U.S. Municipal High Yield Market

High Yield Impact Survey

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We are pleased to share with you the results of the second annual HilltopSecurities High Yield Impact Survey conducted Nov. 7-22. The survey received 110 responses from a diverse group of market participants including investors, sell side intermediaries, bankers and advisors, rating analysts, attorneys, insurers, and other market participants.

The answers to each of these questions brought significant insight into the divergence of opinions and cutting-edge thought leadership regarding factors that drive the High Yield sector.

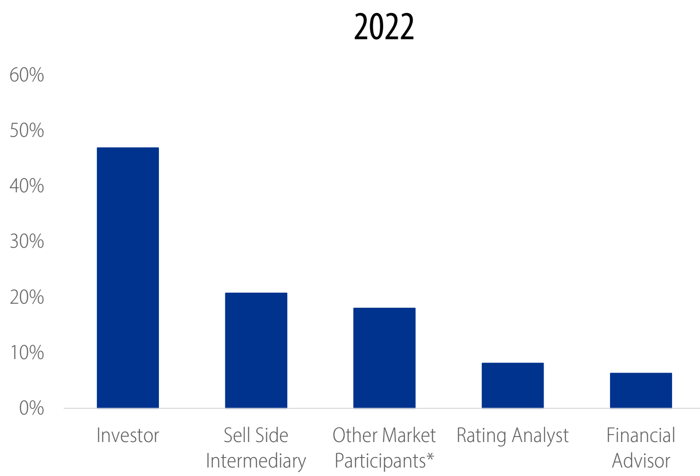
The Highlights

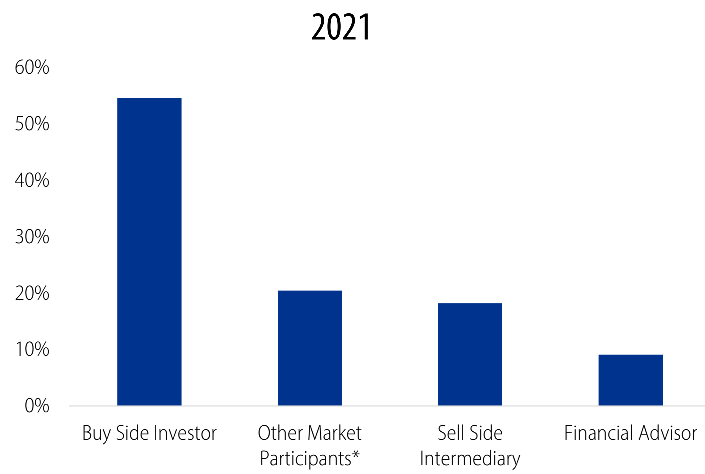
- While 50% of respondents are expecting another increase of 50 basis points on BBB bond yields by July 1, 2023, remaining respondents are split equally between bond yields staying the same or actually decreasing.
- ESG designation is nice to have according to more than 90% of respondents, but that designation does not carry any tangible value.
- Senior living, skilled nursing, project finance, and health care, together comprise the sectors that are most concerning, highlighting the financial vulnerability introduced by labor shortages and wage pressures.
- Respondents are not worried about the impact that working from home might have on revenue streams, nor are they worried about the hotel industry or charter schools.
- Of note, the survey unequivocally projects that COVID-19 will not be an issue in 2023.
- Investors would like to add exposure to toll road/airport, land secured, and charter school sectors.
- Investors that participate in land secured transactions are focused on location and value to lien and are increasingly concerned about Colorado land secured credits.
- Finally, the No. 1 issue in High Yield project evaluation is assessment of liquidity and equity followed by management and covenant package, and in the case of project finance, respondents want to see technology that works and equity. That makes sense. We need ample liquidity and seasoned management to pilot through our expectations of medium-term turbulence.

See the complete survey results below.

1. What is your role in the market?

We received 110 responses with almost half representing buy side investors. The distribution compares similarly to the 2021 distribution. However, we are pleased to report that participation benefited from a 25% year-over-year increase.

