SKY HARBOR
CAPITAL MANAGEMENT

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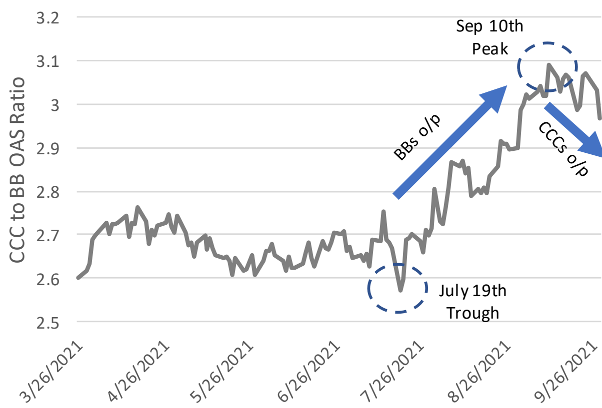
SKY Harbor Weekly Briefing

SKYView: "Performing" CCCs

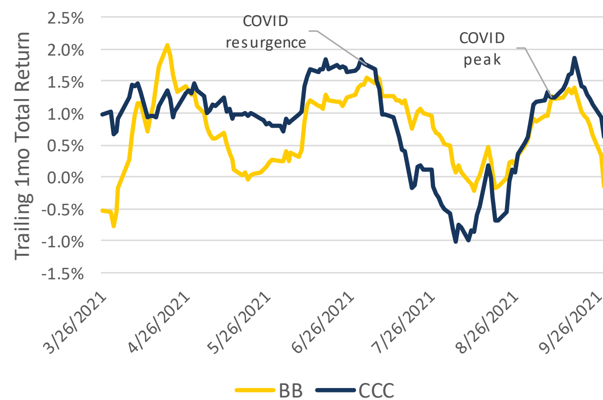
On a year-to-date basis, the lower-rated portion of the high yield market has generated outsized returns, with CCCs outperforming the ICE BofA US High Yield Index (H0A0) by nearly 600 bps. Though outperformance slowed for a brief stretch in the middle of 2021 – BBs actually outpaced CCCs during the summer months – we believe a bias toward lower-rated credit will once again be rewarded in the final quarter of the year. In this *Weekly Briefing*, we outline our investment rationale for favoring lower-rated credits in the current economic environment, and focus on differentiating factors inherent to the rating cohort that further improve relative attractiveness at present.

While a re-opening of the economy had been the primary driver of outsized CCC returns earlier in the year, the resurgence of the coronavirus via the Delta variant (July and August) dampened risk-on sentiment as the US (and the rest of the world) entered a fourth wave of the pandemic. With net new cases having peaked earlier in September, and high yield issuer EBITDA growth and deleveraging progressing at a record-setting pace (see our *Weekly Briefing* entitled "Leverage Has Peaked" here), **investor appetite for credit risk has returned**. As demonstrated below, the CCC to BB OAS ratio troughed in early July, prompting a brief period of higher-quality credit outperformance on the basis of both valuations and waning sentiment. By early September, however, new COVID cases had seemingly reached a peak, ushering in a greater tolerance for risk-taking (consistent with expectations expressed in our *Weekly Briefing* from August entitled "Summer Recap," found here) and a resumption of CCC outperformance.

CCC/BB OAS Ratio Troughed July 19th, Peaked 8 Wks Later
daily data, last 6 months



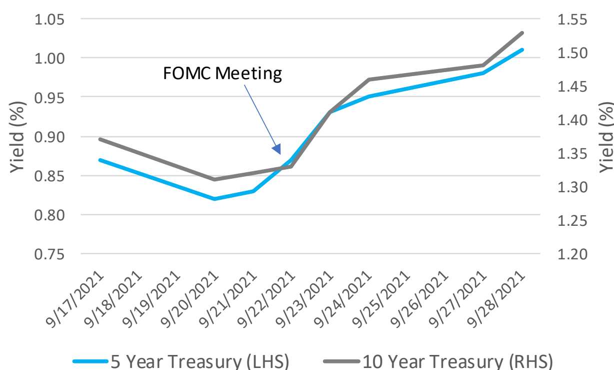
BBs Outperformed This Summer, CCC Resurgence Since
daily data, last 6 months



