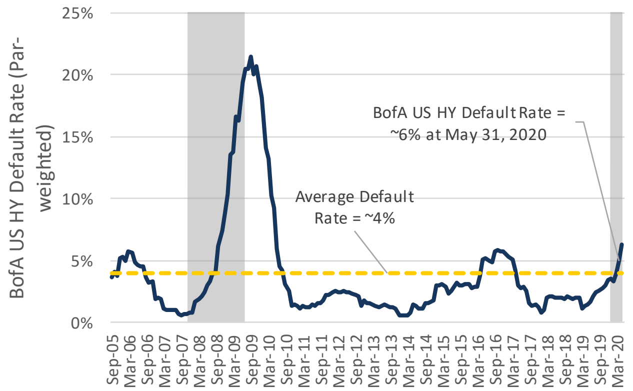
SKYView: Depressed Recovery Rates

On a trailing twelve months basis through May 31, 2020, the BofA US High Yield par-weighted default rate hit 6.3%, up from 3.5% at the end of 2019, and closing in on the 9% - 10% default rate range we project for FY20. At the same time, recovery rates for defaulted issues have declined to ~ 30% of par, down approximately 1,000 bps from FY19 levels. In this *Weekly Briefing*, we examine the drivers behind recently depressed recoveries – which have surprised to the downside relative to estimates included in our *2020 US High Yield Outlook* (published December 13, 2019) - and find that trough levels may now be behind us.

US high yield recovery rates for defaulted issues declined to ~ 30% in the twelve month period ended May 31, 2020, down over 1,000 bps from December '19 levels, and well below long-run index averages of ~ 45%. This decline is consistent with historical norms, as prior periods of weak recovery rates (Global Financial Crisis of '08/'09, Commodity Crisis of '15/'16) coincided with an acceleration of index defaults. At 30%, recovery rates are within their lowest decile based on monthly data since 2005, commensurate with default rates that are approaching top decile levels.

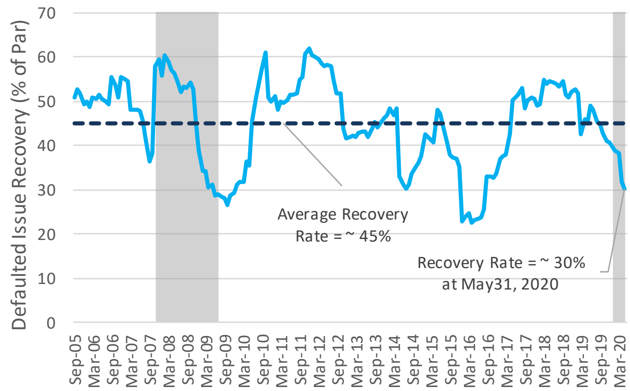
US High Yield Defaults Have Begun to Pick Up…

monthly data since 2005, recession shaded grey



…While US High Yield Recovery Rates Have Declined

monthly data since 2005, recession shaded grey

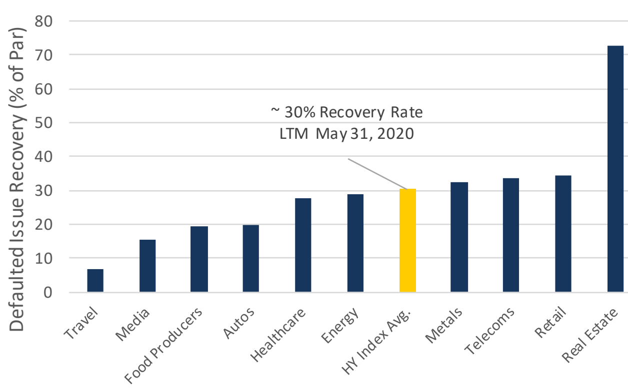


Source: SKY Harbor, BofA Merrill Lynch, ICE BofA Indices, National Bureau of Economic Research (NBER)

On a sector basis, recoveries have varied substantially, ranging from 7% to 73% of par. Also consistent with historical trends, asset-rich sectors (such as Real Estate, Metals & Mining) have fared better than asset-lite counterparts (Travel, Media). While we caution against reading too deeply into sector-level data given the limited sample set (only 1 default in the Travel industry) and the highly idiosyncratic nature of distressed sales and reorganizations, the trend of companies in possession of tangible assets generating stronger recoveries has been consistent over time. Importantly, we would highlight that the Energy sector, which makes up essentially half of all defaults, has experienced a halving of recoveries since 2018, generating a meaningful headwind on aggregate index levels.

