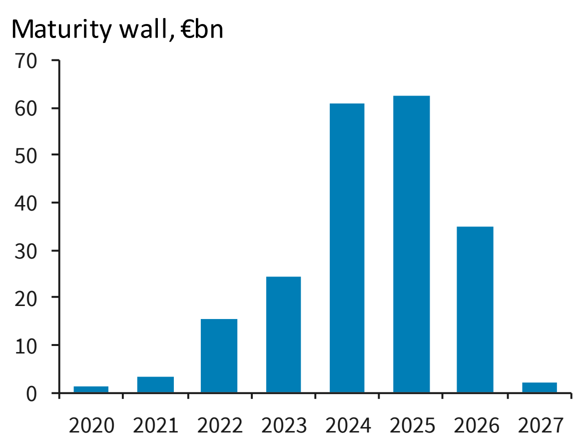
Top-down and bottom-up forecast

Similar to the HY top-down default model, here we model historical trailing 12-month default rate for loans using a multi-linear regression on a number of macro indicators that have previously been significant in explaining the development of default rates historically. We find two variables to be particularly significant, i.e. maturity wall and credit conditions (see nuts and bolts table below for more details on the model).

Based on these two indicators, our model estimates default rates for loans in Europe to be 1.5% in the next 12 months (Figure 15). Indeed, if all of the €1.2bn loans due for refinancing next year fail to be refinanced, it would equal 0.6% of S&P ELLI's par outstanding. Similarly, when we look at loans currently trading at distressed level (Figure 18), about €3bn are currently trading below a cash price of 80, while about €8.7bn are currently trading below 90 – these numbers represents 1.4% and 4.3% of the index respectively. We estimate the default rate for loans in 2020 to be about 1-2%, with upside risks being a very low maturity wall and the downside risks being the deteriorating growth environment and relatively high leverage.

FIGURE 11

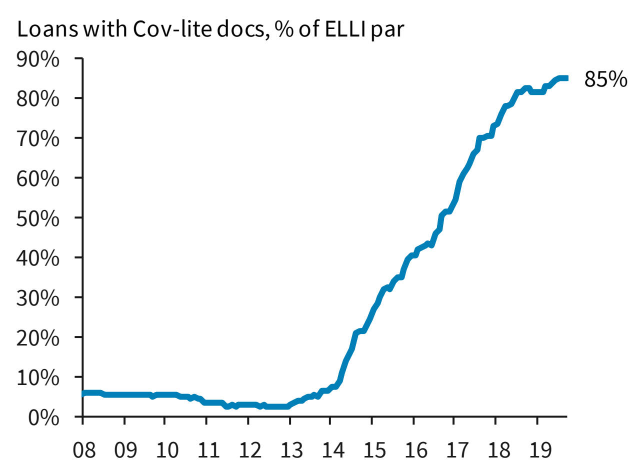
Maturity in 2020 is 0.6% of the index, and 1.5% in 2021



Source: S&P LCD, Barclays Research

FIGURE 12

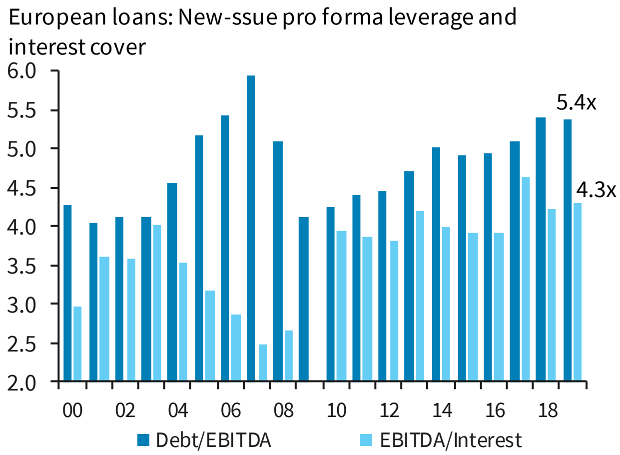
High level of cov-lite loans have likely contributed to the low default rates



