

U.S. Municipal High Yield Market

High Yield Impact Survey

We are pleased to share with you the results of the third annual HilltopSecurities High Yield Impact Survey, conducted from Oct. 30 to Nov. 17. The survey received 125 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 drivers of credit in 2023 and 2024. Some survey responses reflect the market position of the responder, and where possible, we broke out these differences. We thank everyone for their participation and the opportunity to provide the high yield market with cutting-edge thought leadership as we collectively contemplate the end of 2023 and the commencement of 2024. As always, we appreciate all feedback!

The Highlights

- 125 responses from various market participants with 50% from investors
- 41% of responders think that yields have peaked
- Green Bond designation is not important to over 90% of responders
- The top three sectors that participants expect to see defaults are in senior living, skilled nursing, and project finance
- Investors are least concerned about charter schools, land secured transactions, and credits that could be affected by the perpetuation of work from home arrangements
- Liquidity/equity is the single most important factor that investors focus on followed by management and covenant package
- Almost 50% of responders find value in both BB and BB- ratings; whereas 18% reported that the BB is helpful but the BB- is not
- Although almost 60% of responders value a rating solicitation request, investors noted they rarely work
- On a land secured transaction, the three factors that are most heavily factored are location, developer, and value to lien
- Significant equity and technology proven at scale drive participation in a project finance credit
- Almost two-thirds of responders prefer to control the structuring process and approximately one third prefer a traditional marketing structure approach
- Almost half of responders say investor counsel is a must with nuanced positions depending on deal complexity
- Almost two-thirds of responders stated that if they like the deal they will participate, regardless of a transaction's small size
- 30% of high yield investors do not want to see structures with shorter call provision, and over 50% state it depends

See the complete survey results below.

Please see disclosure starting on page 10.

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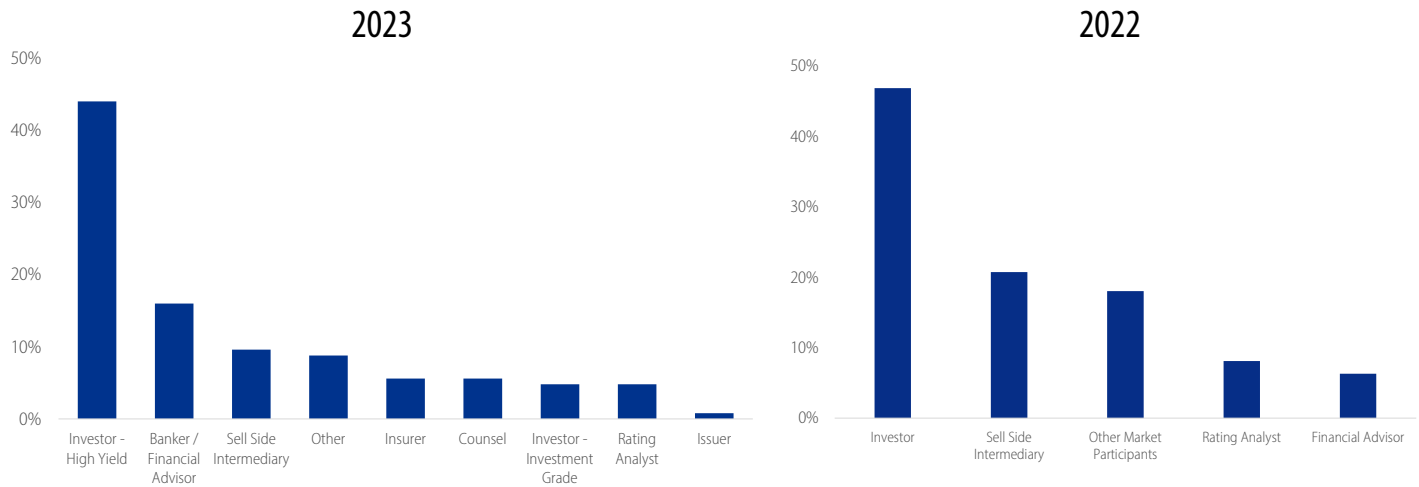
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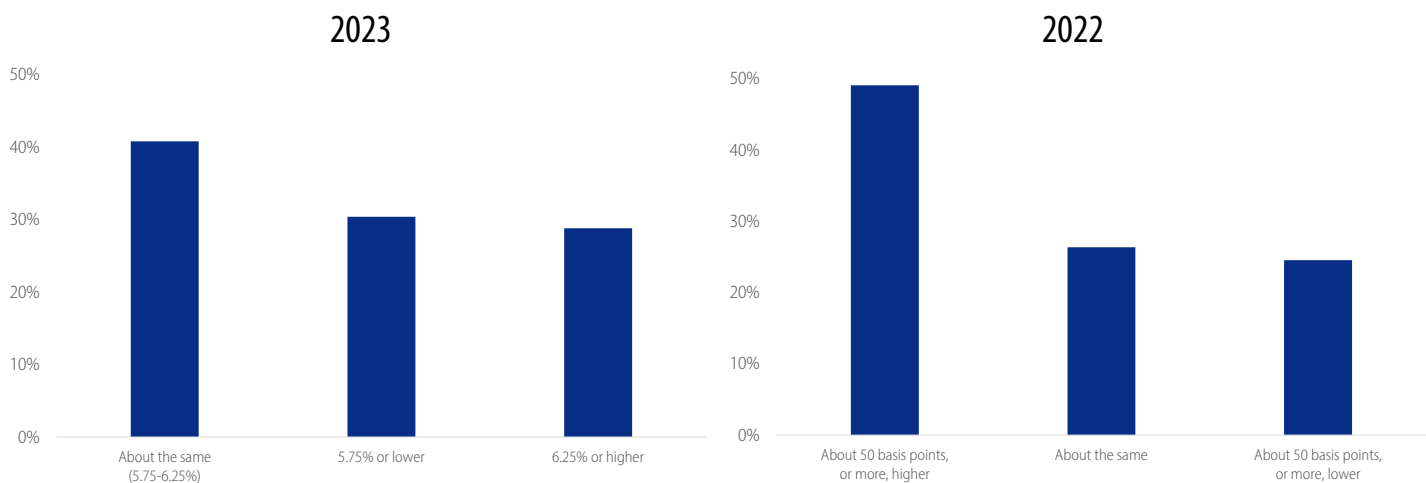
1. What is your role in the market?

