SKY HARBOR
CAPITAL MANAGEMENT

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SKY Harbor Weekly Briefing

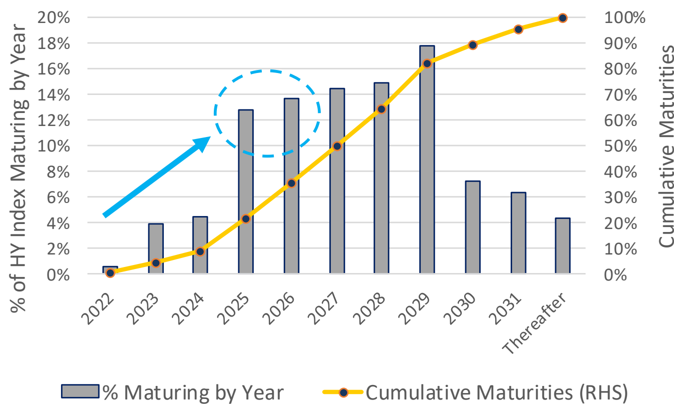
SKYView: Credit Metric Resilience

Amidst war-related stress and uncertainty, high yield new issue markets have nearly slowed to a halt. While some investors may fear this forebodes a gathering storm, we take a more sanguine view – that a reduction in primary market activity is indicative of issuer flexibility in a rising risk premium environment. Furthermore, with index yields breaching the 6% level for only the second time since the onset of the pandemic, concerns abound regarding the staying power of record-high interest coverage ratios, a key determinant of future index default levels. In this *Weekly Briefing*, we evaluate the potential for systemic risk as primary issuance dries up, and gauge the resilience of recently improved high yield issuer credit fundamental metrics under a sustained environment of geopolitical uncertainty.

Strong high yield primary markets – 2020 and 2021 represented consecutive record-high years for bond issuance – provided an opportunity for leveraged credit issuers to address near-term obligations, with most taking advantage of a low interest rate environment to extend maturity profiles. As a result, **the maturity "wall" has been extended to the '25/'26 timeframe, with only modest amounts of debt needing to be addressed in the coming quarters**. More specifically, and as demonstrated below (right chart), only 4% of the index by face value comes due in the next 24 months, a very manageable level that falls well below the trailing 7-year average. With elevated amounts of cash on balance sheets, we view the recent dearth of high yield bond issuance as being driven by issuer choice…i.e., why force a deal when risk premiums are elevated, particularly when your financial runway is so long?

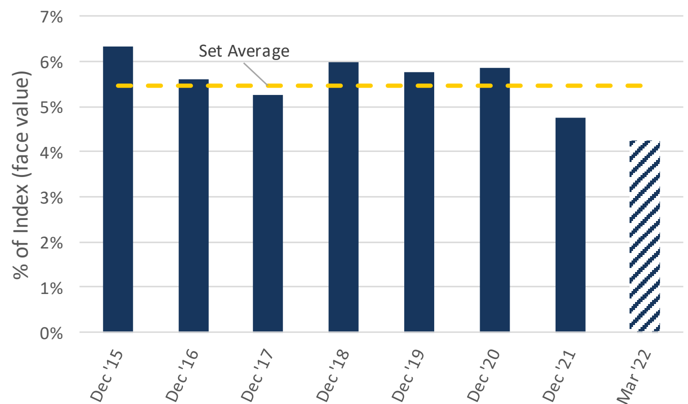
HY Index Maturity Wall Has Been Extended

maturities by face value



Percentage of HY Index Maturing Over Next 2 Years

proxy for risk should primary markets freeze

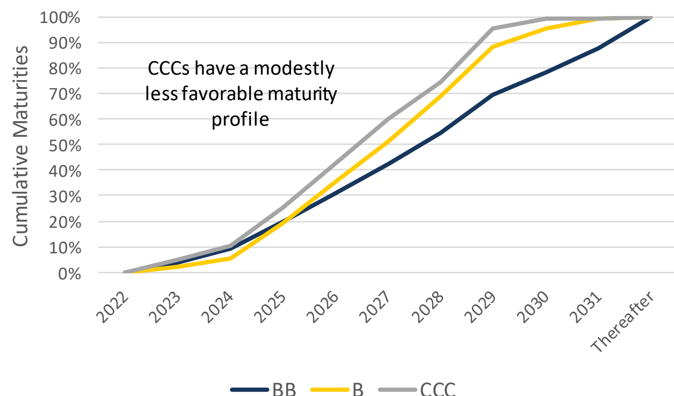


Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch

We would highlight, as well, that lower-rated credit has also pushed out near-term maturities during a surge in primary issuance over the last twenty-four months. While CCC's have a modestly more onerous uptick leading into 2025, **we would characterize all rating classes as having secured a significant amount of financial flexibility**. At the same time, we recognize that rising rates – we view the Fed as still being likely to act in order to curtail inflation despite recent developments in Ukraine – and rising risk premiums have pushed high yield index yield-to-worst levels above the 6% level. Despite this dynamic, an opportunity to materially reduce funding costs still exists in the high yield market. As demonstrated below, **the average in-place coupon of bonds likely to mature or get called in the next two years ("Avg. 0-2 Duration Coupon") still exceeds the average yield currently demanded by the market in the range along the corporate credit curve where most new issuance should fall ("Avg. 6-8 Duration YTW")**. As such, even if leveraged issuers were to come to the new issue market at present – amidst rising rates and elevated geopolitically-driven risk premiums – funding costs could still conceivably decline between 17% and 27%.