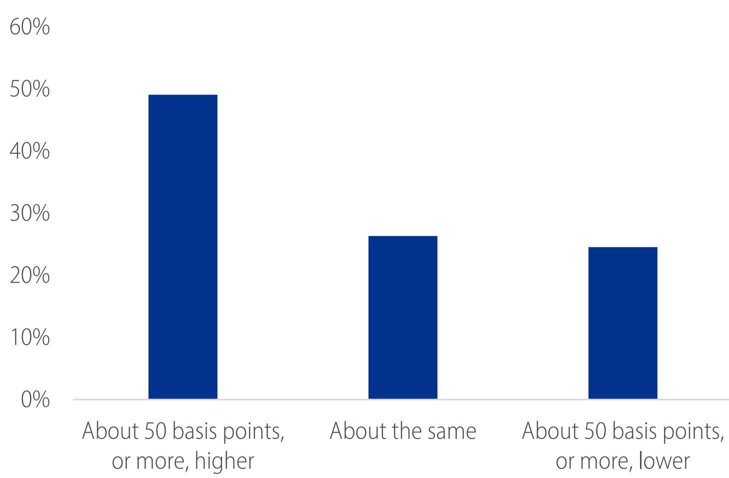




*Market particpants include: independent analysts, attorneys focused on High Yield projects, and other market intelligence providers.

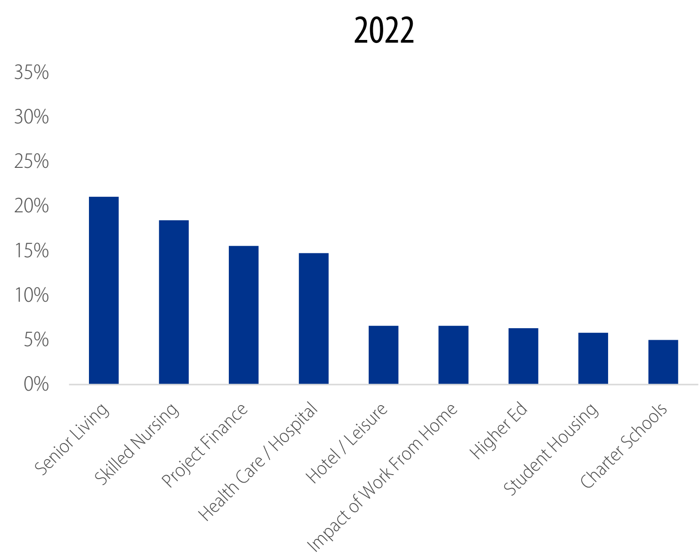
2. A 30-year Baa3/BBB- tax exempt new issue priced to yield 6% in late 2022. Given the same credit, what would you expect the yield to be July 1, 2023?

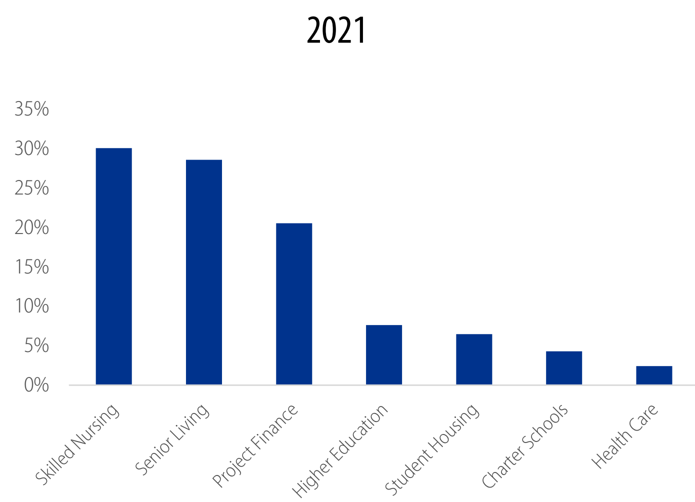
Since we don't have a crystal ball to point us in the direction of long-term rates, we thought to ask this team of experts. Although 50% projected that yields have another 50 basis points to rise over the next six months, the remaining respondents were split evenly between stability and a possible reduction in rates of 50 basis points.



