SKY HARBOR
CAPITAL MANAGEMENT

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SKY Harbor Weekly Briefing

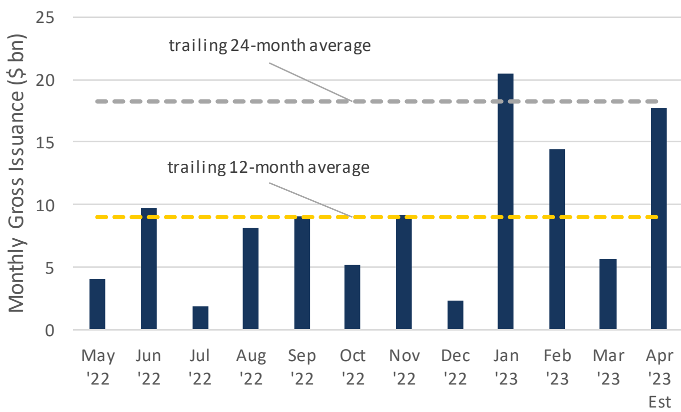
A Turn in Technicals

Primary market activity bounced back this month following an anemic March, with gross issuance likely to exceed the trailing 24-month average once all data is tallied. This rebound comes at a pivotal time, with markets demonstrating resilience in the face of concerns that lending standards will tighten as credit availability constricts. In this *Weekly Briefing*, we take a closer look at April issuance, with a focus on premiums (trending lower) and the subsequent impact on corporate interest expense (trending higher).

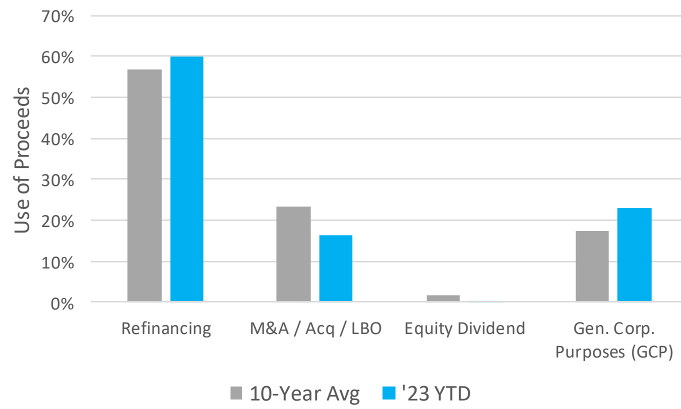
Issuance Remains Conservative

April gross issuance is likely to exceed $18 billion, approximately twice the trailing 12-month average, and in-line with market norms absent a depressed 2022. On a year-to-date basis, primary market activity is set to hit $58bn, up only modestly relative to the equivalent prior year period, but encouraging given a three week stretch during March that saw zero new deals price. **Issuance has remained conservative thus far, with ~ 60% going toward refinancing activity, and less than 17% used for acquisitions, LBOs, and equity monetization** (vs. a trailing 10-year average of 25% of proceeds).

Primary Market Activity Resumes After Weak March
trailing 12 months; current month is through April 26, 2023