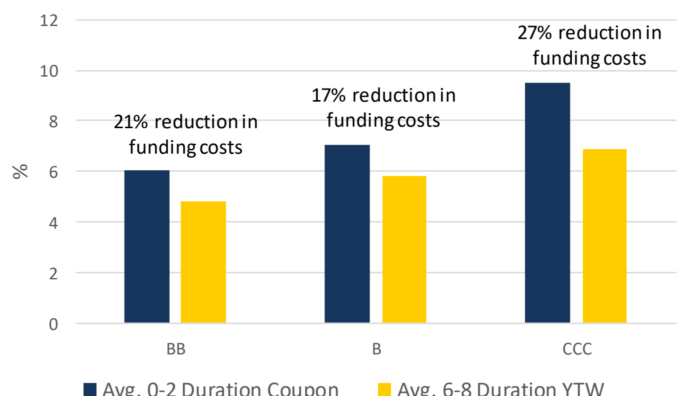
Cumulative Maturities by Rating Bucket

maturities by face value



All Rating Buckets In Position to Improve Funding Costs

data as of March 4, 2022



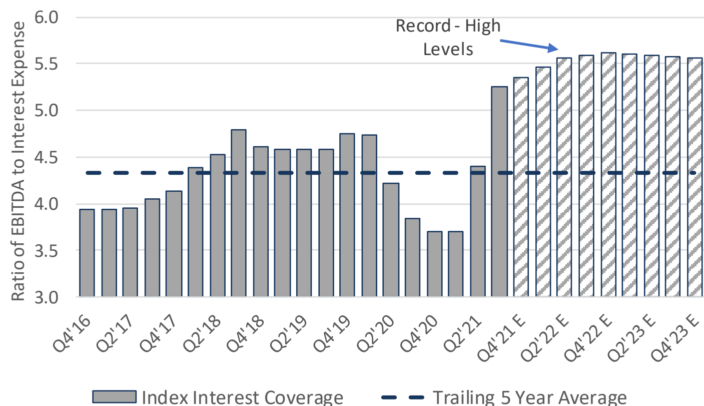
Source: SKY Harbor, Bloomberg, ICE Data Indices

So, it appears as though a lack of new issue activity is not likely to pressure high yield constituents given limited upcoming maturities. Nor should funding costs increase for high yield issuers in the near term despite rising rates and a recent uptick in risk premiums. Could, however, an environment of sustained rate increases and/or heightened risk premiums reverse post-pandemic balance sheet repair, eroding interest coverage metrics to the point at which an increase in the default outlook becomes the base case view?

To set the stage for our analysis, we begin with a look at current fundamentals. At the time of publication, we estimate that ~ 85% of US high yield issuers have reported Q4'21 earnings, a large enough base from which to update our aggregate interest coverage ratio metric (~ 5.3x, and well above the 5-year average of ~ 4.3x). Furthermore, we project index coverage ratios will rise to ~ 5.6x by the end of 2022 (an all-time record), a function of expected underlying EBITDA growth and average coupons that still exceed the market-implied cost of extending debt maturities. **In comparing interest coverage ratios to par-weighted default rates over time, we find the latter typically hits an inflection above the nearly 5% annual average only when coverage metrics migrate below 3.5x, a seemingly comfortable distance from most recent levels**. Therefore, a rapid rise in par-weighted defaults from current levels (0.3%) to above-average levels (5%) seems unlikely in the near term.

