U.S. Municipal High Yield Market

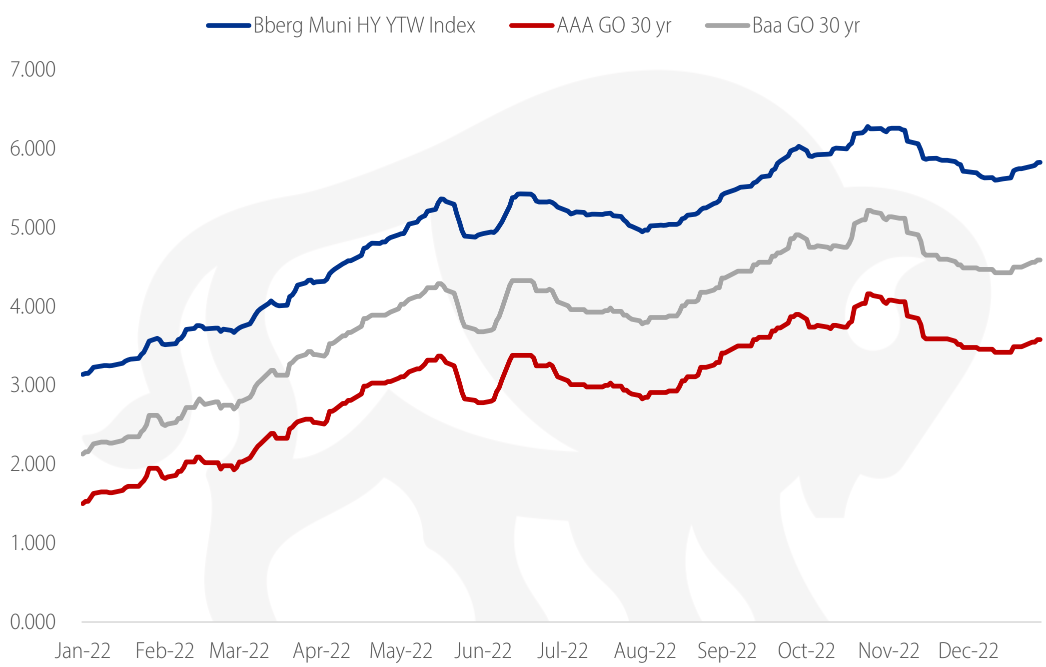
Charter School, Senior Living, and Hospital Sector Outlook

As we head into 2023, the Hilltop Debt Capital Market Team remains constructive on well-structured opportunities in the primary and secondary market. We are issuing a stable outlook for the charter school sector. We are also assigning a negative outlook to the senior living and hospital sectors as these sectors continue to experience significant expense pressures that have not been sufficiently offset by revenue increases resulting in compressed operating margins, lower liquidity, and less turning radius.

2022 Year in Review

The municipal market in 2022 was dominated by interest rate increases, credit spread widening, and outflows which challenged market participants throughout the year. For instance, 30-year MMD started the year at about 1.50% and ended the year at 3.58% a net increase of 208 basis points. To compare, the Bloomberg High Yield Index started the year at 3.13% and ended the year at 5.83% a net increase of 270 basis point which also reflects 60 basis points of credit widening.

2022 Costs of Capital



Source: Bloomberg

The dislocation in the market resulted in an almost 20% decline in year over year municipal issuance and a 40% decline in High Yield Issuance. Given the high yield deals that did not clear last year, market participants are evaluating structures to see if there is a path to issuance this year.

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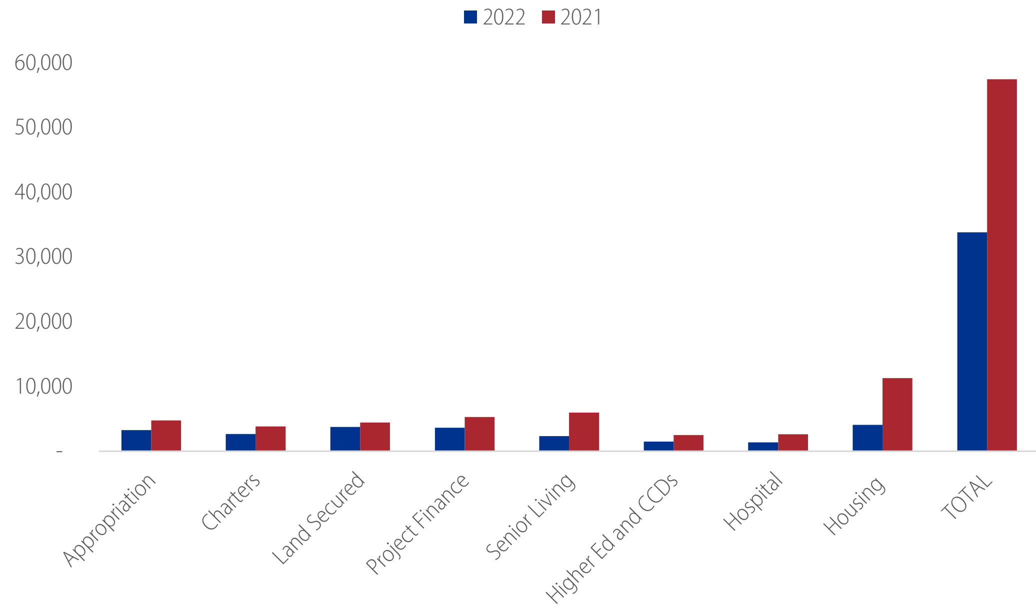
Please see disclosure starting on page 5.

