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Red-Hot High-Yield Bond Market Showing Signs of Restraint and Exuberance

The U.S. high-yield (HY) bond market has come roaring back to life in 2020 after several years of playing second fiddle to the leveraged loan market. HY bond issuance exploded to more than $200 billion in 1H20, including $128 billion in 2Q20, on track for its best year ever.

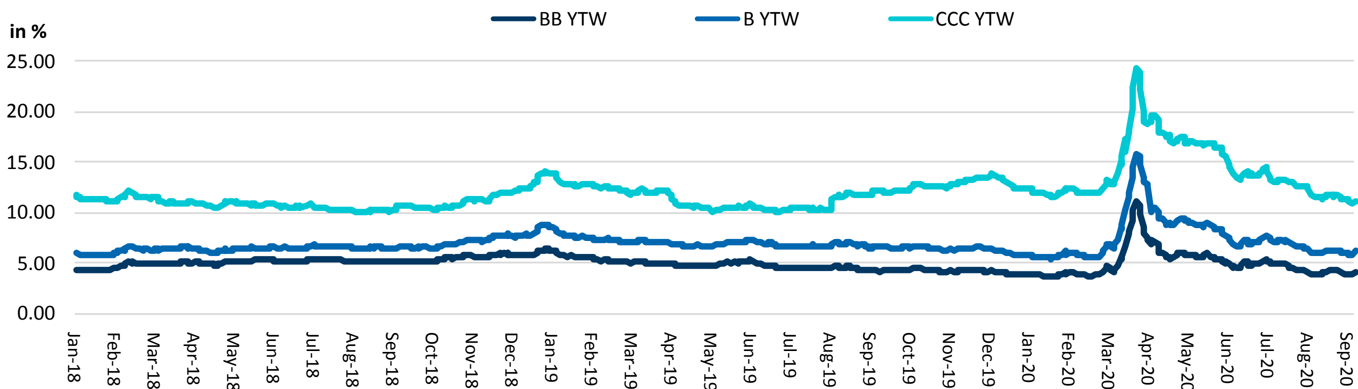
The same can't be said for leveraged loans, where syndication volumes in 2Q20 were down significantly from a year ago as new deal flow dried up. The divergence between these two credit markets has been hard to miss. New HY bond issuance in 2020 has provided crucial financial lifelines to many large businesses suddenly caught in the crosshairs of COVID-19.

Paving the way for this comeback, just as COVID-19 was beginning to wreak havoc on credit markets, was the late March announcement by the Federal Reserve Board of its Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility, two programs which potentially represent up to $750 billion of purchases of new or existing bonds, including "fallen angel" corporate debt and high-yield exchange-traded funds (ETFs).[1] The mere announcement of these programs restored confidence for sputtering corporate credit markets and ushered in a surge of new corporate debt issuance, including junk bonds, to raise liquidity needed to withstand the pandemic's impact. Ironically (and surprisingly), the Fed has barely tapped these two programs to date, with just $13 billion of HY bond and ETF purchases through August. Nonetheless, its commitment to support corporate credit markets should they seize up has been good enough for credit investors who continue to believe that the Fed has their back. In late July, the programs' permitted investment period to make new purchases was extended to year end from September 30, even with corporate credit markets functioning perfectly well on their own — a reminder of how fragile investor confidence may still be. Fed Chair Powell recently indicated that the Fed intends to keep base interest rates close to zero into 2023 via aggressive purchases of Treasuries and mortgage securities. Corporate credit investors fully expect the Fed will backstop credit markets as a buyer of last resort when "free markets" go off the rails.[2] The assumption of the Fed's direct intervention in private credit markets as needed is now embedded among market participants.

