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German market for corporate 'Schuldschein' opens up to non-investment grade issuers

Special comment

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Germany's market for corporate 'Schuldscheindarlehen' (henceforth 'CSSD') is enjoying growing popularity among institutional investors. Issuance volumes in 2014 show a new interim record of EUR 12.1bn and a promising Q12015 comprising the largest CSSD of EUR 2.2bn issued by ZF Group. Scope expects continued growth in this market backed by: (1) investors' search for compelling yield; (2) a supportive regulatory framework; (3) a more diverse group of CSSD issuers particularly from non-investment grade rating categories; and (4) the increased usage of CSSD as a convenient refinancing instrument. This study provides Scope's view on recent trends in the CSSD segment bolstered by an indicative assessment of the credit quality of 30 unrated German, Austrian and French CSSD issuers.

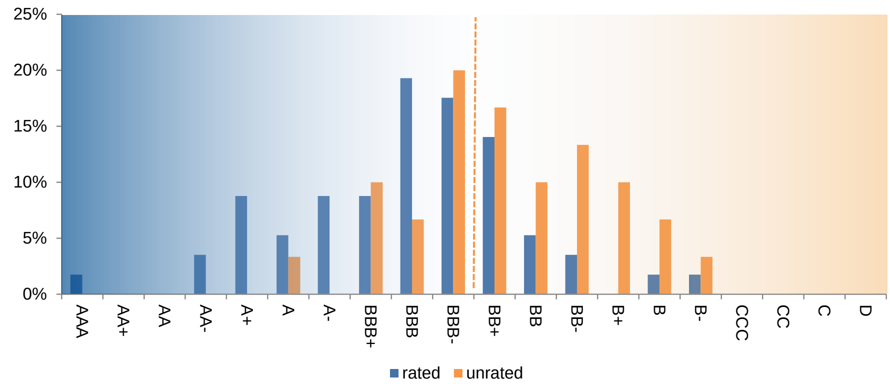
Investors increasingly open for non-investment grade investments

With placements of CSSDs usually heavily oversubscribed, Scope sees evidence the asset class is increasingly attractive to investors looking for alternatives to diversify traditional credit exposure in return for adequate yields, particularly when reinvesting funds. Given the need for reinvestment of maturing bonds, the pain threshold for investors is being continuously reduced from traditionally investment grade CSSD issuers to an increasing percentage of non-investment grade issuers. As transparency on the credit quality of CSSD issuers is limited because of the large portion of unrated issuers, investors need to be aware of what they buy and request adequately risk-adjusted spreads.

Mismatch of average credit quality between rated and unrated CSSD issuers

While less than 25% of CSSD issuers are publicly rated, 75% held an investment grade rating, with a median of BBB, at the time of issuance. Amongst the 75% non-rated and mainly mid-sized CSSD issuers, Scope found that the share of investment grade issuers was only 40%, with a median rating of BB+, based on an indicative credit assessment of 30 corporates. This indicates a share of 38% of non-investment grade issuers in the market overall. Indicated by recent market surveys, however, a minority of investors (22%) is prepared to invest in non-investment grade issuers, suggesting a potential lack of transparency on unrated issuers. Some investors might believe to buy CSSDs issued by investment grade corporates even though a thorough credit analysis might not support this. This is due to the supply-demand imbalance, and investors' need to move down the credit curve in order to achieve satisfactory yields.

Indicative credit assessments of selected - publicly unrated vs. publicly rated CSSD issuers



Source: Scope Ratings, Bloomberg, public ratings at date of CSSD issuance

Recent investment regulation for insurers, pension funds, and also debt fund managers is likely to increase the appetite for non-investment grade issuers. Enhanced transparency will become an important factor for CSSD issuers in the continued success of this market to avoid distorted risk-adjusted pricing as seen in the German bond market for small and medium issuers.

Outlook

Given the strong momentum for CSSD issues, Scope believes the market is geared to further volume growth in 2015 and 2016. This should be strongly backed by successful issues from first-time CSSD issuers exhibiting solid non-investment grade credit quality. At the lower end of the credit spectrum, comprising smaller mid-size companies, Scope expects the CSSD market to remain inaccessible in order to maintain quality levels in the segment.

