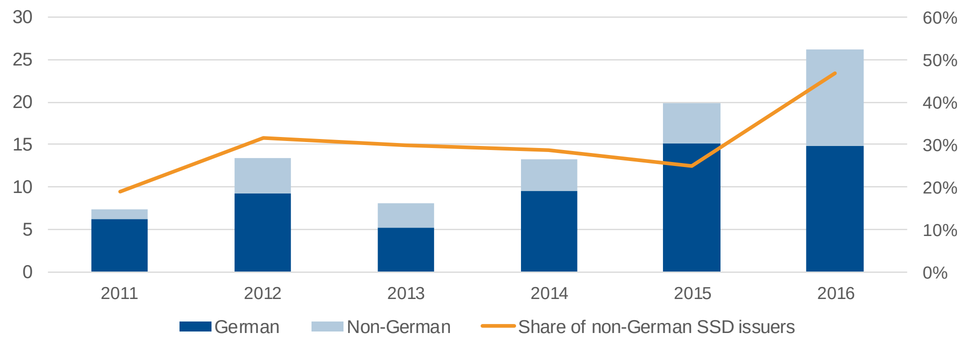
Corporate Schuldschein Market: Demand Bright, Pricing Tight

2016 again saw a new record for Corporate Schuldschein (SSD) transactions – over EUR 26bn across more than 115 transactions (2015: EUR 20bn)[1]. The market growth of over 30% is impressive given the rather sluggish performance in the designated European private placement market Euro-PP and cheap and generous bank lending. This growth is strongly linked to the jump in the number of non-German corporate issuers, at a record of almost 50% of total placements. Moreover, the persistently high demand for SSDs means corporates can continue to dictate the terms of the transactions, with a median interest spread of just 138bps for a five-year tranche, which is commensurate with BBB+ credit quality when mapped against public European bond issues. Scope still deems the overall market to be healthy, but sees increasing obstacles for further growth through a potential interest rate reversal and gradual dilution of credit quality in the market.

Even more international issuers and new currencies

Along with the remarkable growth in issuer heterogeneity, the share of non-German SSD issuers has reached a new record of almost 50% of total transactions, with debt placements totalling about EUR 11bn. While Austrian, Swiss and French corporates already appear to be regulars in the segment, Scope has recorded debut issues from US, Irish and Arabic corporates. The Fed's reversal of interest rates also means debt placements in the European market may make perfect sense for US issuers. Scope notes that the vast majority of non-German issuers experienced in the capital markets (either publicly listed or with public-debt programmes), implying these foreign debut SSD issuers are testing this alternative funding source.

Figure 1: SSD volume of German and non-German issuers (EUR bn)



Source: Scope Ratings

Tight SSD pricing suggests BBB+ credit quality of issuers on average

The market perception of solid investment-grade-rated names, as well as the very few credit events over the last few years, continues to squeeze the pricing for SSDs. Strong competition among investors for a piece of an SSD, along with unusually short placement periods, often results in heavy oversubscription and strong spread compression at the lower end of offered price ranges. The median spread for five-year SSD tranches placed in 2016 – which Scope has compiled from 47 transactions – stands at just 138bps (see Figure 2). Such a low spread aligns with an average credit quality of BBB+ compared with issuances in the European public bond market in 2016. This compares to a median BBB rating across 30 publicly rated issuers. Scope highlights that only about one-quarter of SSD issuers in 2016 carries a public rating (see Figure 3), which suggests the pricing of non-rated SSD issuers strongly benefits from the lack of transparency in this segment.

[1] The actual issuance volume may even be higher as some transactions are reported with some time delay in this highly non-transparent market. Transaction volume based on closing/announcement dates.

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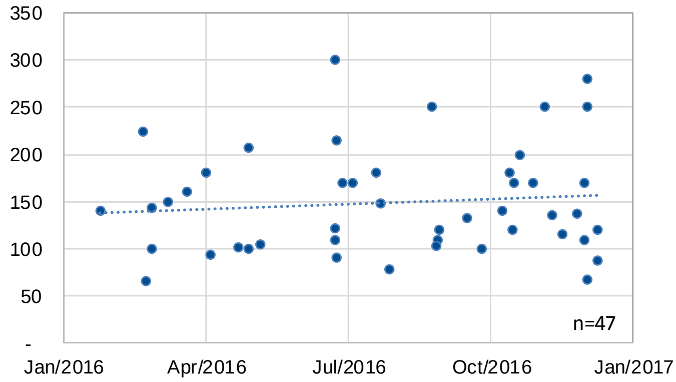
Corporates can dictate the terms

