U.S. Municipal High Yield Market

2024 High Yield Impact Survey

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We are excited to present the findings from the fourth annual HilltopSecurities High Yield Impact Survey, conducted between Oct. 9 and Nov. 1. This year's survey garnered 110 responses from a diverse array of market participants, including investors, sell-side intermediaries, bankers, advisors, rating analysts, attorneys, insurers, trustees, and other professionals in the market.

The responses to these questions have provided valuable insights into the drivers of credit for 2024 and 2025. We extend our gratitude to everyone who participated. Your responses allow us to provide the high yield market with innovative research as we approach the end of 2024 and the beginning of 2025. As always, we welcome and appreciate all feedback!

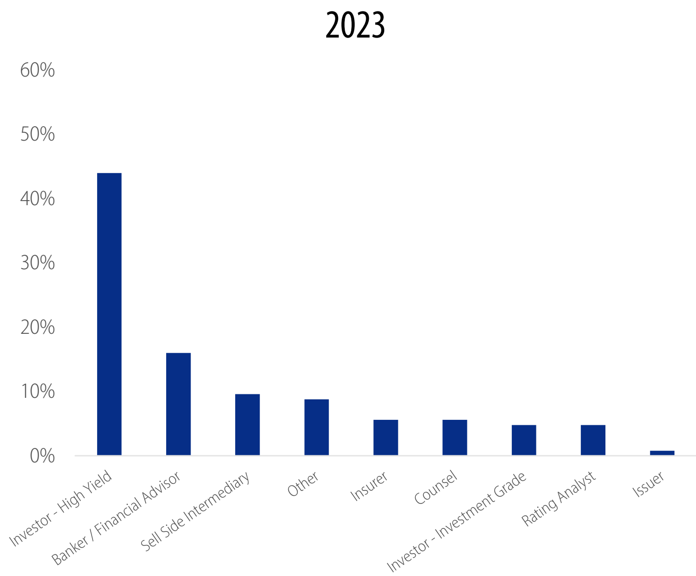
The Highlights

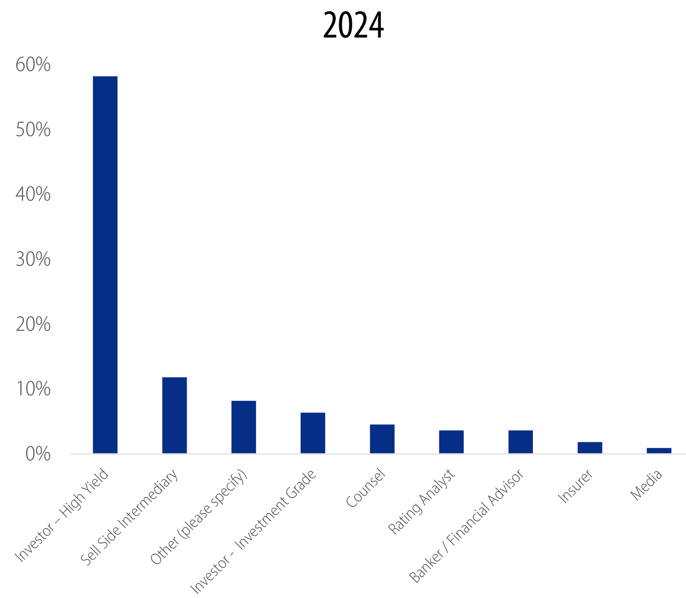
- If predictions hold true, we can expect rates to widen next year, primarily to account for credit nuances.
- 66% of analysts now allocate less than 25% of their time to credit review while in 2023 only 59% of indicated that they spent 25% or less of their time on surveillance.
- Participants anticipate the highest default rates in senior living, higher education, skilled nursing, and project finance.
- Investors are currently least concerned about land-secured transactions and hotels, as well as the impact of remote work on various credits.
- Charter schools with growing enrollments and strong management teams are expected to perform well. Conversely, those with declining enrollments and weaker management controls are likely to face credit impairments.
- In the 2024 survey, the top concern is the risk of smaller colleges and universities closing. To compare in 2023, the focus was still on senior living sector.
- We believe that the focus on covenants is particularly interesting given the number of high-yield deals in the market this year, with some featuring a return to covenant-light collateral packages.
- Liquidity/equity is the single most important factor that investors focus on followed by management and covenant package.
- In 2024, 52% stated that they do not value a rating solicitation covenant, down from 59%.
- We believe that the rise in early-stage land financings in the high-yield market has highlighted the importance of the developer in project execution, especially at project inception or in an economy facing challenges such as higher capital and labor costs.
- No responder chose green bond designation as a driver to project assessment in 2024.
- If the municipal tax exemption is to be eliminated, the Government Finance Officers Association (GFOA) projects that debt issuance costs would increase around 25%, and possibly more for smaller governments.

Please see disclosure starting on page 12.

1. What is your role in the market?

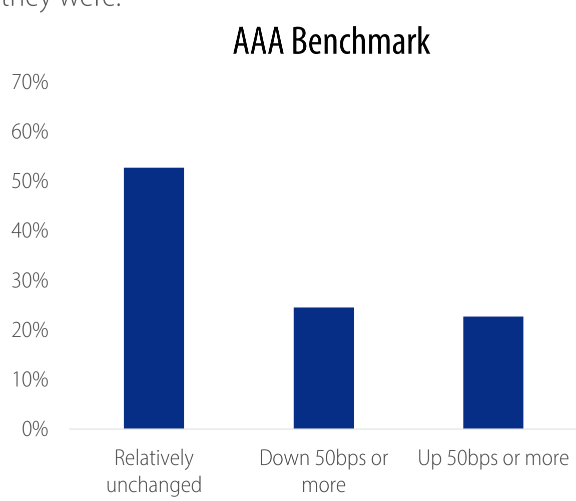
This year, we received 110 responses. Of these, 58% were from high yield investors, and an additional 7 responses came from investment grade investors. Combined, these groups made up nearly two-thirds of the total responses, up from 50% in 2023. Although the total number of responses decreased by 15 year-over-year, the number of high yield investors increased by 9, raising their share to 58% from 44%. We also received responses from sell side intermediaries, counsel, rating analysts, insurers, issuers, and bond trustees.

