

High Yield Talking Points

Defaults and fundamentals

European high yield default activity picked up over the course of 2018, and has carried over into this year. At the end of June, the 12m trailing notional-weighted **default rate stood at 1.8%, far greater than 0.6% a year earlier**, but slightly below the rate from May of 1.9% (Figure 1).

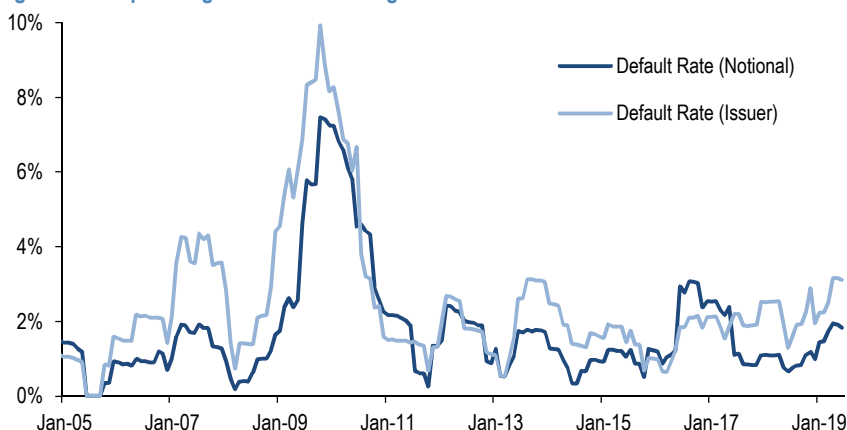
Over the past year, 10 issuers with €5.5bn notional of euro and sterling bonds defaulted within the universe we track. The latest issuer to join the list was Galapagos which missed coupons payments in June. Our data do not include unrated issuers, for example names like Rallye and Lebara.

The **issuer-weighted default rate remains somewhat higher than the par-weighted rate at 3.1%**, indicating that smaller credits have been more likely to restructure than those with larger capital structures. By this measure, the default rate is at its highest since 2010.

Recovery rates over the past year averaged 32%, close to the long-term average of 30% (Figure 2). Within this cohort, first lien bonds recovered 39% on aggregate, while unsecured bonds averaged 24%.

The **distressed ratio** – which we define as the proportion of bonds trading wide of 1000bp – **stands at 7%, slightly below the recent peak of 9%** from December (Figure 3). This is a surprisingly small decline given that index spreads have tightened 100bp in the intervening six months, and a number of distressed bonds have subsequently defaulted and left the index. We think default rates will stay close to current levels over the remainder of 2019.

Figure 1: European High Yield 12M Trailing Default Rate



Source: J.P. Morgan.

European Credit Strategy

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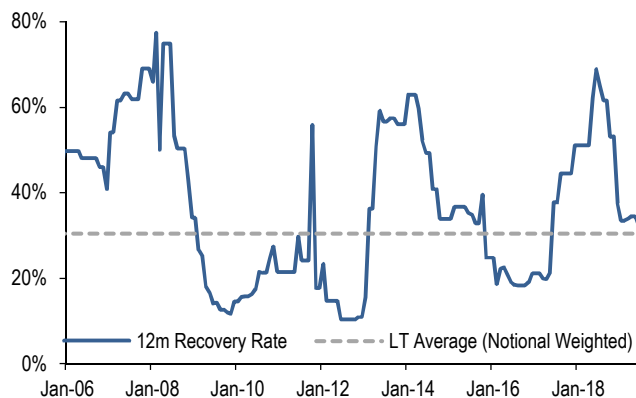
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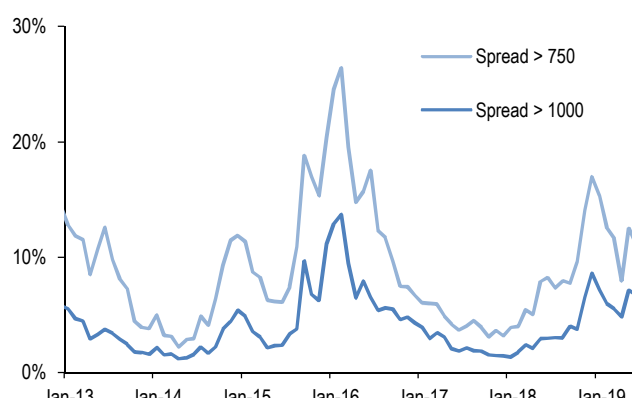
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Figure 2: Trailing 12M European High Yield Recovery Rates



Source: J.P. Morgan.

