SKY HARBOR
CAPITAL MANAGEMENT

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SKY Harbor Weekly Briefing

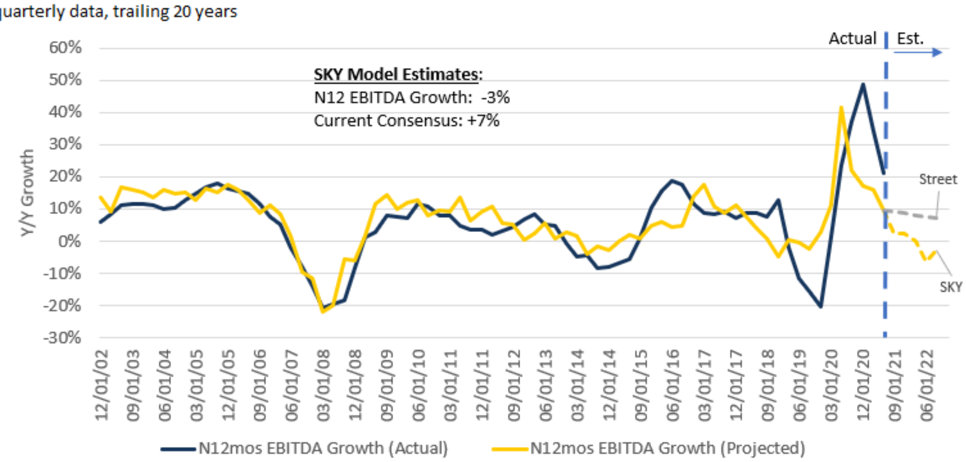
SKYView: Downgrading EBITDA Growth

Coordinated efforts by central banks to stem inflation continue to increase the likelihood of a global downturn, all while exogenous shocks to the market further pressure corporate margins. Though consensus earnings expectations have inched down over the last several weeks, there is reason to believe that analysts will need to re-set estimates even lower, a dynamic that could be expedited by management commentary on upcoming Q3 investor calls. With this in mind, we use this *Weekly Briefing* to update our corporate EBITDA growth model, measuring the difference between our output and consensus expectations, and gauging the impact further pressure may have on credit fundamentals.

Most Independent Variables Trending Negatively

Various measures of CEO confidence have fluctuated over the last several months, with **expectations for overall business conditions in the coming year becoming less predictable and less likely to surprise to the upside**. At the same time, the US Dollar continues to march higher relative to other currencies (recently hit a 20-year high), with an aggressive Fed and a *relatively* stronger domestic growth outlook underpinning the recent surge. These factors, along with rising input costs and an overall slowdown in manufacturing activity, have necessitated a downward revision to corporate EBITDA growth estimates in recent weeks. **In our view, however, estimates have not come down enough**. Updating our four-factor regression model below, we now anticipate HY issuer EBITDA growth in the coming year to *decline* by approximately 3%, well below a consensus view of +7% *growth*.

S&P 1500 Index EBITDA Growth: Actual vs. Next 12mos SKY Model Projection
quarterly data, trailing 20 years

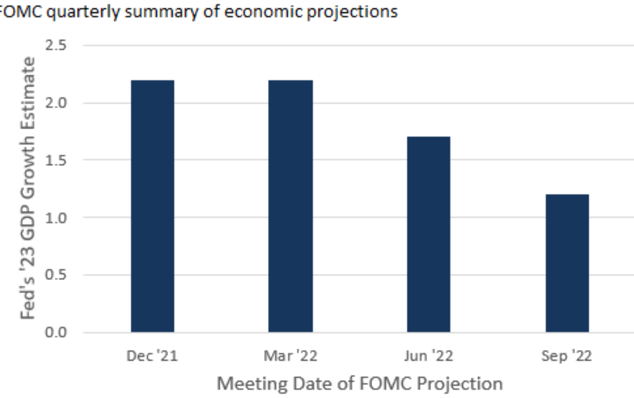


Source: SKY Harbor, Federal Reserve, Baltic Exchange, Chief Executive Magazine, Bloomberg