Source: S&P LCD, Barclays Research

FIGURE 13

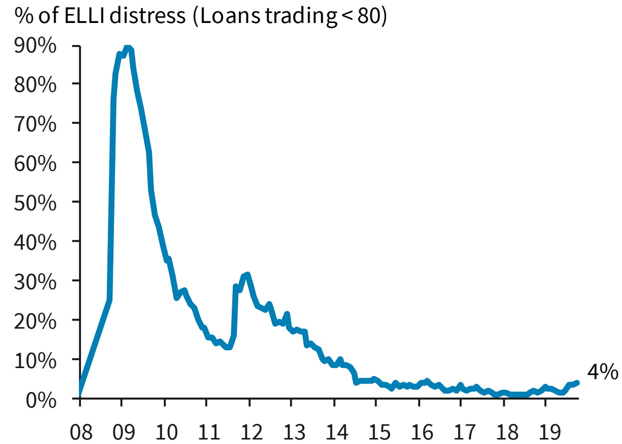
Leverage is relatively high but interest cover is at 4.3x



Source: S&P LCD, Barclays Research

FIGURE 14

Distress-trading loans is up from c. 2% to 4% in the past year



Source: S&P LCD, Barclays Research

Top-down loan default model – nuts and bolts

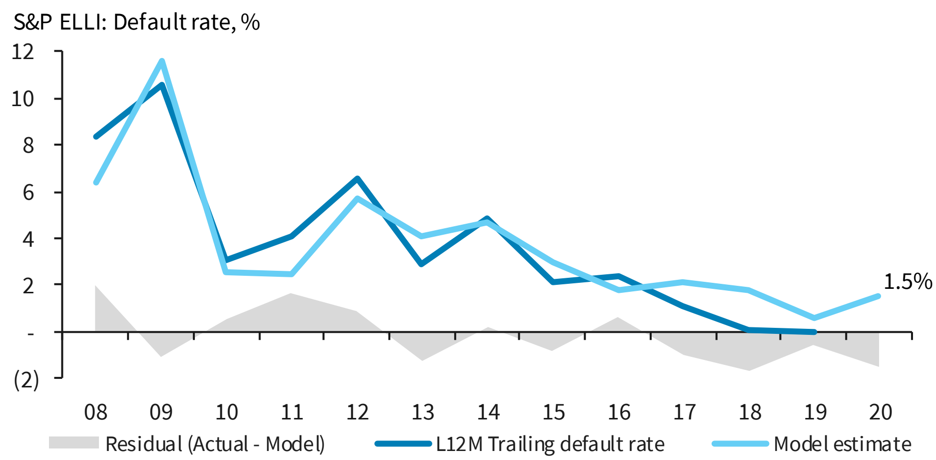
This framework model uses two key factors to forecast the 12-month default rate since 2008. As the maturity wall data for loans is not available on a monthly basis, we have modelled this using annual data where the two explanatory variables were capable of explaining 85% of the variation in loan default rates historically.

- Maturity wall, here we use the 12m forward maturity wall for S&P European Leveraged Loans Index (ELLI). Historically this fitted best with a 12m lag (Figure 16).

- The ECB's bank lending survey (Figure 17), which shows the net percentage of business respondents reporting tighter (looser) lending conditions as a positive (negative) number. This measure captures the difficulty (or ease) with which borrowers can access financing from banks. We find the best fit for this factor when we apply a time lag of 12 months: historically, it has taken about one year from the tightening of lending standards before defaults occurs.