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Private Placements on the Rise for German Mid-sized Corporates

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Increasing popularity of German corporate ‘Schuldscheindarlehen’

CSSDs emerge as mainstay of debt financing

Traditionally a financing instrument for governments and sub-sovereigns, the market of CSSDs[1] is attracting greater attention from two sources:

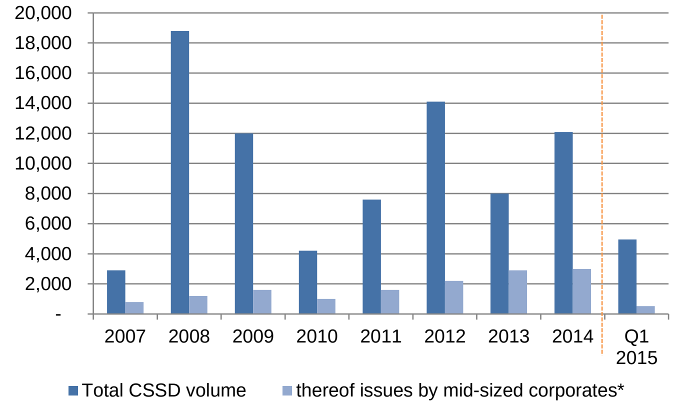
1. Potential issuers who want to diversify their debt structure;
2. Institutional investors with a buy-and-hold investment strategy.

Scope observes that the prosperity of the segment is supported increasingly by financial market regulation. Although this private placement segment of corporate debt lacks transparency by nature – in terms of issuance volumes and deal terms, such as coupons, maturities, covenants – Scope sees an impressive trend for this financing instrument which proved resilient during the financial crisis and emerged as a meaningful financing alternative to conventional bank and capital market financing for treasurers.

Healthy issuance activities

According to market data from Thomson Reuters, German CSSD market issuers – predominantly German, but also Austrian, French and other non-German corporates – have placed a volume of >EUR 12bn in 2014 with institutional investors such as savings and co-operative banks, insurers and pension funds and other institutional fixed-income investors (see figure 1). A promising start to 2015 with a record CSSD issue (EUR 2.2bn from ZF Group) has strengthened the sentiment for CSSDs and its further development.

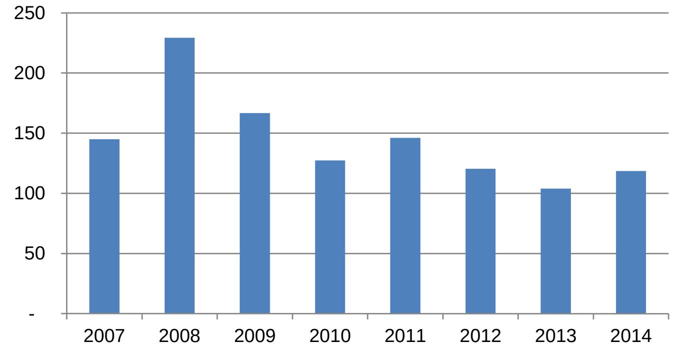
Figure 1: Solid growth trend in the CSSD market (in EURm)



* Corporates with annual turnover of <EUR 1.5bn

Source: Thomson Reuters, Scope Ratings

Figure 2: Decreasing average size of CSSDs (in EURm)



Source: Thomson Reuters, Scope Ratings

Ticket sizes range from EUR 10m to EUR 2.2bn

While the record issuance of >EUR 18bn in 2008 was a knock-on effect of uncertainties in the public bond market and restricted bank lending during the financial crisis, Scope now observes a stabilising trend in the CSSD market. The market displays great diversity with ticket sizes ranging from very small issues of EUR 10m to very large tickets of EUR 2.2bn. While large private placements from large-cap corporates such as Deutsche Lufthansa AG, Hochtief AG, Fraport AG or Porsche AG have historically dominated the segment with issues of >EUR 400m, Scope notes the issuer profile is becoming increasingly diverse with a growing volume of debt issued by mid-sized corporates. This is reflected not only in the increased share of mid-sized corporates[2] (>20% in 2014), but also the decreasing average transaction size (see figures 1+2).