3. What sector are you the most concerned about?

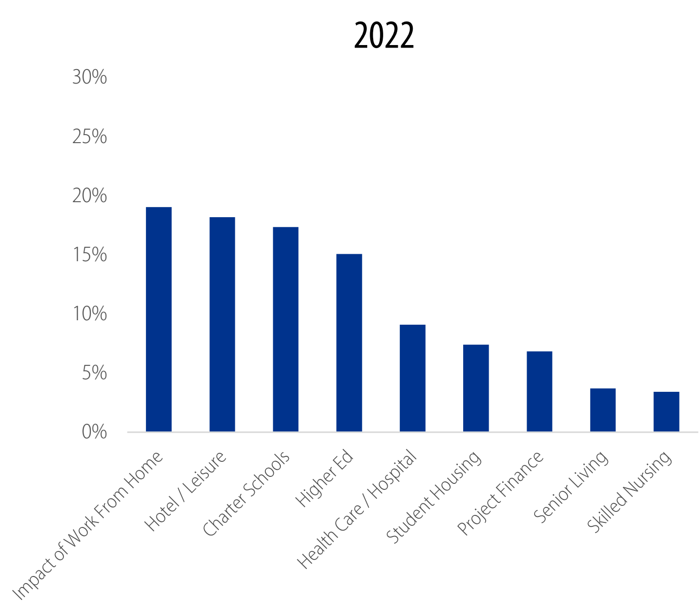
Senior living, skilled nursing, and project finance are the three sectors that received the greatest number of votes for the most concerning following the trend of concern that we saw in 2021. The health care / hospital sector registered in fourth place. This is a very interesting change because investors were least concerned about the health care sector last year. One respondent commented, "Skilled nursing and project finance, worried about defaults, hospitals worried concerned about ratings downgrades." In 2021, investors were feeling relatively confident in the space. Admissions and elective surgeries were increasing, and hospitals were relatively liquid and still benefitting from COVID relief funds. (Please see tables below.) Fast forward 12 months and we can see how sustained wage pressures coupled with volatility in utilization can together compress operating margins and present significant challenges.

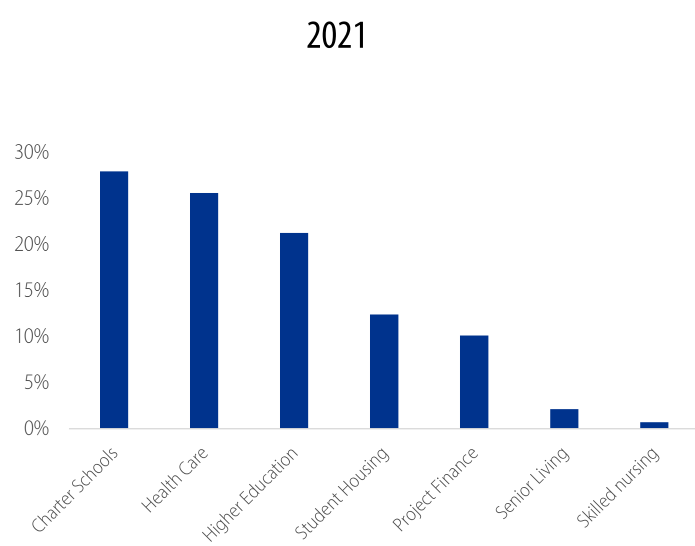




4. What sector are you least concerned about?

When thinking about the areas in which respondents are less concerned, charter schools, work from home impacts and hotel leisure are three areas in which they felt more confident. One respondent stated that transportation should also be a focus area given utilization resurgence and perpetual infrastructure needs. Note that health care is no longer on the least concerned list as was the case in the 2021 survey.

