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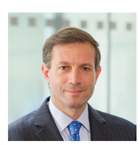
High Yield: Scaling the Maturity Wall

INSIGHTS

The maturity wall facing high yield bond issuers has garnered much attention. But given the market's short duration profile, lower prices and higher-quality relative to history, the reality facing issuers is less daunting.



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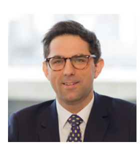

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Maturity walls, which represent the maturity schedule of the aggregate market, are capturing the attention of media and investors alike. In the high yield bond market specifically, the elevated level of interest rates has raised questions about the ability of issuers to refinance their existing, low coupon debt. While these concerns are real, we believe they may be somewhat overblown—and overshadow potential total return opportunities that are compelling in the wider fixed income world.

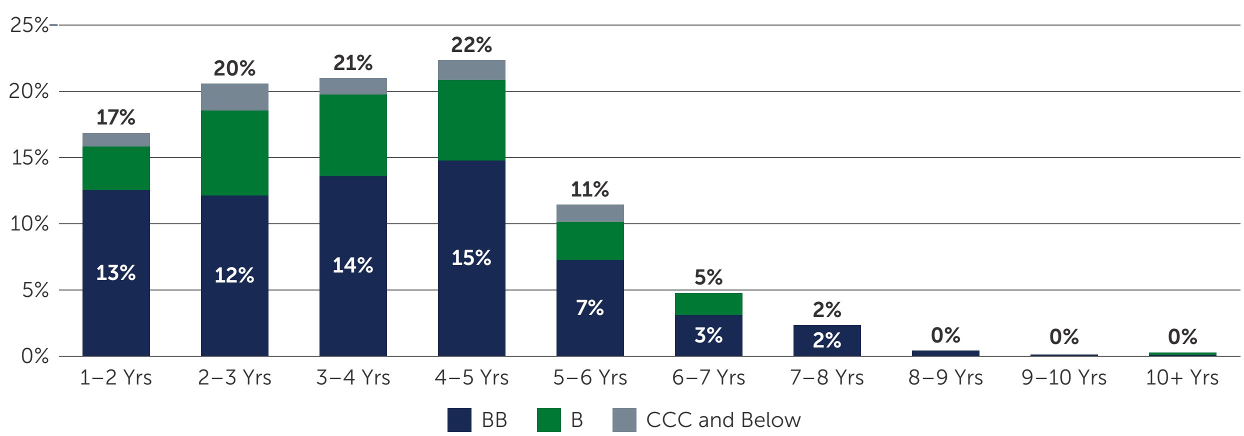
Key Characteristics of the Market Today

There are good reasons for persistently high interest rates to cause concern when it comes to high yield bonds. Namely, higher funding costs can make it challenging for issuers to refinance maturing debt, especially when financial conditions or fundamentals are stretched. In some instances, issuers could be facing a doubling or even trebling of interest costs to maintain the same level of balance sheet debt, which would materially impact cash flows. This could lead to an increase in distressed situations and, in extreme cases, defaults. However, the composition of the high yield market has changed in recent years—and those changes may help to minimize the potential for worst-case outcomes.

HIGHER QUALITY PROFILE

For one, refinancing concerns and default risk loom largest for issuers with CCC and below ratings. Typically, the interest coverage ratio for these issuers is lower than it is for higher-rated companies, and balance sheet leverage tends to be higher, thus magnifying solvency risks. Of note, however, CCCs make up a small portion of the high yield market—in Europe, specifically, they comprise less than 7% of the market, which is a 40% reduction from 15 years ago.[1] Further, with European CCC issuers trading at an average price of 67, much of the risk of impairment has already been priced in by the market.[2] At the same time, CCCs represent only a small fraction of the market that is nearing maturity **(Figure 1)**. In particular, while the proportion of the market with near-term maturities has increased in recent years as issuers have delayed refinancing, of the 37% of today's issuers facing maturities in the next 36 months, only about 3% are currently rated CCC.

Figure 1: CCCs Make Up a Small Fraction of the European High Yield Maturity Schedule



Source: BofA ICE, Bloomberg. As of June 30, 2024.

