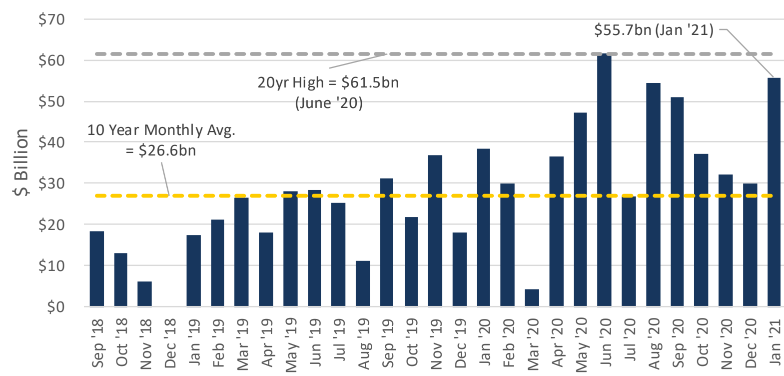
SKYView: The Return of the Dividend Deal

Bond market issuance ramped up noticeably in January ’21, with new deals spanning the full sector and quality spectrums. Though refinancing activity remained the dominant use of proceeds for the month, we have seen – on the margin – a modest uptick in aggressive issuance (defined as equity dividends and acquisitions/leveraged buyouts or LBOs). In this *Weekly Briefing*, we’ve taken a closer look at primary market trends through the start of 2021. While we concede that the combination of low interest rates and healthy investor demand for yield could threaten a multi-year run of conservative balance sheet management, we do not yet see any troubling signs of market froth on the horizon.

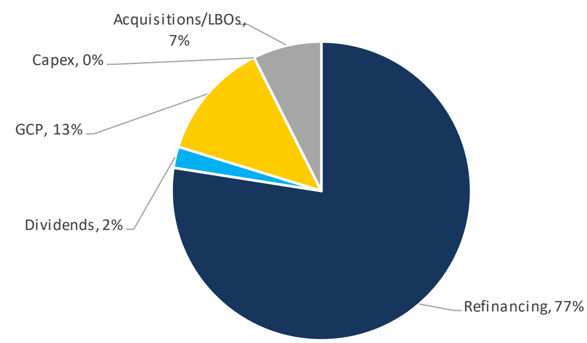
Following a seasonally slow second half of December, primary market activity has rebounded to historically high levels. In particular, gross new issuance totaled $55.7bn in January, above the 10-year trailing monthly average of $26.6bn, and representing the second most active month on record (June 2020 remains #1 with $61.5bn). Importantly, refinancing activity made up 77% of volumes, leaving net issuance of ~ $12.6bn only modestly above the long-run monthly average of ~ $11bn. Of note, approximately 8% of new issue proceeds went to acquisitions/LBOs and equity dividends, a cohort typically considered “aggressive” by high yield investors. Cognizant of the adage that “one month does not a trend make,” we nevertheless note that, if annualized, this measure of aggressive issuance would represent the first yearly increase since 2015.

January '21 Gross Issuance 2nd Strongest Month on Record
monthly data, last 24 months



Source: SKY Harbor, JP Morgan, Lipper, BofA Merrill Lynch

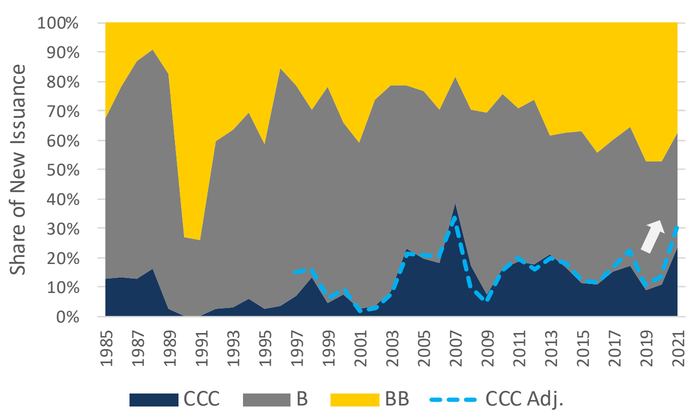
Use of Proceeds Remain Skewed Toward Refinancing Activity
January '21 data



