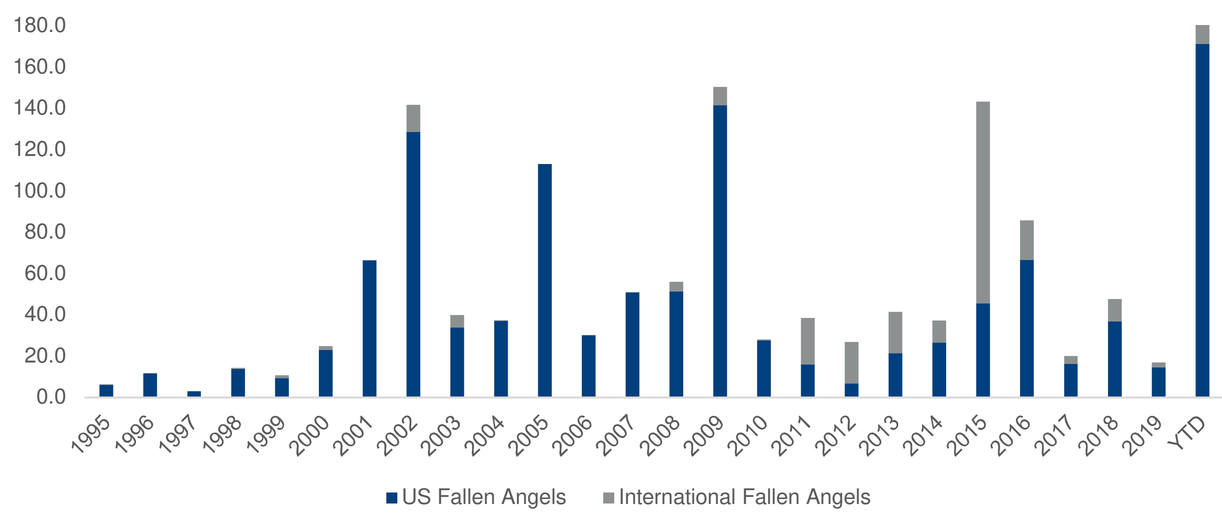
Fallen Angels and the Evolving Risk Profile of the High Yield Opportunity Set

Key takeaways:

- **The economic impact from the virus outbreak has accelerated the long-awaited Fallen Angel Cycle. So far, nearly $200 billion of former Investment-grade ("IG") issuers globally have been downgraded to High Yield and more are likely to come.**
- **The surge of Fallen Angels will have short and longer term implications. For now, it is resulting in a higher quality, more diversified, and larger opportunity set unlike the Global Financial Crisis ("GFC") experience.**
- **Beyond Fallen Angels, the sector and security constituency of the High Yield market is being impacted by recent heavy new issuance.**
- **We acknowledge that we may be in the early stages of a significant downgrade cycle, including defaults. More than ever, we continue to believe that an active, bottom-up fundamental investment approach will be critical in navigating these changes to capture upside opportunities and minimize deteriorating situations.**

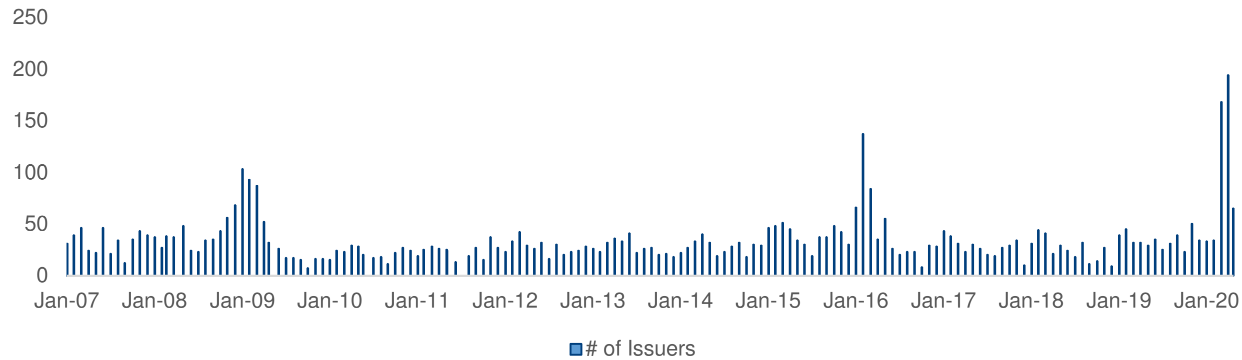
The outbreak of COVID-19 and ensuing economic weakness has resulted in material changes to the High Yield opportunity set, resulting in a far larger and altered risk profile for the broader High Yield Index. The long-rumored BBB downgrade cycle has finally begun, ushering in new and, in some cases, returning issuers into high yield benchmarks (Chart 1). At the same time, numerous issuers are exiting the index through bankruptcies and restructurings, while far more are being downgraded a notch or two due to the pressure from the subsequent shutdown (Chart 2). It is our view that these changes, which we expect will continue through the duration of this crisis and economic downturn, will ultimately result in a higher quality opportunity set so long as we avoid a second demand shock in the near term. More than ever, we continue to believe that an active, bottom-up fundamental investment approach will be critical in navigating these changes to capture upside opportunities and minimize deteriorating situations.

