Global Asset Management

Insights from our European High Yield team

Key high yield market drivers and insights on two significant European sectors – telecommunications and media

For Professional Investors Only | Marketing Communication

We ask our senior portfolio managers and telecommunication and media corporate analyst to share their views on the key market drivers and near-term opportunities within European high yield.

Sid Chhabra
Head of Securitized Credit, CLO Management and European High Yield
RBC Global Asset Management (UK) Limited

Tim van der Weyden,
European High Yield Portfolio Manager
RBC Global Asset Management (UK) Limited

Jean-Yves Guibert
Senior Corporate Analyst
RBC Global Asset Management (UK) Limited

Published August 2024

Key high yield market drivers

Head of European High Yield, Sid Chhabra, and European High Yield Portfolio Manager, Tim van der Weyden, share their views on the market outlook for the asset class.

What market themes might drive European high yield markets in the second half of 2024?

Macroeconomic perspective: In Europe, recent survey data continues to suggest a gradual recovery in economic growth which contrasts with the prior two years. In the US, meanwhile, recent incoming data is indicative of a moderation in economic activity, with decelerating consumer data and a labour market that continues to build slack.

Rates perspective: The market is now pricing a sharper trajectory of rate cuts from the Fed and the ECB over the coming 12 months. We expect the Fed to deliver a first rate cut in September, but we are cautious around the extent of cuts priced in by the market for 2024. Overall, as inflationary pressures abate and rate cuts filter into the economy, we anticipate that the environment for lower, but positive, growth and high all-in yields should provide a supportive backdrop for credit fixed income.

Credit perspective: Capital structure sustainability remains the dominant theme in our analysis of European high yield credits, especially in the context of modest growth. Therefore, we view the alpha opportunity as being primarily in sector allocation and single-name selection. We tend to dislike highly levered structures with limited cashflow, as well as names that do not have pricing power.

Technical perspective: Looking ahead to next quarter, after a quieter summer period, we expect primary market issuance to increase, with September and October typically amongst the most active months for new issue supply. We anticipate an ability to rotate out of positions that have hit profit targets and redeploy capital during this period. From our conversations with issuers, sell-side counterparties, and other advisors, we expect a growing pipeline of single-B credits in the coming months driven by the portion of 2025 and 2026 maturity wall that has not yet been addressed (see Chart 1). There are also signs that the M&A pipeline is growing for later in 2024 and early 2025. On the demand side, there have been net flows of EUR6.85 billion year-to-date (to end July 2024), although the fund flows backdrop for European credit could be more mixed in coming months.

What changes are you expecting to make to portfolios in the coming months?

Portfolio manager perspective: From a risk and positioning perspective, we are constructing portfolios that have been closer to neutral given the growth and valuation backdrop, but expect to lean into single-name opportunities as issuance picks up over the next few months. Recent spread widening has improved valuations and we do not expect an immediate retracement towards the year-to-date spread tights seen in June. In terms of default outlook, we expect defaults to remain stable around 2-3%.

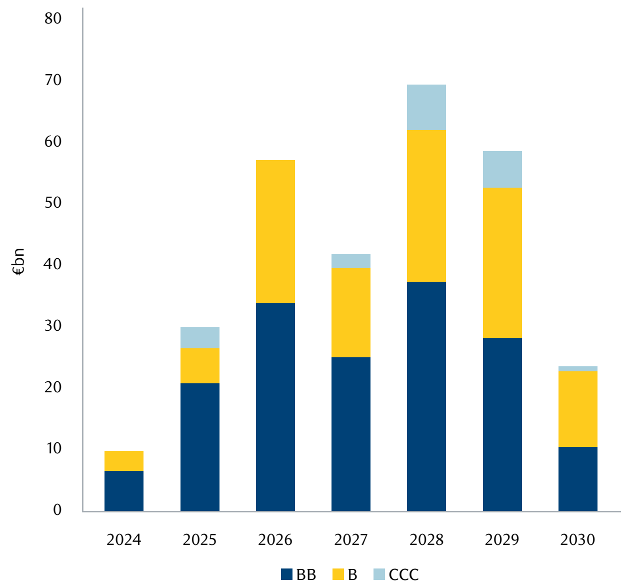
Total return opportunity: Total returns at an index level should continue to post gains and the rate component of high yield bonds provides a hedge to spread moves. We maintain our positive view on the beta opportunity that European high yield markets offer from an all-in-yield perspective. As an active manager, we welcome the growing pipeline of issuance as it is likely to present a range of interesting idiosyncratic opportunities over the coming months.