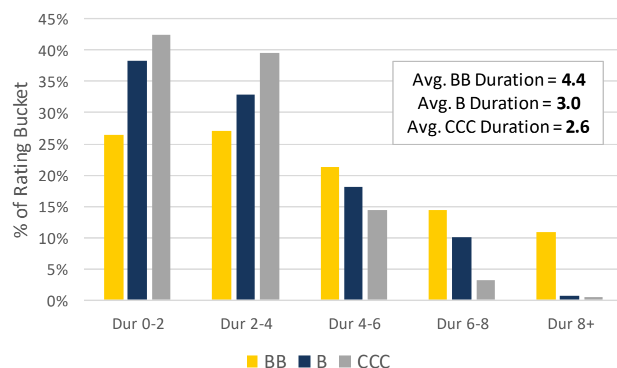
Source: SKY Harbor, ICE Data Indices

While balance sheet repair, strong EBITDA growth, and falling default rates benefit lower-rated credit (both historically and at present), more hawkish than expected notes from the September FOMC meeting (see our *Weekly Briefing* entitled "Distress, Defaults, and Dots" here) spurred a selloff in rates, with Fed guidance for a moderation in the pace of asset purchases and a shifting dot plot the primary drivers of the move. In fact, both 5 and 10-year Treasury yields have increased by ~ 20 bps over the last week, prompting selling pressure in higher-duration corporate bonds. As noted below, **duration among the CCC universe is materially lower than BBs and the broad high yield index in general, with a substantial amount of paper (over 80% by face value) contained within the 0 to 4 buckets**. On the opposite end of the rating spectrum, only 50% of BB-rated debt resides in those buckets, with overall duration nearly 70% higher. Given consensus expectations that rate pressures will persist, we view the shorter nature of lower-rated credit as a benefit, as it affords investors greater protection from the dominant risk factor in the market.

Treasury Selloff Accelerated Since FOMC Meeting
data as of September 28, 2021



CCC Cohort Skewed Toward Shorter Duration
data as of September 28, 2021

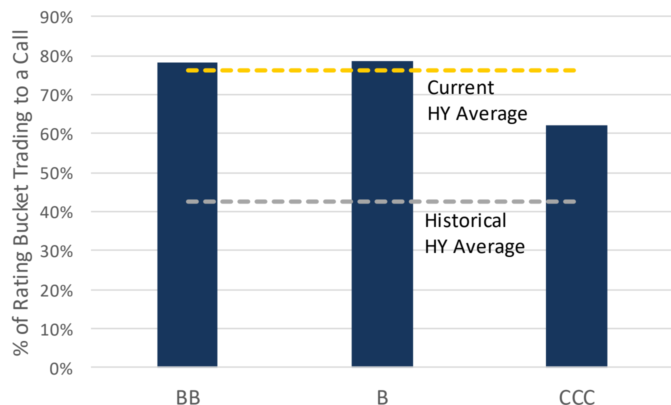


Source: SKY Harbor, ICE Data Indices

A persistent area of concern in the high yield market over the last twelve months is rising convexity in a subdued rate environment. Our proxy – the percentage of high yield bonds trading to a call – is near all-time highs at ~ 75%, and remains well above the trailing 60-month index average. Breaking down the universe by rating bucket, **we find call constraints to be least prevalent among CCCs**. Furthermore, we have been vocal in our preference for smaller issues (< $350mm in size) since last summer, which despite outperforming large issues (> $1bn) by 525 bps in the trailing 1-year period still show a valuation dislocation, in our view. More specifically**, we calculate that compensation for smaller / less liquid issues, after controlling for differences in credit rating and duration, is still 25% above long-run norms, with a higher concentration of such bonds present in lower credit quality buckets**.