Supportive regulatory framework for CSSDs

Tailwinds for CSSDs in the wake of Basel III and ECB eligibility

As an alternative to bank loans and corporate bonds, CSSDs have surged continuously on the back of regulatory tailwinds in the last years. Basel III regulations have had a generally favourable impact on CSSD issuers, as banks begin to limit their loan exposure, particularly to smaller corporates. Moreover, CSSDs have become eligible for ECB credit operations in 2007 and can therefore be used as collateral for eurosystem monetary policy operations and as underlying assets for intraday credit.

[1] Scope defines Corporate ‘Schuldscheindarlehen’ as a medium to long-term senior debt obligation (note or loan format), with a fixed or floating interest rate which is issued privately to a small group of institutional investors. The Schuldscheindarlehen usually is an unlisted and illiquid instrument for buy-to-hold investors, but nonetheless registered and transferable.

[2] In this context Scope follows Thomson Reuters‘ definition of mid-sized corporates as companies with an annual turnover of less than EUR 1.5bn.

German market for corporate 'Schuldschein' opening to non-investment grade issuers

New Investment Directive for insurers and pension funds supports direct lending through CSSD and indirect lending through debt funds

While insurers have traditionally been an important investor group in CSSDs due to favourable accounting treatment (no mark-to-market of plain vanilla CSSDs), the regulatory framework for CSSDs has become even more favourable under the amended investment regulations for insurers and pension funds (Alternative Investment Fund Managers Directive – 'Anlageverordnung und Pensionsfonds-Kapitalanlageverordnung' March 2015). The amended directive enhances the spectrum of investment opportunities for traditional fixed income investors in the current low-interest environment and urges direct lending to corporates, i.e. through a CSSD. Scope believes CSSDs could become an important part of the increasing number of debt funds, stimulating indirect lending of institutional investors to corporates.

Stimulating lending to high-yield corporates

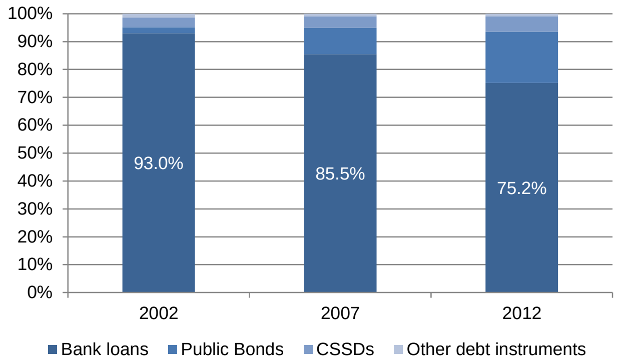
Scope notes that the amended directive opens up the possibility for direct investment in secured loans of so-called high-yield issuers, carrying non-investment grade corporate ratings. Scope believes this could stimulate future issuance of CSSDs in defensive and asset-rich sectors such as real estate and infrastructure where issuance of a CSSD could be secured through recoverable assets.

Issuers looking for alternatives to bank and public lending

Treasurers increasingly look for a diversification

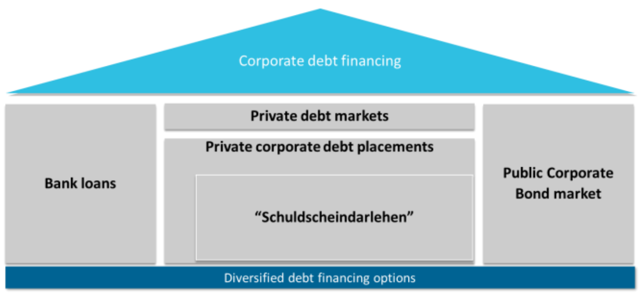
While traditional bank lending remains the dominant source of corporate debt financing (see figure 3), treasurers are increasingly arbitraging and looking beyond classic debt financing instruments. Based on experience from the financial crisis, the market is convinced that broader diversification of funds guarantees a high level of financial independence and supports a company's successful development. In the context of a supportive regulatory framework and the need for corporates to scale back their dependence on banks, CSSDs appear to be a meaningful alternative to bank loans as a supplement to traditional financing sources.

Figure 3: Sourcing of debt in corporate finance (in %)



Source: CAPMARCON, Scope Ratings

Figure 4: Private debt placements through CSSDs as an alternative financing instrument



Source: Scope Ratings

Advantages of German CSSDs

The growing recognition of CSSDs is not simply the result of supportive regulation and decreasing bank financing; it is also due to the various advantages over public corporate bonds when issuing such instruments. Most importantly the speed, efficiency, flexibility, discretion and confidentiality, as well as the light documentation and low issuing costs, make it attractive.

