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SKY Harbor Weekly Briefing

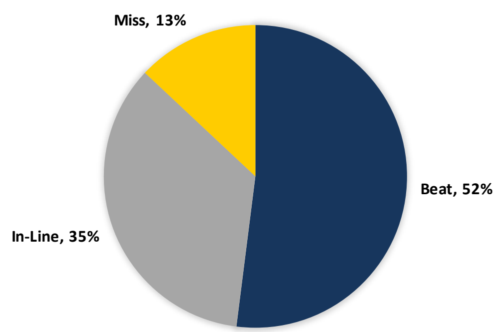
Earnings Prove Resilient…Thus Far

With Q1'23 earnings season coming to an end, we thought it appropriate to provide an update on the relative strength of financial results. On balance, high yield issuers generated modestly positive y/y EBITDA growth during the quarter, resulting in a lower than anticipated uptick in net leverage sequentially. In addition, strong free cash flow generation – in some cases due to a release of cash from working capital – and a touch of creativity on the refinancing side of the equation resulted in a more limited increase in interest expense relative to our internal expectations. As a result, fundamental credit metrics proved more resilient than our base case outlook, which we update in this *Weekly Briefing*.

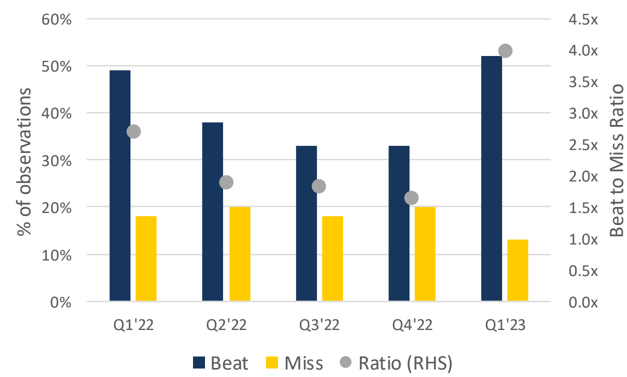
More Beats Than Misses

At the time of writing, nearly all US high yield issuers had released Q1'23 earnings, and results largely come in better than feared. We estimate that **issuer EBITDA growth is up approximately 2% on a y/y basis (vs. our model projection of flat to slightly negative)** owing to successful input cost pass-throughs, operating efficiencies, and some moderation in labor-related stress. In fact, using a subset of high yield constituents with clearly delineated consensus expectations, earnings beats have outpaced misses by a factor of nearly 4:1, well above the prior four quarter trend. Though some of this dynamic can be attributed to a moderation in expectations during the lead-up to earnings season, results have been widely viewed as demonstrating upside surprise.

Q1'23 Earnings Better Than Feared
coverage subset (~ 33% of universe)



Beat-to-Miss Ratio Stronger Than Recent Trend
coverage subset (~ 33% of universe)