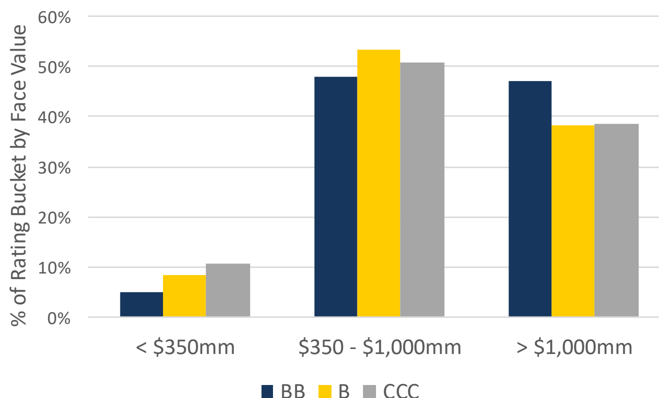
CCC Convexity is Below the Index Average

face value; data as of August month end



Small Issue Bias More Easily Expressed in Lower-Rated Credit

face value; data as of August month end

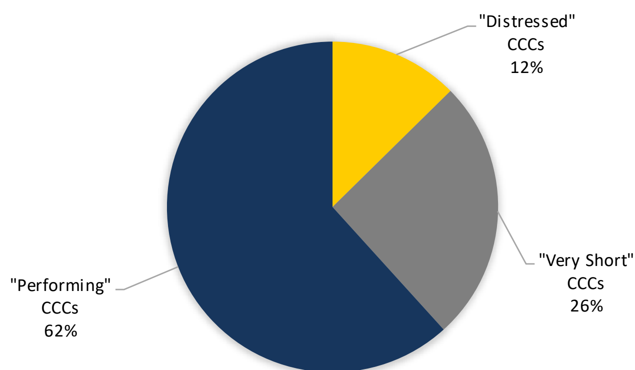


Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch

An admittedly fair criticism that arises when evaluating lower-rated credit from a relative value perspective is the "investability" of the underlying universe. For example, our sanguine view of defaults – we continue to envision an exceptionally low default rate by year end, likely in the high 2% range – must be balanced by the outsized impact they might have on the CCC asset class (since it makes up only 12% of the index). To adjust for likely default candidates that boost CCC sub-index yields despite being unlikely to ultimately pay all remaining coupons, we eliminated issues trading at distressed levels, defined as an OAS above 1,000 bps. Furthermore, we also excluded bonds trading to a very near-term call (duration below 1), given the high likelihood of an imminent refinancing. What is left – we call this the "performing" CCC universe – has a yield of ~ 6.35%. Though below the "headline" CCC yield of over 7%, **this "performing" CCC bucket still offers 200 to 300 bps of additional carry relative to higher-rated credit**, a significant advantage in the context of total return expectations for the balance of the year.