Chart 1: Year-to-Date Global Fallen Angel Volume (USD) has Already Hit Record Highs



Source: JPM, as of 31 May 2020

Chart 2: Downgrades have been Material in the U.S. High Yield Space Year-to-Date



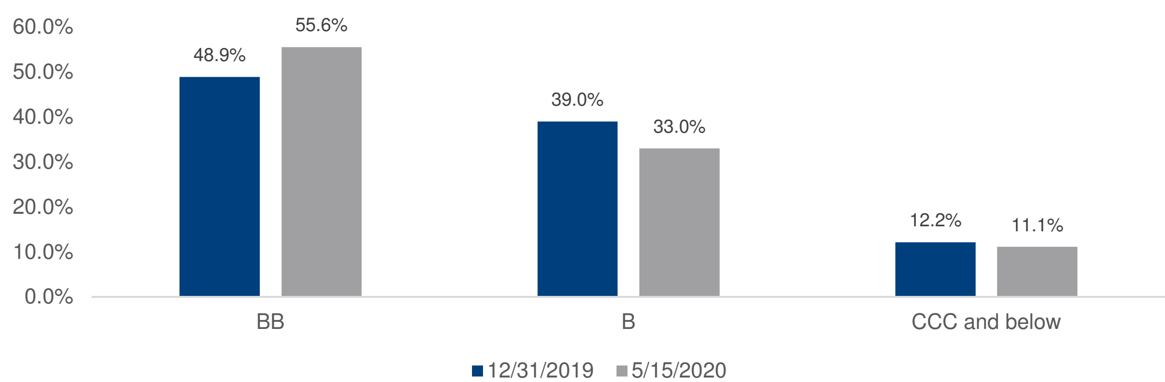
Source: JPM, as of 31 May 2020

Year-to-date through May, the developed High Yield market grew by over 12% in face value to nearly $1.8 trillion. The bulk of this growth, especially in recent weeks, has resulted from downgrades of Investment-grade debt to High Yield, also known as “Fallen Angels”, and has been partially offset by a few rising stars and several defaults. On a global basis this year as of end of May, over $189 billion of former IG-debt representing 44 issuers now trade with High Yield ratings. Some of these Fallen Angels, which possess above-market yields and/or ‘mega-cap’ structures, rank among the largest constituents in High Yield indices, therefore requiring High Yield managers to take an immediate view.

The class of 2020 Fallen Angels includes household names such as Ford, Occidental and Kraft Heinz, which now rank among top five largest issuers in the High Yield benchmark, as well as iconic brands Delta Airlines, Royal Caribbean, Rolls Royce, and Macy’s. At the same time, several larger, seasoned high yield issuers, including Frontier Communications, Intelsat, and Hertz have recently filed for bankruptcy and will no longer be significant index constituents. These rapid changes to High Yield benchmarks driven by the severity of the demand shock are unlike anything seen in previous environments. Compared to the GFC, for example, the material change among the largest constituents from 2006 to 2009 was more gradual and driven mostly by leverage buyout financings for HCA, Intelsat and TXU.