FIGURE 15

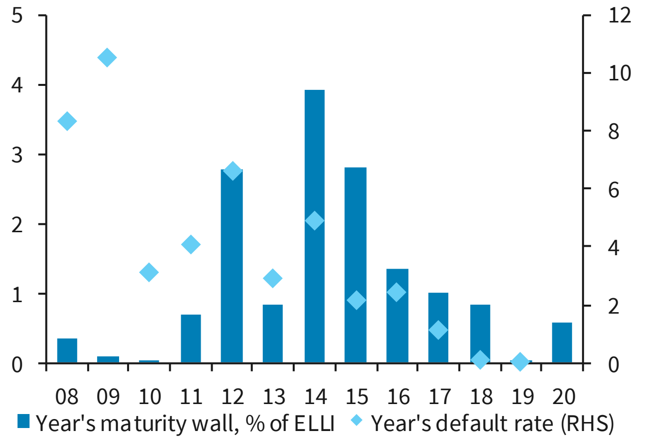
S&P European Leveraged Loan Index: Model implied forecast: 1.5%



Source: S&P LCD, ECB, Barclays Research

FIGURE 16

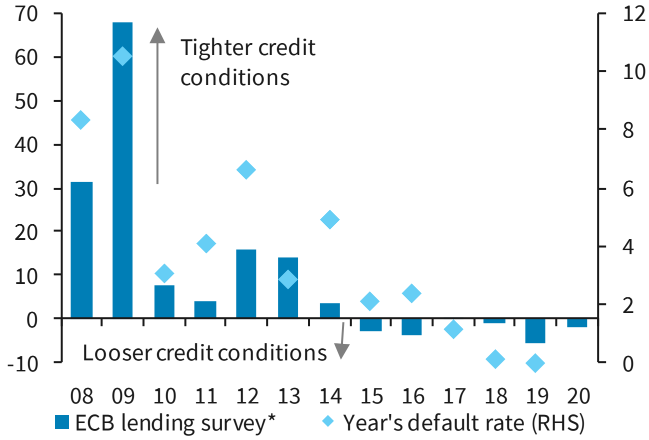
Maturities vs. default rate



Source: S&P LCD, Barclays Research

FIGURE 17

ECB lending conditions to businesses vs. default rate



Source: S&P LCD, ECB, Barclays Research *Last 3m credit conditions to business.