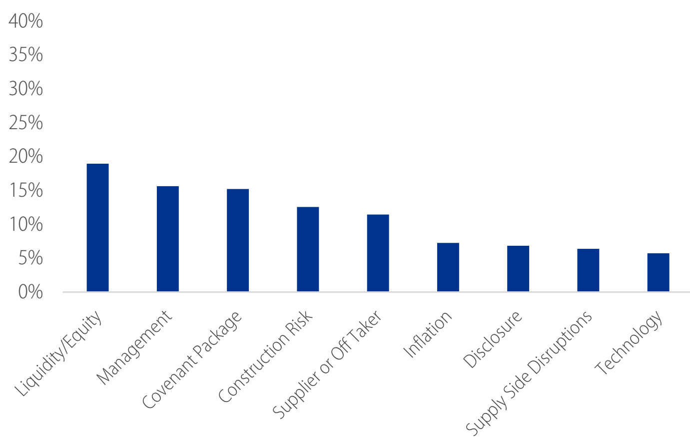




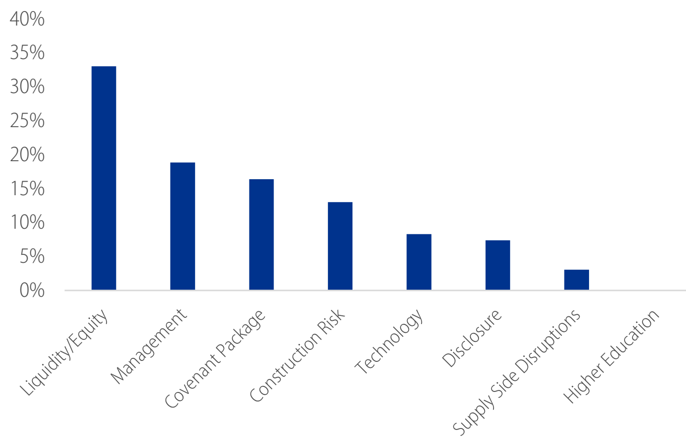
5. What concerns you the most on a High Yield deal?

Liquidity/Equity was ranked the No. 1 concern with management and covenant package respectively ranked No. 2 and No. 3. In today's environment, liquidity can help protect a myriad of project risks including construction issues which were also noted as a key issue. This concept resonates given supply side disruptions and cost overruns that are challenging contractors to deliver projects on time and on budget.

2022



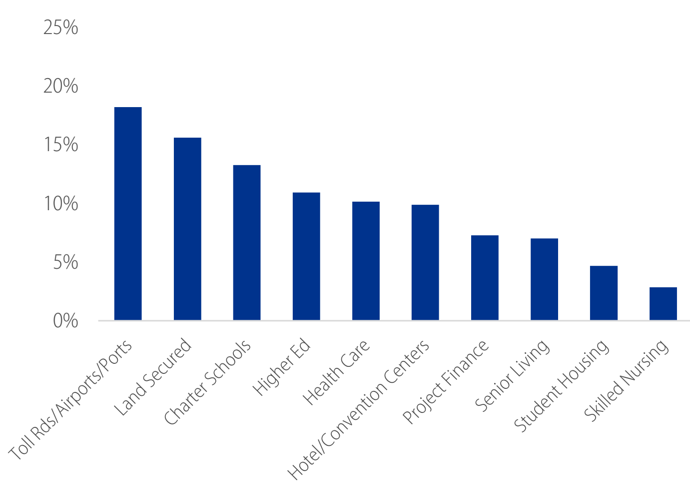
2021



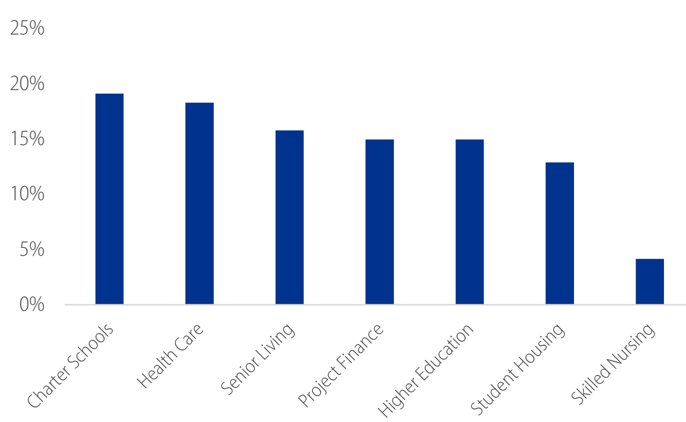
6. Which High Yield sectors are you looking to add exposure?

Toll roads, airports, and ports, followed by land secured credits, and charter schools are the three top sectors for which market participants would be looking to add exposure. This is not a surprise as the airports and land secured opportunities have rebounded sharply since the pandemic while charter schools have benefited from growing enrollment, increased revenues per student, and enhanced balanced sheets that also reflect the presence of COVID relief funds.