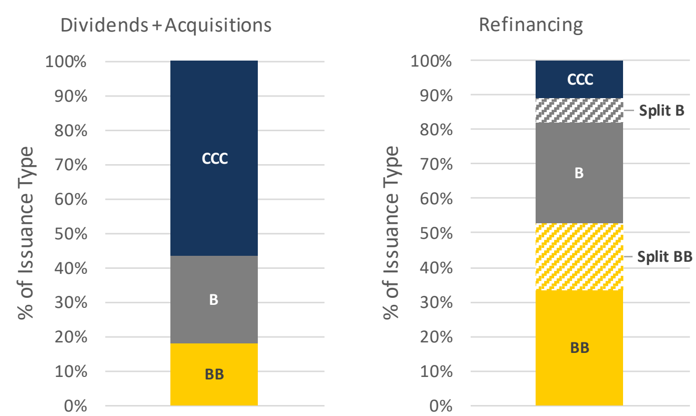
GCP is General Corporate Purposes.

Another observation has been the return of CCC deals to the primary market, this following two full years in which the rating bucket’s penetration of new issuance fell well below its index weighting. In particular, 24% of January issuance was rated CCC, even higher on a relative basis (as denoted by the light blue dotted line in the chart below) if we adjust for the lower weight the rating has in today’s index (13%) in comparison to longer-term averages (17%). Despite starting the year with a modestly more onerous maturity schedule (the amount of CCC debt maturing over the next 24 months is above the equivalent measure in the non-CCC universe), it was aggressive issuance (dividends + acquisitions) that drove the uptick in CCC primary volumes, not refinancing activity.

CCC Issuance Increased in January '21
annual data; 2021 = January only



CCC Issuance Skewed Toward Aggressive Uses
January '21 data



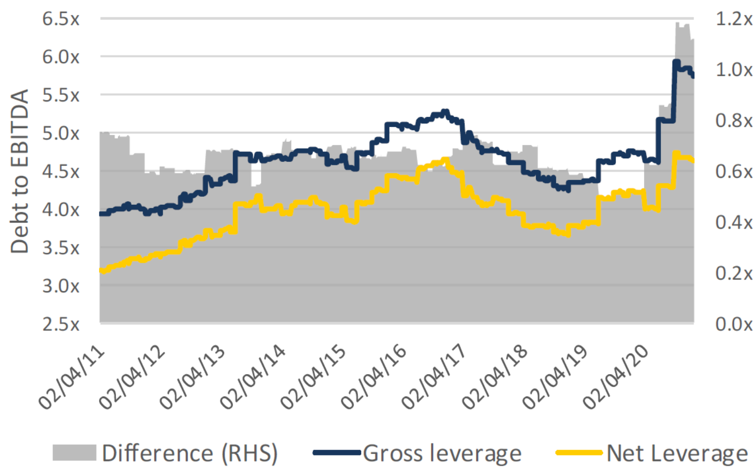
Source: SKY Harbor, JP Morgan, BofA Merrill Lynch, ICE Data Indices

Management teams were proactive in adding cash to balance sheets to protect against extended COVID-19 lockdowns, facilitated by strong investor demand for high yield in a relatively low interest rate environment. While these moves were instrumental in reducing default risk in 2020, we remain aware that a return to more normalized business conditions could compel management teams to embark on increasingly aggressive and equity-friendly initiatives (debt-funded dividends, LBOs, etc.). Though this type of behavior has been absent from the market over the last several years, relatively lofty cash balances – as evidenced by a historically wide differential between gross and net leverage – provide the means to enrich shareholders should balance sheet management drop within the hierarchy of corporate priorities.

Activity, however, has thus far been manageable. The dividend deals completed year-to-date have been relatively well received by the market, with five of the seven now trading above issue price. In our view, this dynamic has been driven, at least in part, by above-market coupons offered by issuers capable of servicing a higher debt load, and have therefore represented an opportunity for total return enhancement rather than a looming market risk.