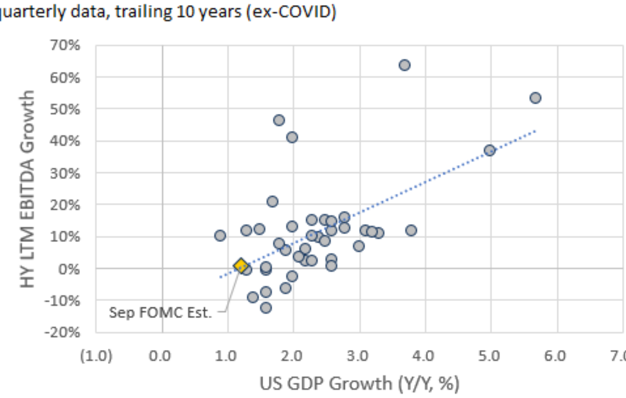
An Alternative Model Also Implies an Overly Optimistic Consensus View

Cognizant of a sizeable (1,000 bps) delta between our regression model output and consensus estimates, we thought it prudent to sanity-check projections using an alternative approach. Below, we present the historically tight relationship between US GDP growth (Y/Y, no lag) and US high yield issuer TTM EBITDA growth. Using the Fed's projection of 2023 US economic activity – which has fallen significantly over the last several quarters – **we find an implied corporate EBITDA growth rate of ~ 0% next year**. Though admittedly more optimistic than our model output, results still imply a reduction in consensus expectations may be on the horizon. And, in our view, **risks to both of our model estimates are skewed to the downside given the current economic backdrop**.

Fed Projection of '23 US GDP Growth Has Fallen
FOMC quarterly summary of economic projections



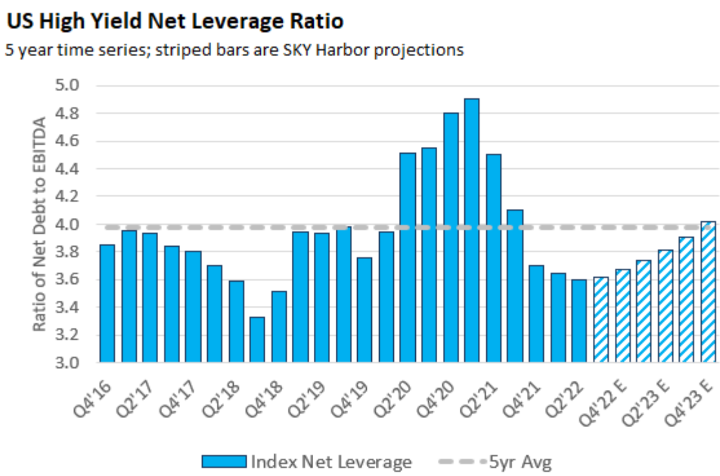
1.2% US GDP Growth Implies Flat EBITDA in 2023
quarterly data, trailing 10 years (ex-COVID)

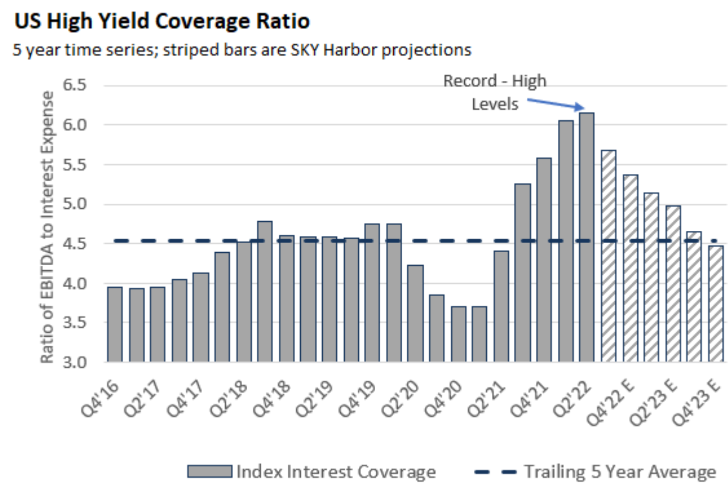


Source: SKY Harbor, Federal Reserve, Bureau of Economic Analysis, BofA Merrill Lynch, Bloomberg, Capital IQ

