European high yield: refinancing risks looking more manageable

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- **We continue to forecast moderate earnings growth for FY24 and see an overall healthy cash flow picture**
- **The average cost of debt is expected to increase by 100bps, but a recent market rally in underlying yields is helping keep levels manageable in aggregate**
- **Sector breakdowns show TMT, gaming, and travel and leisure holding up well, but real estate and parts of basic industry continue to struggle. Healthcare's growth trajectory is expected to return in the latter part of 2024 but from earlier lowered growth expectations.**

Moving out of FY2023 and into 2024 we expect European High Yield (EHY) market revenues and EBITDA (earnings before interest, taxes, depreciation and amortisation) growth to improve. In aggregate, we forecast EBITDA growth of 2.6% in FY23 and 6.7% for FY24. Net leveraging is expected to be stable for the remainder of FY23 with deleveraging returning in FY24.

Free cash flow (FCF) and interest coverage are expected to remain healthy through the year, although we expect interest coverage to decline due to higher funding costs. Overall, we forecast the average cost of debt across our coverage universe to increase to 4.9% in FY24, versus 3.8% in FY22, reflecting refinancing activity at significantly higher rates.

While we expect refinancing activity to continue to put upward pressure on financing costs, the recent rally in core yields has helped mitigate this risk to a level that looks manageable in aggregate.

Applying a circa 100bps increase to 2024 cost-of-debt as a proxy for prevailing BB/B yields, this would still leave relatively healthy mid-single-digit FCF/net debt levels.

Sector commentary

Basic industry The demand picture across a number of key construction and consumer end-markets continued to deteriorate over the course of 2023, resulting in an extended destocking cycle and significantly reduced operating rates for the Chemicals and Building Products sectors. This has driven reduced FY23 forecasts versus our mid-2023 view and we now expect earnings to remain depressed through to mid-2024.

Automotive 2023 was a solid year for the auto sector as Covid and supply-chain constraints eased and raw material cost inflation abated, supported by continued strong demand. The order backlog and level of consumer demand should ease in 2024 and this is reflected in lower but still positive growth versus 2023. Cost restructuring plans and recoveries, declining raw materials and production normalisation should support auto supplier EBITDA in 2024, which in turn should support marginal deleveraging. Uncertainty remains over consumer discretionary spending and the cost of automotive financing and forecasts may be too constructive if rates remain elevated in 2024. The dominance of high-quality BB names, strong liquidity and significant refinancing completed before 2023 has capped financing costs.

Healthcare Overall, we have lowered our growth expectations for the sector driven by reduced demand in the testing and labs segments. We expect a return to double-digit growth for the sector in FY24.

TMT The sector is still expected to have a relatively stable earnings development, reflecting our view that cost inflation can ultimately be passed through via relatively modest price increases, which are by and large now being implemented across the sector. As a result we expect to see margin recovery in 2024 and related EBITDA growth. With capital expenditure pretty much at peak, it should help drive some deleveraging across the sector in 2024.

Gaming The sector has shown strong resilience to any concerns over a consumer downturn, and growth – albeit slowing – should continue into 2024. M&A continues to be accretive to financials with generally strong FCF supporting deleveraging, which remains a focus for gaming management teams. Bond maturities tend to be longer dated but a recent issue saw strong demand, mitigating a substantial step up in financing costs.

Travel and leisure Gyms have experienced a marked recovery post-pandemic and have been investing cash into network expansions. Thanks to this, membership levels have continued to grow while inflation pass through has increased per member yield. In recent months, the sub sector has outperformed expectations with no sign of deterioration into 2024. In travel, the pent-up demand continues to further boost revenue and profits into 2024. Names with the longest booking cycle, such as cruises, are trending even better than we saw for 2023.

Retail Food retail continued to deliver fairly robust sales growth in 2023, driven by high inflation and offset by softer volumes. For 2024 we expect growth to moderate towards the lower single digits, while EBITDA margins are expected to modestly improve (typically by around +20bps). For the rest of retail, sales growth for 2023 is now expected to be better than our previous forecast as the consumer has remained resilient despite inflationary headwinds. This has been particularly true for issuers focused on travel retail and beauty/cosmetics. The one weaker than expected area has been luxury furniture (International Design Group) which has seen sales growth turn negative and margins come under pressure. We expect a continuation of these trends in 2024.

Real estate While much of the real estate sector has benefitted from the more constructive interest rate outlook, we remain cautious on highly leveraged high yield issuers. Net leverage remains very high (in the mid-20s for some companies) – albeit forecast to decline. Similarly, interest coverage remains very low, forecast at 1.9x in both 2023 and 2024. Companies are still generally benefitting from largely fixed rate capital structures which are yet to reflect the impact of higher rates. For the most part, these structures would be unsustainable if they had to refinance today. More positively, underlying operations are generally expected to remain solid across the coverage universe with low vacancy rates and continued like-for-like rent increases.