2022

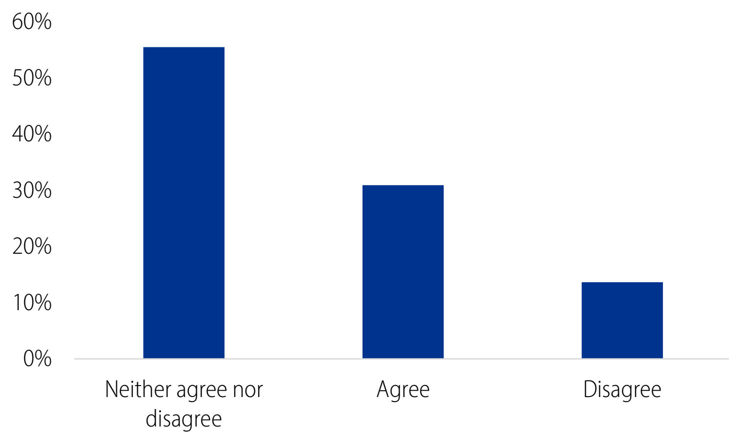


2021



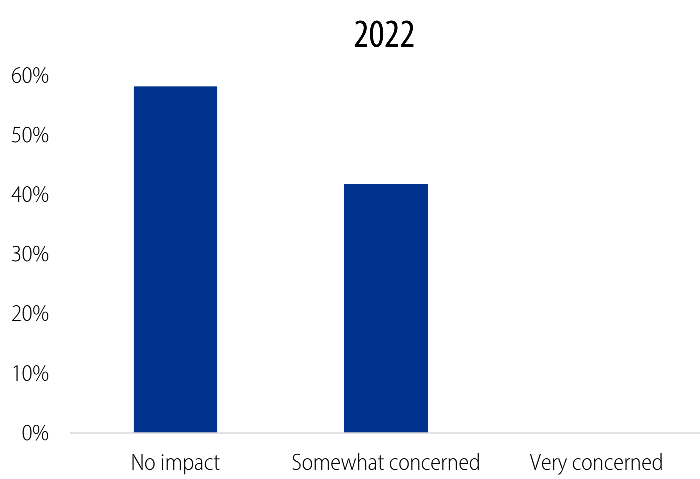
7. The Financial Disclosure Transparency Bill will improve financial disclosure and analysis?

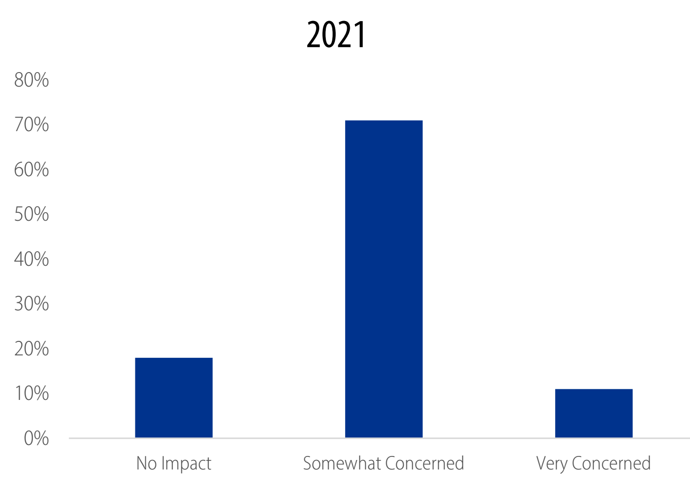
The Financial Disclosure Transparency Bill is a proposed provision that, if passed, will require standardization of municipal financial disclosure over four years. However, since municipal issuers do not necessarily have standardized accounting standards, implementation of the requirement may be challenging and expensive. Of note, more than 50% of respondents did not have a strong feeling on the subject while 30% believed the disclosure will improve analysis. The remaining 12% sharply disagreed and share some of these comments: "New reporting requirements will place a new tax burden on issuers and at the same time will not help any investor that knows how to read a financial statement; Could have unintended consequences; and No one can do your work for you."