> **"Recent spread widening has improved valuations and we do not expect an immediate retracement towards the year-to-date spread tights seen in June."**

Sector rotations: While generally comfortable with our positioning, we continue to look for inflection points in earnings within sectors that have lagged. At present, cyclical sectors are a focus, where we have remained underweight. This is likely a 2025 story rather than 2024.

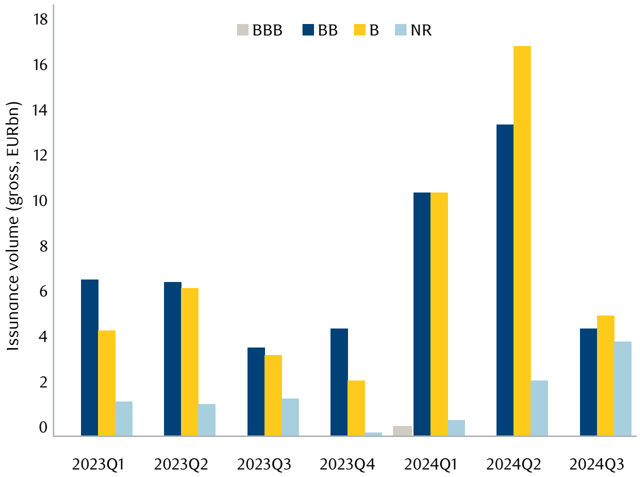
Attractiveness of single-B credits: We expect single-B credits to be a source of alpha as average spreads in this segment of the European high yield remain well above 400bps, and 100bps wide to the US single-B rated high yield complex.

Chart 1: European high yield annual redemption



Source: Deutsche Bank, Bloomberg Finance LP as at 31 July 2024.
€ high yield Non-Financial Seniors, including floaters.

Chart 2: European high yield issuance by rating category



Source: S&P Pitchbook as at 30 June 2024.

Senior corporate analyst, Jean-Yves Guibert shares his insights on the European telecommunications and media sectors, given that both sectors represent a 15% weighting within the ICE BofA European Currency High Yield Constrained Index.

What is our outlook for the European telecommunications sector?

Pricing power: This year, telecoms businesses have regained pricing power, and top-line revenues are improving as a result. Earnings momentum has arisen as companies successfully pass on cost pressures via mechanisms such as CPI-linked pricing for contract-based customers, now prevalent in many European markets. The French market is the notable exception to this rule where companies have struggled to pass through increased costs to customers.

Fibre cycle drives lower industry's capital intensity: Over the past 3-4 years, telecommunications businesses have supported high capital expenditure intensity to fund the roll-out of fixed-fibre infrastructure, alongside 5G roll-out. The roll-out cycle is well-advanced across most European countries, so businesses can reduce their capital investment and increase free cash flow generation. This trend is supported by the fact that fibre is a more 'future-proof' technology that requires lower maintenance capital expenditure. The next 6G roll-out cycle is not anticipated to begin until 2030.

Opportunities for infrastructure-rich businesses: A significant feature of our discussions around the telecoms sector has been in identifying hidden value amongst infrastructure-rich issuers. Amongst integrated telecom industry players, one way in which investors have begun to crystallise value is by carving out the physical fibre network assets (the NetCo) from the telecom service providers (the ServCo). This, in turn, is advantageous to credit investors as securities experience a pull to par.