Use of Proceeds Remain Conservative Despite Ramp-Up
data as of April 26, 2023

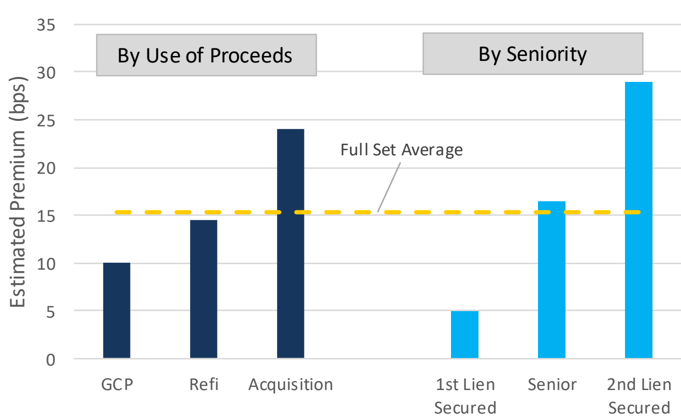


Source: SKY Harbor, JP Morgan, BofA Merrill Lynch

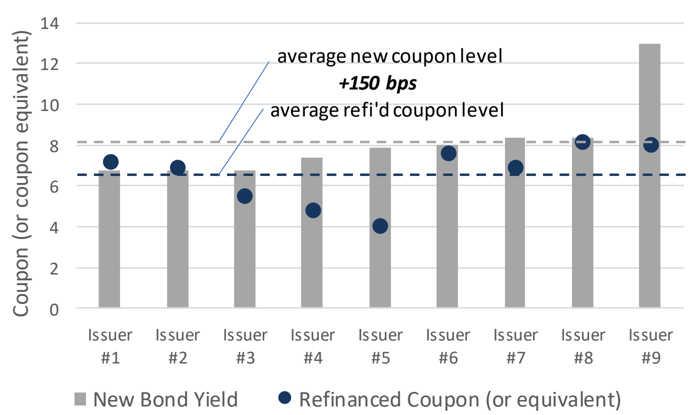
Coupons High, Premiums Low

Analyzing all deals that were issued in April, and comparing coupon levels (adjusted for the presence of original issue discounts) to yields at the conclusion of the first day of secondary market trading, **we calculate an average new issue premium of ~ 15 bps on an equal-weighted basis**. As further nuanced below, investors have received a more substantial premium to participate in deals to fund acquisitions (~ 24 bps), while senior secured issuance has provided, on average, barely more than fair value (~ 5 bps). Though premiums offered to the market in April appear modest by historical standards (this same analysis from a *Weekly Briefing* in May 2020 found a 40 bps new issue premium), the impact to issuer interest expense has been more pronounced. As demonstrated below, **we estimate that the nine refinancing deals completed thus far in April have resulted in 150 bps of increased funding costs for issuers**, with a range of -50 bps to +490 bps.

Premiums Below-Average; Acquisition Financing Proves Costly
premiums calculated as change in yield following first day of trading



Funding Costs Rise Post Refinancing
new vs. refinanced coupon (or floating rate spread)



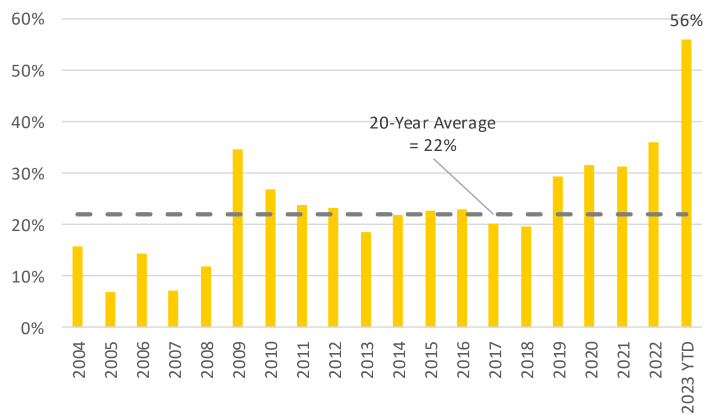
Source: SKY Harbor, JP Morgan, Bloomberg, ICE Data Indices

Going Secured

Investors (and corporate management teams) have long anticipated upward pressure on issuer interest expense, a dynamic largely stemming from rapidly rising rates since record-setting refi activity took place in 2020 and 2021. More specifically, **the average par-weighted coupon of the ICE BofA US High Yield Index (H0A0) was 320 bps below prevailing market yields at the start of this year, one of the most extreme divergences in the post-GFC era**. To alleviate some of this pressure, issuers have, where possible, sought to address upcoming maturities with secured debt. As demonstrated below, secured issuance penetration of primary market activity is at a 20-year high, and is currently running at greater than twice the long-run average. In addition, some lower-rated issuers have sidestepped potential impediments by refinancing unsecured obligations with a secured offering at a higher overall credit rating. As a result, though average funding costs continue to increase, they have done so at a less rapid pace than originally feared.