1. Sources: BofA ICE; Bloomberg. As of June 30, 2024.
2. Source: BofA ICE. As of June 30, 2024.

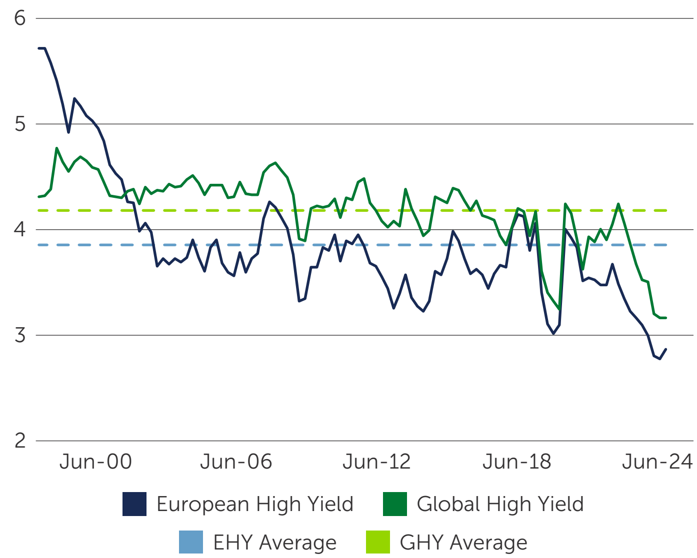
In addition to this, looking at the global high yield market overall, the credit quality is greater than it has been in many years. At the same time the percentage of CCCs in the market has been decreasing, the percentage of BBs—the highest-quality sector of the market—has been increasing. While this trend is evident globally, with 52% of U.S. issuers currently BB-rated, it has been particularly pronounced in Europe, where two-thirds of issuers now carry BB ratings.[3] At the same time, the higher nominal costs of debt have impacted corporate behavior, shifting incentives and leading many high yield issuers to shore up their financial positions. In particular, while a higher cost of debt has reduced interest coverage ratios from recent peak levels, the leverage profile for the majority of issuers has been well managed.

Further, the willingness of the market to refinance high yield issuers' debt is supported by issuance trends this year. In particular, European gross high yield debt issuance during the first six months of 2024 has already surpassed 2023's total, with roughly two-thirds of that amount being used to repay existing debt obligations.[4] With such a high proportion of issuance going toward refinancing, the overall level of net new supply (gross issuance minus repayments) has remained largely flat on the year. This has helped create a strong technical backdrop for the market as aggregate demand for credit continues to exceed supply.[5]

SHORTER-DATED MARKET

Another defining characteristic of the high yield bond market today is its lower duration profile, which stands at just over three years with the remaining years to final maturity approximately 4.6 years **(Figure 2)**.[6] The comparable European figures are even more favorable for investors, with duration standing at just 2.8 years and the years to average maturity slightly less than four years.

Figure 2: High Yield Effective Duration at Historically Low Levels



Source: BofA ICE, Bloomberg. As of June 30, 2024.