Appealing refinancing option

Given the long list of advantages for corporates the asset class has proven itself a valid instrument for refinancing especially in substituting bank loans. This was evident in the wake of the financial crisis in 2008/2009 (see figure 1) when refinancing via bank loans and public bonds was difficult and expensive even for large cap corporates. But the CSSD has also provided a valid refinancing opportunity in calmer times, most recently in the cases of Lonza SpA, Grammer AG or Nabaltec AG.

Issuers of almost all sizes with a growing share of mid-sized corporates

Although CSSDs are often seen as financing instruments for larger, typically investment grade-rated corporates, the German CSSD market is used by corporates of almost all sizes. From large DAX-listed corporates such as BMW AG, E.ON SE, Siemens AG, Deutsche Telekom AG, Deutsche Lufthansa AG, to mid-sized corporates with a balance sheet volume of below EUR 500m and an annual turnover of less than EUR 1bn, such as euromicron AG, All for One Steeb AG, Analytik Jena AG, First Sensor AG, Nabaltec AG, QSC AG or Biotest AG. The latter group of first-time CSSD issuers is increasingly tapping the market, providing strong stimulus for growth in the segment. A market study of 197 German corporates conducted by the German Finance Magazine[3] recently confirmed the growing popularity of CSSDs, with more than one third of those interviewed saying they would consider a first-time issuance of a CSSD.

Non-public issuers favouring the private placement with an CSSD over a public financing instrument

Moreover, Scope notes CSSDs are used strongly by non-public issuers with prominent examples Zech Group GmbH, ZF Group, Otto Bock HealthCare GmbH, Flughafen Düsseldorf GmbH, Hoyer GmbH and municipal utilities like Dortmunder Stadtwerke AG, Stadtwerke München GmbH. Scope believes these companies prefer a privately placed debt instrument over public corporate bonds because of the length and greater complexity involved in issuing public bonds and their reluctance to provide too high transparency to the public.

Usage of CSSDs seen as credit positive

From a credit perspective Scope welcomes the increased usage of CSSDs as a tool for debt financing. Such alternative debt financing options put a corporate's financing on a broader and more stable footing, while exposure to institutional investors demands greater scrutiny of these corporates unlike retail bond segments.

Investors increasingly open to non-investment grade issuers

CSSDs fit perfectly into the investment framework of institutional investors

The other driving force for the development of the German CSSD market is investor demand. In the current low-interest environment, investors are looking for alternatives to diversify from traditional credit exposure, but only in return for adequate yield. Given the short placement periods of a few weeks and oversubscription, Scope sees the appeal to institutional investors as high as ever. CSSDs trigger high demand from institutional investors in the context of comparably compelling yield, asset risk diversification and long-term assets matching.

Advantages for investors

Lack of liquidity in secondary markets for CSSDs as well as limited transparency do not seem to be an issue for buy-and-hold, long-term fixed-income investors. The benefits of CSSDs to investors are not hard to find: tailor-made structuring to investors' needs; availability of long-term maturities; access to private, but also mid- and smaller-sized companies or no mark-to-market accounting.

Debt funds, insurances and pension funds stimulating additional demand

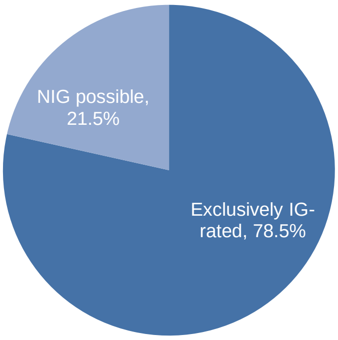
Investors in CSSDs are traditionally savings and co-operative banks given their close relationship to the most active CSSD originators such as LBBW, BayernLB, Heleba, NordLB. However, Scope expects future demand to be backed by insurance, pension fund and debt fund managers and other professional fixed-income investors with a buy-and-hold investment approach. Particularly the beneficial regulatory framework under the amended Alternative Investment Fund Managers Directive will help trigger these investors' increasing demand for the asset class.