2022 vs 2021 Issuance *($ in 000)*



Source: Bloomberg

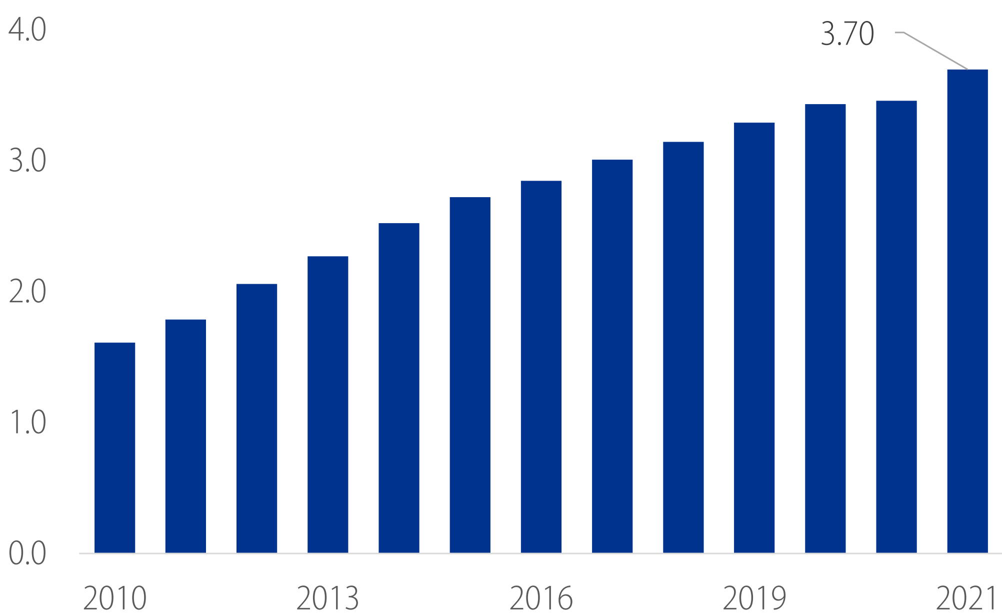
Some investors see charter schools as recession proof as the charters are tuition free for parents, and funding, predominantly state aid, is typically determined by enrollment which has been growing.

Charter Schools Outlook

Hilltop Securities maintains a stable outlook on the Charter School sector which currently educates approximately 3.7 million or 7.5% of K-12 students in the United States and accounted for $4.8 billion in debt issued in 2022. Charter Schools are most prevalent in California, Texas, Florida, Arizona, New York, Pennsylvania, Colorado, and Michigan. Charter Schools gained in enrollment during the pandemic with the enrollment increases maintained as students benefitted from generally more flexible curriculums and academic gains when compared to traditional public schools.

Charter schools with good management, sound academic performance, stable financial operations, and solid enrollment with significant waitlists are poised to weather economic challenges in the medium term.

Annual Charter School Enrollment *(in millions)*



Source: National Alliance for Public Charter Schools

The outlook for Non-Rated and Below Investment Grade Hospitals is negative recognizing the expense pressures, particularly as it relates to labor challenges, that are expected to extend into 2023 and the generally lower turning radius that is exhibited by non-rated or below investment grade hospitals.

Some investors see charter schools as recession proof as the charters are tuition free for parents, and funding, predominantly state aid, is typically determined by enrollment which has been growing. Charter Schools operate via a charter with an authorizer that typically allows more flexibility to educational approach, as long as financial, academic, and governance standards are maintained.

While Investment Grade Hospitals are generally larger with sound market share, and sizable liquidity, hospitals that are below investment grade or non-rated tend to be smaller with less liquidity.

