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SKY Harbor Weekly Briefing

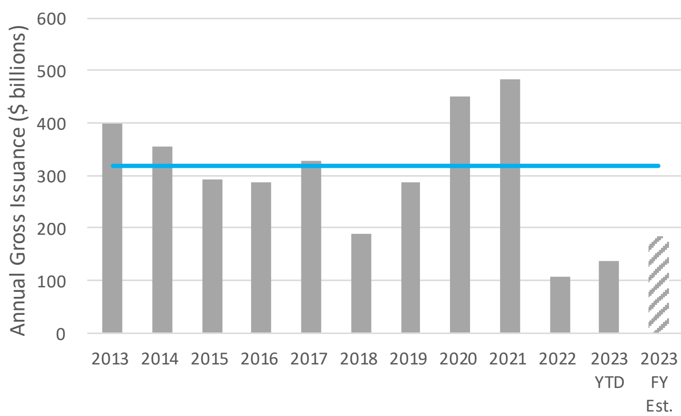
Not Yet Up Against a Wall

A second straight year of limited high yield bond issuance has brought us closer to the '25/'26 maturity wall, a dynamic further complicated under a "higher for longer" outlook for rates. With average par-weighted coupons set to ratchet up from bottom decile levels, some market participants have expressed concern over the impact this repricing will have on fundamental credit ratios, which ultimately drive default rates. In this *Weekly Breifing*, we find that relatively conservative balance sheets and an overall favorable ratings skew should cushion the impact of higher funding costs, with coverage metrics likely to weaken but remain well above critical thresholds that would otherwise undermine our benign default outlook.

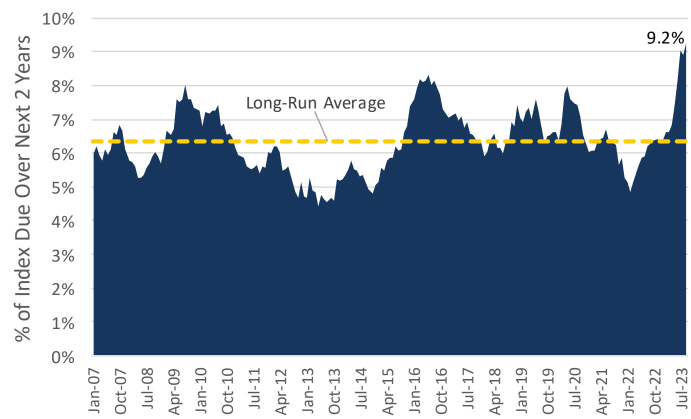
No Longer A Waiting Game

A rapid repricing of rates since the Fed embarked on an aggressive hiking cycle back in March '22 has made existing high yield coupons (sub-6%) look attractive to issuers. This dynamic has significantly contributed to the falloff in primary market activity since a record-setting 2021, with year-to-date figures implying another year of sub-$200bn issuance. As a result, **the amount of debt maturing over the next two years has hit a multi-decade high, in sharp contrast to below-average starting points in both '22 and '23**. Time to wait for elevated rates to subside is now dwindling, and funding costs are set to rise across the high yield index as a greater portion of coupons will re-set higher.