The 125 responses came from various market participants with approximately 45% coming from high yield investors and 5% from investment grade investors. We increased our responses to 125 from 110 in 2022, although the breakdown of participants remains similar. In addition to investors, bankers and advisors accounted for 16% of the responders and sell side intermediaries accounted for 9%. Bond counsel, insurers, and rating analysts contributed 16%. Other market participants (including bond evaluators and researchers) contributed the remaining 9%.



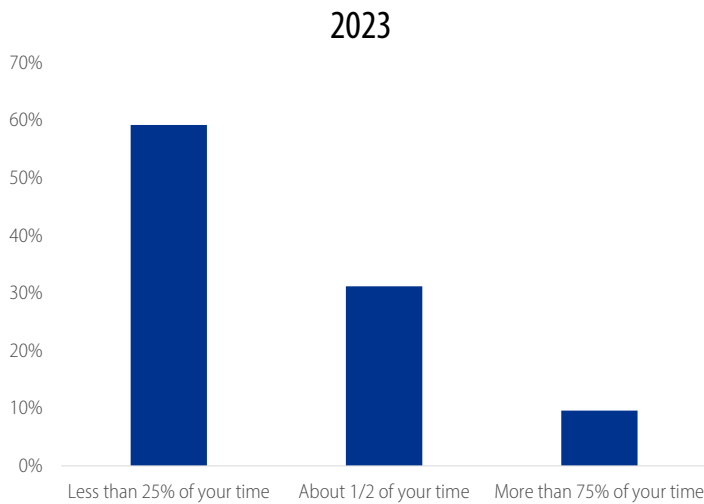
2. A 30 year Baa3/BBB- tax exempt new issue priced to yield 6% in late 2023. Given the same credit, what would you expect the yield to be July 1, 2024?

Almost 41% of responders project that yields will be about the same while the remaining responses were evenly divided between rates going higher and lower. Last year at this time, 50% of analysts were projecting a 50 basis point increase in rates with the rest evenly split. With MMD up over 50 basis points year over year, the majority of last year's survey responders were correct in predicting yield movement in 2023. The rating is certainly a starting point; however when looking at 2023 pricing data, there was significant yield and spread differential depending on credit opinion.



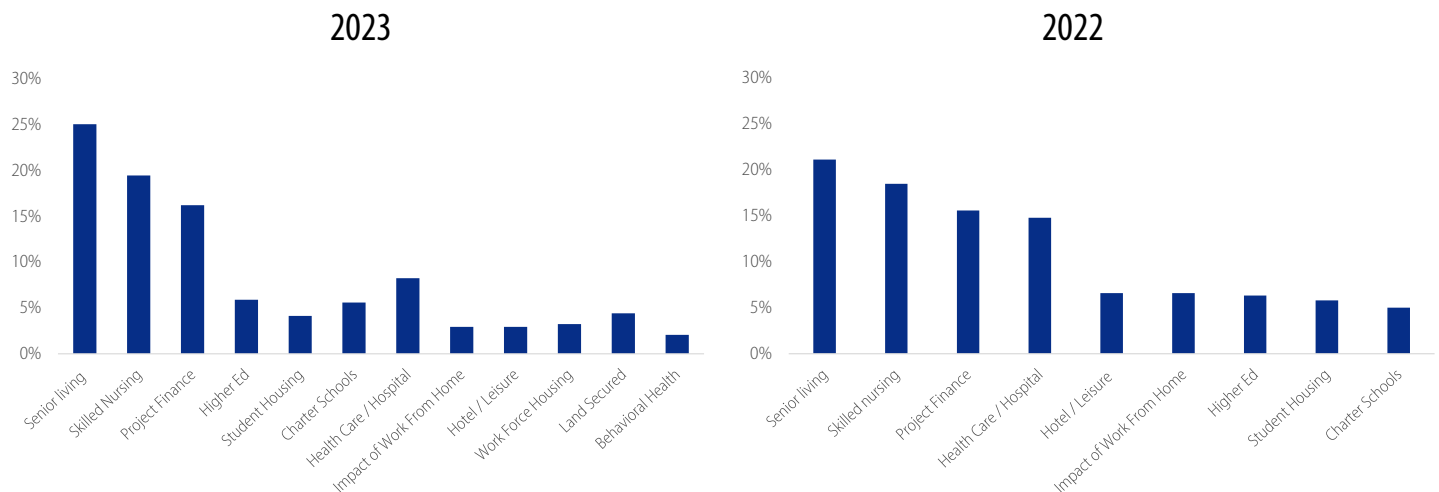
3. How much time do you allocate to surveillance per week?

