CONCISE CAPITAL

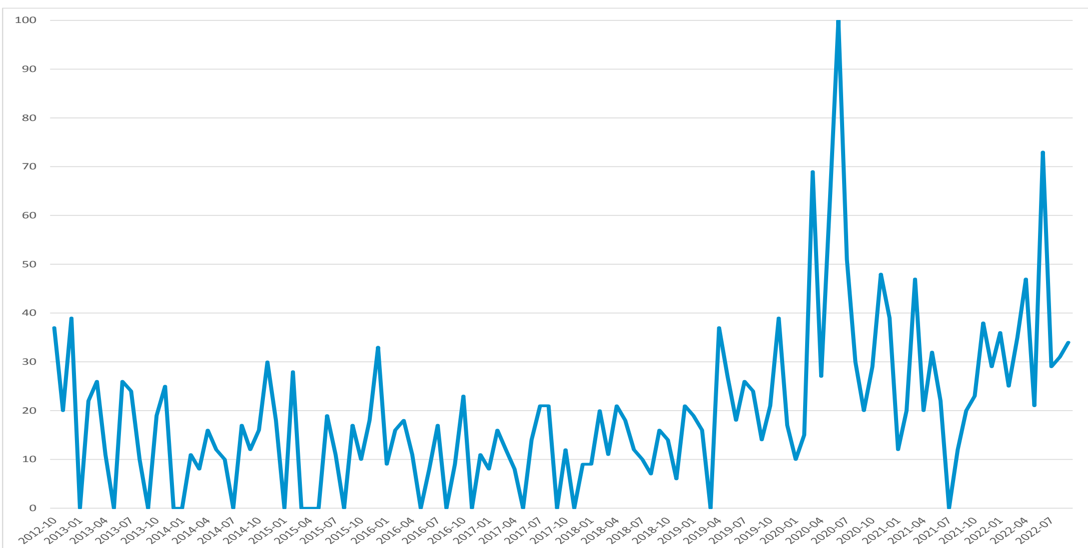
September 2022 High Yield Market Insights

- Some say zombies are on the march!
- Markets are not spooked
- Trouble could come down the road if interest rates reach scary levels

With Halloween fast approaching, this month we look at a subject keeping some investors up at night. A zombie, from Haitian Creole, is an undead corpse that walks the earth. Finance has borrowed the term to denote companies whose cash flow is less than the interest owed on their debt. In the spirit of All Hallows' Eve, let's consider whether the high yield market is going to be assaulted by the undead.

The last few months has seen both more articles about and searches for the term "zombie companies." No wonder. Interest rates have risen sharply in 2022, increasing costs materially for those in need of funds. Should high yield investors be spooked?

Figure 1: Google Search Trend for Term: "Zombie Companies"



Zombie numbers have risen in the wake of the pandemic. An analysis published by Bloomberg News (BN) in May 2022 claims 620 companies qualify as zombies. It would seem, on the surface, that many of these could be high yield issuers. High yield issuers are rated below investment grade for a reason.

From a HY perspective there is less reason for concern.[1] The ICE Bank of America HY(BAHY) index comprises 923 issuers. 92 of those, or 10%, could not cover their interest payments from income in the last year, far fewer zombies than BN uncovered. Using the distress ratio instead (defined as the percent of issuers with bonds spreads >1000 basis points over treasuries), reveals only 7% of the universe qualifies – far below historical levels.