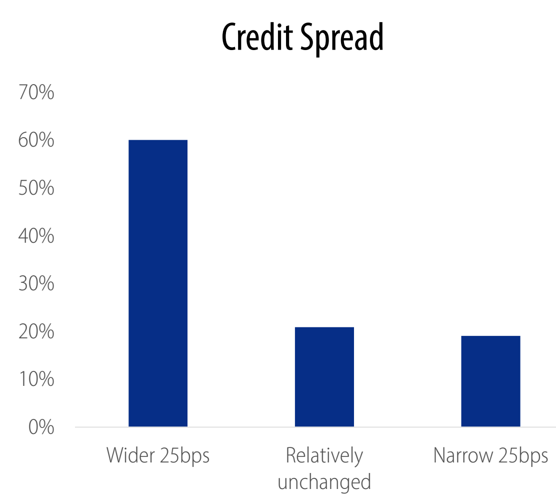




2. & 3. Benchmark AAA 3-year (current ~3.50%): How do you think it will move in 2025? HY Municipal Credit Spreads (currently +165bps): How do you think it will move in 2025?

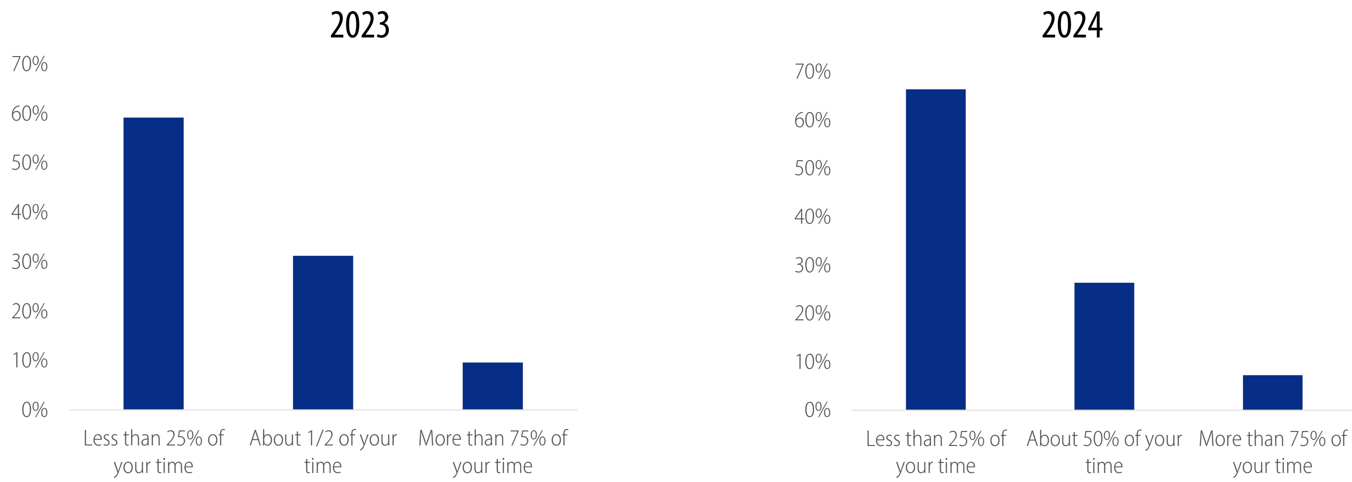
In 2023, we sought specific feedback on a generic Baa3/BBB- credit, and the responses were divided: 40% expected yields to remain the same, 30% anticipated lower rates, and 30% predicted higher rates. For the 2024 survey, we modified this question by splitting it into two parts. This change aims to better isolate expectations around benchmark AAA levels separate from expectations on credit spreads, providing more detailed insights into market rate assessments for 2025. Interestingly, despite expectations of treasury rate reductions in 2025, 50% of respondents believe that the benchmark 30-year AAA rate will remain unchanged. The remaining respondents were equally split, with half expecting a 50-basis point increase and the other half anticipating a 50-basis point decrease. When it comes to credit spreads, nearly 70% of survey participants expect spreads to widen in 2025. About 20% believe they will stay the same, while slightly fewer predict a 25-basis point narrowing next year. If these predictions hold true, we can expect rates to widen next year, primarily to account for credit nuances. We'll revisit these predictions, and see if rates did in fact increase, next year to see how accurate they were.





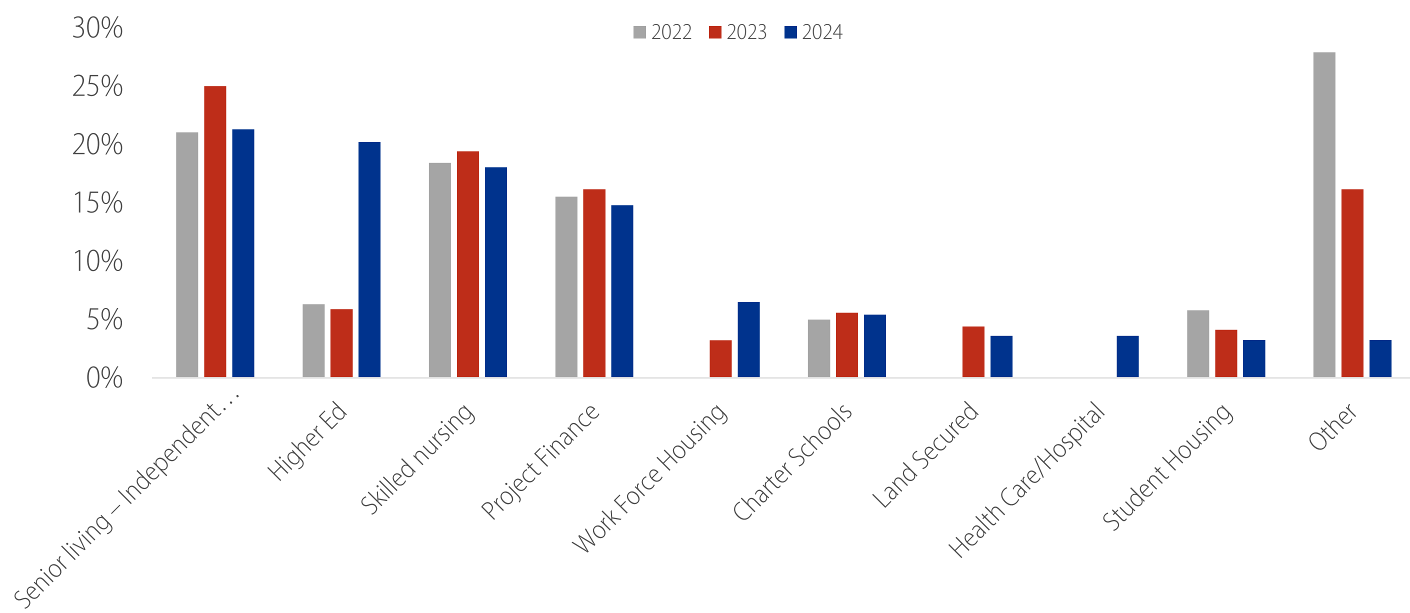
4. How much time do you allocate to surveillance per week?