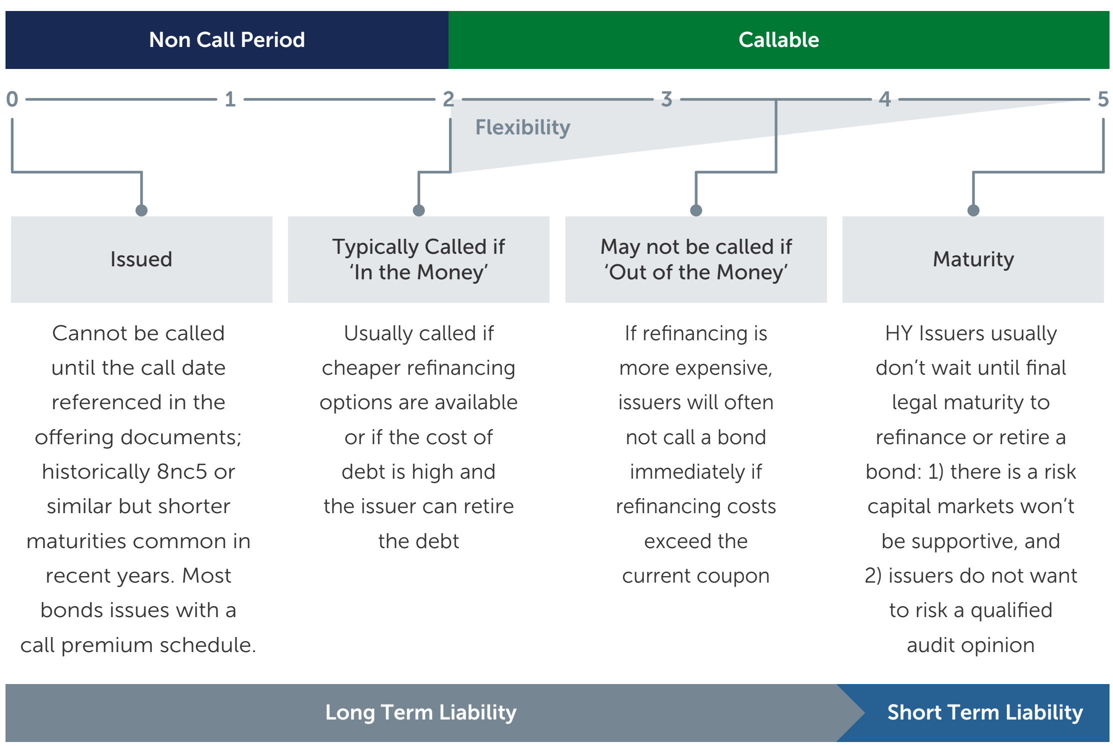
The short-dated nature of the high yield market is largely a function of the subdued issuance trends in recent years. Unlike investment grade corporate bonds, high yield bonds are callable a number of years prior to maturity, and one bond often represents a disproportionate share of an issuer's long-term liabilities. From a high yield bond issuer's perspective, the incentive to exercise the embedded right to redeem bonds early in order to benefit from lower interest rates has materially changed. Prior to 2022, the European high yield market saw record primary issuance as issuers looking to take advantage of historically low rates exercised their early call options, preemptively extending their maturity profiles. Today, many of those issuers have bonds outstanding with coupon levels at or even below current central bank overnight rates. This suggests that any early retirement of debt would be economically irrational. When refinancing a bond is more expensive than the current coupon, the issuer has greater incentive to wait as long as possible before refinancing.

3. Source: BofA ICE, Bloomberg. As of June 30, 2024.
4. Source: S&P LCD. As of June 30, 2024.
5. Source: Barclays. As of June 21, 2024.
6. Source: BofA ICE. As of June 30,2024. Years to final maturity excludes corporate hybrids.

These attributes of the market are important to keep in mind when considering what lies ahead. As mentioned, with the average duration of the high yield market just over three years, and given the market's increasingly short maturity profile, many issuers are beginning to think about refinancing their debt now. High yield issuers typically seek to refinance their debt 12-24 months in advance of the final maturity, as their balance sheets are sensitive to liquidity implications as debt moves from a long-term to a short-term liability. Since most high yield issuers rely upon bullet-like maturity structures (one maturity date for the majority of their long-term liabilities), a reclassification of debt to a short-term liability could lead to a ratings downgrade to CCC, calling into question whether the company can continue to trade as a going concern.

In reality, if an issuer finds itself in this position, it is most likely headed toward default. But management can look to manage this problem by exercising their option to refinance early, at least 12 months prior to any obligation's legal final maturity. This differs from investment grade issuers, which typically have higher cash flows, lower leverage, and debt maturities anywhere from overnight to 30+ years. Because of these characteristics, classification changes between long-term and short-term indebtedness have minimal impact on liquidity and bonds are routinely repaid only at the legal final maturity dates.

Figure 3: Hypothetical High Yield Bond Lifecycle Issued for Five Years, Non-call Two (5nc2)