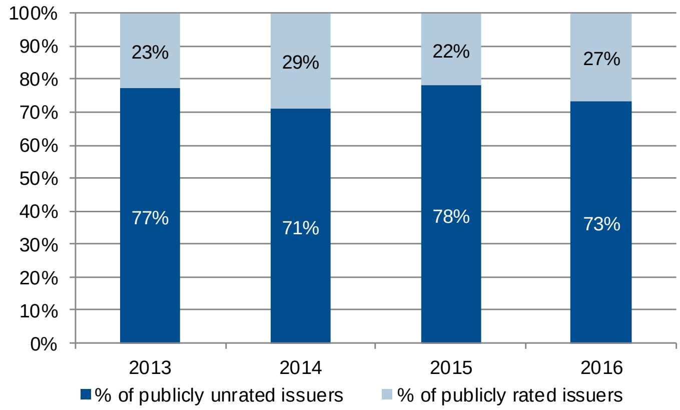
In an environment of heavy oversubscription, corporate issuers can dictate the rules. Deutsche Lufthansa AG is a recent prominent example, recently mothballing a proposed EUR 500m public bond offering after refusing to compromise on pricing, and then successfully placing a second SSD in 2016, which was also strongly oversubscribed (SSD volume increased from EUR 200m to EUR 1.2bn).

Figure 2: Spread (bps) of five-year tranches of SSD



Source: Bloomberg, Thomson Reuters, Scope Ratings

Figure 3: Share of non-rated issuers (measured in number of transactions)



Source: Scope Ratings

Better pricing than in the public bond market

From Scope's perspective, many debt issuers without a public rating prefer to issue in the private market, not only because of the lean documentation and a desire to diversify debt, but also due to the more favourable pricing. For some corporate issuers a placement in the public market may be rather expensive, considering public issuances in the European bond market carry a 200bps median spread for a five-year bond from a crossover (BBB-/BB+) corporate. Hence, Scope reiterates its thesis that the aggressive pricing in the SSD market may not reflect the true credit risk on some issuances. Whereas some outliers in the sample in Figure 2 are due to risk premiums reflecting higher country risks or corporate size, some corporate issuers, which Scope deems to be non-investment grade, are clearly benefiting from the pricing for investment-grade-rated corporates.

Familiar names from German 'Mittelstandsmarkt' entering the SSD segment

Scope considers it particularly striking that again five former issuers of mid-market bonds ('Mittelstandsanleihen') either refinanced formerly public SME bonds with an initial SSD (SANOCHEMIA Pharmazeutika AG, Edel AG, HELMA Eigenheimbau AG) or broadened funding sources (UBM Development AG, KTM AG)[2]. As Scope hears in the market, copycats are likely to follow, not only to avoid negative sentiment in the disrupted market for mid-market bonds, but also because they are enticed by the lower credit spreads for the new debt instruments. This is not negative per se, as Scope believes the German mid-market still contains names that are fully eligible for the quality SSD segment. Moreover, Scope reckons that SSDs from former issuers of mid-market bonds are scrutinised more diligently than former bonds from semi-professional private investors.

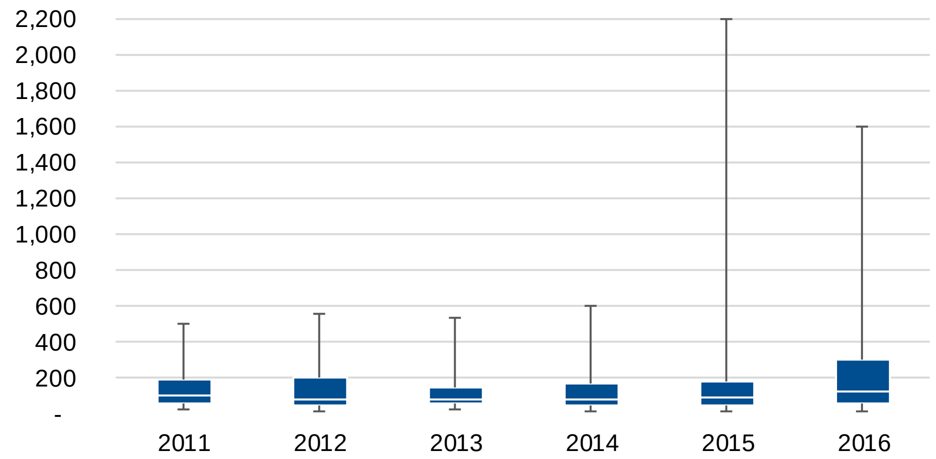
[2] Other SMEs, which issued mid-market bonds such as Nabaltec AG, Cross Industries AG or Mox Telecom AG, have already entered the SSD market segment in earlier years.