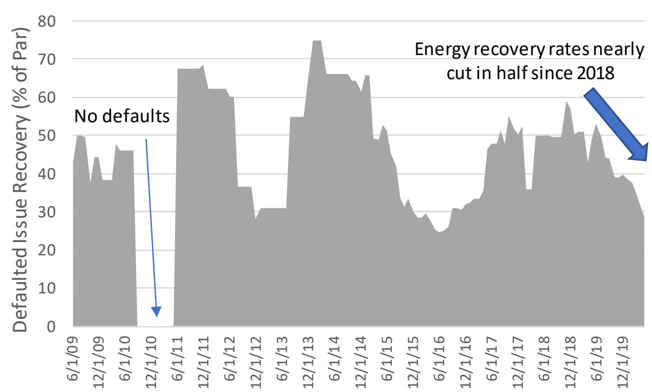
Recovery Rates Vary Dramatically by Sector

par-weighted recoveries, LTM through May 31, 2020



Energy (~ 50% of HY Defaults) Driving Recoveries Lower

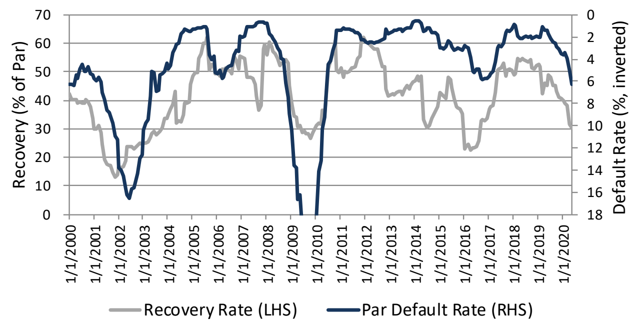
Energy recovery rates, most recent cycle



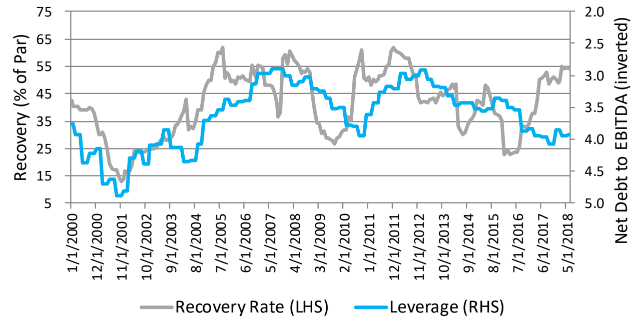
Recovery rates listed above include any sector with at least 1 default in the trailing 12 month period ended May 31, 2020
Source: SKY Harbor, BofA Merrill Lynch, ICE BofA Indices

What drives recovery rates over the long run? It comes as no surprise that default and recovery rates are inversely correlated, likely the result of widespread compression in enterprise value multiples when distress is prevalent across many areas of the economy. Additionally, limited supply of DIP financing and distressed capital logically diminishes the bid from potential financial buyers when there is an abundance of assets to choose from, and at the same time the rising cost of capital may discourage asset sales to strategic buyers. Net leverage has also proven to be negatively correlated with recovery rates over the long run, as higher debt-to-EBITDA ratios imply little to negative equity cushions.

Default Rates and Recoveries Inversely Correlated
monthly data



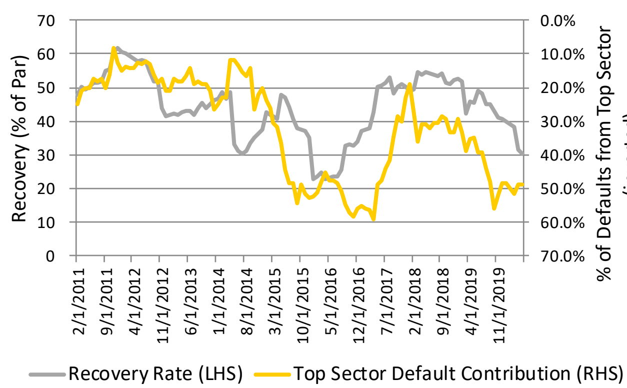
Net Leverage Inversely Correlated to Subsequent Recovery Rates
monthly data