Future M&A activity: By the end of 2024, the new European Commissioner for Competition should have been announced. The announcement is a possible catalyst for increased M&A activity across the sector at a time when expectations for market consolidation around intra-market consolidation remain depressed. Opportunities for acquisitive growth could arise both amongst smaller and mid-cap issuers within the market as well as amongst the largest firms.

Stable de-leveraging: Prudent and proactive debt liability management has been a supportive feature of the European telecoms sector in recent years. Generally, management teams have delivered stable financial policies and deleveraged over time with a view to preserving or improving corporate ratings.

What are our expectations for the European media sector going forwards?

Stabilising advertising demand: The media sector is beginning to show signs that advertising revenues may be stabilising which should sustain content demand from traditional linear broadcasters.

Success of non-scripted content: We expect content producers, especially independent producers, to continue to benefit from structurally high demand for non-scripted content (such as documentaries and game shows, as opposed to scripted television series and films). This demand comes from both traditional broadcasters as well as from streamers, giving non-scripted content a broad viewership reach.

> "We expect content producers, especially independent producers, to continue to benefit from structurally high demand for non-scripted content."

Favourable content funding models: A higher demand for non-scripted content implies a more favourable content mix for content producers. For non-scripted content, producers are usually fully pre-funded by their clients, as new programmes are sold ahead of production to broadcasters. This is beneficial to producers as it reduces cash outflows and spreads the risk of production. Likewise, for scripted content, roughly half of production costs are now borne by broadcasters and the balance from financing from distributors, local productions facilities and/or tax credit schemes.

Authors

Sid Chhabra

Head of Securitized Credit, CLO Management and European High Yield, RBC Global Asset Management (UK) Limited

Sid joined BlueBay Asset Management (BlueBay) (which is now part of RBC Global Asset Management) in June 2018 and has over 20 years of leveraged finance, securitized credit and CLO experience. In his current role, he leads the investment process, underwriting and portfolio construction of the European High Yield, US and European CLO vehicles which hold both leveraged loan and high yield bond assets and Securitized Credit funds. Prior to BlueBay, Sid was a London-based Managing Director responsible for securitized credit and CLOs, at Anchorage Capital Europe, a USD15 billion alternative credit manager. Prior to Anchorage, Sid was part of the Credit/CDO Group, EMEA, at JPMorgan. Sid holds a BTech from the Indian Institute of Technology, Madras (IITM) and an MS from the London School of Economics.

Tim van der Weyden

European High Yield Portfolio Manager, RBC Global Asset Management (UK) Limited

Tim is a BlueBay Portfolio Manager and is primarily focused on European High Yield strategies. Tim is also a co-portfolio manager for Global High Yield strategies. Tim joined BlueBay Asset Management (which is now part of RBC Global Asset Management) in February 2007 as a trader before being promoted to senior trader within the Global Leveraged Finance Group. Tim assumed portfolio management responsibilities in July 2024. Prior to BlueBay, Tim worked at Deutsche Bank in trade support on the propriety trading desk. Tim holds a BA of Commerce from the University of Sydney and is a CFA charterholder.

Jean-Yves Guibert

Senior Corporate Analyst, RBC Global Asset Management (UK) Limited

Jean-Yves joined BlueBay in February 2016 as a Senior Credit Analyst within the Global Leveraged Finance Group. Prior to joining BlueBay, Jean-Yves worked for BNP Paribas in London since 1999, where he was latterly Head of European High Yield Sector Specialists, covering European TMT and Cable as a sector specialisation. Jean-Yves previously held various positions in both high yield and investment grade credit research at BNP Paribas. He holds an MSc in corporate finance and financial engineering from the Paris-Dauphine University.

Published August 2024

RE0124/08/24

Global Asset
Management