There is no doubt that surveillance is an important component of a market participant's day. However, the allocation of time varies significantly depending on job function. Almost 60% of responders spend less than 25% of their time on surveillance each week with about 30% spending about 50% of their time, and 10% spending more than 75% of their time on surveillance each week. When further sorting the data about half of the high yield investors spend half of their day on surveillance while the remainder are evenly split between 25% and 75%. To compare, most investment grade analysts, sell side intermediaries, bankers, advisors, counsel, and bond insurers spend 25% or less of their time on surveillance. Rating analysts tend to spend 50% of their time on surveillance.



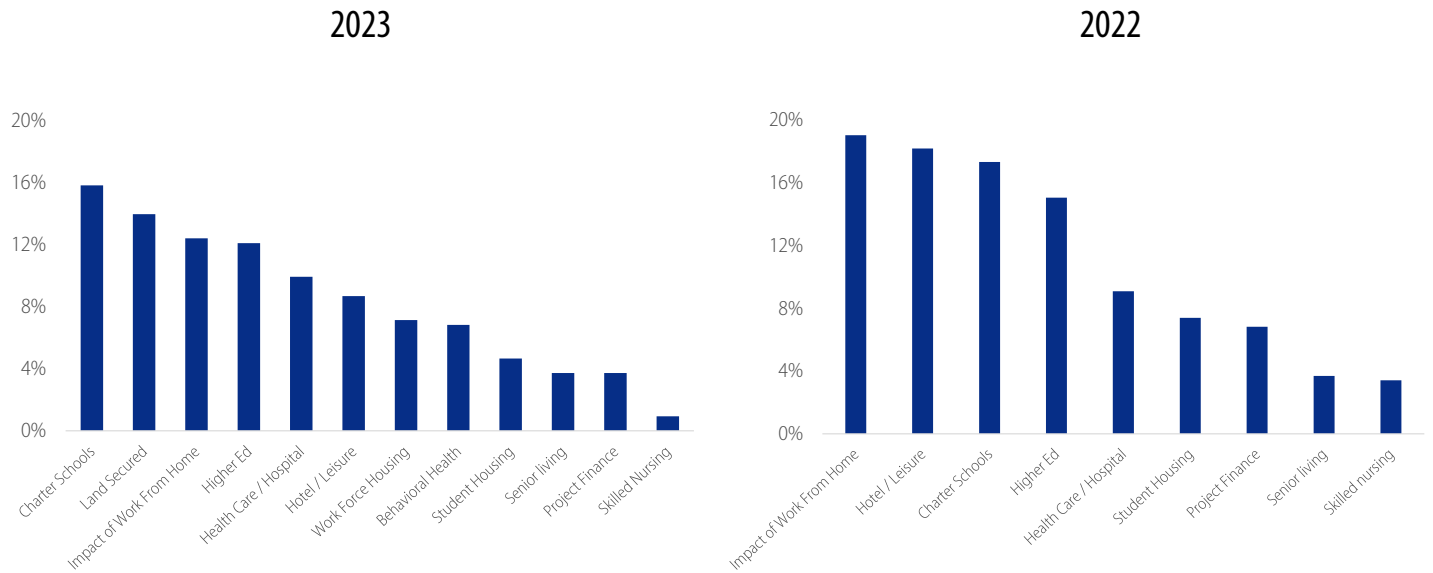
4. What sector do you expect to see the greatest number of defaults in 2024?

The top three sectors where participants expect to see defaults are in senior living, skilled nursing, and project finance. The results are similar to 2022 in which senior living, skilled nursing and project finance took the top three spots. However, in 2023 higher ed took the fourth position compared to hospitals in 2022 recognizing that some of the extreme labor and revenue pressures in the hospital sector have begun to moderate. Generally, responders assigned little to no concern to the behavioral health, hotels, work force housing sectors, or the impact that work from home will have on credits.



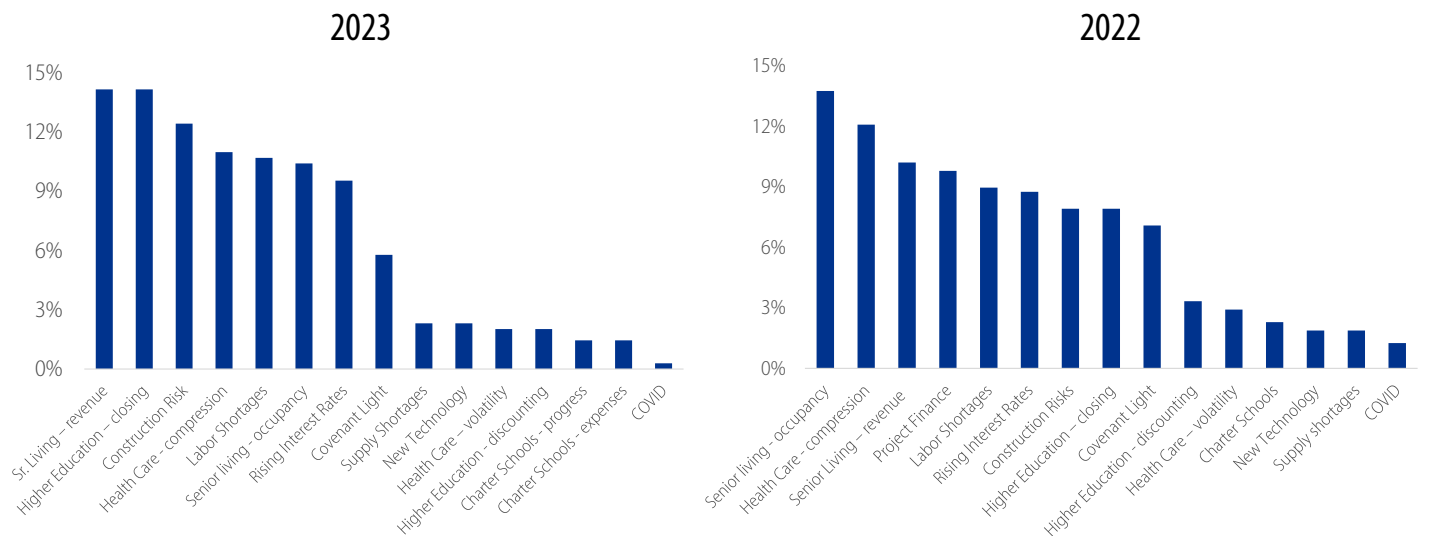
5. What sector are you LEAST concerned about?