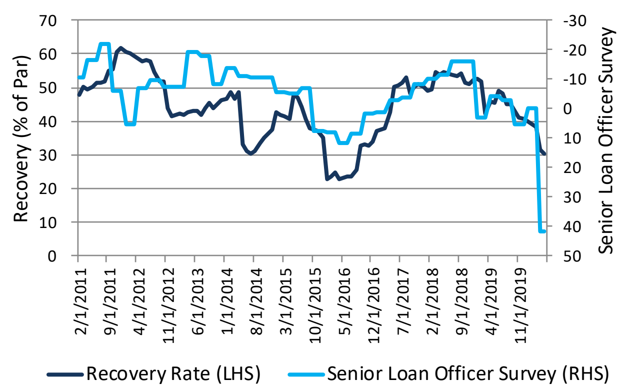
Source: SKY Harbor, BofA Merrill Lynch, Capital IQ, Bloomberg

Our statistical analysis also implies that recoveries dwindle when defaults are concentrated in one or a very small number of sectors. Acute default concentration can be indicative of a sector shock – perhaps due to the onset of secular headwinds or a rapid drop in commodity prices – often eliminating a bid from strategic buyers (since all industry competitors are suffering from the same stress) and making investment from distressed funds a more competitive process. Historically, US high yield recoveries have been weakest in '01/'02 (Telecom bust), '08/'09 (Financial Institution focused stress), and '15/'16 (Commodity crisis leading to Energy and Metals & Mining troubles), all periods in which one or two sectors made up the vast majority of all defaults. Finally, we highlight that availability of credit can influence recoveries, as frozen credit markets can make it difficult for issuers to roll upcoming maturities and/or receive exit financing. Not surprisingly, net tightening of lending standards has been a consistent theme since the beginning of 2020, including a record-high sequential uptick reported in the most recent Senior Loan Officer Survey.

Sector Default Concentration Harms Recoveries
% of Total Defaults from Top Sector



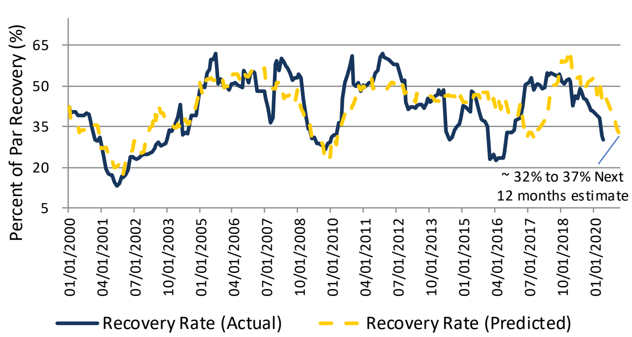
Lending Conditions Influence Recoveries
% of large / medium banks tightening lending standards



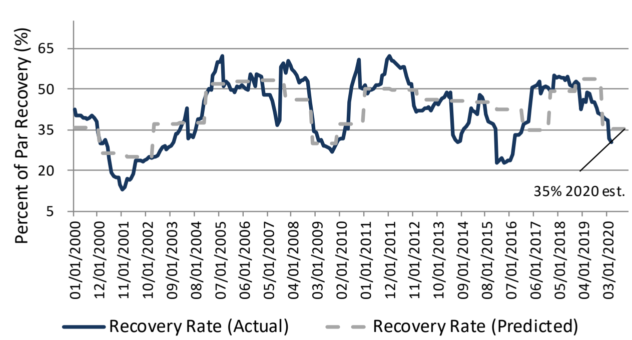
Source: SKY Harbor, BofA Merrill Lynch, Capital IQ, Federal Reserve, Bloomberg

So, where does this leave us? In our *2020 US High Yield Outlook* (published December 13, 2019, with a summary report posted here), we projected recovery rates would be in the 48% - 50% range for the full year, alongside our estimated default rate of ~ 4%. The coronavirus pandemic and subsequent economic lockdowns, however, changed our view on credit losses. Concurrent with an updated default projection of 9% - 10%, we now think recovery rates will end the year in the 32% - 37% range, the output of which is derived from our five-factor regression model. Though below high yield annual averages, this recovery estimate does imply an uptick from current levels, largely on anticipated improvements in the Senior Loan Officer Survey.

