RBC BlueBay
Asset Management

Stress and distress in the European mid-market: where we are today

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With an ever-changing macro backdrop, we look at the outlook for stress and defaults in the European mid-market space and what this means for investors.

The market remains optimistic that the Federal Reserve has successfully stayed ahead of the curve and engineered a soft landing for the US economy. Latest data releases indicate that the labour market continues to hold strong, despite a hiring slowdown. Current market pricing is for three more rate cuts in the US before year end. However, there is still the potential for further volatility, with the conflict in both Ukraine and the Middle East rumbling on, geopolitical risks from elections across Europe, and importantly, in the US between Trump and Harris, and weakness particularly in the German economy, to name a few.

In this paper, we look at the forces affecting speculative grade lending including:

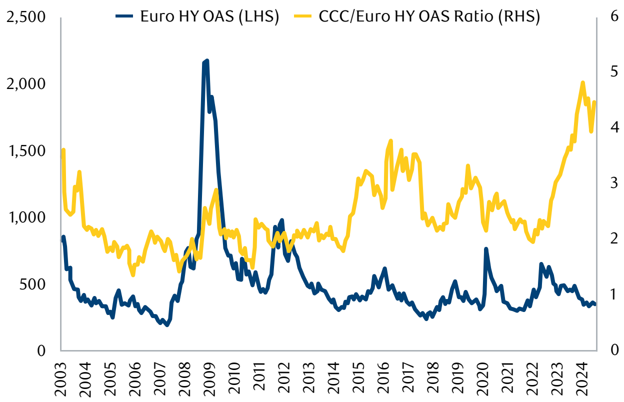
- The current borrowing environment.
- The distress environment at present.
- The picture in private credit.
- Germany – the 'sick man' of Europe.
- The timely opportunity set this offers to investors.

The current cost of borrowing

To get a sense of the environment for businesses' ability to borrow, we can look to the current cost of borrowing. Large, solvent, cashflow-rich businesses have access to markets, but others with more challenged business models are likely to find punitive rates or restrictive covenants applied.

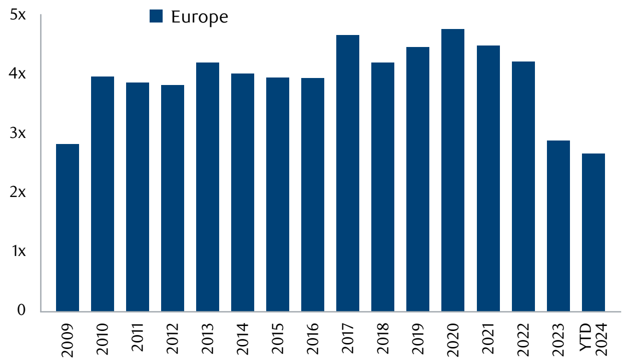
In loans and private debt, interest coverage has fallen dramatically as a direct result of increased borrowing costs, meaning the ability for companies to service their debt going forward has dramatically declined. Issuance in both loans and high yield (HY) had been reduced during 2022 and 2023. However, in 2024, borrowers have come back to markets meaningfully, as existing debts have matured, and the cost of refinancing has decreased.

Figure 1: Ratio of CCC spreads to Euro HY Index



Source: Bloomberg, as at 31 August 2024.

Figure 2: European leveraged loan interest rate coverage



Source: S&P LCD, as at 30 June 2024.

Despite this, the level of bifurcation in the Euro HY market is at all-time highs, as evidenced by the CCC ratio to the broader index (Figure 1). This means that it is almost impossible for CCC and lower-rated issuers to refinance or issue debt. Companies unable to access the public markets are having to turn to alternative sources to finance their capital needs.

A challenging backdrop creates opportunities

Despite inflation moderating across major economies, the economic picture in Europe still remains challenging. The unwinding of leverage, which will need to take place over the next few years, will create opportunities for Special Situations investors, even without a significant recession in Europe. Within Europe, the 12-month trailing default rate in high yield is 2.41%[1] and in loans is 0.78%[2]. Part of the reason for the lack of stress within markets is due to the amount of covenant lite (cov-lite) issuance in the leveraged loan universe. In prior periods of stress, companies breaching covenants meant action being taken either by banks or lenders, with the bond or loan price acting accordingly.

In today's market, almost 100% of the issuance in leveraged loans is cov-lite compared to approximately 50% in 2015[3]. This means that there is no trigger from a covenant perspective for an issuer to be under stress with regards to the loan price. It is therefore taking longer for stress to feed through the system until these troubled companies have effectively run out of cash on the balance sheet or need to refinance their debts. From a fundamentals perspective, interest rate coverage is at levels not seen since 2009 in Europe (Figure 2). Whilst pressures will abate as the rate cutting cycle continues, there still remains the issue that, in many companies and sectors, profitability and revenues have not recovered to previous peaks and are unlikely to do so. External factors, such as the potential imposition of tariffs, could significantly impact profitability further.