Increasing heterogeneity in the market

Multi-level diversity in the market

Scope highlights that the new record of SSD transactions is largely due to the increasing diversity of issuers. This development is evident on multiple levels: transaction size, the issuers' size, the issuers' country of origin, ultimate investors, and – in a rather new trend – currencies. While the median transaction size has remained stable over the last few years, at around EUR 100m (2016: EUR 120m), the following box plot demonstrates the greater diversity of transaction sizes, with tails and box sizes (25-75% percentile) increasing at an impressive rate. This points to a growing number of jumbo transactions with a ticket size of more than EUR 1bn, but also to a steady number of small issuances below EUR 50m.

Figure 4: Range of ticket sizes in EUR m (box plots)



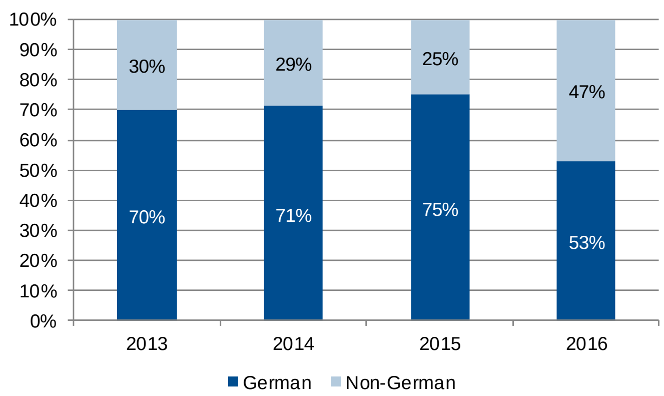
Source: Scope Ratings

Non-German issuers make up half of issuances

New record from non-German issuers

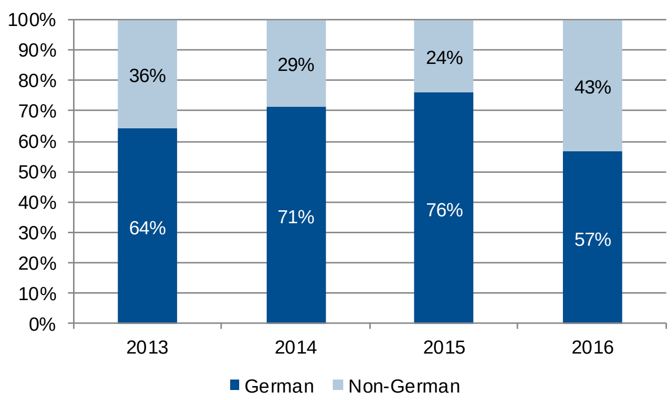
Scope has seen a steep increase in non-German issuance activity, now responsible for almost 50% of total transactions (43% of placed debt volume) against the 25% in 2015. While many transactions are linked to Austrian but also French corporates (with at least 17 and 10 transactions respectively in 2016), Scope has also seen first SSD activity from the Middle East and North Africa (Etihad), and from US corporates entering the European debt market. Scope notes that the vast majority of non-German issuers are publicly listed often with public-debt programmes, implying these foreign debut SSD issuers are successfully testing the alternative funding source.