Investors are least concerned about charter schools, land secured transactions, and credits that could be affected by the perpetuation of work from home arrangements. Charter schools continue to grow in acceptance by market participants. Last year they were in third place with respect to this question, compared to this year's No. 1 least worry. Higher education came in fourth place in both 2023 and 2022 recognizing some of the growing risks that the sector faces including the demographic enrollment cliff, tuition pressures, and affordability.



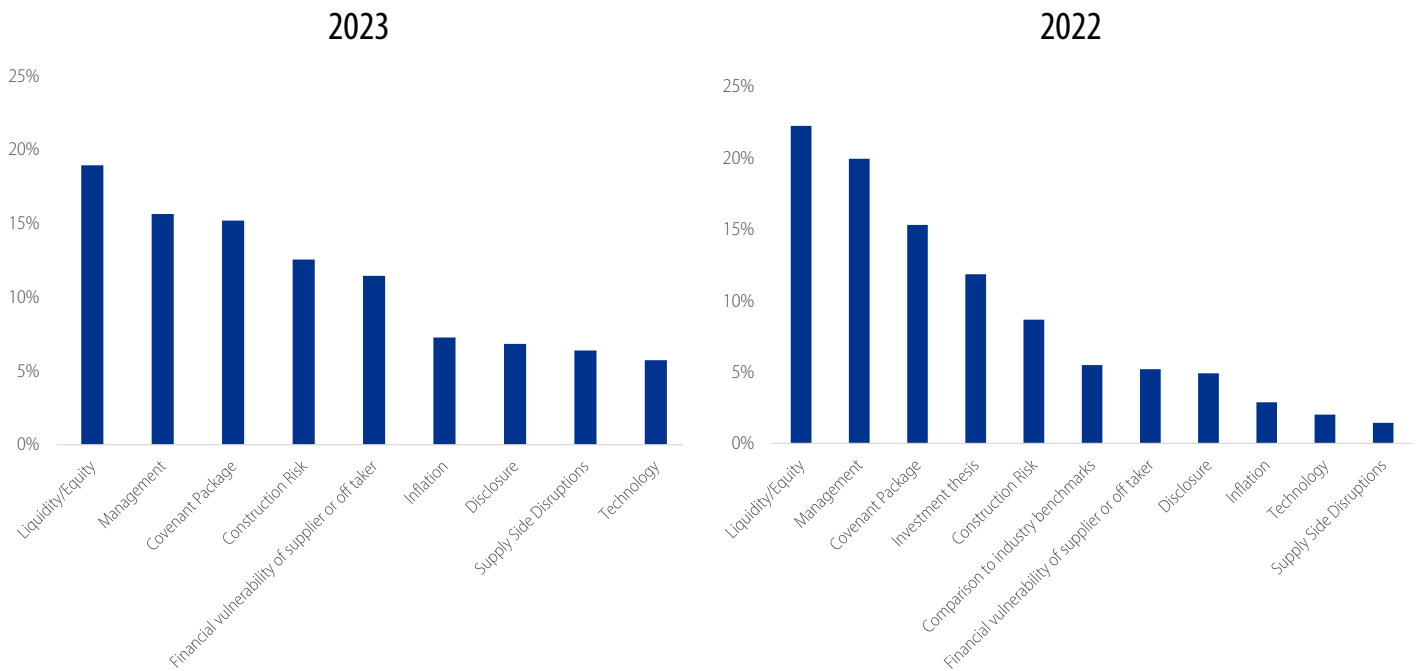
6. In your opinion, what is the biggest HY Sector Risk to watch out for in 2024?

The largest high yield sector risks to watch out for in 2024 are risks in senior living revenue growth, higher education and associated concerns for smaller institutions, and project construction risks. As most senior living campuses have not quite returned to pre-covid levels, revenue pressures are not a surprise. The move of higher education to the No. 2 spot from No. 8 last year reflects the challenges that are being faced in the smaller private higher education sector as institutions are trying to effectuate financial and operating pivots to attain structural balance despite declining enrollment, increased competition and expense pressures.



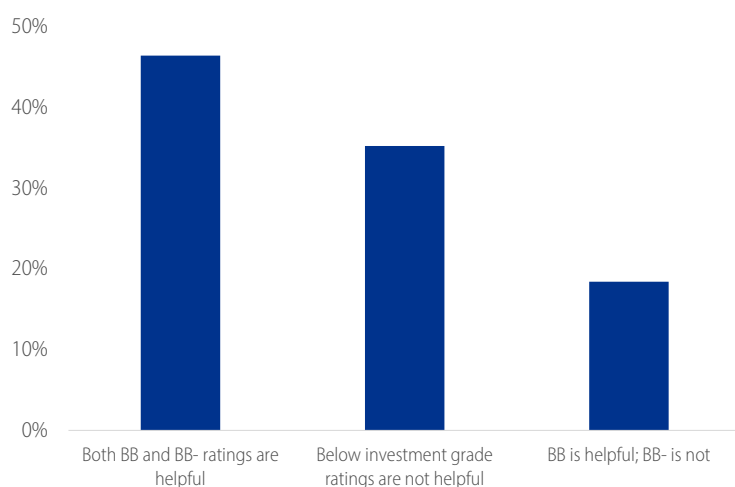
7. What do you focus on the most when you analyze a HY Deal?