Pain threshold for investors drops as they have to re-invest maturing bonds

Scope believes the search for yield has altered investors' risk-taking behaviour. This attitude is evident in an increased demand for CSSD tranches with longer maturities at higher coupons and the request for fixed rather than floating coupons. Given the historically low yields on sovereign bonds, and increasingly compressed yields for corporate bonds issued by large investment grade rated corporates, investors are likely to seek higher yields with little additional risk. Scope expects the pain threshold for investors to drop further as investors look increasingly at the high-yield corporate bond segment, as well as non-investment grade rated issuers of CSSDs. The urgent need to reinvest maturing bonds which carry higher coupons will likely accelerate this trend.

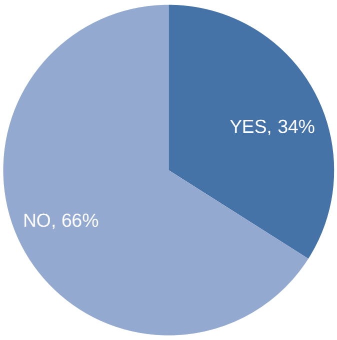
[3] Finance Magazine: „Der Schuldschein im Aufwind – Die Einschätzung von Emittenten und Investoren", February 2015, V.i.S.d.P. FRANKFURT BUSINESS MEDIA GmbH. The field study among 193 corporate decision makers and 218 investors examines the use and prospects of CSSDs. 34% of the interviewed corporate representatives have already issued a CSSD.

Figure 5: Minimum rating required for a CSSD investment



Source: Finance-Research, Scope Ratings

Figure 6: Required minimum corporate size (annual turnover >EUR200m on average) for a CSSD issue



Source: Finance-Research , Scope Ratings

Increasing willingness to invest in non-investment grade issues

Over the last four years Scope has observed a significant number of CSSD issues from mid-sized and potentially non-investment grade issuers. A field study among German and international investors by Finance Magazine[4] confirms the trend of investors increasingly willing to invest in corporate debt issued by non-investment grade issuers. However, the study revealed that only a comparably small percentage of just over 20% would be willing to look at CSSD transactions initiated by non-investment grade corporates (see figure 5). Scope expects this share to increase should the low-interest rate environment persist, particularly in light of the liberalisation of the legal framework for insurance companies and debt fund managers. However, Finance Magazine's research revealed investors are very willing to look at mid-sized corporates in search of a private debt placement (see figure 6).

Many not rated and private company require higher scrutiny

At the same time, Scope notes there is a growing trend of publicly unrated, non-public corporates as well as mid-sized corporates who opt for a CSSD — a development that comes at the expense of potential investors. While traditional institutional investors such as savings banks can apply internal rating or credit assessment systems, new investors for CSSD do not generally have the resources to conduct inhouse rating analyses. The market suffers from lack of transparency and demands greater scrutiny than the public corporate bond market.

Oversubscription and feedback from investors suggests shrinking illiquidity premiums for CSSDs

Given the lack of transparency of the German CSSD market in terms of coupons for different CSSD tranches and the absence of public information on a meaningful sample of coupons for different CSSD tranches, it is almost impossible to assess whether investor demands for a significant illiquidity premium over public bonds can be met. Research by Hartford Investment Management on the US-American private placement market[5] reveals that spreads of US-PP over comparable public bonds are between 20-50 bps, feedback from German investors shows that spreads are continuously shrinking due to the supply-demand imbalance, and oversubscription of most new CSSD issues. With spreads so tight, Scope presumes that investors are looking for other ways to lock in yield, notably through longer maturities.

Mismatch of average credit quality between rated and unrated CSSD issuers

While no public rating is required for CSSD issuers, such corporates are historically associated with investment grade credit quality. This is not surprising as >70% of CSSD issuers carried an investment grade rating at the date of issuance (see figure 10). Nevertheless, Scope notes that overall less than 25% CSSD issuers have a public rating. In particular mid-sized corporates and non-public corporates are unrated, thereby leaving investors to judge their respective credit quality.