SKY Harbor Recovery Model - Actual vs. Predicted (Monthly)
monthly data, 12 month lag, includes forward looking estimates



SKY Harbor Recovery Model - Actual vs. Predicted (Annual)
monthly data, 12 month lag, includes forward looking estimates

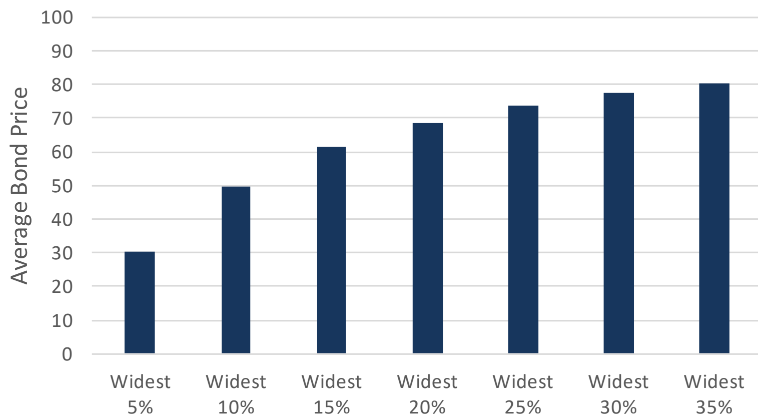


Source: SKY Harbor, BofA Merrill Lynch, ICE BofA Indices, Capital IQ, Federal Reserve, Bloomberg, NBER

Finally, we would highlight that default and recovery rates are only part of the credit loss equation. Prevailing market prices of bonds likely to default can meaningfully impact ultimate principal loss. As we noted in our June 1, 2020 *Weekly Briefing* entitled "Re-opening Relative Value," index dispersion remains elevated post the May rally, with investors creating a highly bifurcated market with clearly identified "winners" and "losers." Assuming that our 2020 default estimate is correct, and factoring in restructurings that have already occurred through the first five months of the year, an estimated $58 billion of additional bankruptcies are likely to materialize by December. The widest trading $58 billion of debt in H0A0 has an average dollar price at present of ~ 35, essentially in-line with our full year 2020 recovery rate. As such, principal losses may be muted for the balance of the year despite an uptick in overall default rates, and meager recoveries across a number of high-profile filings (right side chart below) could potentially represent a near-term bottom.

Average Bond Price by OAS Bucket

data as of June 8, 2020



Recent Defaults & Recoveries Have Been Weak

recent CDS auction results for large 2020 filings

Company Name	Auction Date	Industry	Recovery
Neiman Marcus	29-May-20	Retail	3.0
Diamond Offshore Drilling	22-May-20	Energy	7.4
Frontier Communications	13-May-20	Telecom	28.8
Whiting Petroleum	6-May-20	Energy	7.0
McClatchy	10-Mar-20	Media	2.0

SKY Harbor 2020 Default Rate Estimate	9% - 10%
Midpoint of Estimate Range	9.5%
Implied Amt. Of Debt Left to File in 2020	~ $58bn
Avg. Price of Widest $58bn of Index Debt	**~ 35**

Source: SKY Harbor, Goldman Sachs, ICE BofA Indices

In conclusion, weak recovery rates of late are not, in our view, indicative of a permanent shift higher in principal risk within the asset class. Rather, they are the natural consequence of a sharp uptick in defaults with single-sector concentration, particularly amidst an economic shutdown that has led to a rapid tightening of lending standards. As the year progresses, we expect a gradual uptick in prevailing default rates to be met with recoveries more closely aligned with long-term norms. Additionally, we have not perceived an indiscriminate risk rally over the last several weeks, as likely default candidates now trade at a depressed average dollar price of 35 - equal to our projected FY20 recovery rate - despite index OAS compression of ~ 500 bps since recent wides (March 23, 2020). As such, we think credit losses will be muted for the balance of the year.