Liquidity/Equity is the single most important factor that investors focus on, followed by Management and Covenant Package. One respondent suggested that we also need to “look at Population and Enrollment.” We agree that understanding Population and Enrollment is particularly important in the higher education and charter school sectors. Two high yield investors separately commented: “sustainability of revenue streams” and “I need to make sure that there is qualified management running the project in between disclosure postings”. These comments resonate as seasoned management is critical to effectuate predictable revenues, margin, and debt service coverage. Yet another high yield investor wrote: “Does the project makes sense? Can I understand it and communicate the investment basis”. This concept also makes significant sense as investors evaluate more esoteric municipal projects. Another comment: “Covenants matter less as they won’t make a bad project good or a good project bad.” This is a prophetic position and telegraphs the careful balance between predictive and protective covenants and a collateral package that could be too burdensome on a project. Yet another investor added the need to have “confidence in financial projections and feasibility studies,” and we strongly agree with that comment. Finally, another high yield investor asked an important question: “How do we assess new deals without a benchmark to compare?” This is a question that has no easy answer but supports the focus on liquidity/equity and management.



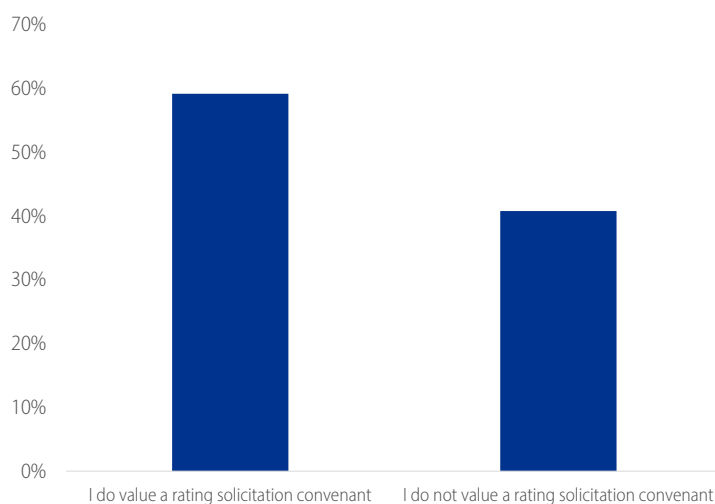
8. What value do you place on a BB or BB- rating?

This is a new question to the survey. Almost 50% of responders find value in both BB and BB- ratings; whereas 18% reported that the BB is helpful but the BB- is not. Interesting to note is that 35% reported that below investment grade ratings are not helpful. There were some interesting insights that are worth noting: "I don't read rating agency reports, but the rating, even if below investment grade, tends to help with liquidity" stated one market participant. An attorney responded it "depends on sector". Eight high yield investors had similar insights, of which we will share: "While I would like to see more ratings utilized in the non-investment grade side of the scale, I have found that the rating agencies struggle with credits that may be of a smaller size or differ from their score card. As a result, I find the greatest utility in a BB or higher rating". Response 2: "Rating agencies are not equipped to nuance ratings when they are below Investment Grade. I do not place credit value. However, there "might" be some liquidity value in secondary trading". The third comment was: "Rating agencies do less well in the HY space. There are solid credits that don't conform to a scorecard". Finally, another investor mentioned: "At a BB- I would rather assess myself. However, could be interesting if I perceive credit upgrade opportunity".



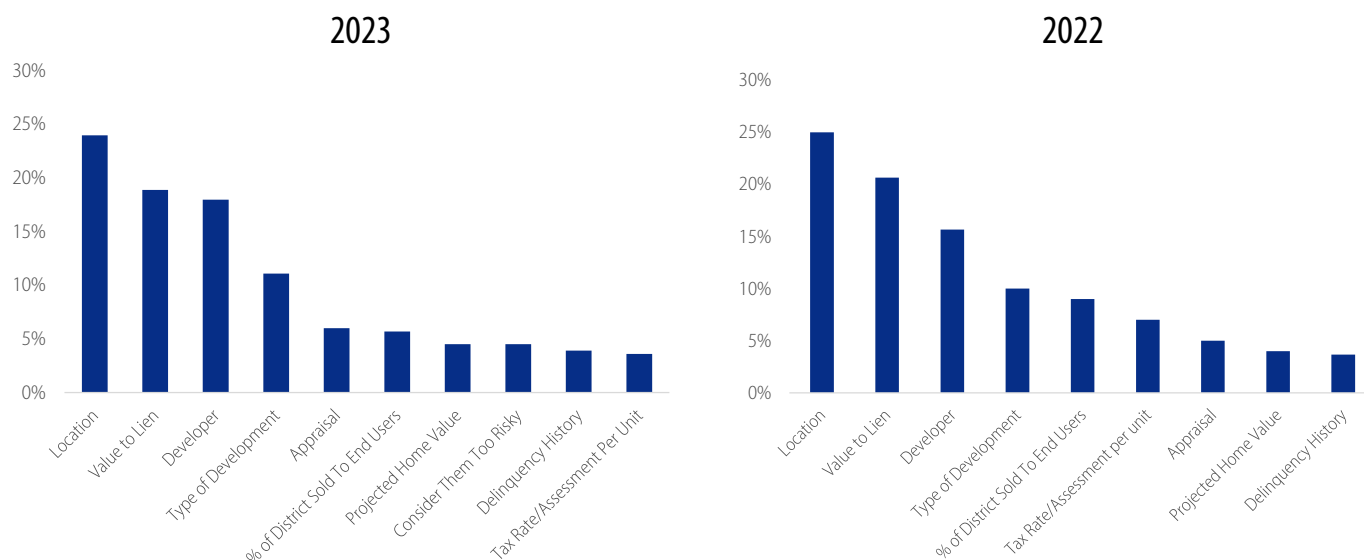
9. Do you value a rating solicitation covenant on a non-rated transaction?