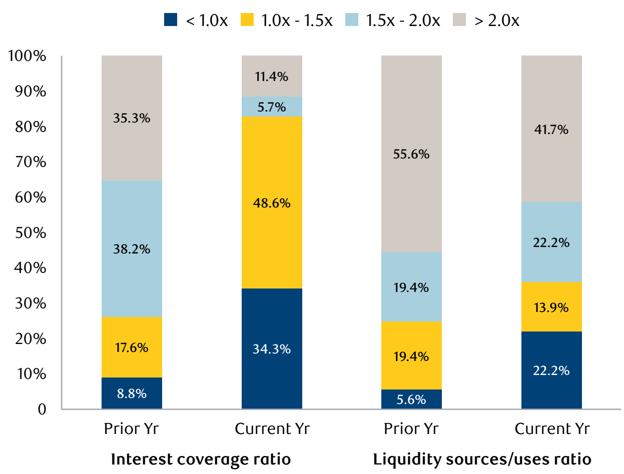
The private credit picture

Looking within the global private credit market where covenants do exist, Morningstar DBRS has reported that 9.8% of actively rated issuers were operating under covenant waivers or amendments. More importantly, the frequency of covenant relief has been rising, and with the exception of the Covid era, is at the highest level since 2016. If you consider that this does not capture the full private credit universe, our view is that the level of stress in private markets is likely much greater.

> **"Despite inflation moderating across major economies, the economic picture in Europe still remains challenging."**

When analysing the operating performance of the covenant relief/amendment group, the proportion of the group with less than 1x interest rate coverage increased to 34%, while the average liquidity ratio also declined over the same one-year period (Figure 3).

Figure 3: Credit metrics for private credit borrowers requesting relief have deteriorated



Source: Morningstar, as at 17 June 2024.

[1] JPMorgan. [2] LCD. [3] LCD as at 30 June 2024.

An interesting development within the private credit universe has been the rise of pay-in-kind (PIK) toggle provisions, which accounted for 16% of relief cases. Mentions of PIK provisions in company filings, presentations and transcripts has doubled since the start of the pandemic, according to Bloomberg (Figure 4).

PIK obligations often amount to hidden leverage for companies, as delayed interest gets tacked on to principal due. Due to lower valuations and higher borrowing costs, PIK obligations have proven particularly attractive to private equity firms. While delaying interest payments for a few quarters can ease short-term cash squeezes, extended delays make refinancing debt more difficult. This, in turn, is raising regulatory concerns.

> "Given its importance to the European economy, we are keeping a keen eye on the economic landscape in Germany in particular."

Despite the risks surrounding the use of PIK, it can be a useful tool for issuers looking to reinvest cash into growth opportunities, rather than servicing debt. Additionally, it can also increase the time for a company to negotiate terms during periods of stress rather than filing for default.

However, the rise in the use of PIK cannot be ignored and should there be a worsening in macroeconomic conditions, companies could come to a reckoning when debts are due.

Germany – the 'sick man' of Europe

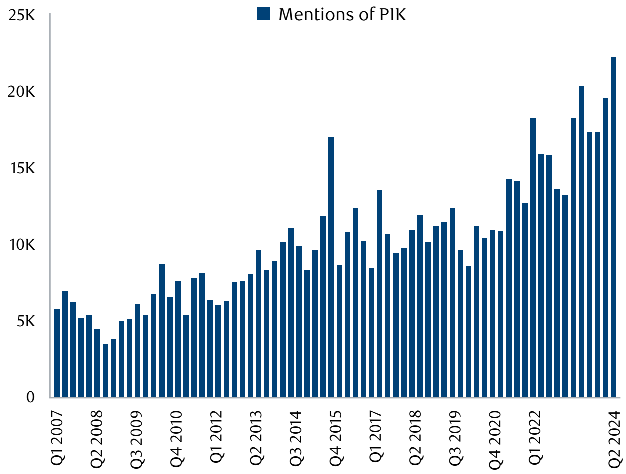
Given its importance to the European economy, we are keeping a keen eye on the economic landscape in Germany in particular. For the last 50 years, Germany has been the economic powerhouse of Europe, with a GDP of USD4.46 trillion which represents 24% of European GDP[4].

Given the country's importance, the current GDP projections are concerning, with growth of just 0.1% expected in 2024 and 1% in 2025[5]. This is significantly below Spain, France, Italy and the UK (Figure 5).

Similarly, PMI and data from the ZEW institute is bleak reading for the German economy. In terms of the most recent PMI data, the composite reading fell to 48.4 in August (Figure 6), whilst the manufacturing reading deteriorated further to 42.4.

