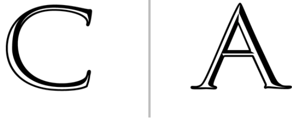

CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENT: EUROPEAN HIGH-YIELD MARKET

January 31, 2001

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European High-Yield Market

European companies have been late to embrace debt financing and, up until 1997, only the bluest of blue chips issued corporate debt. However, the economic integration on the Continent and the overall trend of deregulation and privatisation has culminated in significant structural changes taking place throughout Europe. Such changes are providing the catalyst for the development of a broad high-yield bond market.

As Table A indicates, the European high-yield bond market has grown into a €63bn universe in the space of nearly four years. Although the advent of the single currency has been the prime factor for the growth of the market, creating a huge pool of cross-border capital, supplementary factors include the surge in M&A activity and the increasing acceptance of leverage in corporate finance. Given the favourable environment, many debt analysts anticipated that the market would grow a lot faster than it has done, but non-investment grade corporations are unlikely to embrace bond financing until cheap bank lending has winged its way out of the system. According to the International Monetary Fund, European companies rely far more heavily on bank loans (72%) than they do on the capital markets (28%) as a source of finance, although evidence does suggest that Europe is slowly converging towards the U.S. route of dis-intermediation. In the States, bank loans constitute only 33% of corporate financing, whereas capital market financing accounts for 67%.

Last year was difficult for European high-yield investors as the downside risks of illiquidity and volatility, in what is essentially a new asset class, hit home. The immaturity of the market largely explains the predominance of media[1] and telecom companies (see Table B), which have an almost unquenchable thirst for capital. At present, the European high-yield market is basically a low-grade telecoms play, and until industrial deals show their head, the success of the market will continue to hinge on telecoms. When sentiment towards 'new economy' companies turned sour last year, the European high-yield market duly tanked. However, in December and January, not only did established investors return to the asset class but continental European pension funds also started to show an interest.

Unlike investment grade bonds, whose prices are very much dependent on interest rate movements, high-yield bonds tend to reflect company- or sector-specific financial conditions, since investors' primary concern is simply whether issuers can generate sufficient cash flow to service their debt. In this context it is perhaps worth noting that Standard & Poor's define a single B credit, which accounts for roughly

[1] The media sector is dominated by 'cable' companies, which some might classify as falling within the 'telecom' universe.

60% of the European high-yield universe, as a debt with "*greater vulnerability to default which currently has the capacity to meet interest and principal payments*" but "*adverse business, financial and economic conditions will likely impair capacity or willingness to pay interest and repay principal.*"

High-yield spreads in the States reached a high of nearly 11 percentage points during the 1990-91 recession, as companies that had loaded up on debt during the 1980s were unable to service their debt when revenues slowed, and default rates subsequently spiked in excess of 13% (compared to a historical average of 3.1%). However, high-yield bond investors who stuck it through were rewarded with a 39% return in 1991. Despite a hike in 1998 (Asian crisis), U.S. high-yield spreads have tended to stabilise between three and five percentage points. In Europe, however, yield spreads peaked at 12.8 percentage points in November last year (see Table C), and although the spread has fallen to 9.6 percentage points over the last two months, the market is still pricing in a 10% default rate.

The magnitude of the yield spread in Europe reflects a lot of uncertainty about a newly developing market, which has yet to witness its first significant default. In many European countries, bond creditors do not have the same priority claims as do those in the States, where the Chapter 11 laws have ensured a more transparent and straightforward bankruptcy process. The European market has yet to be tested in this respect. Secondly, there are a wide variety of accounting systems and reporting practices in Europe, which also tend to be less transparent than those required by the U.S. Generally Accepted Accounting Principles. Thirdly, the danger point for single B credits tends to be two to four years after issuance, and given the one-time surge in euro-denominated bond issuance after economic and monetary union, default rates are expected to rise from 3.0% in 2000 to 3.6% this year and then higher in subsequent years. Investors should also be focusing on recovery rates; that is, the residual value of principal remaining in the event of default. At present, estimates of prospective recovery rates in Europe are little more than educated guesses, with the consensus ranging from 25% to 37%. In comparison, the actual U.S. historical average is 41% of par value.

A final point worth noting about this nascent market is the quality of disclosure by issuing companies and their investment bankers at the time of issuance. This question has recently come to the fore as a result of the CP Kelco debacle, in which a bond issuance led by Lehman Brothers lost almost half its value within two months, triggering investor accusations of due diligence negligence against the investment bank. The case has since been resolved, but it has left investors questioning how much they can rely on due diligence undertaken by investment banks with a vested interest in selling the product at the highest possible price.