Figure 3: European High Yield Distressed Ratio



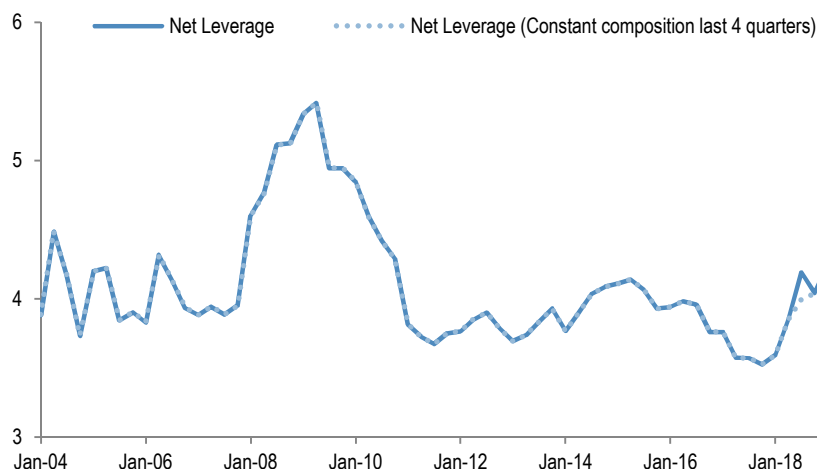
Source: J.P. Morgan.

Leverage is up, but how much is due to IFRS 16?

As we noted in our latest roundup of investment grade issuer fundamentals, the implementation of IFRS 16 has muddied the water when it comes to tracking broader trends in credit metrics. Our first cut of 1Q19 earnings in high yield shows a similar effect, namely **a large rise in net leverage, stemming from a sharp increase in reported debt**. While much of this is purely a reclassification of operating leases as financial liabilities, **we have not yet been able to disaggregate the effect of the new accounting standards on our entire issuer sample**. We present the unadjusted numbers for completeness, but warn against reaching any firm conclusions from the data.

With numbers now available from around three-quarters of issuers, **the headline figure for net leverage rose 0.4x on the quarter, to 4.6x. The four-quarter increase in leverage stands at 0.7x, or 0.5x if we hold the composition constant** (Figure 5).

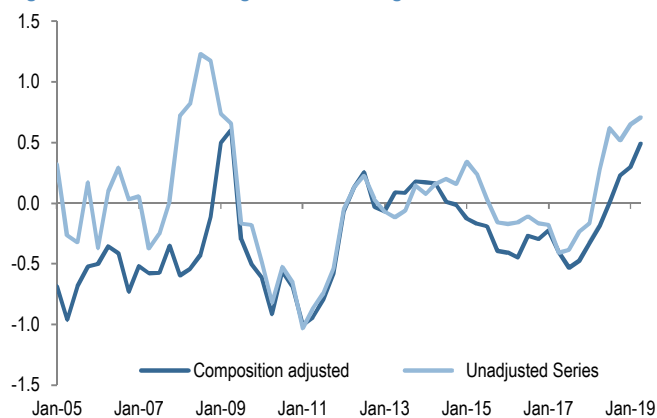
Figure 4: European High Yield Issuer Net Leverage



Source: J.P. Morgan, Bloomberg. Weighted by debt outstanding.

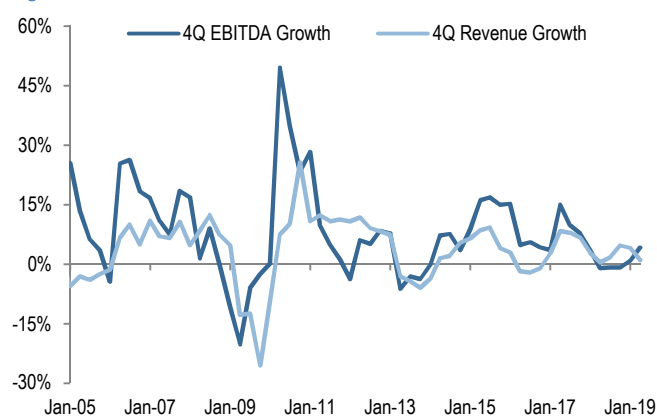
Aggregate **EBITDA across the issuer universe improved by 4%** versus the same quarter last year, a faster pace of than in the previous four quarters where y/y growth was essentially flat (Figure 6). However, as EBITDA is also impacted by IFRS 16, these figures will overstate underlying EBITDA growth, in our view.