This is a new question to the survey. Almost 60% of responders value a rating solicitation request. One high yield investor wrote: "I wish they would work with more frequency" and a second investor responded that they have only see them work once. Another wrote: "why not". An additional high yield investor response was: "Important signal of intent of borrower; but not as important as stepped-up liquidity covenants". Another high yield investor likes to see the covenant on senior living transactions, but otherwise will not make the request.



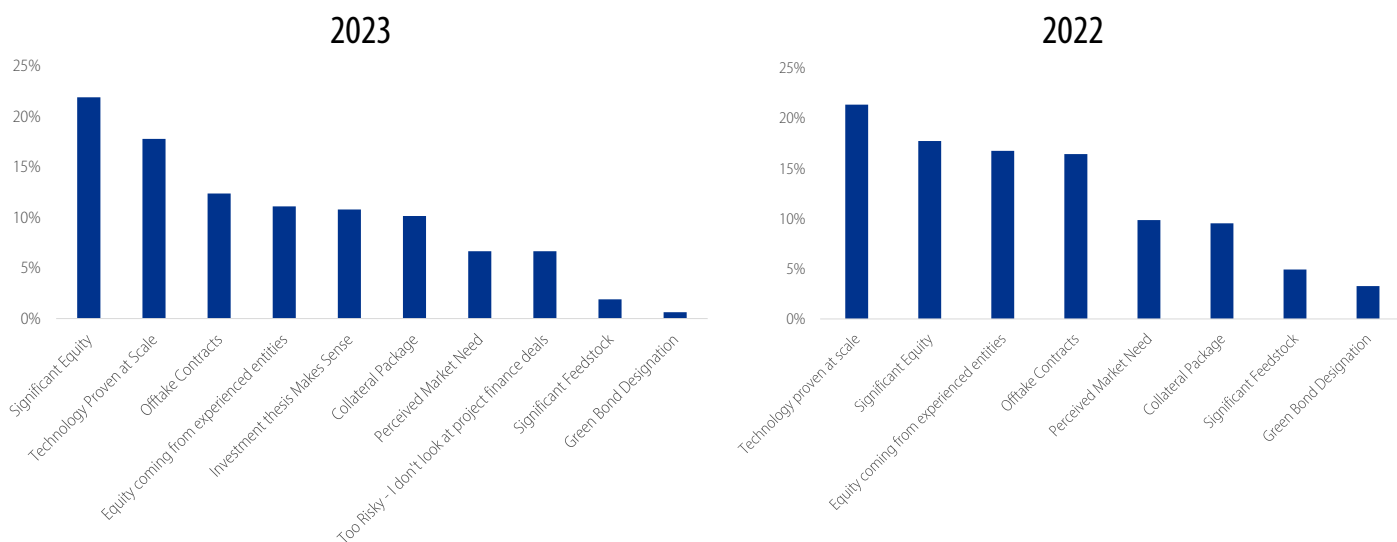
10. What drives your decision on early-stage development projects?

The three factors that are most heavily factored are Location, Developer, and Value to Lien. These results were consistent with 2022 and 2021 results. These concepts resonate in the current environment where mortgage rates have approached 8% and build out may be slower than anticipated. Ultimately a prime location with a sound value to lien and a well-capitalized developer can together support a project head to success. Surprising factors that mattered less were Delinquency History, Tax Rate, and Projected Home Value.