8. How concerned are you that COVID will disrupt operations at the project level in 2023?

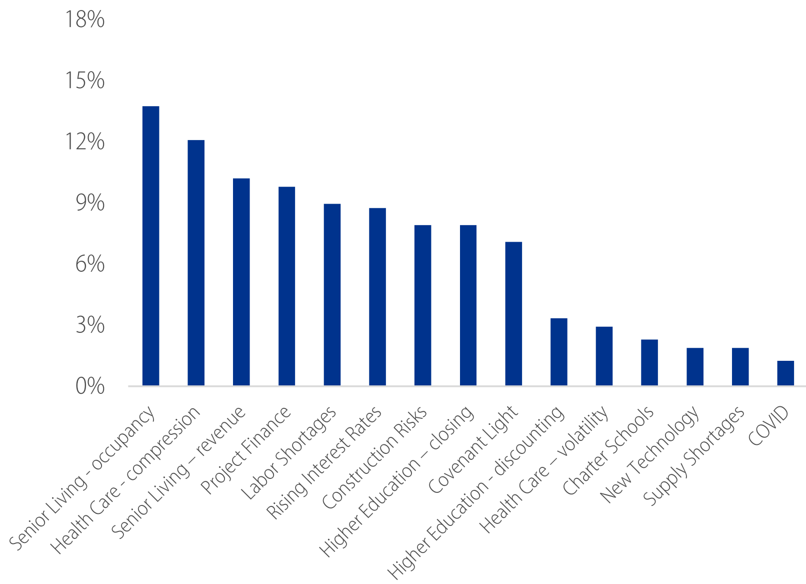
In 2021 70% of respondents were somewhat concerned about COVID and almost 20% were very concerned. Fast forward another year of living with the pandemic and approximately 60% of respondents believe COVID will have no impact and 0% are very concerned. In fact, one respondent stated: "Covid is over." However, we also received some more analytical comments including, "Indirect impacts such as labor, supply chain, 'the money' won't allow COVID to wholesale stop the economic train; Beginning to see signs of projects not recovering to pre-COVID levels now impacting DSC and other covenants, especially in healthcare arena."





9. In your opinion, what is the biggest High Yield Sector challenge to watch out for in 2023? (Pick top 4)

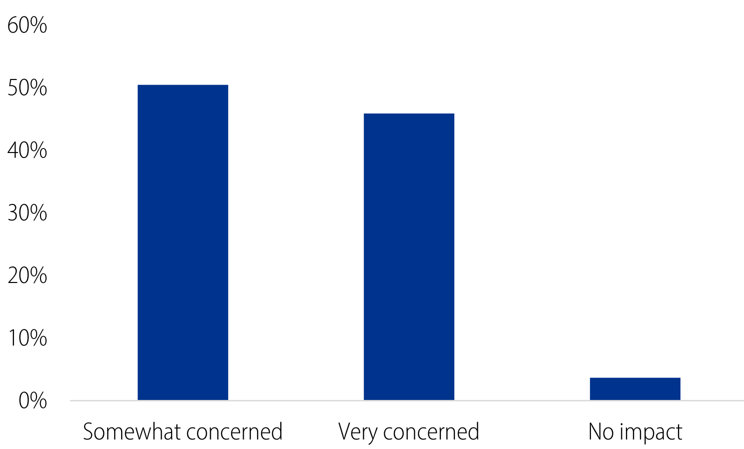
Health care, senior living, and project finance deals are sectors that are concerning. However, digging more deeply, the four biggest subsector trends are Senior living - occupancy and staffing, Health Care - compression of hospital operating margins and reduced liquidity, Senior Living – revenue growth not keeping pace with expense growth, and Project Finance deals that do not work. Consistent with question No. 8, COVID was assigned the least significance.



Sector Challenge	%
Senior Living - occupancy and staffing	14
Health Care - compression of hospital operating margins & reduced liquidity	12
Senior Living – revenue growth not keeping pace with expense growth	10
Project Finance deals that do not work	10
Labor Shortages	9
Rising Interest Rates	9
Construction Risks and increased costs	8
Higher Education – concern that schools with enrollment of 1200 and lower will close	8
Covenant Light transactions	7
Higher Education - discounting and competition	3
Health Care – volatility of admissions	3
Charter Schools management and academic progress	2
New Technology	2
Supply Shortages	2
COVID	1

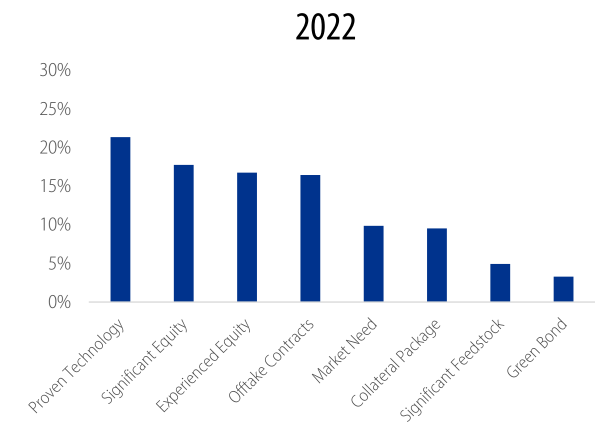
10. How concerned are you that labor shortages will affect cost containment/expense budgets in 2023?