FIGURE 18

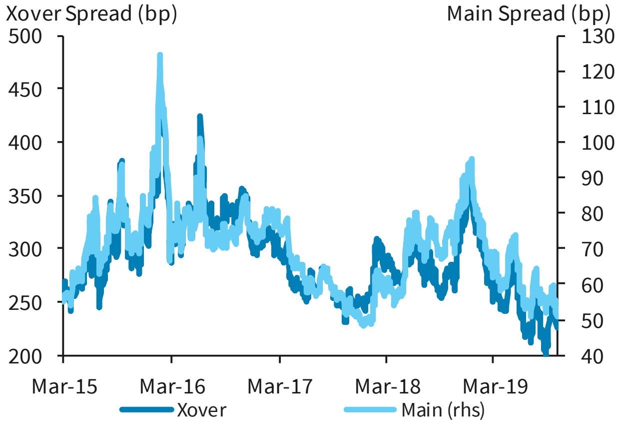
Loans with cash price < 90

Sector	Issuer Name	Security	Country	Maturity	Rating			Currency	Latest Price	Par Amount
					Fitch	Moody's	S&P			
Aerospace and Defense	**Doncasters plc**	DONCAS TL C 1L GBP	UK	09/04/2020	-	Caa3	CCC-	GBP	**68.1**	160
Automotive	**Britax Childcare Holdings**	BRITLN TL B 1L EUR	UK	15/10/2020	-	Caa3	CCC+	EUR	**87.6**	65
Building and Develop.	**Flakt Woods Group**	FLAKTW TL B 1L EUR	Switzerland	12/10/2023	-	-	-	EUR	**89.5**	300
Business Equip. & Svs.	**OGF Holdings**	VESCAP TL B 1L EUR	France	11/04/2023	-	B3	B+	EUR	**88.8**	960
Chemical/Plastics	**Flint Group**	FLINT TL B6 1L EUR	Luxembourg	09/03/2021	-	Caa1	CCC+	EUR	**89.1**	21
Packaging	**Klockner Pentaplast**	KPERST TL B 1L EUR	Luxembourg	30/06/2022	-	B3	B-	EUR	**82.7**	725
Food & Bev	**Deoleo S.A.**	SOSSM TL 2L EUR	Spain	13/06/2022	-	C	CC	EUR	**4.4**	55
		SOSSM TL B 1L EUR	Spain	30/05/2021	-	Ca	CC	EUR	**46.7**	460
	Holland & Barrett	LRHBFI TL B 1L EUR	UK	31/08/2024	-	B2	B	EUR	**64.3**	416
		LRHBFI TL B 1L GBP	UK	01/09/2024	-	B2	B	GBP	**70.6**	450
	Kalle Nalo GmbH	KALLE TL B 1L EUR	Germany	28/06/2023	-	-	-	EUR	**81.8**	145
	Prezzo	PAPBID TL B 1L GBP	UK	16/12/2021	-	-	-	GBP	**83.6**	130
Health care	**Curaeos B.V.**	CUREOS TL B 1L EUR	Netherlands	23/05/2025	-	-	-	EUR	**81.1**	268
Home furnishings	**Hilding Anders AB**	HILAND PIK-TERM B 1L EUR	Sweden	30/11/2024	-	-	-	EUR	**80.0**	500
	Keter Group	KETGRO TL B3-B 1L EUR	Israel	05/10/2023	-	Caa1	CCC+	EUR	**81.9**	89
		KETGRO TL B1 1L EUR	Israel	31/10/2023	-	Caa1	CCC+	EUR	**85.6**	690
Industrial equipment	**SGB-SMIT**	SGBSMI TL B 1L EUR	Germany	29/06/2024	-	-	-	EUR	**56.8**	360
	Survitec Ltd	SURVGB TL B 1L GBP	UK	03/01/2022	-	-	-	GBP	**71.3**	125
Leisure	**Technicolor**	TCHFP TL B 1L EUR	France	31/01/2023	-	B3	B	EUR	**87.5**	450
		TCHFP TL B 1L EUR	France	06/12/2023	-	B3	B	EUR	**89.1**	275
Retailers (non-food)	**Christ Juweliere GmbH**	CHRJEW TL B 1L EUR	Germany	25/11/2021	-	-	-	EUR	**85.6**	170
	Douglas Holding AG	DOUGR TL B1 1L EUR	Germany	13/08/2022	-	B1	B	EUR	**89.1**	348
		DOUGR TL B8 1L EUR	Germany	12/08/2022	-	B1	B	EUR	**89.6**	300
	Dummen Orange NV	DNAGRE TL B 1L EUR	Netherlands	20/05/2024	-	-	-	EUR	**69.1**	385
	Fat Face Ltd	FATFLN TL B 1L GBP	UK	25/09/2020	-	-	-	GBP	**89.4**	140
Telcommunications	**GTT Communications Inc**	GTT TL B 1L EUR	US	25/04/2025	BB-	B2	B-	EUR	**82.3**	741