US HY Bond Index Has Seen Limited Issuance Since 2021
monthly data



Maturity Wall is Getting Closer
monthly data

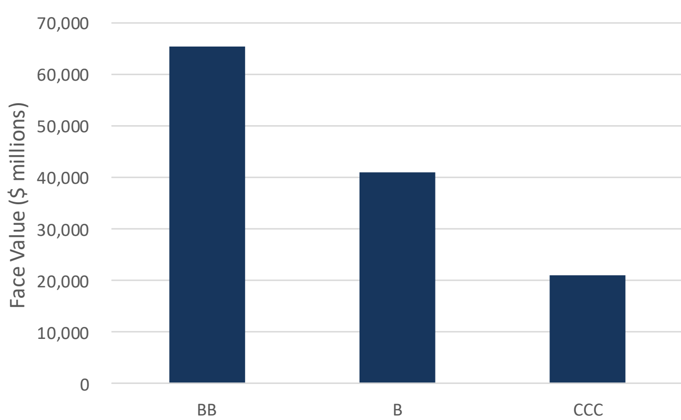


Source: SKY Harbor, ICE Data Indices, JP Morgan

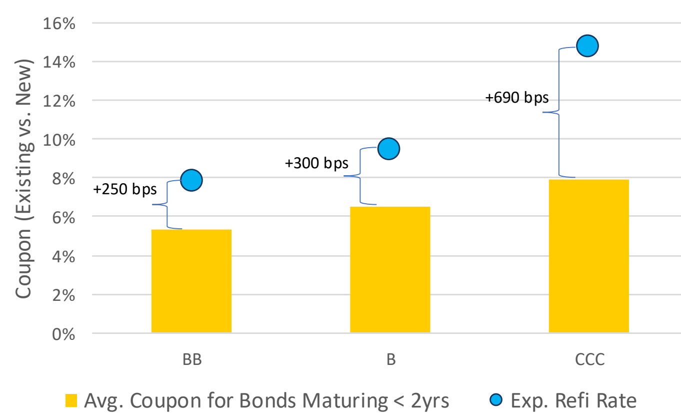
A Higher Quality Skew

We estimate that approximately $130bn of high yield debt will need to be refinanced over the next year, assuming issuers remain averse to letting bonds go current on their balance sheets. With this in mind, we broke down the universe of bonds maturing in < 2 years (period ending September 30, 2025) by rating (left chart below), and found them to skew higher quality in nature (~ 85% of likely refi candidates are non-CCCs). Furthermore, comparing average coupons of bonds likely to be refinanced to market yields for paper with similar ratings and of a tenor commensurate with primary market activity (5 to 7 years) **we find an implied average cost uptick of ~ 340 bps, with CCCs facing the most daunting step change (nearly +700 bps).** Given this dynamic, we think issuers and private equity sponsors will be highly incentivized to conserve cash at the expense of shareholder friendly initiatives, as the penalty for a lower credit rating becomes increasingly severe.

Nearly 85% of Debt Due Over Next 2Yrs is Rated BB or Single-B
maturities through September '25, by face value



Expected Coupon Uptick Most Severe for CCCs
maturities through September '25, by face value

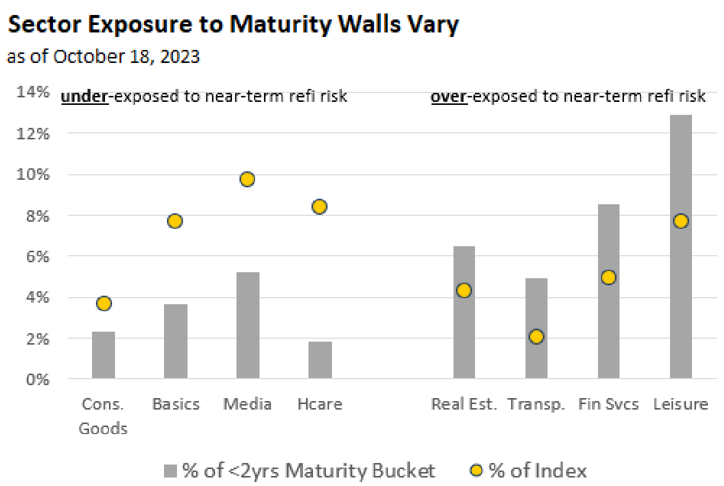


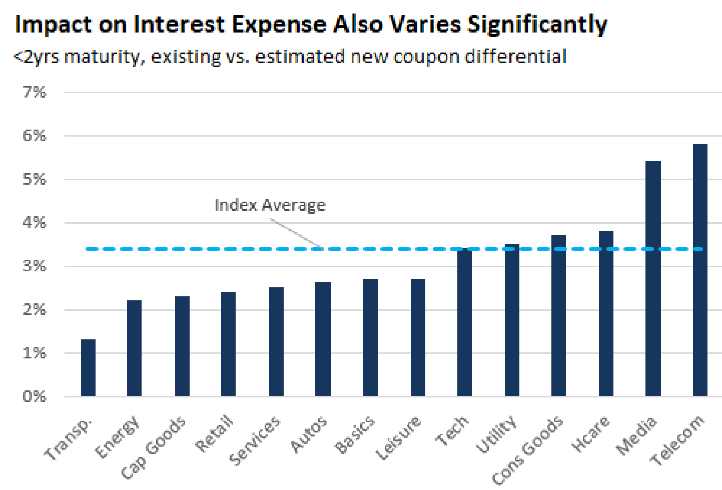
Source: SKY Harbor, ICE Data Indices

Sector Discrepancies

Owing to new issue premiums and portfolio constraints, we remain cognizant that sectors inundated with refi activity could potentially generate returns that lag the balance of the index. With this in mind, we next broke down the < 2 year maturity bucket by sector, looking for outliers that could pressure secondary market trading levels. As demonstrated below (left side), Healthcare, Media, Basic Materials, and Consumer Goods are less exposed to the "likely to refi" constituent set relative to their representation in the overall ICE BofA US High Yield Index, in our view implying a lower degree of risk, all else being equal. Conversely, **Leisure, Financial Services, Transportation, and Real Estate have disproportionately greater exposure to near-term maturities**.