Surveillance remains an important component of an analyst's job regardless of the role that they play. What is particularly interesting is that 66% of analysts now allocated less than 25% of their time to credit review while in 2023 only 59% indicated that they spent 25% or less of their time on surveillance. We believe that this trend may partially reflect the year-over-year increase of high yield issuance without necessarily a commensurate personnel increase on the analytical team. We also wonder if the use of artificial intelligence to monitor outstanding financial information or the use of dedicated outsourced surveillance teams is contributing to this answer.



5. What sector do you expect to see the greatest number of defaults in 2024? (Select top 3)

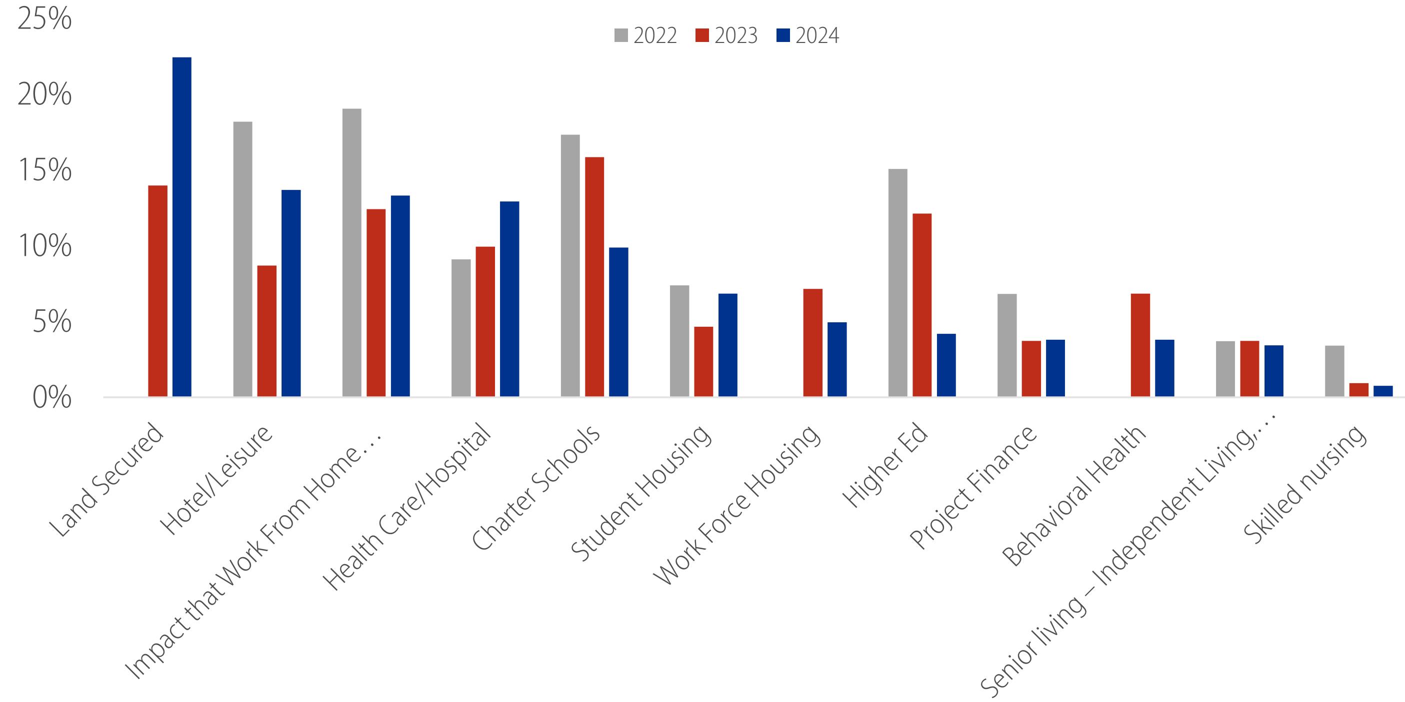
Participants anticipate the highest default rates in senior living, higher education, skilled nursing, and project finance. As compared to 2023 and 2022, higher education has now moved to the second spot, while project finance has slipped from third to fourth place in 2024. The higher education sector faces ongoing challenges such as the 2025 enrollment cliff approaches and intense competition for tuition dollars among less selective schools continues. Additionally, workforce housing has risen to the fifth position, likely due to impairments observed in California and the rising operating costs of these assets, including insurance as well as capital expenditures, relative to the incremental increase in revenues.