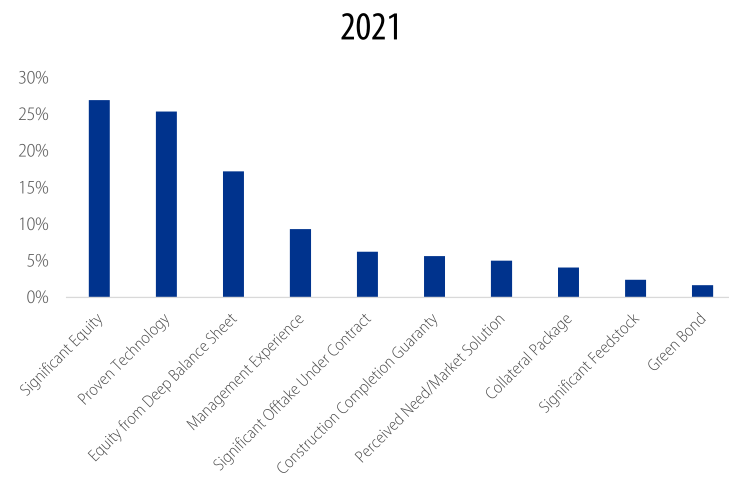
More than 96% of respondents are concerned to very concerned that labor shortages will affect expenses in 2023. One respondent was particularly focused on "how long this might last."



11. What drives your assessment of a renewable energy bond?

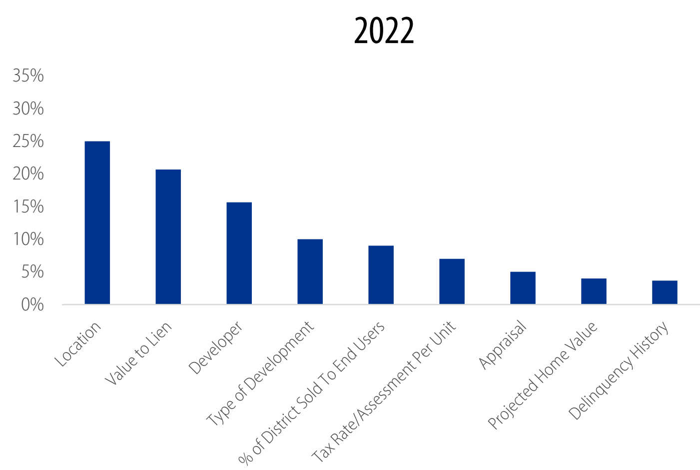
The No. 1 focus is technology proven at scale followed by significant equity. In our prior two surveys, equity was the more pronounced answer. We believe a number of recent challenging transactions have underscored the critical need for technology proven at scale. Off take contracts are important too. According to respondents, the other issues pale in comparison. This makes sense. If you do not have a workable technology what good is your green bond designation or significant feedstock?