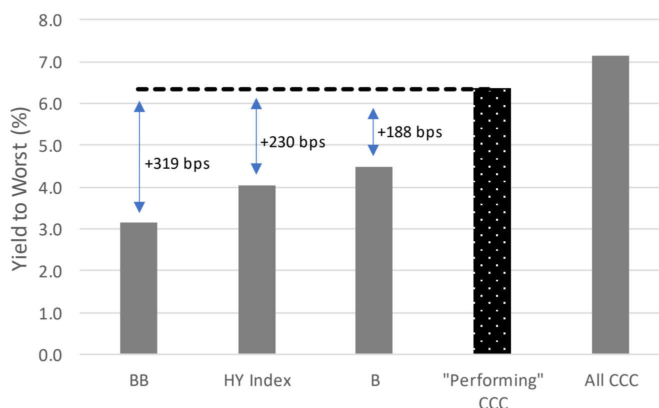
Not All CCCs Are Alike

data as of September 28, 2021



"Performing" CCCs Have Significant Carry Advantage

data as of September 28, 2021



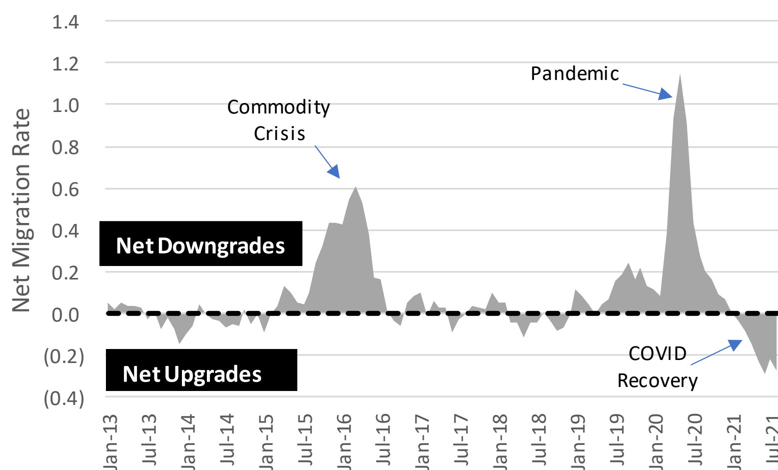
"Distressed" = strong default potential, spread > 1,000 bps, "Very Short" = likely refinancing in near term, duration < 1

Source: SKY Harbor, ICE Data Indices

Another key theme in our market outlook is credit migration rates, which in our view should continue to skew toward upgrades for the balance of the year. Historically speaking, upgrade candidates have generated excess returns for investors, with spread levels converging toward that of the next highest rating class as the potential for rating action becomes more likely. While issue-specific spread levels and the cadence of convergence is in all cases unique, **the theoretical capital gain potential – spread tightening multiplied by the starting duration – seems to favor CCCs, as the amount of spread separating each asset class (to be conservative, we use "performing" CCC spreads, not the full CCC index) is largest in the lower-rated portion of the market.** Given a significant number of outperforming CCC upgrades thus far in 2021 (listed in the table below), we remain optimistic that high-conviction credit picking among lower-rated bonds will offer additional excess returns over the balance of the year. In fact, the practice of fundamental credit research supporting the purchase of above-market yielding securities (using SKY Harbor custom market segmentations, this would historically involve bonds in the "9+" yield bucket) in anticipation of tightening into lower yielding and less volatile cohorts (with or without a rating upgrade) has underpinned our credit risk-taking for decades.

Upgrades Dominating Downgrades

monthly data, trailing 5 years



Source: SKY Harbor, ICE Data Indices, Bloomberg

Upgrade Capital Gains

theoretical framework

Rating Cohort	Spread	Duration	Theoretical Upgrade Cap Gain (bps)
BBB	108	7.97	
BB	216	4.37	472
B	316	2.95	295
Performing CCC	537	3.44	760

Select SKY CCC Upgrades This Year:

Bond	
FXI Holdings	The Fresh Market
Titan International	Uber
US Steel	Beacon Roofing Supply
First Quantum Minerals	Realogy
Ashton Woods	Six Flags Entertainment
Cornerstone Building Brands	Dave & Busters

In conclusion, we continue to like lower-rated credit, as past periods of high EBITDA growth, declining leverage, and falling default rates have typically been supportive of the riskier segments of the high yield market. In additional, lower-rated credits have, on average, materially lower duration than the balance of the high yield index, an important distinction as the threat of rising rates is justifiably the dominant concern of the market at present. Furthermore, fewer call constrained bonds, a higher concentration of small issues, superior carry, and higher (albeit theoretical) capital gain potential upon a credit upgrade further improve the attractiveness of lower-rated bonds, even when limiting the universe to "performing" CCCs.

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