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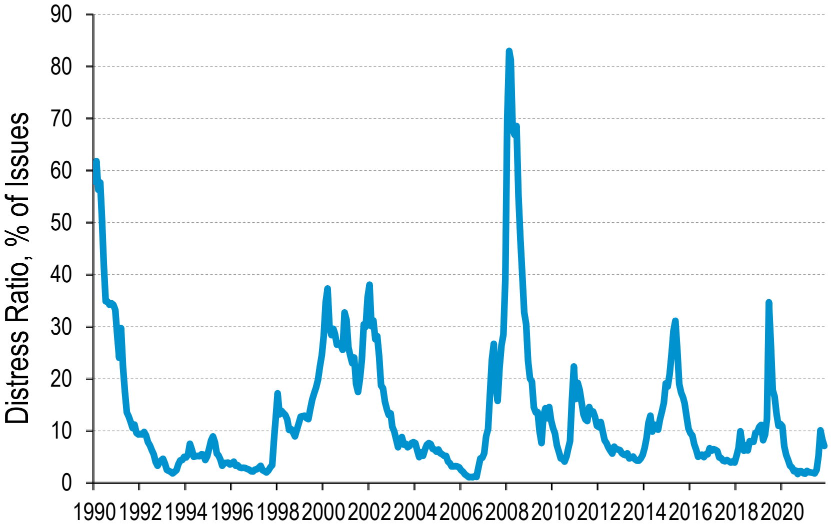
Figure 2: US High Yield Distress Ratio

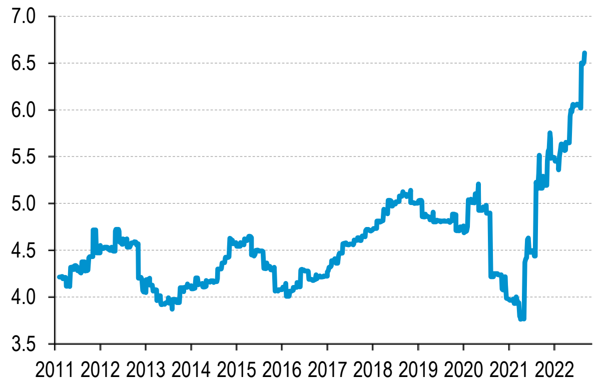


Still, there is a large gap between the BN analysis and the HY perspective. Why? BN was looking at an equity index that contains both HY issuers and younger firms that are burning cash as they grow. The latter may not be able to cover their interest, but their prospects might not be dire either. Not all zombies are HY issuers. Banks and non-bank lenders could be funding other undead bloodsuckers.

It does not appear zombie companies are a critical issue for the HY bond market right now, nor is default inevitable. Interest as a share of earnings is historically low. There is little pressure to refinance at current rates. HY maturities are not significant until 2024, making interest a fixed cost until then. Firms may also be able to pass on inflationary increases in their costs, or sell off assets.

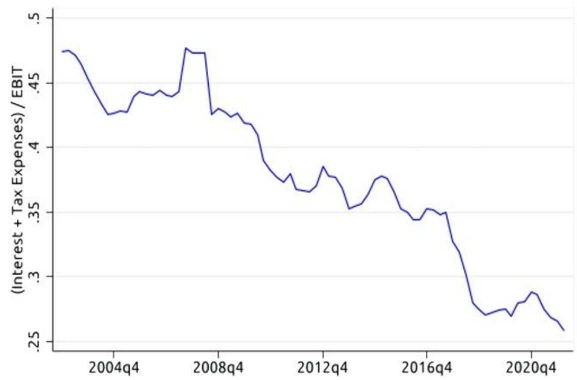
This could change if interest rates exceed normalization, or if taxes rise. Low taxes and rock bottom interest rates have animated earnings improvements for the last twenty years. Corporate taxes are as low as they have been in a generation. They are unlikely to go lower.

Figure 3: EBITDA to Interest



Source: Concise Capital, BAML

Figure 4: US Interest and Tax Expenses as Share of Earnings



Source: Federal Reserve Board

Delay the run for ammo and canned goods. The zombies are not upon us. Not yet. In the longer run, inflation and higher interest rates could compress earnings. If that happens, financial accidents may come lumbering along if companies do not adjust to the new regime. For in financial markets, little is as scary as a central bank policy error.

[1] The data in this paragraph relies upon "*Fridson: Assessing the threat of high-yield zombies", S&P Global.*