6. What sector are you LEAST concerned about? (Select top 3)

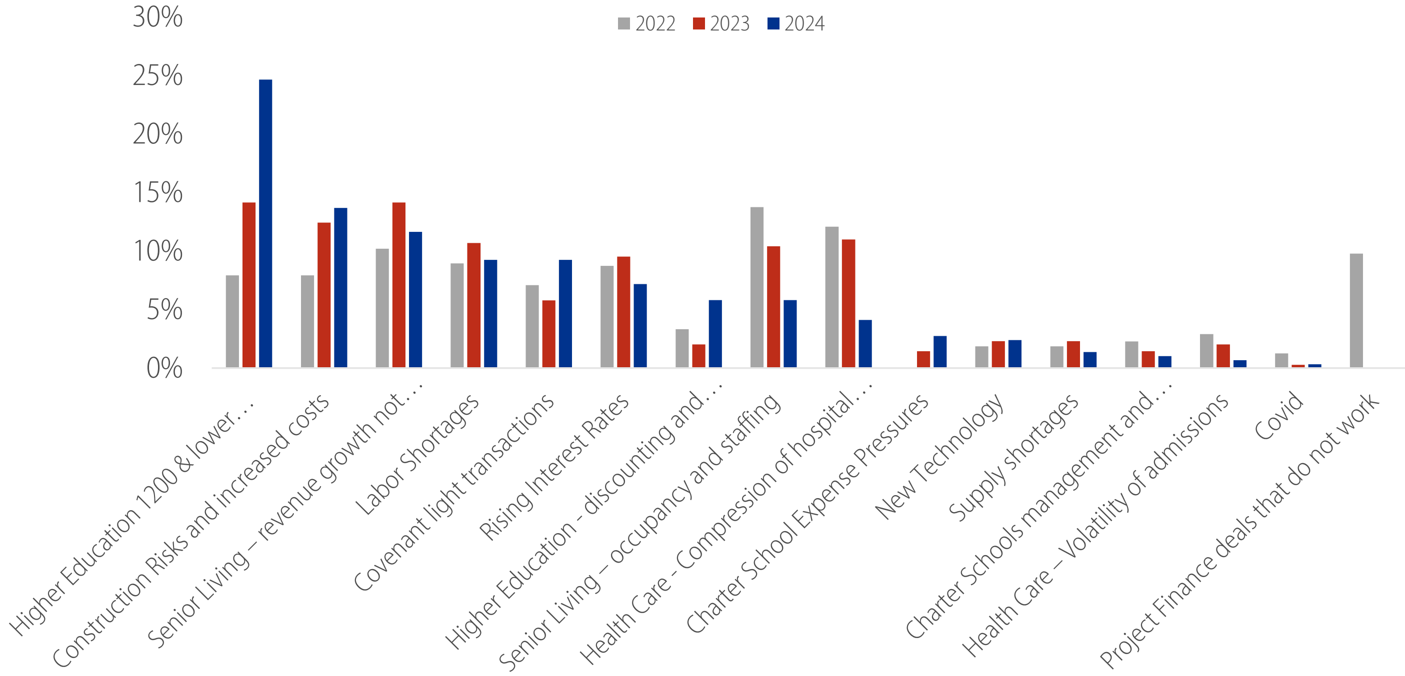
Investors are currently least concerned about land-secured transactions and hotels, as well as the impact of remote work on various credits. Over the past two years, charter schools were among the top three categories causing the least concern. However, in 2024, this sector has dropped to fifth place. This shift is unsurprising, given that federal COVID funds have largely been exhausted, forcing charter schools to rely on recurring revenues, primarily state aid allocated by enrollment, to cover ongoing expenses. In fact, charter schools have reported more than a ½ dozen defaults in 2023 and 2024 compared to zero in 2022. Charter schools with growing enrollments and strong management teams are expected to perform well. Conversely, those with declining enrollments and weaker management controls are likely to face credit impairments, as evidenced by the year-over-year increase in defaults reported so far in 2024.

Another interesting trend is seen in healthcare. Investors are less concerned about hospitals in 2024 as compared to 2023, when hospitals were ranked fourth and fifth, respectively. This movement reflects a return to more normalized volume and revenue forecasting, which is partially offset by stabilized, albeit higher, expenses. In other words, hospitals are learning to operate in a new, more compressed margin environment.