Relative Corporate Cash Balances At All-Time Highs

quarterly gross vs. net leverage differential, trailing 10 years



Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch, Bloomberg, Capital IQ, JP Morgan

Recent High Yield Market Dividend Deals

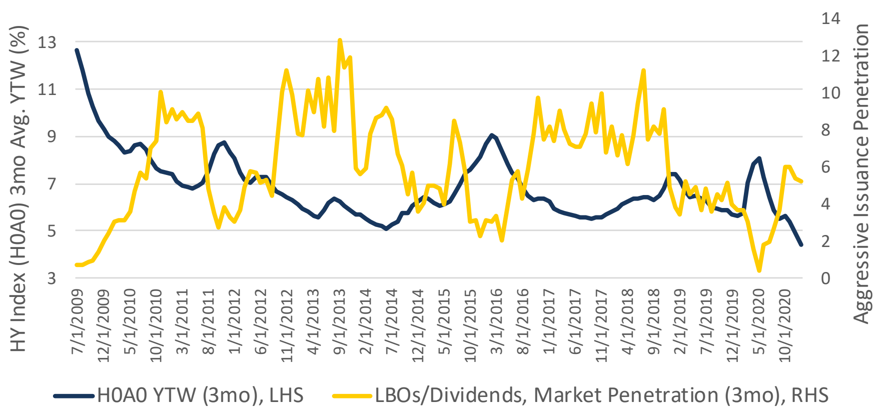
year-to-date

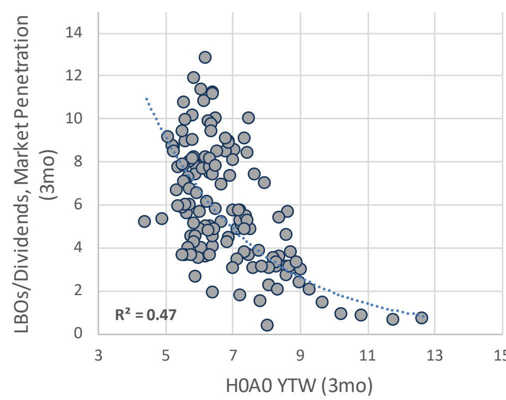
Date	Issuer	YTW (issuance)	YTW (today)	Change
01/13/21	CP Atlas Buyer (AMBATH)	5.91%	5.97%	0.06%
01/13/21	Home Point Capital	5.00%	4.58%	-0.42%
01/21/21	BCPE Ulysses Intermediate (USLBMH)	7.75%	7.28%	-0.47%
01/22/21	Colgate Energy Partners	8.00%	8.62%	0.62%
01/28/21	WhiteCap Parent	8.25%	6.80%	-1.45%
2/3/2021	Victra (partial)	7.75%	7.06%	-0.69%
2/3/2021	Iris Holdings (IPHS)	8.75%	8.60%	-0.15%
	Avg Coupon ('21 dividend deals)	7.34%		
	Avg Coupon ('21 all deals)	5.74%		
		+ 1.60%		

While strong corporate cash balances have likely contributed to a recent run of dividend deals, there are likely other contributing factors at play. First, anticipated changes in tax policy under the Biden Administration may incentivize the distribution of dividends before more onerous hikes are implemented. Second, relatively low leveraged credit yields make dividends less costly to corporate issuers. As demonstrated below, the rolling 3-month yield-to-worst (YTW) of the ICE BofA US High Yield Index (H0A0) is negatively correlated to the rolling 3-month market penetration of LBO and dividend deals, making an uptick in such activity appear natural even absent policy uncertainty and COVID-induced general corporate purpose cash raises.