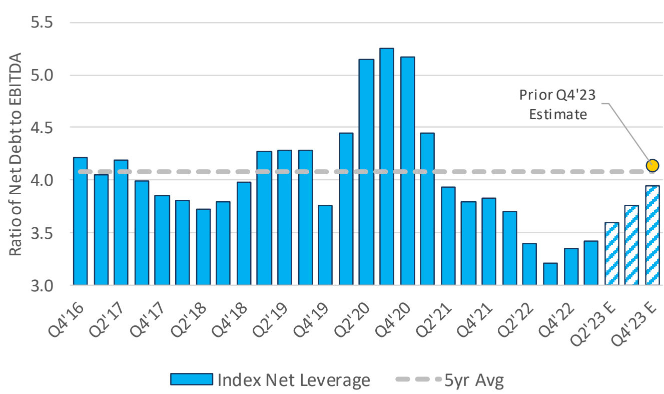


Source: SKY Harbor, JP Morgan, Bloomberg, company filings

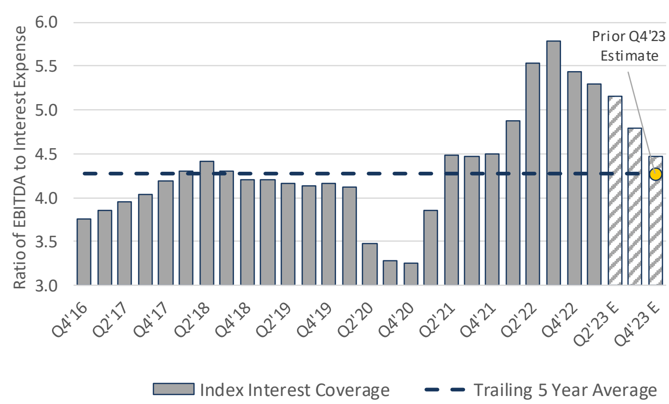
Re-simulating the Path of Credit Metrics

At the time of writing, average high yield net leverage and interest coverage ratios were 3.4x and 5.3x, respectively, both notably stronger than trailing 5-year averages. If we overlay our estimation of EBITDA growth through the next year (-7%), assume an 80/20 average fixed/floating debt mix, assume little in the way of interest rate hedges in place near-term, and force companies to refinance fixed-rate debt one 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 twelve months. With that said, and under our current set of assumptions, **net leverage and coverage ratios remain modestly below their trailing 5-year average by the end of the year, a 0.2x improvement for both metrics since our last simulation** (at the conclusion of Q4'22 earnings season). Furthermore, and acknowledging that underlying assumptions are quite sensitive to any changes in the economic outlook, strength in corporate balance sheets better position high yield index constituents to weather a (potential) downturn than in recent years, in our view. Notably, interest coverage – the key determinant of eventual defaults – is now at a better starting point (5.3x) than prior to COVID (4.2x) and in quarters leading up to the Global Financial Crisis (3.8x).

Net Leverage Set to Rise but Remain Below Average
quarterly time series; striped bars are SKY Harbor projections



Interest Coverage Set to Fall but Remain Above Average
quarterly time series; striped bars are SKY Harbor projections



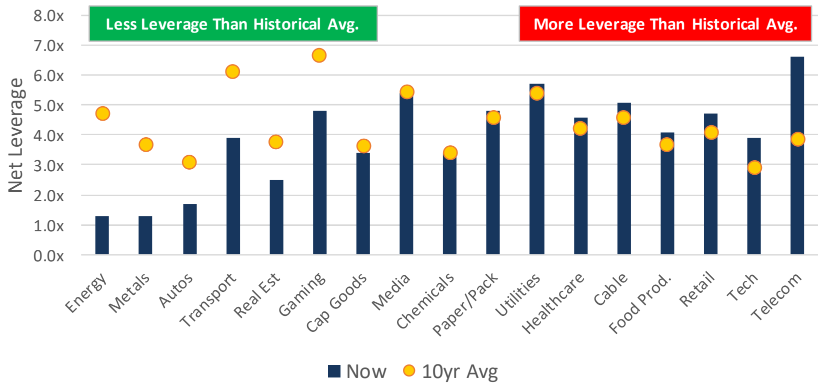
Source: SKY Harbor, BofA Merrill Lynch, ICE Data Indices, Bloomberg, Capital IQ

Non-Uniform Deleveraging

Despite net leverage for the index as a whole trending below historical levels, not all high yield constituents can boast more conservative than average balance sheets. **Of the groups that have achieved lower than historical leverage, four (Energy, Metals, Transportation, and Media) are among the five sectors with the highest post-GFC default rate within the index**. Conversely, of groups with higher than historical leverage, three (Food Producers, Cable, and Healthcare) are among the five sectors with the lowest post-GFC default rate within the index. We can perhaps speculate that management teams more closely associated with stress over the last decade have had greater reason to de-lever in the post-pandemic period, further bolstering our view that default rates will remain relatively benign even if economic output modestly slows in the intermediate term.