Not only has new issuance soared since April, but market yields on high-yield bonds have nearly reverted to pre-pandemic levels **(Exhibit 1)** from double-digit rates in March — a remarkable turnaround considering how

1 https://www.federalreserve.gov/monetarypolicy/pmccf.htm
2 https://www.nytimes.com/2020/08/27/business/economy/federal-reserve-inflation-jerome-powell.html

Exhibit 1 – U.S. Speculative-Grade Bond Yield-to-Worst



Source: Bloomberg

much uncertainty still pervades the corporate landscape. Embedded within this comeback story is the widely held expectation that 2021 will represent a return to normalcy for most issuers with respect to COVID-19 impacts. Financial markets long ago gave most of the corporate sector a pass for 2020, but how realistic are its expectations for 2021 and beyond? Notable attributes of HY bond issuances to date help inform that discussion.

New High-Yield Bond Issuance Trends Tell a Story of Restraint and Exuberance

We evaluated speculative-grade bond issuances via Rule 144 private placement offerings by U.S.-based public companies in the recent six-month period from March through August. In all, there were 182 bond issues placed by 134 spec-grade companies in this period, totaling $151 billion of issuance proceeds. Some noteworthy takeaways from these issuances include the following:

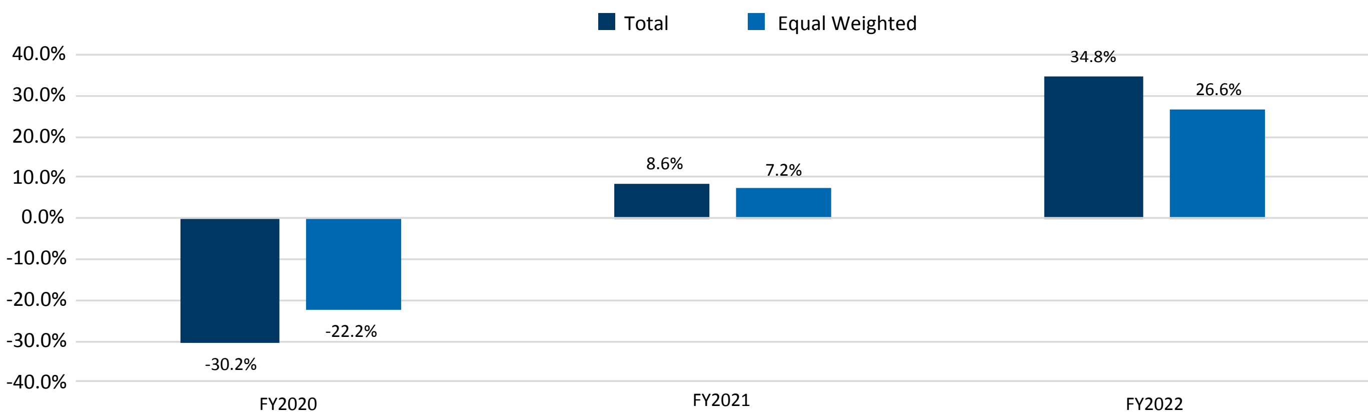
- In the aggregate, new spec-grade bond issuance of $151 billion represented a 21% increase in total debt for these issuers compared to the end of 2019 — a huge uptake in such a short period. On an equally weighted basis, total debt increased by an average of 24% for these issuers — again, a huge jump in just two quarters. Average total debt-to-EBITDA (using EBITDA in FY2019) for these issuers increased to 4.9x from 4.1x at the end of 2019. (The average leverage metric is likely even larger than 4.9x, as nearly 35% of issuers sold debt subsequent to their most recent quarter end.) Credit investors are again in risk-on mode, and spec-grade issuers have seized the opportunity to tap this market. Given the many uncertainties around the duration of the pandemic's financial effect, most impacted companies took the money if it was available.
- However, net debt (total debt minus cash and equivalents) for these issuers increased by much smaller rates, indicating that many of these companies issued debt to raise liquidity amid the pandemic rather than for purposes of investment, acquisitions, refinancing or shareholder returns. (Though for some recent issuances, it may be too soon to have deployed this capital.) In the aggregate, net debt increased by 10% compared to the end of 2019, and by 7.5% on an equally weighted basis. Average net debt-to-EBITDA (again using EBITDA in FY2019) for these issuers increased more moderately, to 3.8x from 3.5x at the end of 2019, with most companies apparently sitting on newly raised cash. This is consistent with the prevailing narrative that these issuers raised capital to ensure they had enough cash on hand to outlast the pandemic.
- The average S&P rating of these issuances was smack in between a BB– and B+ rating, a reassuring indication that HY markets were discerning and mostly receptive to better-quality junk issuances. About 55% of the issues we evaluated had credit ratings within the BB family, while only 15% of these spec-grade issuances were rated B– or below, ratings associated with "deep junk." The high-yield market may have recovered impressively since March, but its doors are not wide open to all borrowers.