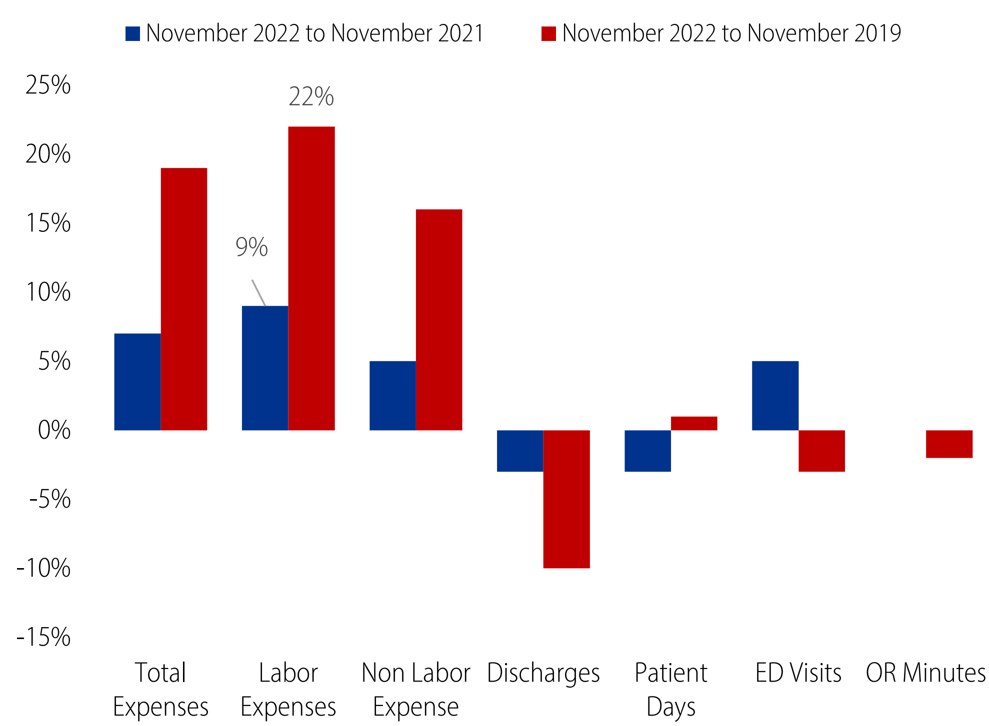
Given the sharp increases in enrollment, from 1.6 million children in 2009 to 3.7 million children today, there has been a race to construct appropriate facilities for these schools. Funding for the schools, varies state by state but follows the student and increases with enrollment growth. Factors to watch on individual charter schools are liquidity, capital needs, teacher availability, academic performance, demographic trends in the area, and a management team that can produce stable financial and academic results. Charter schools with good management, sound academic performance, stable financial operations, and solid enrollment with significant waitlists are poised to weather economic challenges in the medium term.

Non-Rated and Below Investment Grade Hospitals Outlook

The outlook for Non-Rated and Below Investment Grade Hospitals is negative recognizing the expense pressures, particularly as it relates to labor challenges, that are expected to extend into 2023 and the generally lower turning radius that is exhibited by non-rated or below investment grade hospitals. In fact, total expenses for hospitals increased between November 2022 and November 2021 by 7% or 19% when comparing to 2019, with labor expenses accounting for 9% year to date growth. According to data from KaufmanHall, adjusted patient days were up slightly at 3% year over year, emergency room visits were up 5%, and operating room minutes were flat, exacerbating the structural imbalance between recurring revenues and recurring expenses.

Based upon the significant decreases in net income generation and liquidity, management teams of lower rated and non-rated hospitals generally have less flexibility in reacting to financial challenges which supports our negative outlook.

National Hospital Utilization Data, *Year-over-Year Changes*



Source: KaufmanHall

Our outlook for the Senior Living sector is negative as we expect greater operating headwinds over the medium term. Although 10,000 baby boomers turn 65 every day, many people choose to age in place and are not necessarily seeking congregate care.

While Investment Grade Hospitals are generally larger with sound market share, and sizable liquidity, hospitals that are below investment grade or non-rated tend to be smaller with less liquidity. As a result, there is generally less flexibility if utilization trends down or expenses trend up. Together the revenue and expense issues have eroded net income, compressed operating margins, and available liquidity.

Occupancy in Assisted Living units, which reflects a more need-based care, has had the strongest recovery to date, while occupancy in Independent Living and Nursing Care units have lagged.