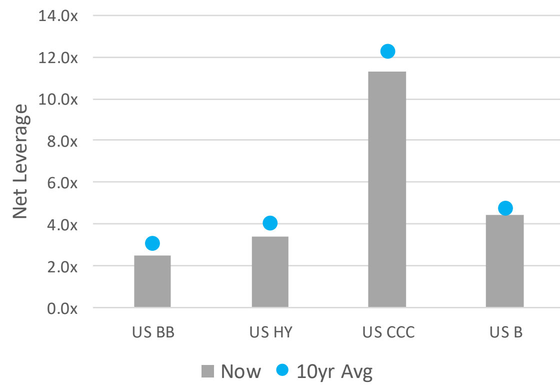
Deleveraging Hasn't Been Consistent Across Industry Groups

data through Q1'23



BBs Have Deleveraged the Most, Followed by CCCs

data through Q1'23



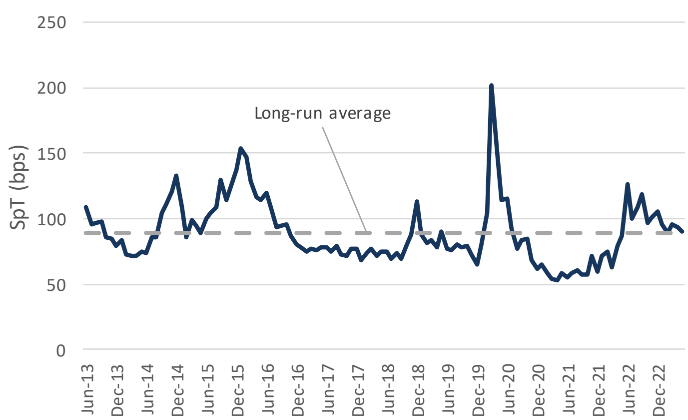
Source: SKY Harbor, BofA Merrill Lynch

Valuations Favor Higher-Rated Credit

On a spread-per-turn of leverage basis, valuations at present appear in-line with historical norms. A breakdown by quality, however, supports our view that higher-rated credit may be better positioned in the coming quarters. As demonstrated below, **single-B and BB credits offer better than average spread-per-turn compensation relative to CCCs**, with the divergence likely to gap out more meaningfully should economic contraction occur later this year.

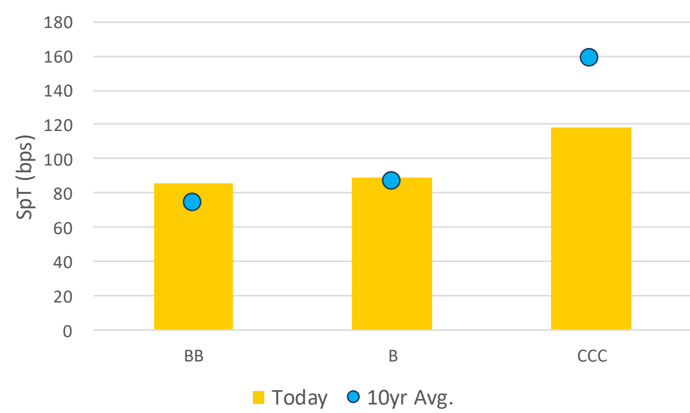
Spread per Turn of Net Leverage In-Line With Historical Norms

trailing 10 years



Higher-Quality Credit Screens More Favorably

data through May 31, 2023



Source: SKY Harbor, BofA Merrill Lynch

Still Prefer Better Quality

There has been an increasing amount of chatter in recent weeks that the odds of a "soft landing" are rising, which could bolster the outlook for high yield constituent EBITDA growth in the coming quarters. Though we are not yet comfortable making this our base case view, earnings resilience through 1Q'23 should allow fundamental credit ratios to end the year at more favorable levels than previously anticipated. Finally, better than average spread-per-turn metrics amidst lingering uncertainty underpin our bias toward higher-rated credit, though a more definitive path toward recession avoidance would merit a reduction in our underweight to the most speculative parts of the high yield index.

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