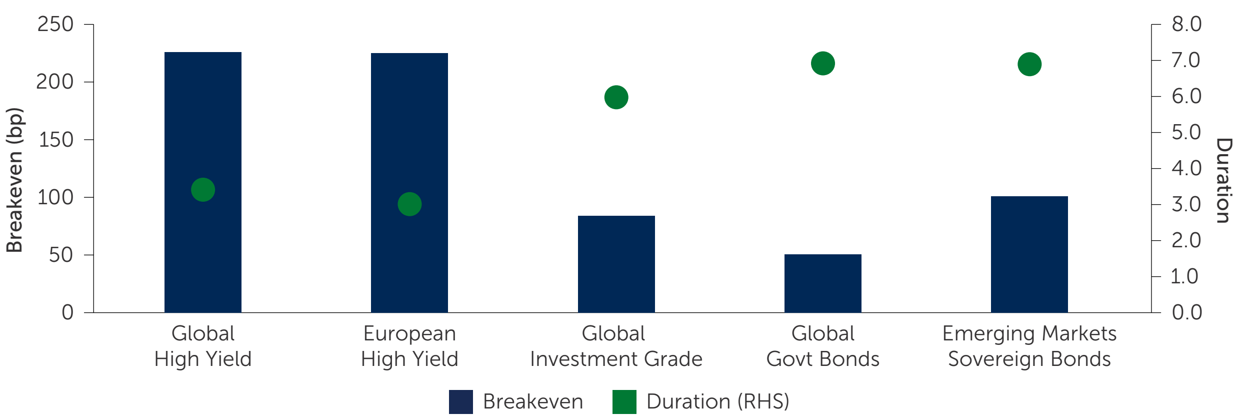
Source: Barings. For illustrative purposes only.

There are potentially significant implications of this effect on total returns. Specifically, for the six to 12 months prior to a refinancing, potential returns are more likely to be event-driven (with refinancings servicing as the event catalyst) versus being primarily driven by changes in government bond yields or spread widening. As issuers come to market to refinance 2025, 2026 and even 2027 maturities, there will be a 'pull-to-par' effect, where discounted bonds are repaid at par, thus monetizing price discounts over a shorter period than standard yield calculations would indicate. This suggests that the total return potential may exceed yield estimates. As an example, the average price of bonds in the European high yield market today is 92.87, which ranks in the cheapest quartile over the last 10 years.[7] For a bond scheduled to mature within the next 24 months, the refinancing effect could potentially add an extra 50 basis points (bps) to 150 bps to returns, over and above those indicated by a traditional yield-to-worse calculation.[8] Further, as there are fundamental corporate finance reasons for this behavior, it will be largely independent of broader interest rate movements—which would enable high yield to increase the potential for diversification in a broader fixed income portfolio.

Downside Protection Potential

Due to the market's short duration profile, there is also potential for compelling downside protection relative to other fixed income markets. In particular, given the current high levels of income coupled with a historically low duration profile, the high yield market exhibits one of the most attractive breakeven profiles across global fixed income markets **(Figure 4)**. On a standard breakeven calculation (yield/ duration), government bond yields would have to increase by 226 bps before generating a negative return in global high yield (assuming a 12-month holding period). It is perhaps no surprise that these figures are some of the highest on record given the market's historically low duration profile combined with some of the highest yields seen over the last decade. For comparison, high yield's breakeven levels are much higher than those of more interest rate sensitive fixed income markets, such as investment grade bonds (84 bps), global government bonds (51 bps), and emerging markets sovereign bonds (101 bps).

Figure 4: High Yield Breakevens Illustrate the Attractive Income and Low Duration of the Asset Class Today



Sources: ICE BoA; Barings' analysis. As of June 30, 2024. Calculated as yield to worst divided by modified duration to worst. For illustrative purposes only. This analysis is intended to demonstrate only the specific elements discussed. This analysis does not represent all of the elements and variables that could be factored into the potential outcome.

7. Sources: Barings; ICE BofA. As of June 30, 2024.
8. Source: Barings' calculations. As of June 30, 2024.

As a result, for investors who may be somewhat reticent about incurring losses due to spread widening, or those looking to diversify risk exposures away from interest rate changes alone, there may be reassurance in understanding that the total return effect of government bond yield changes on the high yield market is likely to be less impactful due to today's market structure.

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Key Takeaway

In addition to the higher income on offer, the maturity wall presents potential attractive opportunities in high yield bonds today. These opportunities include a higher return potential than may be evidenced by simplistic yield measures, downside protection given the market's short duration profile, and diversification benefits somewhat independent of changes to interest rates and inflation expectations.

That said, there are risks to consider. While spreads are tight, the asset class is far from homogenous and refinancing risks for individual companies vary widely. For example, the recent emergence of potential liability management exercises (LMEs) in Europe is a reminder of the importance of informed security selection underpinned by robust fundamental credit research. In addition, we believe an active approach, deep resources and experience in the market can better position investors to navigate the headwinds on the horizon and capture the potential opportunities ahead.

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**As of June 30, 2024*

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