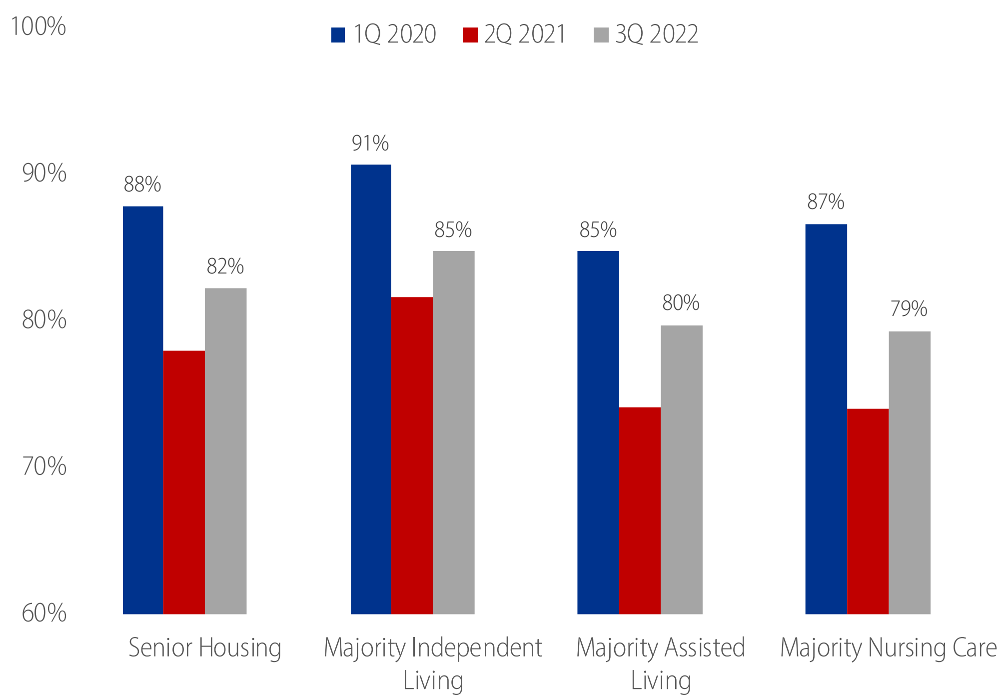
Take for example, liquidity as measured in Days Cash on Hand (DCOH) or Unrestricted Reserves to Debt. According to Standard and Poor's Global Ratings, the median level of DCOH for an A-rated hospital is 301.6 with 2.1x Unrestricted Cash to debt. To compare, in the case of a BBB level credit, this number is reduced to 172 DCOH and 1.87x Unrestricted Cash to Debt. Finally, for S&P hospitals rated in the Speculative Grade Category, DCOH is reduced to 112 and cash to debt is only 78.5%. In 2022, according to Bloomberg data, there was approximately $3 billion in hospital related debt issued that was rated BBB or lower or non-rated. Based upon the significant decreases in net income generation and liquidity, management teams of lower rated and non-rated hospitals generally have less flexibility in reacting to financial challenges which supports our negative outlook.

Senior Living Outlook

Our outlook for the Senior Living sector is negative as we expect greater operating headwinds over the medium term. Although 10,000 baby boomers turn 65 every day, many people choose to age in place and are not necessarily seeking congregate care. According to the National Investment Council, senior living occupancy approximated 82.8% as of October 2022 across all types of housing including Independent Living, Assisted Living and Nursing Care. While this is a significant increase from the pandemic low of 77.9% recorded in June 2021, occupancy has not fully recovered to the 88% level recorded at the end of 2019 before the pandemic began.

Together the relatively flat growth in incremental revenues coupled with the more significant acceleration of expenses have compressed operating margins and have challenged operators to produce stable financial results.

Senior Living Occupancey Peak to Trough



Source: NIC MAP Data, powered by NIC MAP Vision

Communities with limited liquidity or those that are operating in more competitive locations, are poised for additional challenges in 2023.

Occupancy in Assisted Living units, which reflects a more need-based care, has had the strongest recovery to date, while occupancy in Independent Living and Nursing Care units have lagged. In general, revenues generated from Independent Living units generate the highest operating margin as they are less labor intensive than Assisted Living and Nursing Care. Given available supply, unit rate increases have remained relatively muted, on average, at approximately 4-5%, while the costs for labor and food rose in many cases by more than 10%. Together the relatively flat growth in incremental revenues coupled with the more significant acceleration of expenses have compressed operating margins and have challenged operators to produce stable financial results. To date, there have been significant headlines in the space and approximately 50% of the 2022 municipal defaults have been in the retirement space according to Municipal Market Analytics and Bloomberg.

We believe that senior living communities that are in highly desirable areas, with strong occupancy, seasoned management, and good liquidity are prepared to weather these challenging times. However, communities with limited liquidity or those that are operating in more competitive locations, are poised for additional challenges in 2023.

Recent HilltopSecurities Debt Capital Markets Commentary

- High Yield Impact Survey, Dec. 5, 2022
- The Next Big Risk, Sept. 8, 2022
- Senior Living Issuance, August 29, 2022

Readers may view all of the HilltopSecurities Debt Capital Markets Commentary here.