7. In your opinion, what is the biggest HY Sector Risk to watch out for in 2024? (Select top 3)

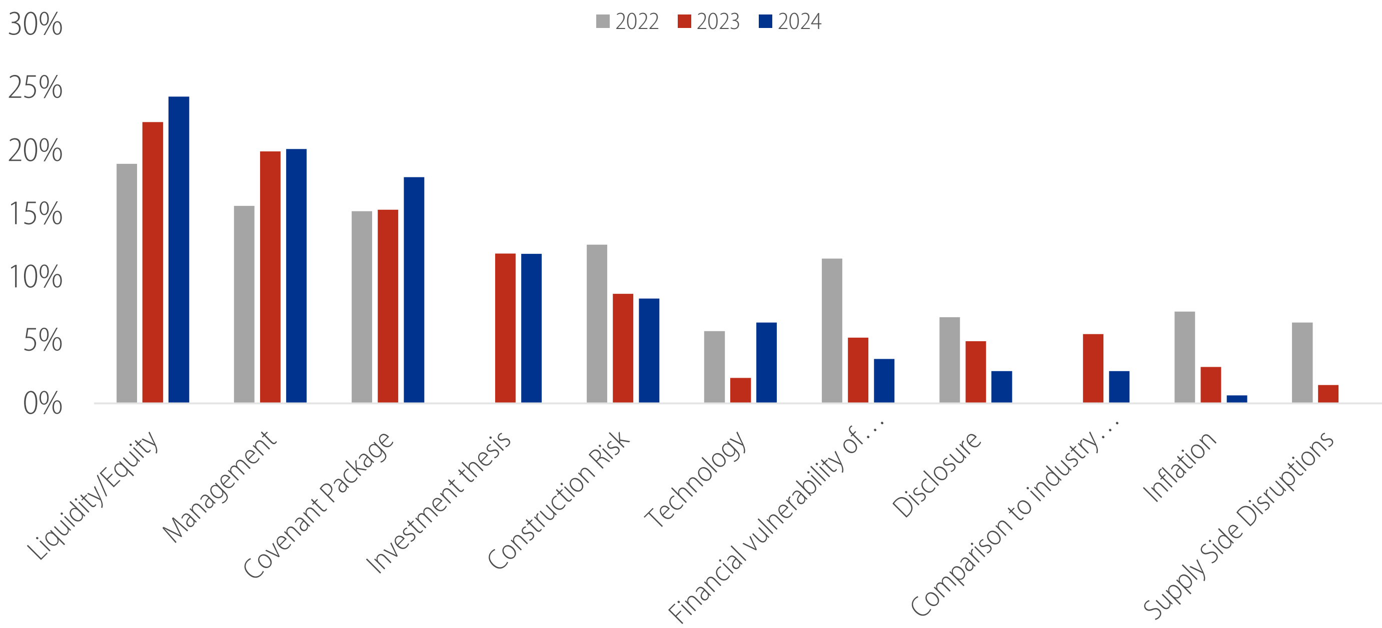
Expectations for the biggest high-yield sector risks to watch in 2025 have diverged significantly from 2023 results. In the 2024 survey, the top concern is the risk of smaller colleges and universities closing. To compare in 2023, the focus was still on the senior living sector. However, as trends in occupancy continue to improve and expenses continue to moderate, this risk has dropped to third place, down from number one in both 2023 and 2022. The second identified risk is in the construction sector, given concerns around material and labor costs, which can challenge completion or budget execution, followed by senior living in third place. Notably, in fourth place is covenant light transactions which has moved up from number eight in 2023. We believe that the focus on covenants is particularly interesting given the number of high-yield deals in the market this year, with some featuring a return to covenant-light collateral packages. Labor shortages have consistently ranked as the fifth biggest concern in each of the last three surveys.



8. What do you focus on the most when you analyze a HY Deal? (Select top 3)

Liquidity/equity is the single most important factor that investors focus on followed by management and covenant package. This trend is not a surprise as additional equity can solve a myriad of potential issues on a high yield transaction and the importance has not changed in 2024 when compared to 2023 and 2022.

There were a couple of interesting comments that investors shared: Although asked to choose the top three, an investor wrote: "I picked four. Management, liquidity, and technology are always critical but ultimately you need to get the asset constructed". Another high yield investor cited the need to "look at reasonableness of projections in conjunction with how forgiving the structure is if things don't happen as projected." This investor then went on to discuss the lower risk profile of an earlier stage California Community Facility District when compared to an early stage Colorado Metro District. This investor also mentions that "beyond management are the deal participants, including underwriter, appraisers, feasibility consultants". These responses and insights underscore the importance of the integration of liquidity, management, and collateral package, to the practical considerations including investment thesis in order to support optimal investment decisions.

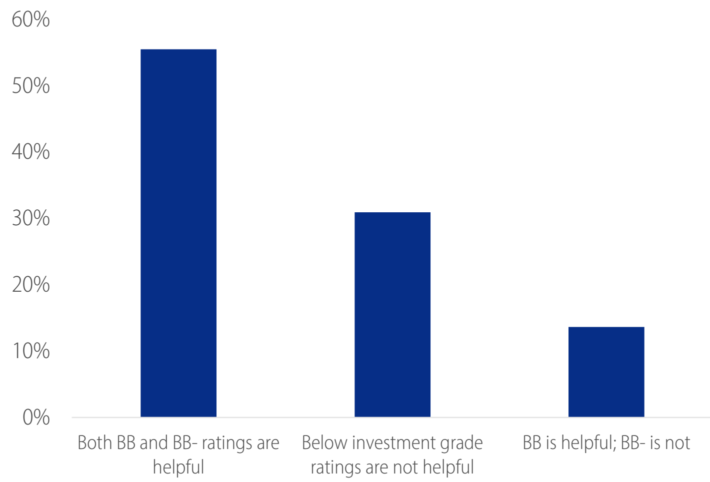


9. What value do you place on a BB or BB- rating?

This is the second year that we have asked this question. In 2024, approximately 55% of responders felt that both BB and BB- ratings were helpful up from 46% last year. The number of responders who felt that below investment grade ratings are not helpful declined to 31% from 34%. This interesting trend may reflect the increase in below investment grade ratings assigned in 2024 particularly in the charter school and senior living sectors.

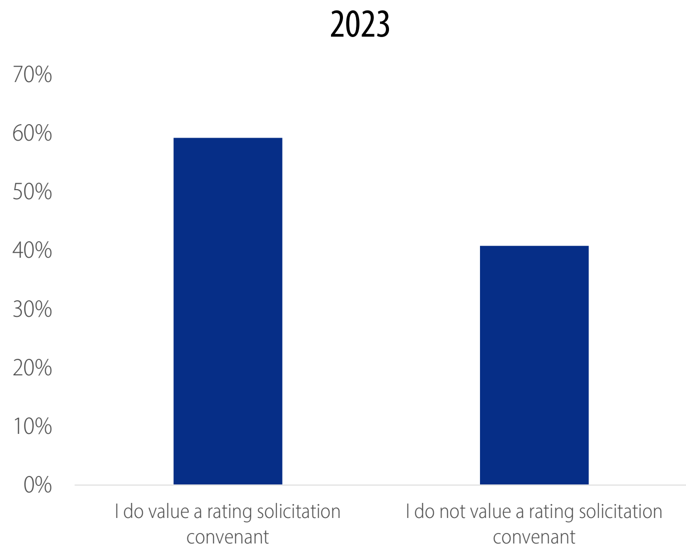
It is interesting to note that this question received the greatest number of written comments including: "My approach continues to evolve. I would like any rating. However, would do my own research and underwrite to a potential upgrade, which I would find faster than the rating agency." Conversely, another responder wrote: "HY ratings are helpful from a liquidity/trading perspective but do not add much value otherwise in my opinion." Two other responses shared opposite observations: "We have client accounts that allow HY but only if rated" which is the opposite of another responder: "Better to be non-rated than have below investment grade rating". A very specific comment came from another high yield investor: "while helpful to have another set of eyes, the rating agencies are not particularly good with HY Munis (we find their ratings with charters, TIFs, land secured, student housing, multi-family housing, and CCRCs for the most part are inflated)". One other perspective is also interesting: "rating itself does not provide significant value, but the access rating agencies gain to management can be".