Figure 5: Domestic versus international SSD issuers (measured in number of transactions)



Source: Scope Ratings

Figure 6: Domestic versus international SSD issuers (measured as percentage of total placement volume)



Source: Scope Ratings

SSD entering new currencies

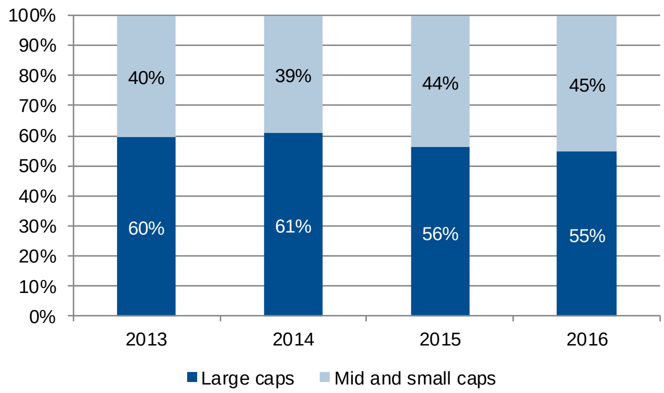
The same applies to an increasing internationalisation of issued currencies, underpinning the variability of the debt instrument. Since the first 'exotic' SSD transaction in 2015, denominated in Renminbi, Scope has seen some good expansion of the the variety of currencies in the market. While non-eurozone corporate issuers are enjoying a debt exposure in euros, some eurozone corporates have expanded into other currencies, and not only through one SSD tranche denominated in US dollars. Most prominently, Austrian Semperit AG issued three non-euro tranches: in US dollars, Polish zloty and Czech koruna. Swiss Aryzta AG also issued two SSD tranches in euros and US dollars.

Consistently high share of SMEs[3] among SSD issuers

Almost 50% of total transactions from SMEs

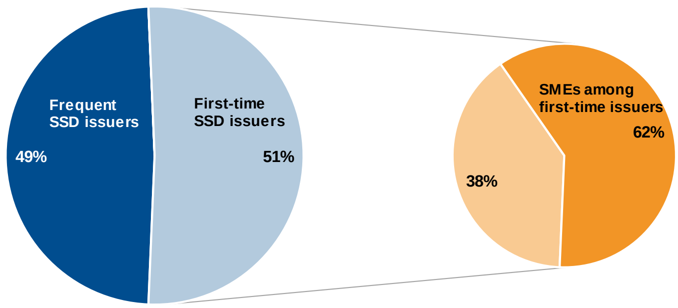
While the first half of 2016 was strongly driven by a handful of jumbo transactions (over EUR 1bn each), many SMEs have tapped the market in the second half of 2016 with smaller transactions. Overall, the activities of SMEs remain buoyant with issuances comprising almost 50% of transactions, raising an overall debt volume of EUR 4.2bn in 2016 (at the same level of 2015).

Figure 7: Growing share of mid- and small-cap issuers (measured in number of transactions)



Source: Scope Ratings

Figure 8: High share SMEs among first-time issuers in 2016 (measured in number of transactions)



Source: Scope Ratings

SMEs dominating among SSD debutants

Frequent SSD issuers, which placed a total volume of over EUR 16bn in 2016, have clearly dominated issuances. Large issuers such as Deutsche Lufthansa, freenet or Fresenius even visited the SSD market twice in 2016. However, Scope highlights the persistently high share of SMEs among first-time issuers (Figure 8), at around two-thirds, which includes the aforementioned former mid-market bond issuers. Such debut transactions are likely to drive further growth in the market, however, may also gradually dilute the overall credit quality on the market.

[3] Defined as corporates with annual turnover of less than EUR 1bn.

Outlook 2017

Good chance to again surpass threshold of EUR 20bn

The currently marketed EUR 500m SSD from KION Group AG and a few smaller SSDs in the pipeline already promise a good start to 2017. Scope expects the market to stay buoyant, however with overall transaction volumes to remain dependent on jumbo transactions. Scope presumes that the market will again exceed the EUR 20bn threshold, supported by various positive market triggers such as:

+ Growing international reach with more SSDs expected from US corporates, which may benefit from eurozone interest rates;
+ Refinancing activities of seven-year and five-year tranches of SSDs issued in 2010 and 2012 (2012 was particularly strong with an overall market volume of more than EUR 13bn);
+ Refinancing activities of European public corporate bonds through cheaper SSDs;
+ Copycat issuers from the German SME bond market that seek refinancing options;
+ Volatile market conditions in the public bond market; and
+ Tailwinds from regulations and lobbying.

Nevertheless, Scope sees increasing obstacles for further growth, such as:

– A potential interest rate reversal; and

– Higher spreads through an ongoing dilution of the market's overall credit quality, heightening the risk perception among investors.

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