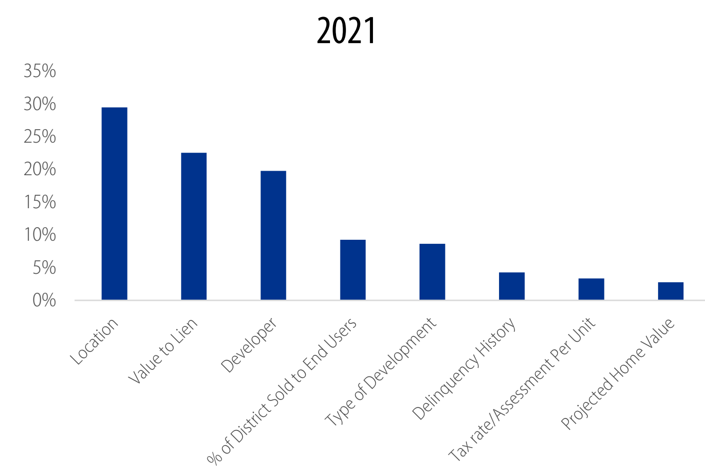




12. What drives your decision on development projects?

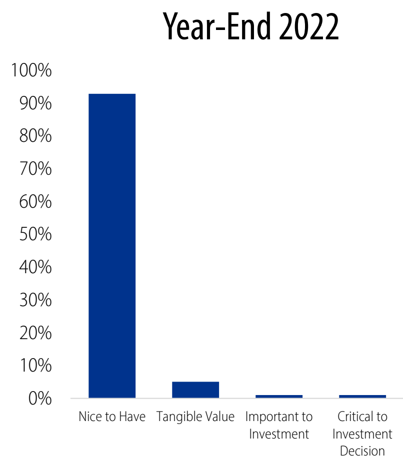
Location continues to be the most important factor driving a development investment decision followed by value to lien and developer. The health of the developer is important to ensure property tax payments if the project takes longer to develop and also allows for the "ability to discount or provide incentives for first time home buyers—important in rising interest rate environment," according to a respondent.

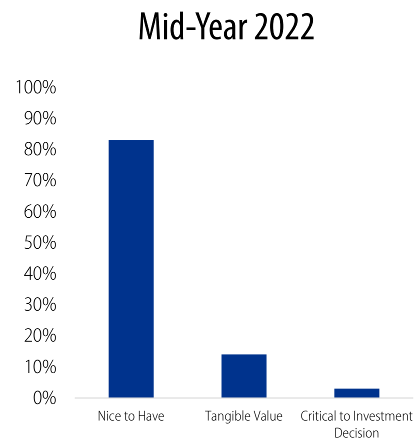


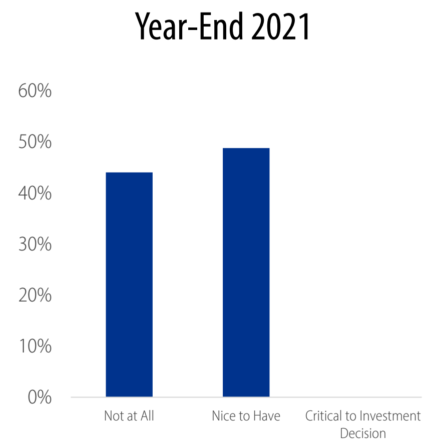


13. How important is the green bond designation to your investment in a High Yield credit?

Almost 93% of respondents indicated that the green bond designation was nice to have but would not pay extra. Only 5% allocated a tangible value of 1 to 4 basis points. Given massive attention to ESG and a rising interest rate environment, we thought that some investors would allocate a tangible benefit. However, respondent comments were telling: "We don't care really, a full description of use of proceeds can be more helpful in determining internally if deals meet internal ESG requirements; Dislike. It's a greenwash scam; I do not think 'Green' makes enough of a difference—not yet; I find them useless." The final comment was, "Isn't every deal in the muni space ESG?"

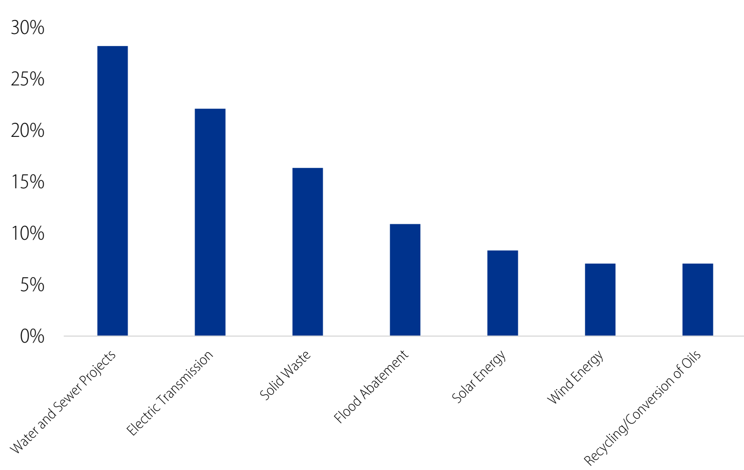






14. Which High Yield projects in the Utility/Power sector would you most likely choose to invest in?

Critical infrastructure such as water and sewer, as well as electric transmission followed by solid waste are the three sectors in which participants would like to invest.



15. Regarding Land Secured/Development transactions, in which states are you most interested in future investment? (Please Rank)

Texas, California, and Florida are the three states in which investors would like to participate. Colorado is a distant fourth which is a substantial shift from our 2022 mid-year update and generated some interesting comments, including "We need to be better compensated for risk in certain states like Colorado." Other investors mentioned opportunities in New York, Pennsylvania, and Nevada.