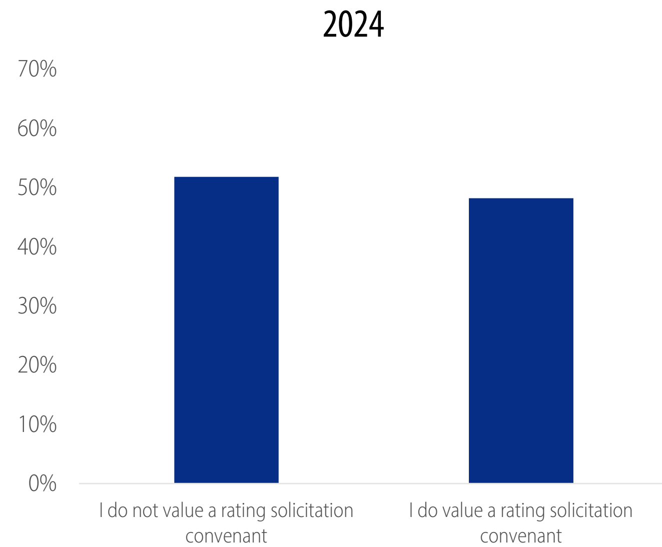
This final comment underscores the predominant focus on management in project finance which was also underscored in Question 7.



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

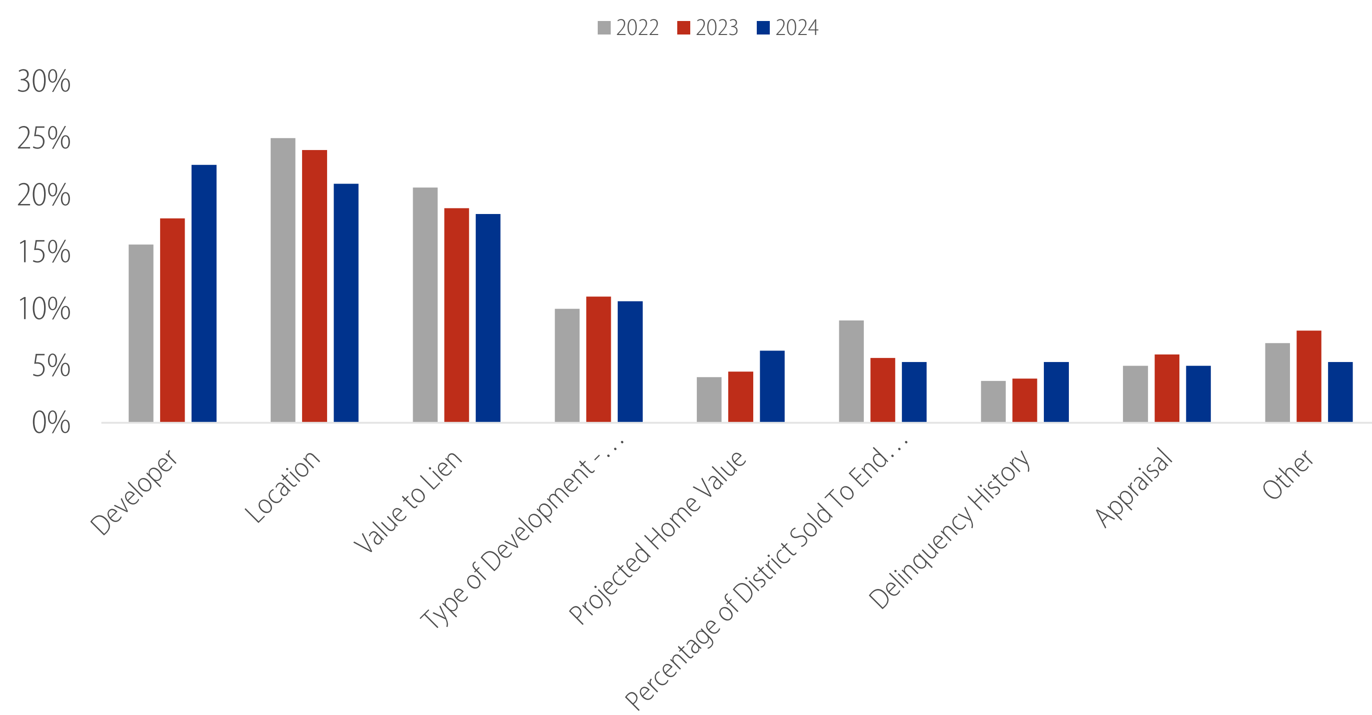
This question was added to the survey in 2023. In 2024, 52% stated that they do not value a rating solicitation covenant, down from 59%. Although the majority still do not value the covenant, the margin has narrowed, which was a surprising shift. However, when considering this in the context of the prior question which shows investors increasingly appreciate the assignment of below investment grade ratings, perhaps the movement toward appreciating the covenant resonates. Some investor comments on the subject include: "when the credit can qualify for a rating, management should solicit one for the benefit of bondholders - especially if it changes the denominations". However, another investor noted the opposite point of view: "Nice to have. It almost never materializes".