Fund managers in the sector believe that the introduction of the single currency has opened up a market with the potential to provide comparable complexity and, eventually, as much depth as the $680 billion U.S. high-yield market.[2] The realisation of such potential is very much dependent on the market's ability to mature: the most immediate phase of which is diversification beyond the telecoms sector, the concentration of which unquestionably damages the market's further development by scaring away many potential investors. Until the European high-yield market broadens in this way, we could concur in the prevailing view that it remains of interest only to opportunistic speculators rather than to long-term investors.

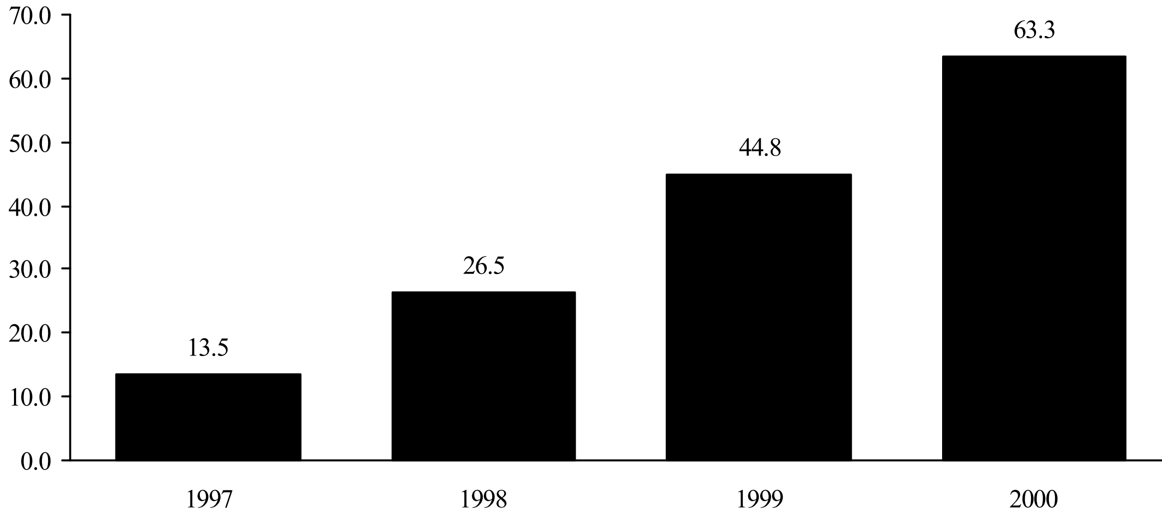
[2] Source: CSFB.

Table A

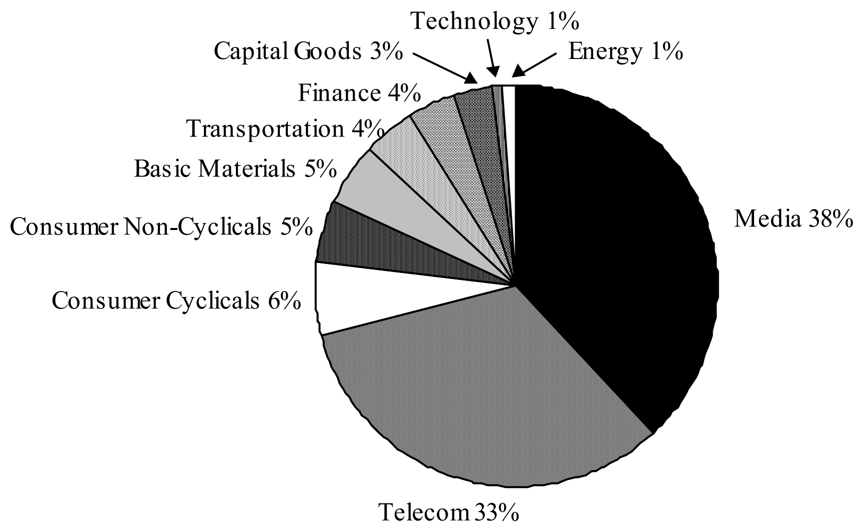
GROWTH OF THE EUROPEAN HIGH-YIELD UNIVERSE

Market Value of Total Issuance

(€ billions)



