Coupon and Convexity in the European High Yield Market

MARCH 2023

Summary

- In H1 2022, the European high yield market weighted-average coupon bottomed at 3.6%.
- Following spread widening and unprecedented rate hikes — both in pace and quantum — coupons on new issue bonds have re-rated upward, likely pulling the market average towards 5%.
- Increasingly the market features both (1) lower coupon bonds trading with deeper discounts to par, and (2) newly-issued, higher coupon bonds priced closer to par.
- European high yield at 7.9% yield-to-maturity tracks at the highest level in more than a decade, however price dispersion is uneven across sectors, security types and ratings categories. This creates a unique opportunity for stock picking in an environment of positive price convexity and higher current income.
- We consider this a beneficial dynamic for Hayfin's active, flexible approach and fundamentally-driven credit process where we seek to optimise between all fixed rate bonds classes and loans, to deliver attractive risk-adjusted returns.

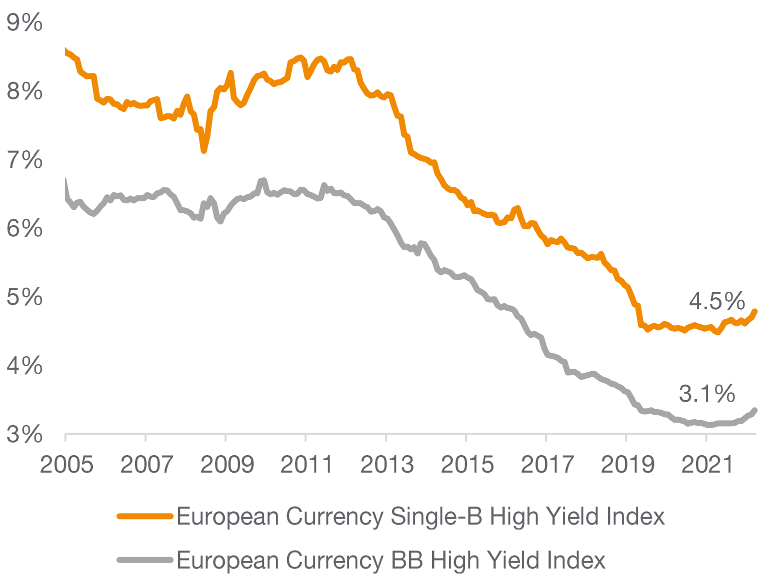
Over the past 12 months, high yield yield-to-maturity has reverted to historically compelling levels. At 7.9% today, it is the most attractive in over a decade. Only during the Global Financial Crisis in 2008/09 and the European Sovereign Debt Crisis in 2011/12 has greater all-in return been offered. Macro uncertainty has influenced both levers:

- Spread has widened more than 100 basis points, compensating investors for increasing earnings volatility driven by post-COVID inflation and supply chain disruption, and higher default risk; and
- Rates have re-priced as the European Central Bank (ECB) raised the base rate by 350 basis points — an unprecedented move both in timing and magnitude. On top of that, ECB corporate purchasing activity — which supported low yields in investment grade and high yield — will unwind from March 2023.

This dynamic has abruptly stalled the long-running trend of declining high yield coupons. In early 2022, European high yield coupon bottomed at 3.6% (3.1% for BBs and 4.5% for Single-B); rising incrementally to 3.8% today.

Adding perspective, in July 2012 — when the market last offered 7.9% yield — the average coupon was nearly double at 7.3% (price 98). Today, most high yield securities trade at a deep discount to par in order to solve for yield; the index average price is 87.

Exhibit 1: European High Yield Par-Weighted Coupon



Source: Ice BAML Indices (HP20, HP10)

Exhibit 2: European Currency ex. Sub. Financials High Yield Index (HPS2) Statistics

Parallel	Yield-to-Maturity	Coupon	Price	Spread-to-Worst	Trailing 12m Default Rate	Weighed Average Rating	Market Size	Event Overhang
Jul-2012	7.9%	7.3%	97.6	725 bps	>2.0%	BB-	€169bn	Real prospect of Eurozone break-up
Mar-2023	7.9%	3.8%	86.5	519 bps	0.1%	BB-	€394bn	Most aggressive rate hiking cycle since 1980s

Source: Ice BAML European Currency High Yield Index ex. Subordinated Financials (HPS2) as of 22-Mar-23.