Source: S&P LCD, Bloomberg, Barclays Research

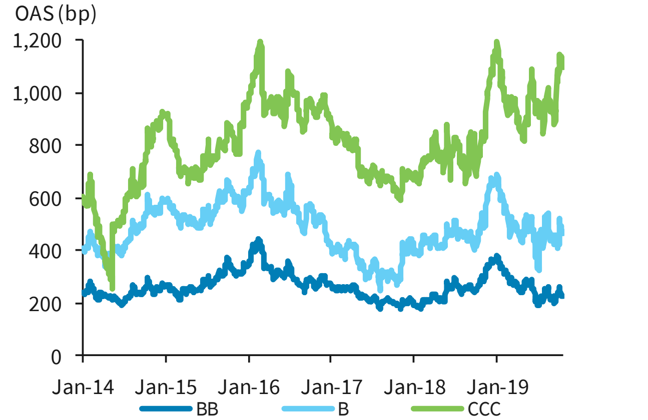
HY credit at a glance

FIGURE 19
iTraxx Crossover vs. iTraxx Main



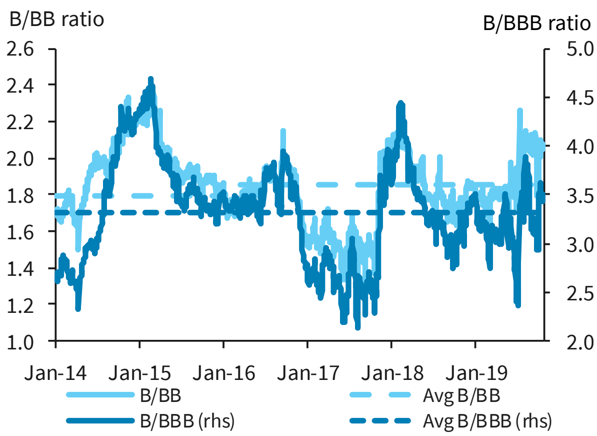
Please click *here* to see on Barclays Live.
Source: Markit, Barclays Research

FIGURE 20
Pan-Europe HY (ex-financials) spread by rating



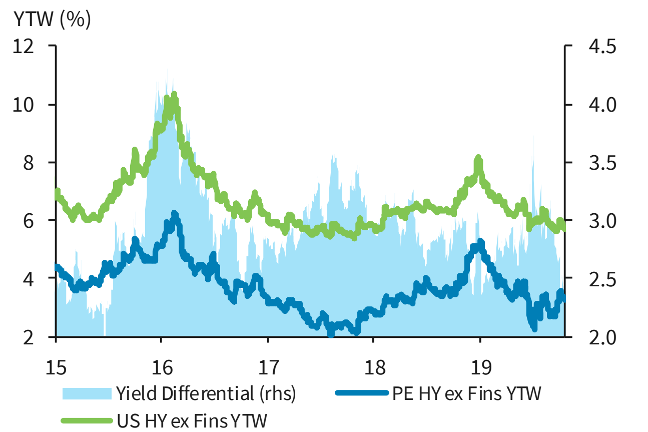
Please click *here* to see on Barclays Live
Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 21
Pan-Europe HY (ex-financials): B vs. BB and BBB ratios



Please click *here* to see on Barclays Live
Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 22
Pan-Europe HY vs. US HY (ex-financials for both)



Please click *here* to see on Barclays Live.
Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 23
European HY issuance

Issuers:	All firms, in any European currency		European firms
Market:	Pan-European High Yield		US High Yield
Crncy:	€	£, CHF, other	$
WTD	0.8	0.0	0.8
MTD	3.5	0.0	1.9
FY '19	46.2	4.0	9.5
YoY	-10%	-3%	+0%
YTD '18	51.6	4.1	9.5

Source: S&P LCD, Bloomberg, Barclays Research Note: Supply in billion.

FIGURE 24
European HY issuance monthly trends

Issuers:	All firms, in any European currency				European firms	
Market:	Pan-European High Yield				US High Yield	
Crncy:	€		£, CHF, other		$	
Year:	2018	2019	2018	2019	2018	2019
Jan	4.6	2.8	1.6	0.2	0.7	
Feb	3.8	2.7	0.1	0.1	0.7	
Mar	8.8	4.8	0.6		2.4	
Apr	8.4	8.1	0.3	0.9	1.4	
May	3.6	6.6	0.3	0.7	0.8	3.1
Jun	6.5	2.1		1.0	0.8	0.5
Jul	4.8	7.0		0.5	1.5	2.4
Aug	1.3	0.9				0.5
Sep	7.9	7.8	1.3	0.6	0.6	1.0
Oct	3.2	3.5	0.3		0.4	1.9
Nov	1.7					
Dec						
Total	**54.5**	**46.2**	**4.4**	**4.0**	**9.5**	**9.5**

Source: S&P LCD, Bloomberg, Barclays Research Note: Supply in billion.

Analyst Certification

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be less than the six-month total return of the relevant index.

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Market Weight (MW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be in line with the six-month expected excess return of the relevant sector.
Underweight (UW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be less than the six-month expected excess return of the relevant sector.
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