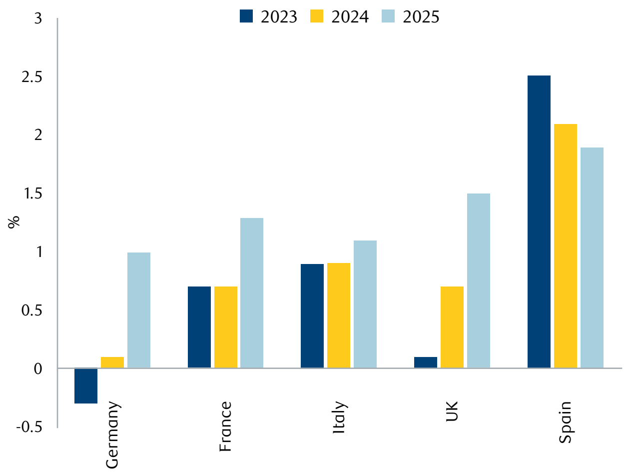
[4] Germany GDP (tradingeconomics.com).
[5] Economic forecast for Germany - European Commission (europa.eu).

Figure 4: Mentions of PIK



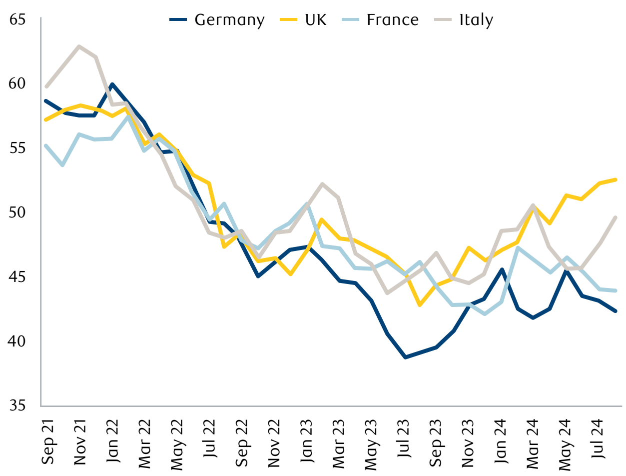
Source: Bloomberg, as at 30 June 2024.

Figure 5: Actual and forecast GDP growth



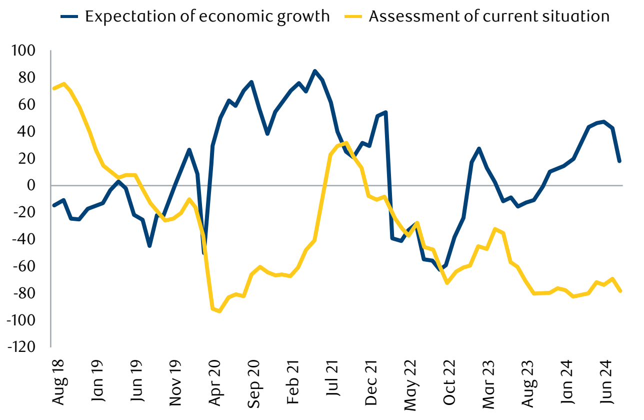
Source: IMF (UK), as at 10 September 2024. European Commission (France, Germany, Italy, Spain), as at 15 May 2024.

Figure 6: European manufacturing PMIs



Source: Bloomberg, as at 31 August 2024.

Figure 7: German ZEW economic sentiment indices



Source: Bloomberg, as at 31 August 2024.

Investor confidence fell to the lowest level since January, as the ZEW investor expectations data fell to 19.2 versus 34.0 estimated. Additionally, the current conditions index fell to -77.3 versus -74.5 estimated (Figure 7). In mid-August, ZEW President, Achim Wamback, attributed the deteriorating data to the high levels of uncertainty 'driven by ambiguous monetary policy, disappointing business data from the US economy and growing concerns over an escalation of the conflict in the Middle East'.

Specific sectors where we have seen investment opportunities and are likely to see further activity are within the automotive and manufacturing sectors. The manufacturing sector has seen contraction, with PMI data in July marking the third consecutive month of decline. Both sectors have been impacted by wage and energy inflation over the previous 24 months which has left its mark. In the last few months, even larger companies within the space have revised profit guidance downwards, citing weakness and wage inflation. With well-funded, large corporations feeling the pain of the economic climate in Germany, the pain in the mid-market is likely to be even higher.

Looking forward, there is the potential for further weakness, as new EU tariffs have been announced on Chinese electric vehicles. These could have an unintended knock-on effect on German automotive manufacturers, as well as companies within the automotive supply chain. The possibility of Trump in the White House could also add to headwinds, as he has previously stated that tariffs of 10% will be implemented across the board.

What does this mean for investors?

The challenge for borrowers is going to be exacerbated within the mid-market, as these borrowers have more limited access to capital markets and an inability to borrow if they are experiencing any stress. The rapid expansion of borrowing over a period of benign economic stress has led to a large cohort of borrowers who are now facing significant pressure. An increasing number of problematic economic conditions due to lower growth, higher inflation and higher rates is likely to lead to even more stress and distress for European issuers, particularly mid-market issuers. Data on European bankruptcies already makes for sober reading.

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Given the unwind of leverage required as a result of quantitative easing post the GFC, there is a considerable amount of opportunity for Special Situation investors. For the remainder of 2024, the possibility of volatility remains, due to geopolitical tensions and the electoral landscape in both Europe and the US. Due to the reasons outlined above, we do not think there will be a full-blown recession, but we do not need this for there to be lots of special situation opportunities, particularly in the European mid-market.

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