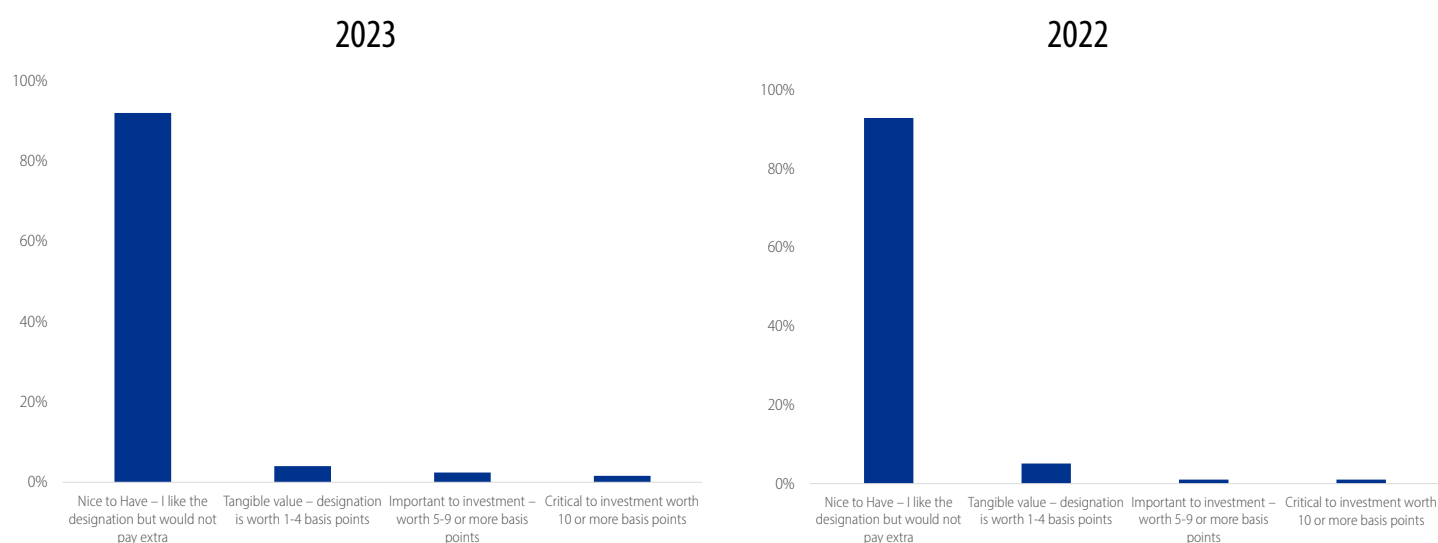
11. What drives your assessment of a project finance / renewable energy bond?

The top two choices were resounding. They were: Significant Equity and Technology Proven at Scale. Interesting to note that Significant Equity was now ranked as No. 1 in front of Technology Proven at Scale which is the reverse of 2022. A distant third was the Offtake Contracts. After the top three choices, three other factors were basically tied for fourth to sixth place – including Equity Coming from Experienced Parties, Investment Thesis that Makes Sense, and Collateral Package. The green bond designation was chosen in fewer than 1% of total responses. Investor responses were centered on equity and technology. Two meaningful investor responses include: “Sufficient equity often means there is a pocket of cash that is willing to contribute a bit more financially if that’s what it takes to get the project up and running assuming the technology works”. That comment dovetails with this thought from a high yield investor: “Default rate in Project Finance sector is too high. Technology at scale is very difficult to implement and historically has failed more often than not”. A final observation dovetails with question 12: “Green bond designation does not help my recovery when a deal defaults. Equity does.” This sentiment underscores investor sentiment as to why the green bond designation came in last with respect to drivers of project finance assessment.



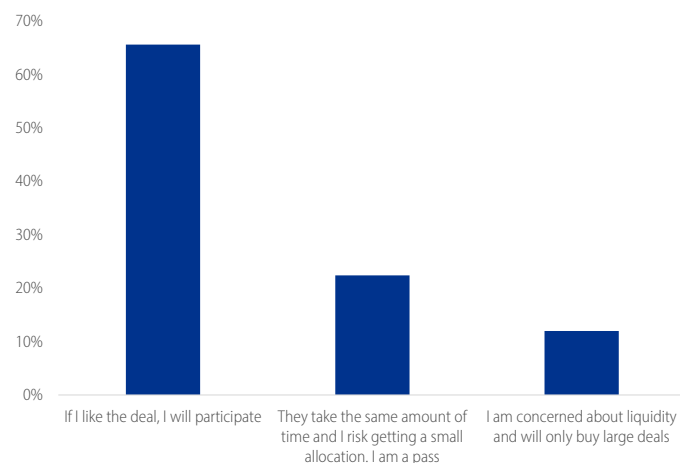
12. How important is the Green Bond Designation to your investment in a High Yield Credit? (Choose 1)

This question has appeared in each of the three surveys and in each instance the answer is resounding. The green bond designation is nice to have; however, 92% of responders say they would not pay extra. 4% believe the designation is worth 1-4 basis points. 2.4% believe the designation is important and worth 5-9 basis points and 1.6% believe that the designation is critical and worth 10 basis points. To compare, in 2022 93% of investors 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. A bond counsel thoughtfully shared: "Designation" can mean different things. Self-designation is not worth anything, but careful and well-disclosed verification by a third party/second party opinion, to the extent the verified analysis ties to specific ESG factors valued by a particular investor would be more valuable to that specific investor. Most ESG investors have their own internal priorities, so not every ESG deal is equally attractive to different investors". Conversely, two high yield investors stated the following: "Why would I pay extra???? Rates are high and I am not willing to exchange yield for ESG when virtually all projects are ESG anyway" and "0 value on it". Finally, one sell side participant wrote: "There is no lower selection, but I place no value at all on high yield green bond designations".



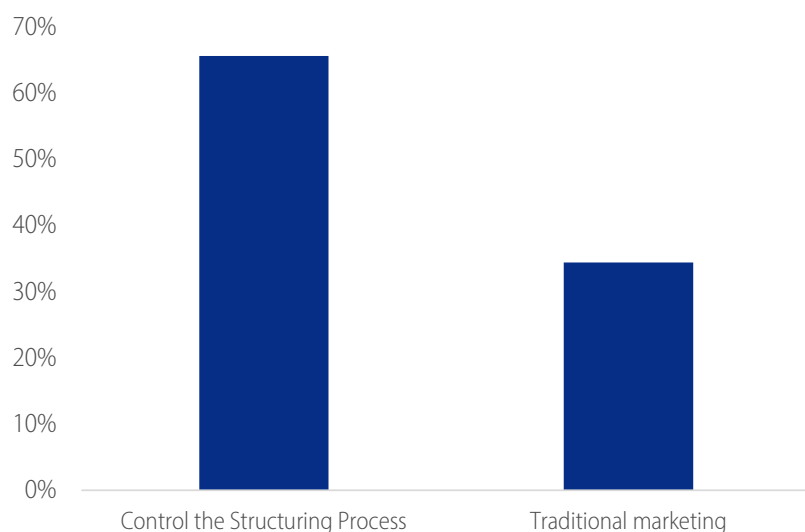
13. In light of the challenges in the HY market the past two years, how do you feel about investing in small deals (\$20 million or less)?