11. What drives your decision on early-stage development projects? (Select top 3)

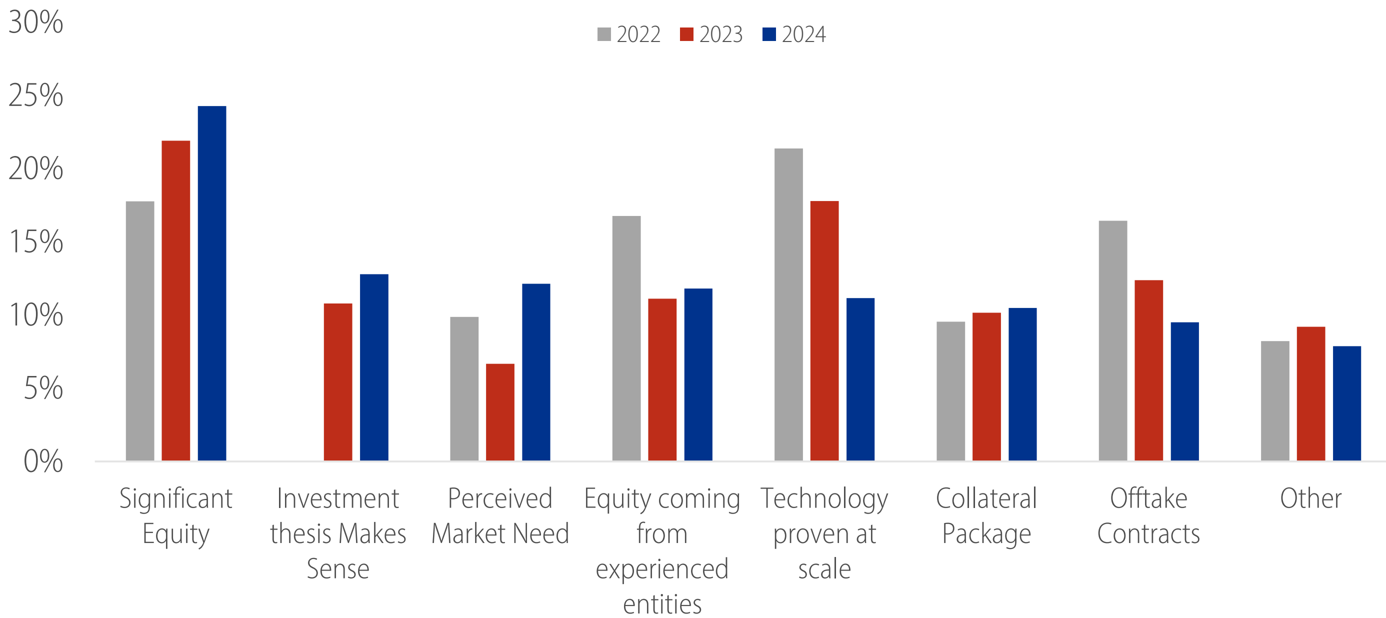
The three most heavily weighted factors are the developer, location, and value to lien. Interestingly, the developer has become the top priority in 2024, up from the third position in both 2022 and 2023. We believe that the rise in early-stage land financings in the high-yield market has highlighted the importance of the developer in project execution, especially at project inception or in an economy facing challenges such as higher capital and labor costs. Ultimately, a well-capitalized developer, prime location, and a solid value to lien can collectively aid project success. Surprisingly, the tax rate/assessment per unit was not considered a significant factor.



12. What drives your assessment of a project finance / renewable energy bond? (Select top 3)

The top choice driving investor participation in a project finance transaction is significant equity. The next three choices: investment thesis making sense, perceived market need, and equity coming from experienced investors were each virtually tied for second place. It is remarkable to note that the choice of investment thesis making sense and perceived market need respectively moved from fifth and seventh choice in 2023 to second and third place in 2024. One responder wrote: "with Project Finance deals, too many things to go wrong and they probably have higher default rates than marriage as measured by divorce rate" This quote places into context the need for significant equity and the concept that investors want to answer a market need which could lead to higher recovery in case the project does not perform as expected. Technology proven at scale moved from second to fifth place this year as increased focus was given to the question of market need and investment thesis. However, one responder shared "If the technology is not proven at scale, I will not look at it".

It is important to note that no responder chose green bond designation as a driver to project assessment in 2024. This compares to two responses that included the green bond designation in 2023. In fact, one responder wrote: "please take green bond designation off the list. It is never a factor to a get to a yes". Two other responders wrote virtually the same comment "never (the) green bond designation".