Simulating the Impact to HY Credit Metrics

At the time of publication – we use metrics through Q2'22 – average high yield net leverage and interest coverage ratios were 3.6x and 6.2x, respectively, both notably stronger than trailing 5-year averages. If we overlay our estimation of EBITDA growth over the next year (-3%), assume an 80/20 average fixed/floating debt mix, assume nearly all of the recent increase in rates negatively impacts floating rate debt (i.e. we assume little in the way of hedges in place near-term), and force companies to refinance fixed-rate debt 1 year ahead of maturity dates (with an interest expense uptick equal to the difference between current coupons and prevailing market yields), **we can clearly see credit metrics eroding over the next six quarters**. With that said, and under our current set of assumptions, **leverage and coverage ratios merely revert to their trailing 5-year average by the end of 2023**. Acknowledging that underlying assumptions are quite sensitive to any changes in the economic outlook, and with recent developments implying more downside than upside risk, relative strength in corporate balance sheets better position high yield index constituents to weather a recession than in recent years, in our view. Notably, **interest coverage is now at a better starting point (6.2x) than prior to COVID (4.7x) and in quarters leading up to the Global Financial Crisis (3.9x)**.

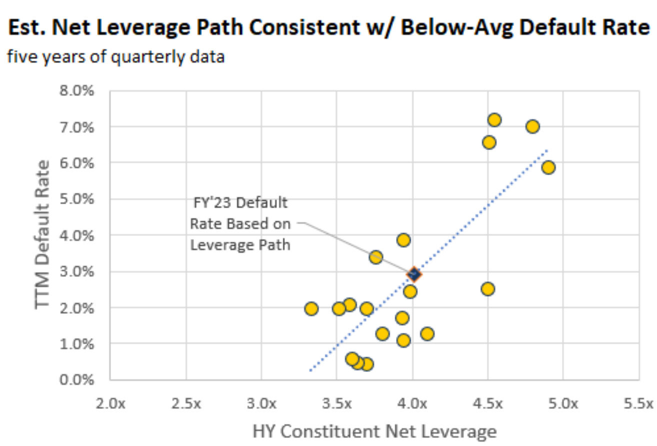


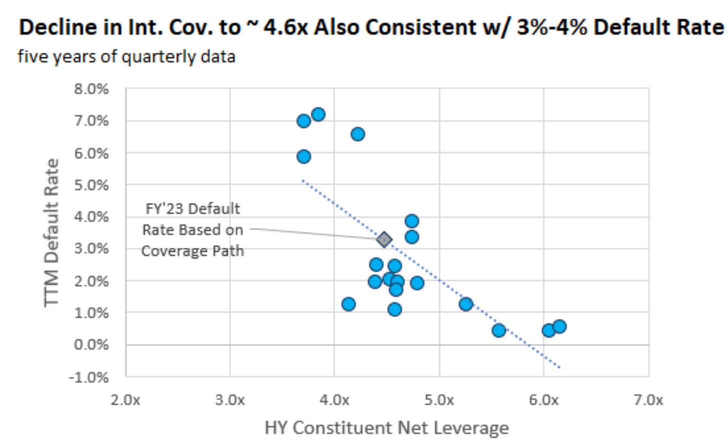


Source: SKY Harbor, BofA Merrill Lynch, Bloomberg, Capital IQ

Implication is for Defaults to Rise

In our most recent *Weekly Briefing* entitled "Valuation in Uncertain Times," we put forth an updated 2023 default rate estimate of 3.7%, largely derived from an internal regression model. Though index net leverage and interest coverage metrics are not input variables for this model, they do correlate quite well to prevailing default rates over time. As demonstrated below, **our simulation of the path of leverage and coverage metrics by FYE23 imply a default rate in the 3% to 4% area, largely consistent with our regression model estimate**. Again, recognizing that underlying estimates are subject to change amidst an evolving economic backdrop, the proximity of our dual-method approach increases our overall level of confidence in the reasonableness of such projections given what is currently known by the market.





Source: SKY Harbor, BofA Merrill Lynch, Bloomberg, Capital IQ

Risks Abound but Recent B/S Repair Provides Cushion

We are clearly of the belief that consensus expectations need to fall in the coming months, and anticipate EBITDA growth for high yield constituents will likely turn negative in 2023. With that said, rapid balance sheet repair in the post-COVID era has provided some cushion for issuers, which we think will translate into worsening – albeit manageable – credit metric migration in the coming quarters. Still, given downside risk to our underlying assumptions, we continue to think a focus on higher-quality credits within the ICE BofA US High Yield Index provides the best risk-reward tradeoff.

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