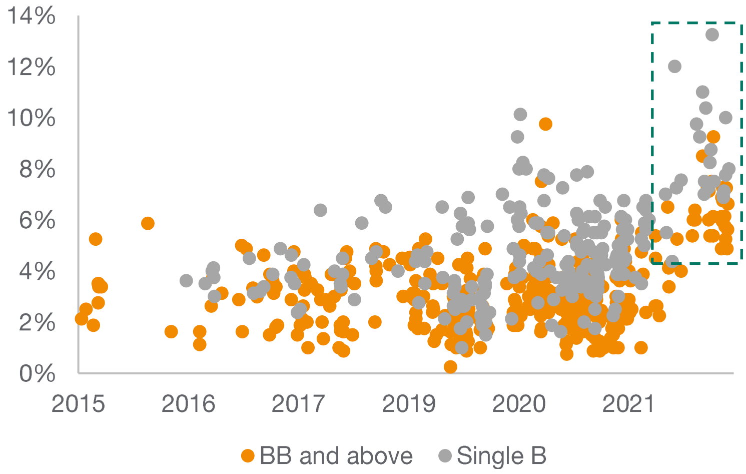
Gradually, average price should normalise. Newly issued high yield bonds carry larger coupons and as capital markets activity increases, this refinancing activity will overtake the trend in a higher rates environment. As Exhibit 3 shows, a steep upward trajectory in coupons is already evident. Extrapolating this trend, JP Morgan estimate the market average may hit 5% as early as next year[1].

In the interim, high yield investors have an opportunity to weigh up:

- *(older vintage)* lower coupon bonds offering upward price convexity, with lower relative current income;
- *(newer issue)* high coupon bonds offering higher relative coupon but more limited price appreciation potential — depending on non-call features.

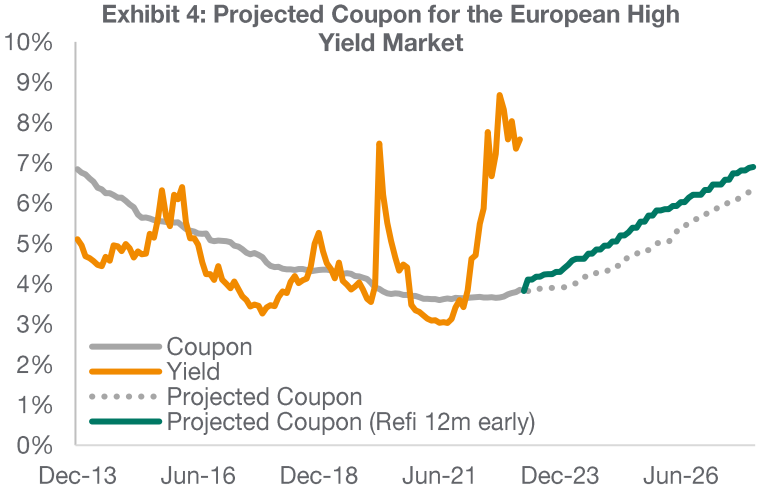
Price bifurcation is prevalent. Exhibit 5 illustrates low and high coupon bonds within single issuer capital structures, i.e. for similar credit risk[2] and yield, there is a contrasting balance on offer between (1) a mix of current yield and par appreciation and (2) predominately current yield. Exhibit 6 shows this decomposition.

Exhibit 3: Coupon Distribution by Issuance Vintage



Source: Ice BAML Indices (HP20, HP10)

Exhibit 4: Projected Coupon for the European High Yield Market



Source: JP Morgan – The Great Rate Reset – 4-Oct-22

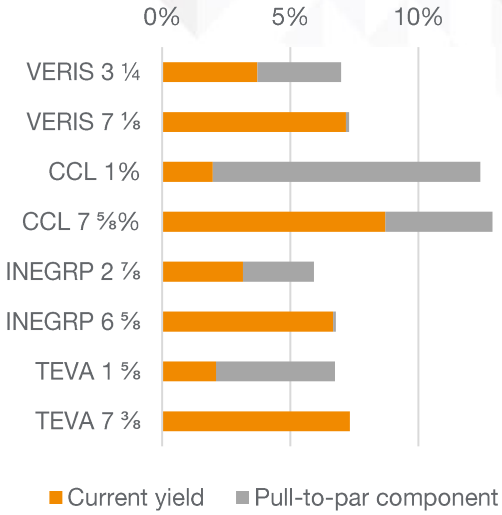
[1] *Source: JP Morgan – The Great Rate Reset – 4-Oct-22.*
[2] Notably, maturity dates are not aligned.