This is a new question to the survey. Given the lack of supply in the high yield market, the fact that almost two-thirds of responders stated that if they like the deal they will participate, regardless of a transaction's small size. However, a third of responders will pass because of concerns of liquidity and the amount of time it will take to surveil the credit for a relatively small position.



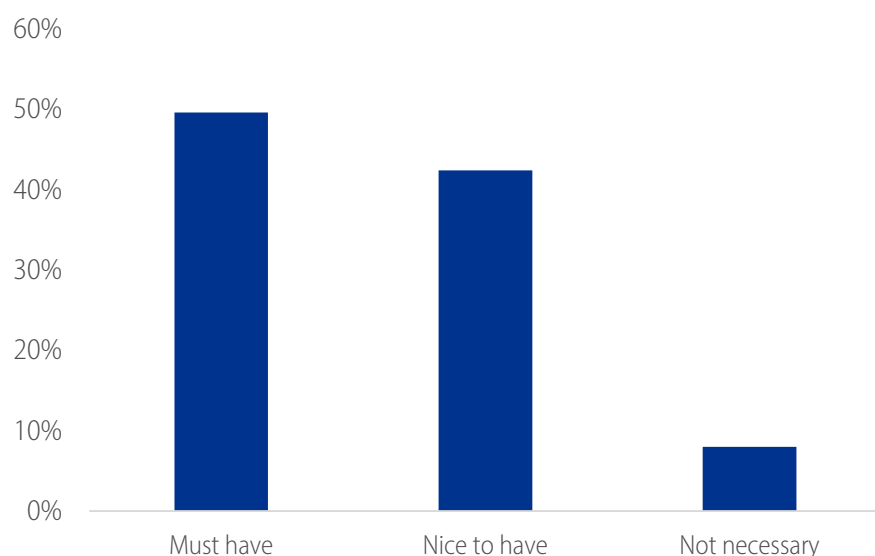
14. Do you prefer a traditional marketing approach or would you rather negotiate directly and control the structuring process?

This is a new question to the survey. Almost two-thirds of responders prefer to control the structuring process, and approximately one-third prefer a traditional marketing structure. Given the decline in high yield issuance, investors have anecdotally reported positive experiences when working collaboratively with underwriters and counsel to structure transactions in more esoteric sectors.



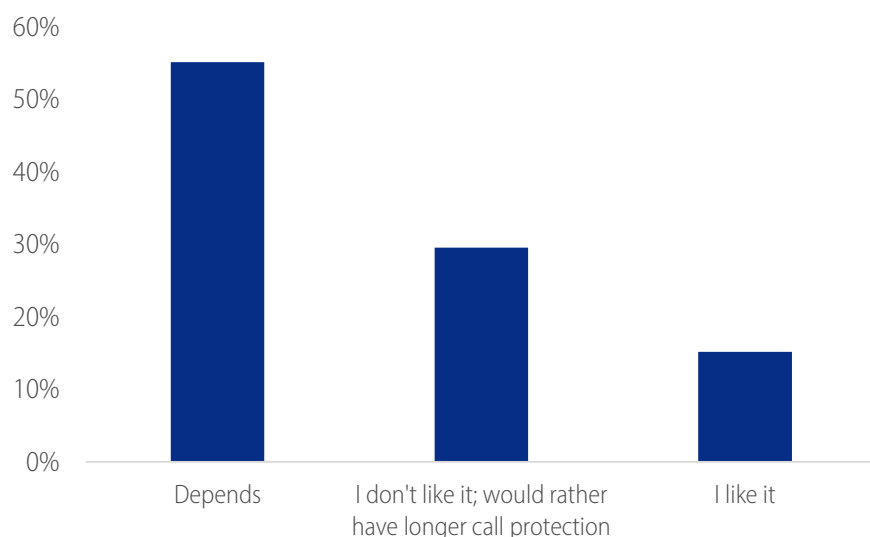
15. On a high yield deal, how important is investor counsel to your firm?

This is a new question to the survey. Almost half of responders say investor counsel is a must; 42% responded it is nice to have; and 8% believe that the investor counsel is not necessary. Several high yield investors had similar comments. One summed up the situation well: "It really depends upon the complexity of the structure and participants". Another commented: "It is good that we know that Business Terms match Legal Terms".



16. What is your view on shorter call features, such as 7 year versus traditional 10 year, if applicable?

This is a new question to the survey. In 2023, the use of short calls or puts have increased in the market. As a direct response to this increasing trend, we wanted to better understand how market participants view this trend. More than 55% remarked that "it depends" with 15% of respondents stating they like it, and almost 30% prefer not to see this structure. One high yield investor remarked: "It really depends. But at the end of the day, it could feel that we are taking the construction risk and not benefiting from stabilization." Another stated: "The longer the better, as a HY borrower will defease as soon as they can after completion and stabilization. If agreeing to anything less than 10-year, there should be a meaningful premium to offset the call risk". Another investor remarked that they are not willing to buy anything with less than a 10 year call.



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