Technical headwinds aside, we are also mindful that greater refinancing activity likely translates into higher interest expense in the coming year, as relatively modest coupons ratchet up to new market norms. As such, we calculated – on a sector basis – the difference between existing coupons likely to be refinanced with our estimate of the resulting new funding cost. With regard to the latter, our estimates were based on similarly rated bonds with a 5 to 7 year tenor within the same sectors as the refi candidates, though excluded deeply distressed issues likely to exit the index via bankruptcy over the next year (i.e. the widest 5% of index constituents, in-line with our expected default rate and, in general, representing a bond with an option-adjusted spread above 1,250 bps). As demonstrated below, and excluding financial sectors from our set, **we find that Telecom, Media, and Healthcare refinancings are likely to result in the largest uptick in issuer interest expense**, while Transportation, Energy, and Capital Goods face the lowest adjustments.





Source: SKY Harbor, ICE Data Indices

A Palatable Path

Putting it all together, we next attempt to simulate the path of coverage metrics (the ratio of EBITDA to interest expense) after accounting for the impact refinancing activity will likely have on average high yield coupons in the context of varied earnings growth environments. In our base case, the < 2 years constituent set is refinanced in the coming year with an average coupon ~ 340 bps above what is being replaced (pushing the overall index average coupon up by 30-35 bps). This, in conjunction with no earnings growth, **results in a coverage ratio of 4.4x by year end, down from 4.8x at present but well above the 3.4x threshold we typically associate as being the gateway to a spike in the default rate** (see our recent *Weekly Briefing* entitled "Notes from the Road – Miami Edition," for additional details on default trends). In fact, further reducing our EBITDA growth outlook to -10%, while also assuming a more onerous refinancing burden (+80 bps uptick in funding costs relative to our base case) compresses but does not completely eliminate the coverage cushion before hitting critical levels. Note as well that this basic model assumes no proactive maneuvering by management teams and equity sponsors, who will be highly incentivized to focus their cash on enhancing balance sheet strength, likely at the expense of shareholder friendly initiatives.

Interest Coverage Sensitivity Table

assumes 2% debt growth, other factors vary

HY Index EBITDA Growth	Uptick in Funding Costs Relative to Base Case								
	+ 0 bps	+ 10 bps	+ 20 bps	+ 30 bps	+ 40 bps	+ 50 bps	+ 60 bps	+ 70 bps	+ 80 bps
+ 2%	4.5x	4.4x	4.3x	4.3x	4.2x	4.1x	4.0x	4.0x	3.9x
0%	4.4x	4.3x	4.3x	4.2x	4.1x	4.0x	4.0x	3.9x	3.8x
- 2%	4.3x	4.2x	4.2x	4.1x	4.0x	4.0x	3.9x	3.8x	3.8x
-4%	4.2x	4.2x	4.1x	4.0x	3.9x	3.9x	3.8x	3.7x	3.7x
-6%	4.1x	4.1x	4.0x	3.9x	3.9x	3.8x	3.7x	3.7x	3.6x
-8%	4.1x	4.0x	3.9x	3.8x	3.8x	3.7x	3.6x	3.6x	3.5x
-10%	4.0x	3.9x	3.8x	3.8x	3.7x	3.6x	3.6x	3.5x	3.5x

Source: SKY Harbor, ICE Data Indices

Stay the Course

With the maturity wall getting closer and rates staying persistently elevated, an uptick in issuer interest expense has become inevitable. However, refinancing is manageable, in our view, given the higher credit quality skew of maturities over the next two years. Not all sectors, however, will fare equally, as several have disproportionate exposure to near-term maturities, and the magnitude of coupon re-sets can vary dramatically. Ultimately, we think high yield bond index fundamentals, in aggregate, should remain healthy, with significant balance sheet repair in the post-pandemic period offering constituents a lofty starting point. Lower-rated credit, given the most sizeable gap between existing coupons and prevailing market yields, are poised to suffer most, though all issuers will be incentivized to focus on credit quality enhancement. As such, though we don't see defaults accelerating rapidly above long-run average levels, the comparatively small CCC cohort within the high yield index will experience stress. We therefore continue to prefer an underweight to the most speculative credits in the index, and remain mindful of the impact a potential wave of refinancing activity may have on certain sectors facing a disproportionate amount of coupon re-sets.

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