Exhibit 5: Single Issuer Low/High Coupon Examples

Issuer/ Security	Issue Date	Maturity Date	Coupon	Price	Yield
Verisure Senior Secured Notes	2021	2027	3.25%	87.5	7.0%
	2023	2028	7.125%	99.3	7.3%
Carnival Senior Notes	2019	2029	1%	50.6	12.4%
	2020	2026	7.625%	87.5	12.9%
Ineos Senior Secured Notes	2019	2026	2.875%	91.5	5.9%
	2023	2028	6.625%	99.3	6.8%
Teva Senior Notes	2016	2028	1.625%	76.9	6.7%
	2023	2029	7.375%	100.7	7.2%

Source: Bloomberg. Prices as of 23-Mar-23.

Exhibit 6: Yield-to-Maturity Decomposition



Many considerations influence Hayfin's preference for low price (lower coupon) versus high coupon (higher price). Some of these are portfolio preferences, while others are security and issuer-specific.

Exhibit 7: Investor Considerations based on Market Conditions of March 2023[3]

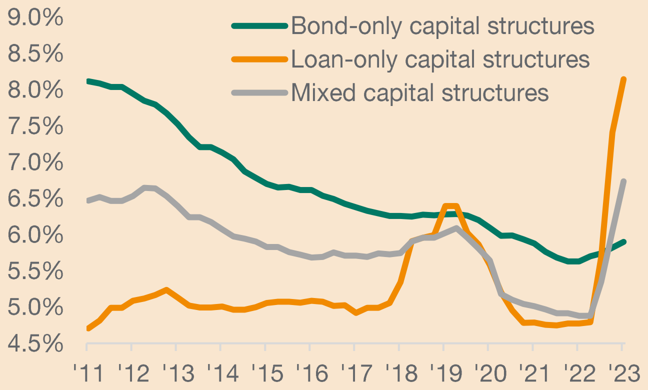
Scenario	Prefer Low Price (Low Coupon)	Prefer High Coupon (High Price)
Positive event-risk, e.g. M&A trigger change-of-control, asset sales used for debt repayment	●	
Higher stress or restructuring risk	●[4]	
Smaller, less complex capital structures that are likely to refi >12 months ahead of contractual maturity	●	
Larger issuers/capital structures with rolling programmes of issuance		●
And more generally …		
Redeploying cash, moving up in credit quality	●	
Spread or rate widening environment, where current cash carry is preferred		●
Spread or rate tightening environment, where positive price convexity is preferred	●	

[3] Investor considerations are subject to change based on market conditions. No strategy, formula or approach can guarantee gains or avoid losses.
[4] All else equal, bonds with lower dollar prices benefit from higher recoveries in case of default. Source: *BAML – Credit Market Strategist – "Price Fall" – 6-May-22*.

Cost of Capital Implications

Floating rate securities, including loans and bond floating rate notes, adjust automatically to higher rates and therefore have not required the same level of price discount to par as fixed rate bonds. While individual issuers may have had (or have more recently put in place) interest rate hedging, in general this higher capital cost is felt contemporaneously by these borrowers. In contrast, fixed rate bond issuers are not experiencing the same coupon shock. This “great capital structure divide”, as described by Goldman Sachs[5], is just one of the reasons we have a preference for bonds over loans in the current environment.

Exhibit 8: Weighted Average Coupon for US Sub-Investment Grade Borrowers



[5] Source: *Goldman Sachs – The Global Credit Trader – 10-Mar-23*

In a high yielding environment, this market phenomenon provides an additional element of dynamic opportunity for Hayfin. It allows us to evaluate security-by-security, across each of our portfolios, how much value we place on positive price convexity, i.e. low dollar price — and, conversely, how much current income resilience we want to build via exposure to higher coupon securities in a higher-for-longer rates environment. Whilst we identify themes at the macro, portfolio level, we seek to implement these themes at the security level based on our fundamental credit investing process.

For further information, please reach out to the team at Hayfin.

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