Rolling 3mo US High Yield YTW vs. Rolling 3mo Leveraged Credit Aggressive Issuance

monthly data, post Global Financial Crisis (July '09 to present)



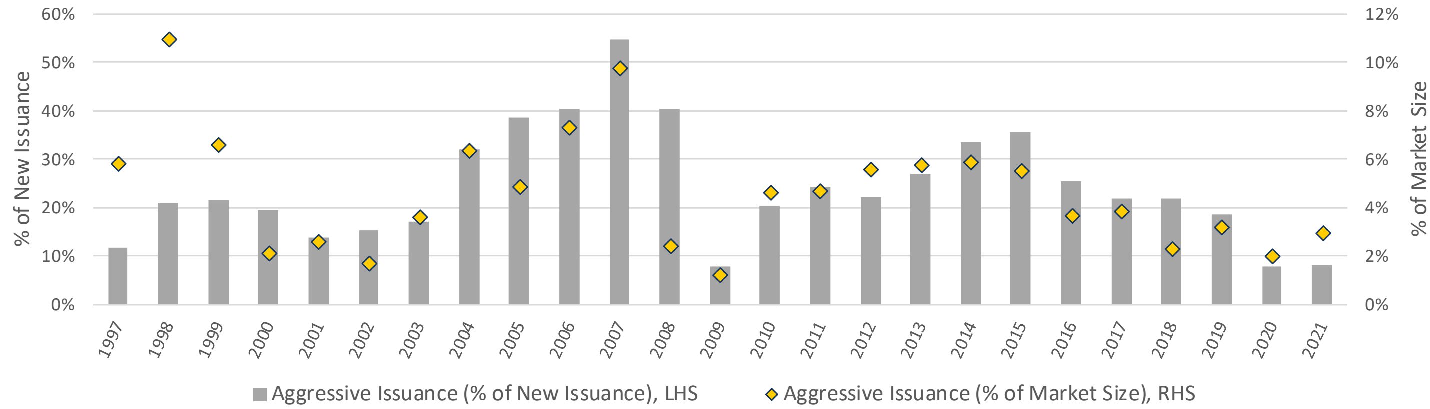


Source: SKY Harbor, BofA Merrill Lynch, ICE Data Indices

These trends, in the context of historical norms, do not yet appear worrisome. If we were to annualize January's primary market activity, aggressive issuance as a percentage of all new issuance (~ 8%) would still be meaningfully below the trailing 25-year average of 24%. Furthermore, aggressive issuance as a percentage of market size (~ 3%) would also be meaningfully below the trailing 25-year average of 5%. In the context of prior aggressive issuance peaks ('06/'07, '14/'15), the annualization of a very active January still fails to raise alarms.

Aggressive Issuance Trends

annual data; 2021 = January annualized



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

In conclusion, January represented a near record-setting month for high yield issuance. Though dividends and acquisitions/LBOs continue to make up a relatively small portion of primary market activity (~ 8%), there was a perceived uptick in January that runs counter to a six-year run (2015 to 2020) of declining aggressive issuance. In our view, cash-heavy balance sheets and anticipated changes in taxation represent idiosyncratic drivers of this dynamic, though the historically negative correlation between high yield market yields and shareholder friendly initiatives make some escalation inevitable. Even so, recent dividend deals have been relatively well received by the market, and aggressive issuance – normalized by both total issuance and overall index size – continue to indicate the persistence of relatively conservative market conditions. As such, we view the recent spate of dividend deals as opportunities to improve portfolio yield in select credits with both strong financial flexibility and operating potential, and do not interpret current trends as being indicative of trouble on the horizon.

Definitions

Coupon is the annual interest rate paid on a bond, expressed as a percentage of the face value and paid from issue date until maturity.
Credit Ratings are used by the S&P and Fitch credit agencies for long-term bonds and some other investments. They range from the highest rating of AAA (the borrower's capacity to meet its financial commitment the obligation is extremely strong) to D (the borrower is in default). Ratings in order of quality include AAA, AA, A, BBB, BB, CCC, CC, C and D.
Dividend is the percentage of earnings paid to a company's shareholders in dividends.
EBITDA is earnings before interest, taxes, depreciation, and amortization, is a measure of a company's overall financial performance and is used as an alternative to net income in some circumstances.
ICE BofA US High Yield Index: An index that tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. The index is further defined by sub-indexes associated with credit ratings (e.g., the CCC sub-index).
Leveraged Buyout (LBO) is the acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition. The assets of the company being acquired are often used as collateral for the loans, along with the assets of the acquiring company.
Yield-to-Worst (YTW) is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. It is a type of yield that is referenced when a bond has provisions that would allow the issuer to close it out before it matures.