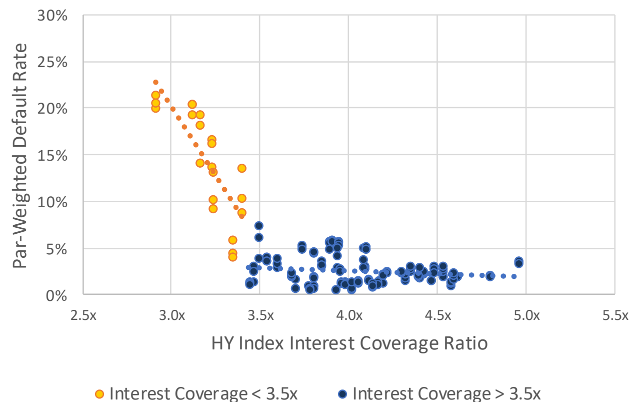
US High Yield Coverage Ratio

5 year time series; striped bars are SKY Harbor projections



Defaults Tend to Rise When Interest Coverage Falls Below 3.5x

quarterly data, trailing 15 years



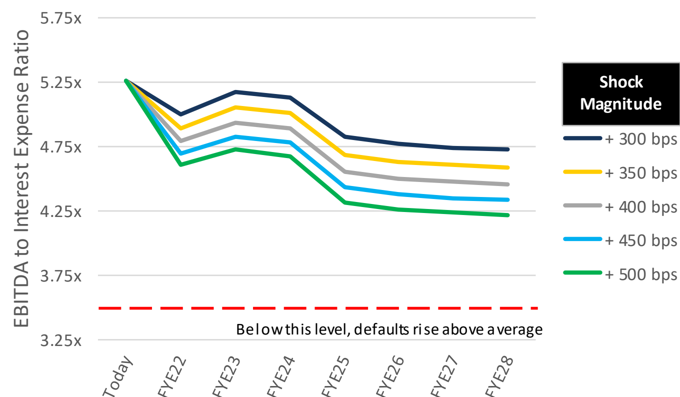
Source: SKY Harbor, BofA Merrill Lynch, Capital IQ, Bloomberg

However, a Fed liftoff in the coming days, as well as rising risk premiums should conflict between Russia and Ukraine persist, will likely result in higher funding costs on a go-forward basis. In an extreme case of the latter, global GDP constriction could cause our issuer EBITDA growth projection to decline (currently +9% in '22, +5% in '23). To simulate how this all could play out, we created an index-level stress test to gauge the resilience of interest coverage metrics under a variety of rate scenarios.

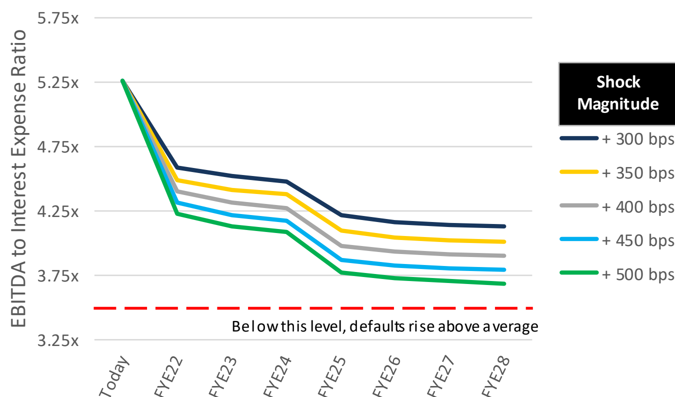
Below, **we force an instantaneous surge in prevailing market yields, representing a combination of Fed action and higher risk premiums, onto high yield constituents**. These shocks – which range in magnitude from +300 bps to +500 bps – immediately increase the cost of floating rate debt for index constituents (conservative, in our view, since we believe many management teams swap floating for fixed rate exposure after issuance). Furthermore, we assume fixed-rate (bond) funding costs increase by the difference between actual coupons and post-shock index-level yields as debt comes due each year. We further nuance our findings by allowing issuer EBITDA to grow at a level consistent with our internal projections (left side) and by 0% for all periods (right side). **In both cases, we assume no free cash flow to proactively pay down debt, no ability for management teams to improve internal cost structures, and no ability to switch funding sources** (unsecured to secured, bond to loan, etc.), all of which seem overly conservative, at least in our view.

Interest Coverage Path Under Various Rate Shock Scenarios

assumes SKY Harbor EBITDA growth estimates



assumes no EBITDA growth



Source: SKY Harbor, BofA Merrill Lynch, Capital IQ, Bloomberg

As demonstrated above, and under circumstances that are admittedly draconian in nature, interest coverage metrics for the entire high yield index remain relatively resilient following yield shocks. In fact, **interest coverage metrics fail to degrade below worrisome levels (sub 3.5x, the point at which default rates tend to increase precipitously) even under a scenario that includes a 500 bps yield shock with no EBITDA growth over a 5+ year period**.

In conclusion, we do not find a recent slowdown in new issue market activity to be alarming. Rather, the corporate maturity runway created over a two-year period of record-high refinancing activity has given most issuers the ability to avoid primary markets when risk premiums are elevated. Furthermore, while we acknowledge that rates are likely to rise and risk premiums are likely to remain elevated in the near term, the overall impact to interest coverage metrics should be quite manageable. Through scenario analysis, we find it unlikely for credit metrics to degrade toward a level historically consistent with an uptick in defaults without sizeable erosion in underlying EBITDA. As such, we anticipate balance sheets will remain healthy and the default environment will remain benign, despite macro headwinds that have introduced increasingly higher levels of uncertainty into the current market environment.

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