Scope's indicative credit assessment of selected CSSD shows high

Scope's analysis of selected unrated CSSD issuers shows that many successful and often oversubscribed issues have been placed by non-investment grade issuers. Scope applied its corporate rating methodology as well as its different sector criteria to 30 German, Austrian and

[4] See footnote 3

[5] Hartford Investment Management: "Private Placement Debt: Diversification, yield potential in a complementary IG asset", November 2013 (link to HIMCo study)

heterogeneity of the market segment

French corporates to derive an indicative credit assessment based on publicly available information. The sample comprises corporates across a wide range of industries and different corporate sizes. Scope selected these corporates based on the availability of sufficient public information and on the assumption that the credit quality of other CSSD issuers not included in the sample display a credit quality not significantly different.

Figure 7: Selected CSSD issuers

Industry	Issuer	Revenues (latest FY in EURm)
Auto Supplier	Compagnie Plastic Omnium SA	4,437
	Norma Group SE	695
	Progress-Werk Oberkirch AG	381
	Leoni AG	4,103
	POLYTEC HOLDING AG	491
	Grammer AG	1,366
Biotech & Pharma	Biotest AG	582
Building Materials	RHI AG	1,721
Chemicals	Altana AG	1,952
	Lenzing AG	1,864
	Nabaltec AG	143
Construction	Zech Group GmbH	773
Distributors	BayWa AG	15,201
	Overlack AG	348
Health Care	Otto Bock Holding GmbH & Co.KG	861
	Sana Kliniken AG	2,156
	Korian Medica SA	2,222
Logistics	Hoyer GmbH Internationale Fachspedition	1,087
Manufacturing	Jungheinrich AG	2,498
Packaged Foods	Halloren Schokoladenfabrik GmbH	122
Real Estate	Deutsche Annington Immobilien SE	789
Software	Software AG	857
Telecommunications	United Internet AG	3,065
	QSC AG	431
Transportation & Logistics	Flughafen Düsseldorf GmbH	431
	Fraport AG	2,395
Utilities	Hansewasser Bremen GmbH	88
	LVV Leipziger Versorgungs- und Verkehrsgesellschaft mbH	3,632
	Stadtwerke München GmbH	6,543
	STEAG GmbH	2,936

Source: Scope Ratings

Median rating of BB+ in Scope's sample of publicly unrated CSSD issuers

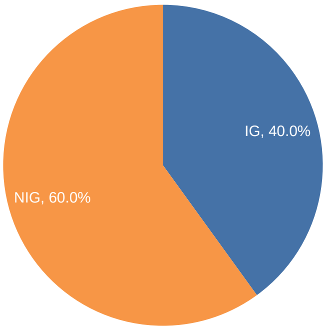
An average indicative credit assessment of BB+ as the median rating in Scope's sample (see figure 9) confirms the market trends on supply and demand for CSSDs:

(1) A more heterogeneous group of corporates is considering the asset class of CSSDs with a large share of first-time CSSD – predominantly mid-sized – issuers with an annual turnover of less than EUR 1.5bn.

(2) Institutional investors are shifting down the credit curve by supporting CSSDs from lower rated corporates in the context of their search for adequate yield.

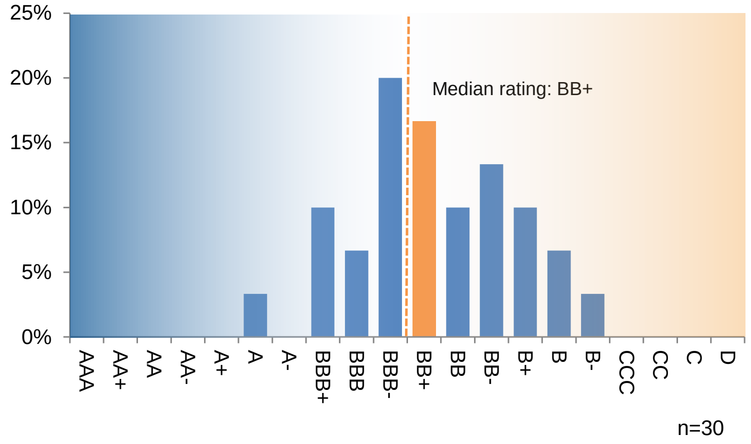
Almost 2/3 of Scope's sample of unrated CSSD issuers show a non-investment grade credit quality (see figure 8). Although Scope believes the percentage on non-investment grade CSSD issuers will grow further, we are likely to see a threshold of credit quality of around BB-, matching the buy-and-hold strategy of fixed-income investors with a risk-averse investment approach. Scope notes that CSSD issuers with credit quality in the lower non-investment grade category remain a rare exception as the risk attached to higher yield barely fits the rather illiquid investment such as a CSSD.