Figure 5: 4 Quarter Change in Net Leverage



Source: J.P. Morgan, Bloomberg.

Figure 6: 4 Quarter Growth in Revenue and EBITDA

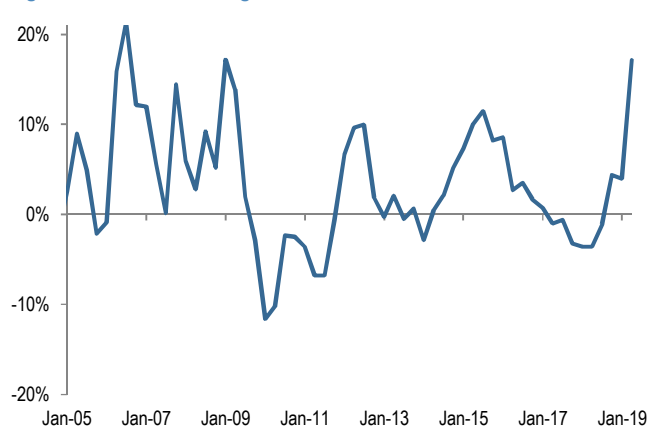


Source: J.P. Morgan, Bloomberg. Adjusted for composition change.

A more reliable indicator of performance is revenue growth, we think, since this is unaffected by recent accounting changes. First quarter revenue was only 1% above 1Q18, reflecting the slow pace of nominal growth GDP in Europe.

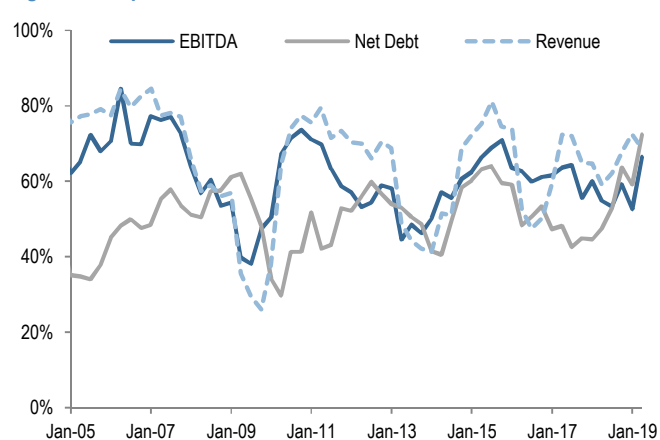
The annual growth rate of net debt rose from 4% over 2H18, to 17% in 1Q19, chiefly due to IFRS 16. Three-quarters of issuers reported an increased level of debt, with the rise particularly pronounced among Transport & Leisure and Retail.

Figure 7: 4 Quarter Change in Net Debt



Source: J.P. Morgan, Bloomberg. Adjusted for composition change.

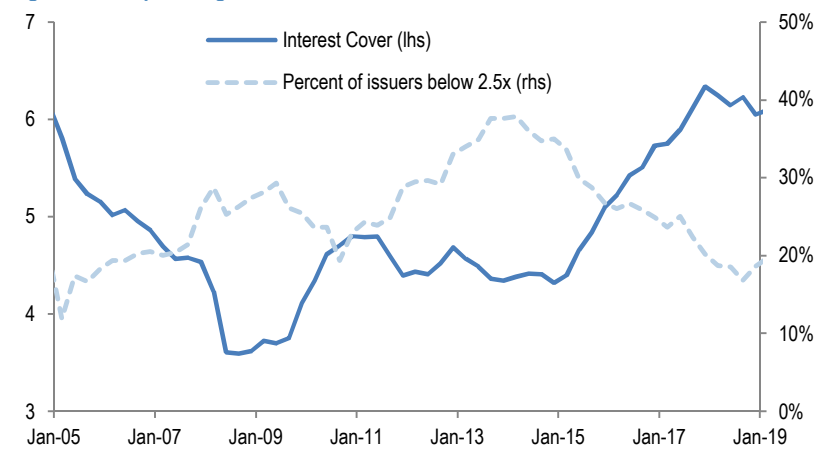
Figure 8: Proportion of Issuers with Y/Y Increase in certain Metrics



Source: J.P. Morgan, Bloomberg.

Finally, the weighted-average interest coverage ratio held broadly stable around 6x, a very healthy aggregate level (Figure 9). The proportion of issuers below 2.5x – those with less headroom when it comes to servicing debt costs – rose a touch to 20%, but remains low from a historical perspective.

Figure 9: European High Yield Issuer Interest Cover



Source: J.P. Morgan, Bloomberg.

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