These dynamics have resulted in a High Yield opportunity set that is higher-rated despite the overall wave of downgrades seen across the spectrum. As Chart 3 illustrates, the change has been most pronounced in the BB weighting in the US High Yield index, which has grown to over 55% of the overall index from around 49% at the start of the year. For now, almost all of the recent Fallen Angels have been downgraded to the BB level, though we may see several of these come under additional rating downgrade pressure over the next 6 to 12 months absent a pickup in demand.

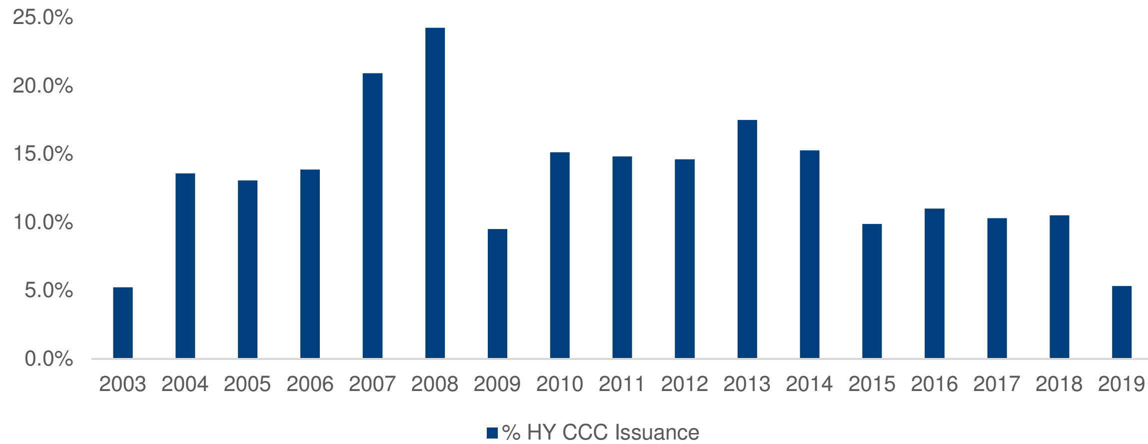
Chart 3: Overall Credit Quality of the US High Yield Index has Improved despite Downgrades



Source: ICE BofAML Indices, as of 15 May 2020

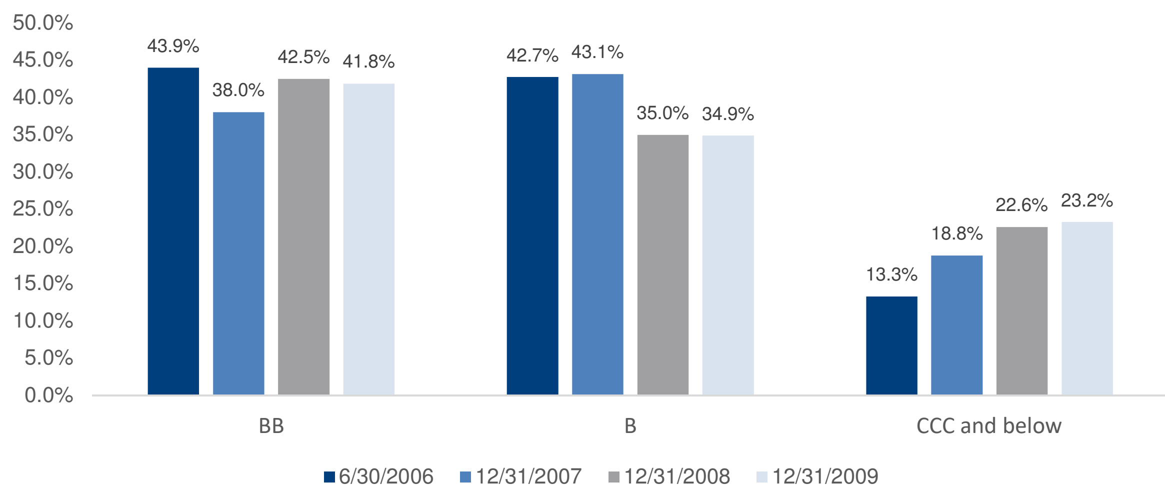
We acknowledge that we may be in the early stages of a significant downgrade cycle that could include further migrations to B and to CCC and below given the severity. However, we believe that the lack of LBOs and other aggressive financings leading into this crisis has established a relative healthier cohort than in the GFC era. This has been most evident in the issuance of the lowest quality paper in recent years, with CCC issuance representing a decreasing percentage of the overall high yield primary issuance.