Figure 8: Indicative credit quality of selected CSSD issuers



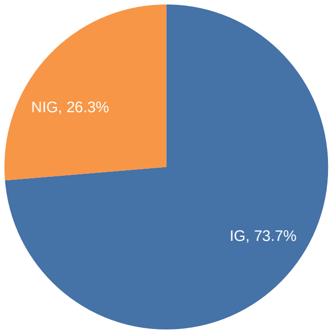
Source: Scope Ratings

Figure 9: Distribution of indicative credit quality assessments of selected CSSD issuers



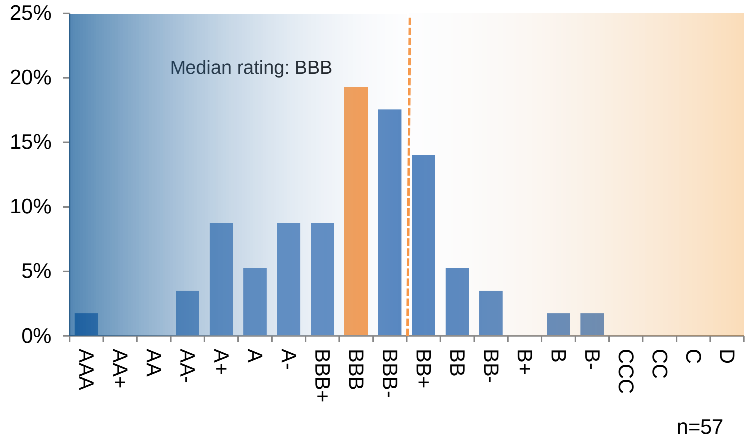
Source: Scope Ratings

Figure 10: Credit quality of publicly rated CSSD issuers



Source: Scope Ratings

Figure 11: Distribution of credit quality of publicly rated CSSD issuers



Source: Bloomberg, other CRAs, Scope Ratings

Median rating of BBB of publicly rated CSSD issuers

It is striking that ratings of publicly rated CSSD issuers show a stronger bias towards investment grade credit quality with a median BBB rating (based on a sample of 57 CSSD isusers – see figure 11). Scope believes this picture can hardly be applied to the overall CSSD market as mid-sized corporates in particular do not carry public ratings. Combining the two samples, this indicates a share of 38% of non-investment grade issuers in the overall market.

Are investors fully aware of credit quality of publicly unrated CSSD issuers?

Some investors might believe to buy CSSDs issued by investment grade corporates even though a thorough credit analysis might not support this. Hence, investors need to be attentive to what credit quality they buy in their hunt for attractive yields, and demand adequate, risk-adjusted spreads. An awareness and scrutiny of a CSSD issuer’s credit quality in the non-investment grade categories is, in Scope’s view, especially important for this less liquid asset class.

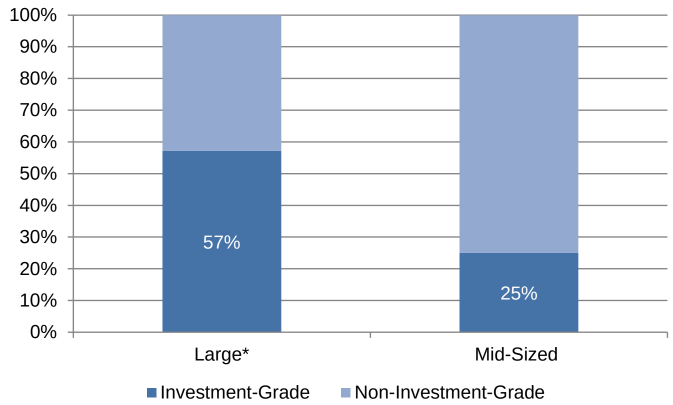
Higher scrutiny required in an opaque market

The increasing acceptance for non-investment grade issuers in the CSSD market calls for appropriate caution and scrutiny from market participants. This holds particularly true for mid-sized but also larger non-public CSSD issuers who do not offer the same transparency to investors through coverage by brokerage firms, financial analysts or rating agencies. These companies require a greater degree of fundamental analysis of their business models and market position as they often act in highly specialised niche markets. As a result, investors need to trust their own primary analysis and elaborate on the CSSD issuer’s management’s tolerance for risk.