- Since the onset of COVID-19, HY investors have sought out new issues that place them higher up in the capital structure. Historically, HY bonds issues have tended to be senior unsecured or subordinated unsecured debt, but this year nearly 40% of the issues we evaluated were senior secured debt — a notable departure from the past.
- The average maturity of these 182 issues was nearly seven years, with 43% of new issues maturing in five years or less, an indication that borrowers don't anticipate a long-term need for this funding. The average yield at offering date was 6.5%, while average current yield (YTM) has since fallen to 5.3% as credit markets continue to rally.

All in all, these findings are indicative of a HY bond market that has been fairly disciplined even as deals are being done with near abandon. However, markets are also very optimistic regarding forward-looking operating performance, perhaps unrealistically so. It's a given that 2020 is a washout; consensus EBITDA estimates for the 134 issuers we evaluated will decrease within the range of 22%-30% vs. 2019, depending on whether issuers are weighted by size or equally weighted. Moreover, 22 of these issuers are expected to report negative EBITDA in 2020 versus two in 2019. But 2021 is another story entirely, with consensus EBITDA expectations more than wiping out 2020's declines and posting mid- to high-single-digit gains compared to 2019; expectations for 2022 are much more bullish, with consensus EBITDA estimates expected to top those of 2019 by 26%-34% **(Exhibit 2)**. Such lofty expectations imply, in the aggregate, a near doubling of EBITDA by 2022 compared to 2020.

If one were tempted to believe that these expectations aren't exceedingly aggressive, consider that many of these issuers operate in industries hardest hit by COVID-19. In fact, 40% of the issuers we evaluated were operating in beleaguered industry sectors, including energy, retail & restaurants, airlines & travel, and leisure & entertainment. It seems unlikely that these industry sectors will be thriving again by 2022. Moody's and S&P expect the U.S. spec-grade corporate default rate to nearly double from current levels by early to mid-2021, led by these very same industries. That doesn't exactly sound like the comeback story implied by earnings estimates for next year. Moreover, many recent HY borrowings are intended to fund operating shortfalls rather than investment, meaning that many of these risky issuers will be considerably more leveraged by the time they arrive on the

Exhibit 2 – HY Issuers' EBITDA % Change Compared to 2019



Source: S&P Capital IQ and FTI analysis

other side of COVID. In short, there is no economic return on money borrowed to fund losses.

Increasingly, the ongoing showdown between bulls and bears, optimists and pessimists, cheerleaders and realists won't be resolved until we can glean what a post-pandemic world will really look like. Will folks again be piling into planes, hotels, casinos, malls and amusement parks by 2022? Will fossil fuels ever stage a comeback? Will a significant percentage of the workforce continue to work from home indefinitely or permanently? Will consumers be content to remain comfortably ensconced homebodies? Will the uneven recovery hobble consumer spending beyond 2020? **In short, will COVID-19 alter the way most Americans choose to live after the virus is tamed? This is the fundamental debate taking place as markets wrestle with sharply conflicting views of a highly uncertain future.** The HY market seems to be assuming that most of us eventually will go back to our old ways. Only time knows the answer to this one.

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