Chart 4: Higher Quality US Issuance since the Global Financial Crisis



The turbulent performance in March has drawn some comparisons to the GFC but there was a steady deterioration in the underlying credit quality of the High Yield market leading into the GFC that has been largely absent in this era (see Chart 4). The change in credit quality constituents from 2006 through 2009 was heavily influenced by aggressive LBOs, leaving many of these capital structures with thin cushions that were vulnerable to downgrades, and in some cases defaults, during an economic recession. As a result, we saw a sharp downward shift in quality for High Yield indices during the GFC period compared to a much different composition than we see in today's market (Chart 5).

Chart 5: Deteriorating Quality Metrics leading up to the Global Financial Crisis



Source: ICE BofAML Indices

It is worth noting that the deluge of Fallen Angels, with a particular contribution from auto and energy issuers thus far, has changed the complexion of the industry exposure of the index. According to Goldman Sachs, Consumer Cyclicals now ranks as 20% and Energy 15% of the notional value of the High Yield opportunity set, up from 16% and 13% at the end of 2019, respectively, while Communications has declined to 17% from 21%. Looking ahead, the largest constituents of the non-financial BBB universe include Energy, Healthcare and Telecom.

In addition to the Fallen Angels, the High Yield market's composition is also being affected by heavy new issuance in recent months. In April and May, global High Yield experienced over $70 billion in primary issuance with proceeds heavily skewed towards general corporate purposes that included bolstering balance sheet liquidity. While all sectors have tapped the new issue market, auto and leisure-related sectors have been more prolific relative to their fair share.

Finally, nearly 40% of the issuance since March has been secured borrowings with first lien collateral, compared to an average of 28% of secured borrowings from 2010-2019. We believe that the US High Yield market will continue to see increased primary issuance in coming months and likely to take some market share from potential loan issuance, including secured borrowings, given the strength in High Yield inflows and end market demand. Senior secured bonds have represented a significant portion of the High Yield primary market since the GFC, which, in addition to the growth of the BB segment, has also led to a higher quality index composition.

While the overall quality of the High Yield index will benefit from the higher quality trends highlighted above, we bring attention to the fact that we are currently in the midst of an unprecedented demand shock, which will lead to an increase in defaults. While we do not believe defaults will reach the peaks of the GFC, we believe that default rates will spike to a higher level than at any point over the last ten years. As earnings soften and defaults become more likely, we believe that active management and disciplined security selection are the most effective way of mitigating default risk, while still availing of the attractive opportunity set currently in the High Yield market. Even amongst the 2020 Fallen Angels cohort, the need to differentiate between the structures that can maintain strong liquidity, stable financial performance and that have a chance to return to IG is important to determine the fallen angels that will outperform and to which we will want to lend.

Alcentra's Positioning:

We continue to believe that operating visibility remains uncertain in light of the virus impact. While businesses are slowly re-opening, we remain mindful given the potential for further outbreaks and that return to pre-COVID economy is unlikely in the near-term. That said, we are encouraged and excited by the enhanced opportunity set available in the High Yield market and believe that more Investment-grade names will be downgraded in coming months; for context, the non-financial BBB universe has nearly $2.9 trillion outstanding and the typical migration from BBB to BB during economic recessions has ranged in the 4-5% range annually. Historically, select Fallen Angels have provided compelling relative returns and we have already seen several such opportunities in this latest cohort.

These recent changes to the High Yield opportunity set along with potentially more IG downgrades in coming months will continue to have a material impact on the risk profile of the High Yield asset class. This cycle will be different than the fallout from the GFC and likely result in a higher quality, more diversified, and larger opportunity set. In our view, not all Fallen Angels will make investable sense, and we will remain disciplined, focusing on sectors, liquidity, asset strength, management and valuation.

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FP 993 – 05062020