Diligent analysis required as investment grade credit quality does not always come with size

Although there is some correlation between a corporate's size and credit quality, a corporate's comparably smaller size is not necessarily linked to a weaker credit quality in the non-investment grade rating categories. Even larger corporates with an annual turnover of >EUR 1.5bn may show sub-investment grade credit quality as with 57% of corporates from Scope's sample (see figure 12). Although less common, mid-sized corporates can exhibit solid and robust investment grade credit quality if well positioned in the market with low substitution risks for their services or products and a sound financial structure.

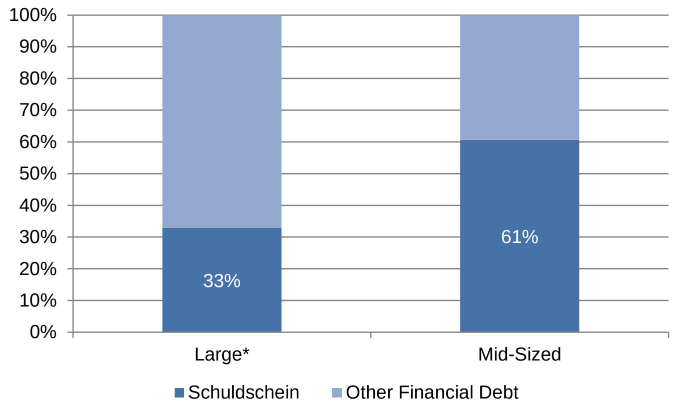
Figure 12: Credit Quality of large caps vs SMEs



* Corporates with an annual turnover of >EUR 1.5bn

Source: Scope Ratings

Figure 13: Share of CSSD in debt structure of selected CSSD issuers



* Corporates with an annual turnover of >EUR 1.5bn

Source: Scope Ratings

Mid-sized companies increasingly dependent on CSSD

Scope recognises that mid-sized CSSD issuers in particular are increasing their dependency on this finance instrument, confirming CSSD's status as an important pillar of debt financing strategy not just for large cap, but also mid-sized corporates. As large corporate size often goes hand-in-hand with strong access to the capital markets and bank financing, larger corporates (annual revenues > EUR 1.5bn) are on average more diversified in terms of external financing (bank loans, public & private bonds, CSSDs) exhibiting an average 1/3 of total financial debt attributable to a CSSD. By contrast, mid-sized corporates in Scope's data sample show a greater dependency on CSSDs almost two times higher (share of 61% of financial debt).

Comparable European markets at different development stages

Comparable European private placement market at nascent stages

The German CSSD market appears to be the most established market in terms of volumes and issuer diversity in the European landscape of private corporate debt placements. Scope notes that comparable European private placement markets such as the Euro-PP segment which is primarily used by French corporates or some private debt placements in the Spanish MARF segment are in their nascent phases. Furthermore, different market segments display different degrees of standardisation and target different groups of corporate issuers (mostly SMEs).

Ambitions for a pan-European PP-market

Scope recognises that further development of such private debt markets is on the agenda of national governments, and is a major plank of the European Commission's initiatives to create a Capital Markets Union and harmonise European capital markets. Furthermore, capital markets associations such as ICMA, AFME or the Pan-European Private Placement Working Group provide guidance on best practice regarding documentation, market practices and principles for private debt issues. Scope welcomes such efforts for the further development of a pan-European private debt placement market in improving opportunities for corporate debt funding that will likely enhance the credit quality of European corporates.

Outlook

Excellent prospects for the CSSD market

Scope believes the market for CSSD in 2015 is likely to beat issuance volume of 2014 (EUR 12bn) backed by: (1) favourable regulations and various initiatives to grow the private placement market; (2) strong supply from frequent but also first-time issuers; and (3) strong demand backed by search for yield which consider issuances from lower rated corporates. While investors welcome mid-sized, private issuers of corporate debt and lower rated CSSD issuers, the preference for buy-and-hold investment strategies will in Scope's view constrain the rating threshold to BB- with issues of lower rated corporates remaining a rare exception.

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