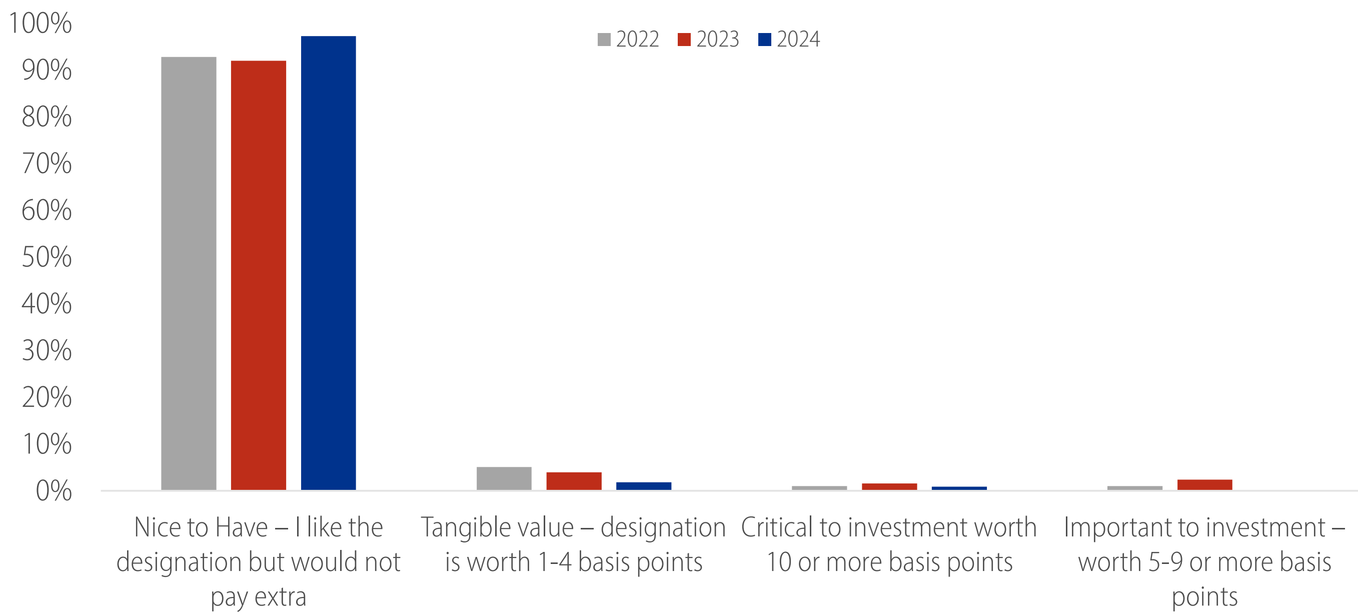


13. How important is the Green Bond Designation to your investment in a High Yield Credit

This question has appeared in each of the four surveys that we have conducted from 2021 – 2024 and the answer is resounding. The green bond designation is nice to have; however, 97% of responders say they would not pay extra. 2% believe the designation is worth 1-4 basis points, no response attributed the designation as important and worth 5-9 basis points and only 1 response believed that the designation was critical and worth 10 basis points. To compare, in 2023, 92% of investors of respondents indicated that the green bond designation was nice to have but would not pay extra and 4% allocated a tangible value of 1 to 4 basis points.

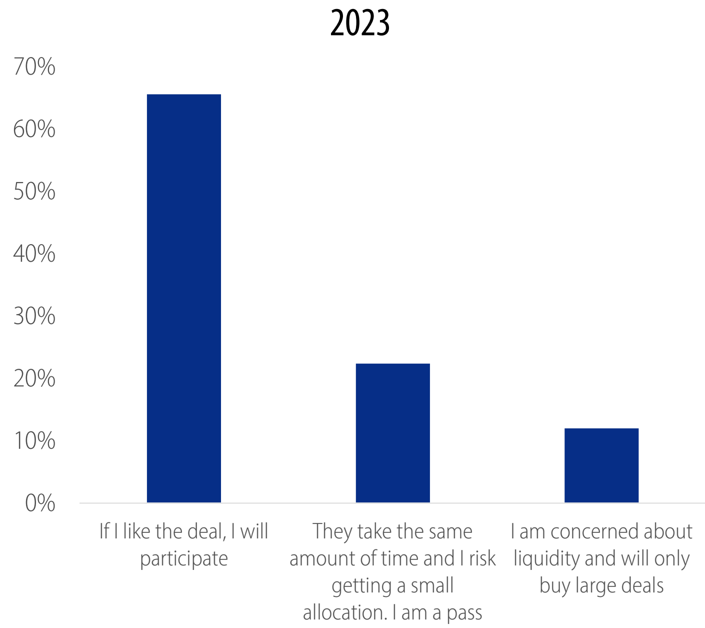
The written comments on this question are always very interesting and underscore a deep disillusionment with the Green Bond Designation.

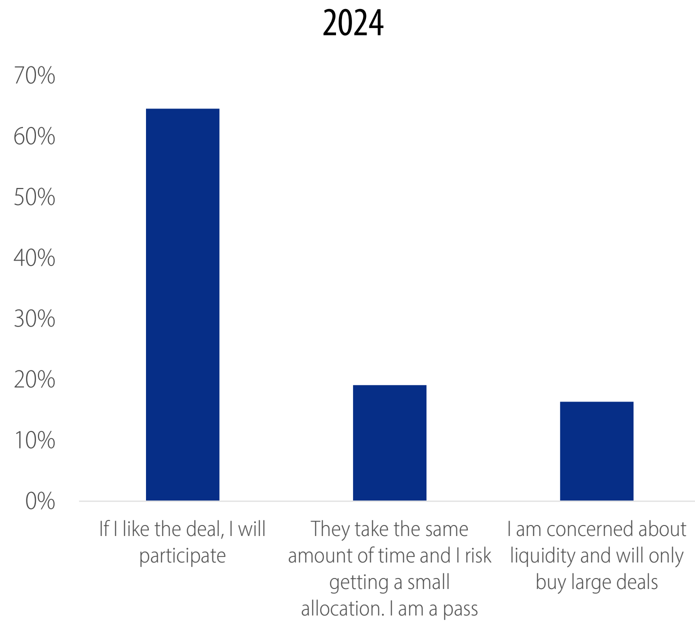
- "Can you add a box that says it is not important?"
- "I would choose 'zero value' if it was available."
- "I really like this question and look forward to seeing if the answer changes. However, from my vantage point, I really only focus on the investment thesis and probability of project success."
- "pointless."
- "Only tangible to ESG mandates - would not pay up for non-ESG mandates, which still make up the vast majority of market assets."
- "Whitewashing."
- "I think it's misleading."



14. In light of the challenges in the HY market since 2021, how do you feel about investing in small deals ($20 million or less)? And, do you prefer a traditional marketing approach or would you rather negotiate directly and control the structuring process?

We added this question to the survey last year and the results are very similar. In 2023 and 2024, almost two-thirds of responders stated that if they like the deal they will participate, regardless of a transaction's small size. The rest of the responses were largely split between concerns over small allocation and concerns over liquidity.





15. How concerned are you that legislative changes (tax reform) can affect the ability to issue tax exempt bonds in the High Yield space in 2025?

We added this question to the survey in 2024 as the discussion of tax reform and the possibility of the elimination of tax-exempt issuance has been a subject of many industry participants. The interesting takeaway is the divergence of answers with the answers roughly equally distributed between not concerned, not sure, and very concerned. This is an area that we all need to be watching as the GFOA writes "The steadfastness of state and local governments exhibits an unparalleled accomplishment of our investments via the municipal bond toward our nation's infrastructure."

We remain concerned that the threat of elimination is still prevalent. If state and local governments lose the ability to use tax-exempt bonds and are compelled to issue taxable bonds as an alternative, the Government Finance Officers Association (GFOA) has it estimated that debt issuance costs would increase around 25%, and possibly more for smaller governments.