European High-Yield Universe: By Sector

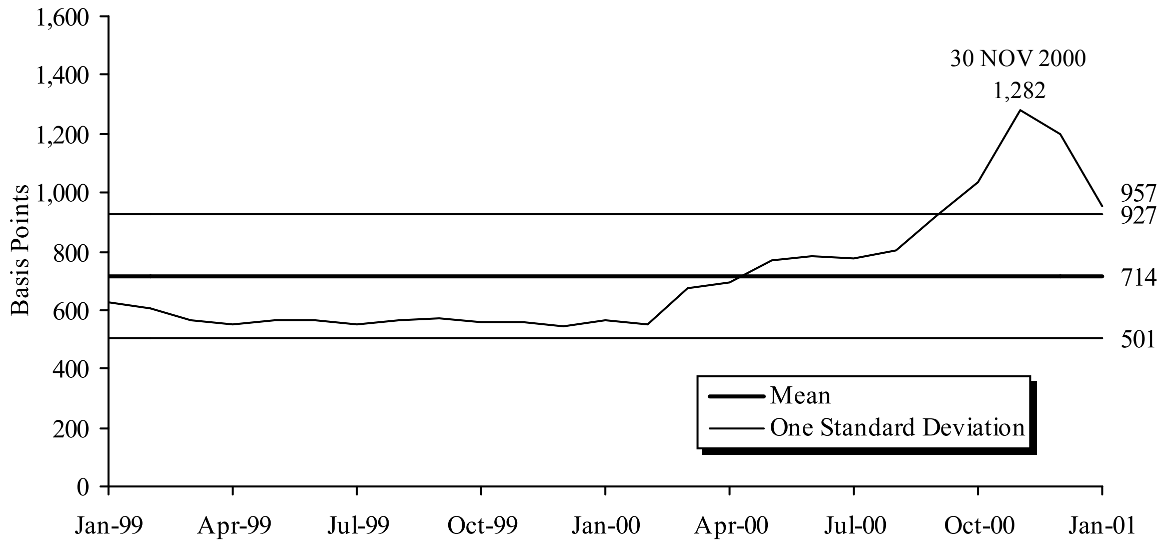


Source: New Flag Asset Management.

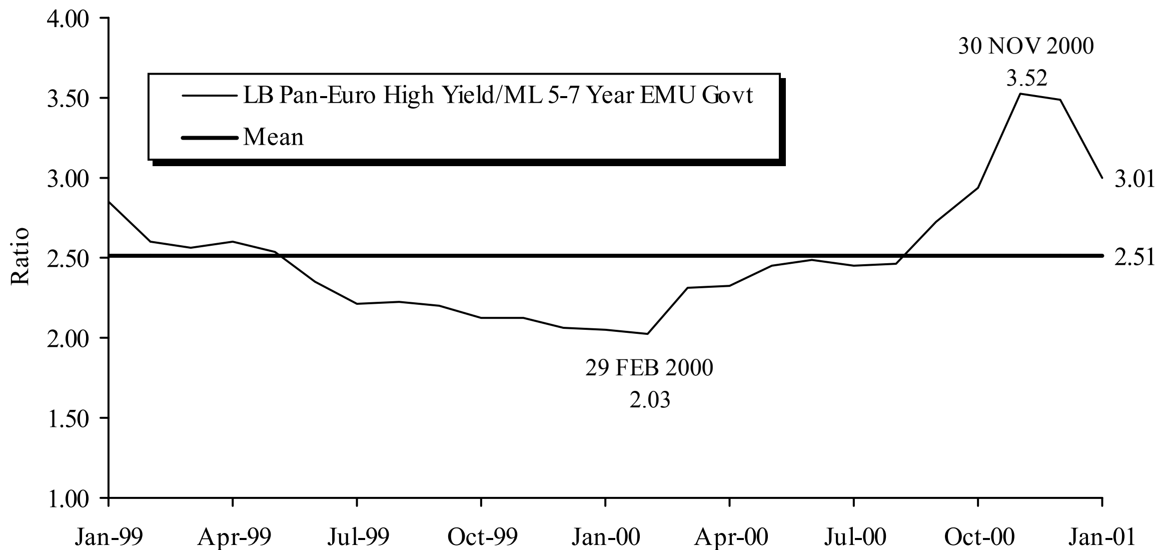
Notes: Sector weights are as of 31 December 2000. This universe comprises Europe-based non-investment grade non-financial corporate bonds issued in €, US$, and £. These bonds are based in investment-grade European countries. Also included, are certain non-investment grade companies issuing in €, US$, and £, who have substantial or a predominant portion of their assets, revenues, or operating profits in, or emanating from, Europe.

Table B

EUROPEAN HIGH-YIELD BOND SPREADS



YIELD SPREAD RATIO OF EUROPEAN HIGH-YIELD BONDS



Sources: The Bloomberg and Lehman Brothers, Inc.

Notes: Data are from 1 January 1999 through 31 January 2001. The yield spread in Table C is the difference between the Lehman Brothers Pan-European High Yield Bond Index and the Merrill Lynch EMU Direct 5-7 Year Government Bond Index. For Table D, yield ratios are based on the ratio between the weighted-average yield-to-worst (the lower of yield-to-maturity and yield-to-call) for the Lehman Brothers Pan-European High Yield Bond Index and the yield-to-maturity for the Merrill Lynch EMU Direct 5-7 Year Government Bond Index.