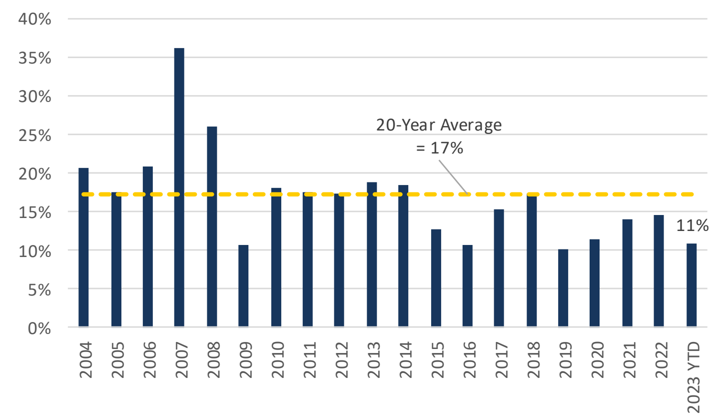
Companies Using Secured Issuance to Manage Expense

annual data; 2023 YTD figures through April 26, 2023



Lower-Rated Issuance Remains Light

% of deals rated B/CCC or lower



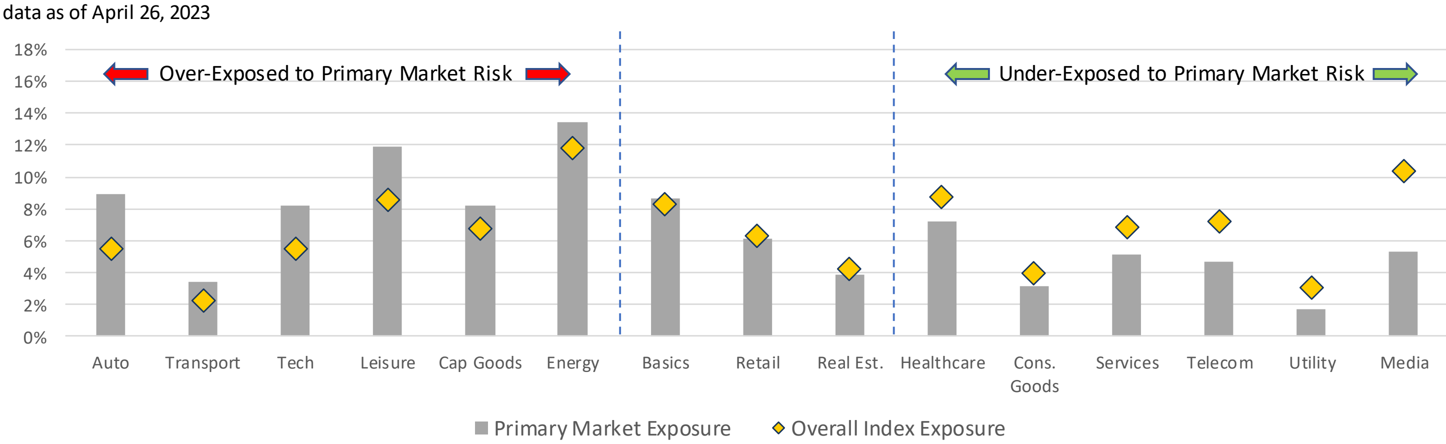
Source: SKY Harbor, JP Morgan

Still Some Wood to Chop

$8bn in high yield inflows (ETFs + actively managed mutual funds) on top of already elevated cash levels may have contributed to muted new issue premiums in April, as portfolio managers had funds to put to work. Though self-correcting to a degree, primary market activity can be volatile, and demands for higher premiums on future issuance could impact secondary trading levels. As such, we remain mindful of technical risk in sectors with building forward calendars. In the analysis below, we estimated potential sector issuance by aggregating next 36-month maturities (a proxy for refi volumes) with known funding needs for announced acquisitions. Normalizing sector data relative to the index as a whole, **we highlight that auto, transportation, and tech sectors have disproportionately more new issue risk, while media, utilities, and telecom have less**.

Announced Forward Calendar + Next 36 Month Maturities Show Sector Risks

data as of April 26, 2023



Source: SKY Harbor, ICE Data Indices, Deutsche Bank

Both a Risk and an Opportunity

We estimate that 72% of April's new deals tightened upon issuance, representing a modest – albeit positive – embedded premium. Perhaps of greater importance, however, was the normalization of primary market activity after minimal volumes in March, alleviating some concerns over credit availability. Looking forward into May, we think access to primary markets will remain open, and expect issuers will continue to pull multiple levers (secured issuance, shorter maturities, etc.) to dampen the overall impact to interest expense. Nevertheless, we remain cautious of sectors over-exposed to primary market risk, as wider premiums demanded by investors could re-price existing holdings.

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