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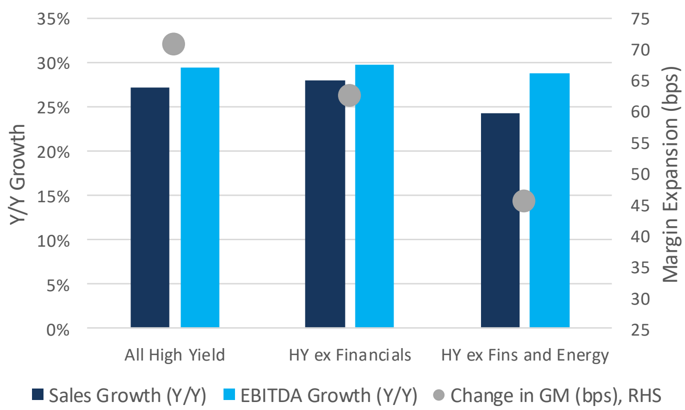
SKY Harbor Weekly Briefing

SKYView: Q1'22 Earnings - So Far So Good

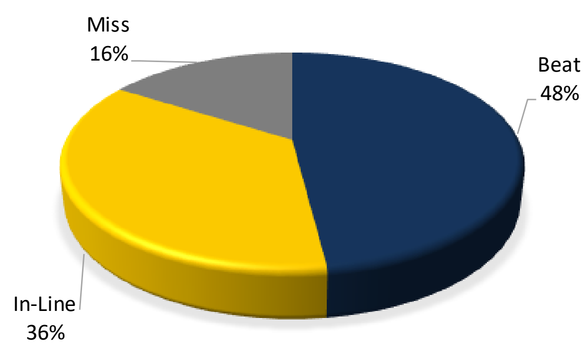
Markets continue to be volatile, with an aversion to credit risk most recently driving our factor return model. A handful of notable earnings misses have been met with significant price declines across a handful of capital structures, investors seemingly penalizing downside surprises more severely than in the recent past. That said, the majority of Q1'22 earnings releases have been favorable relative to consensus, with overall trends demonstrating a continuation of fundamental credit improvement. In this *Weekly Briefing*, we examine earnings trends thus far in the quarter, with particular interest in how companies are dealing with persistent inflation.

At the time of writing, we estimate that approximately 50% of US high yield issuers have released Q1'22 results, a figure based solely on those with publicly available financials. Though we would note that some of the more stressed credits in the ICE BofA US High Yield Index (H0A0) tend to report later than average, we view the current sample set as being more than robust enough to begin drawing observations. First, **sales and EBITDA growth have been solidly positive, the latter coming in slightly better than our model projection and reaching the mid-to-high 20% range**. Despite persistent raw material inflation – a concern echoed on the vast majority of earnings conference calls – gross margins have expanded relative to the prior year period, even after stripping out Financials and Energy credits (among the sectors experiencing the most margin expansion). Furthermore, **only 16% of issuers have reported EBITDA below consensus expectations, a figure 200 bps below the same measure from the prior quarter**. On balance, and not withstanding a few outlying issuers whose disappointing releases resulted in multiple point bond declines, Q1'22 earnings season is off to a relatively strong start.

Q1'22 Earnings Season Off to a Solid Start
data through May 10, 2022; ~ 50% of companies have reported



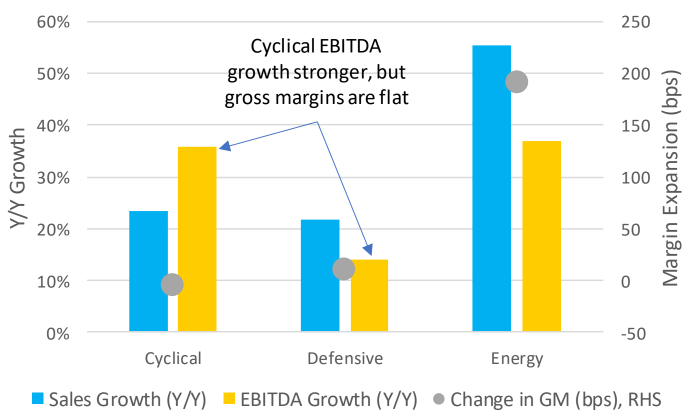
Earnings Misses Penalized, But Relatively Uncommon
data through May 10, 2022; ~ 50% of companies have reported



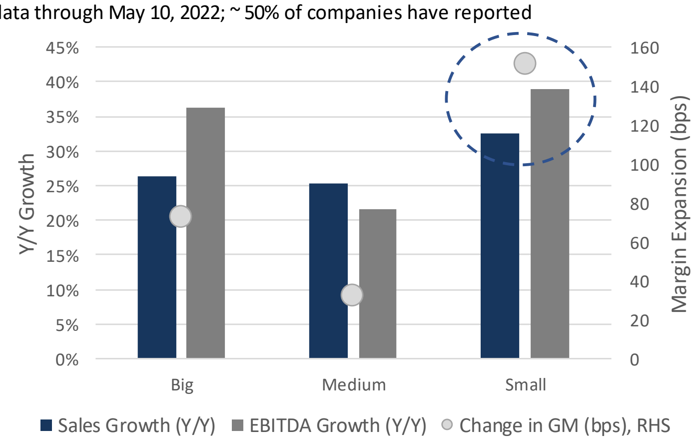
Source: SKY Harbor, Capital IQ, Bloomberg, JP Morgan

Segmenting our dataset into issuer types, we find that **Energy and Cyclical credits have demonstrated superior EBITDA growth thus far in Q1'22**, as would be expected given commodity inflation and a still rapid uptick across many measures of economic activity. Despite more significant growth, we would note that Cyclicals have experienced greater gross margin pressure than Defensives, with the former generally more exposed to rising energy and raw material input costs. Perhaps more surprising is the relative outperformance of "small" issues (bottom quartile revenue generation in our dataset) relative to "big" issues (top quartile revenue generation). Despite rampant speculation that only the largest companies would have the scale and pricing power to push up sales prices in tandem with input cost escalation, **small issuers have out-gained big issuers on the gross margin front by a factor of 2:1**.

Cyclicals and Energy Generating Greater EBITDA Growth
data through May 10, 2022; ~ 50% of companies have reported



Small Issuers Seeing The Greatest Profitability Gains
data through May 10, 2022; ~ 50% of companies have reported

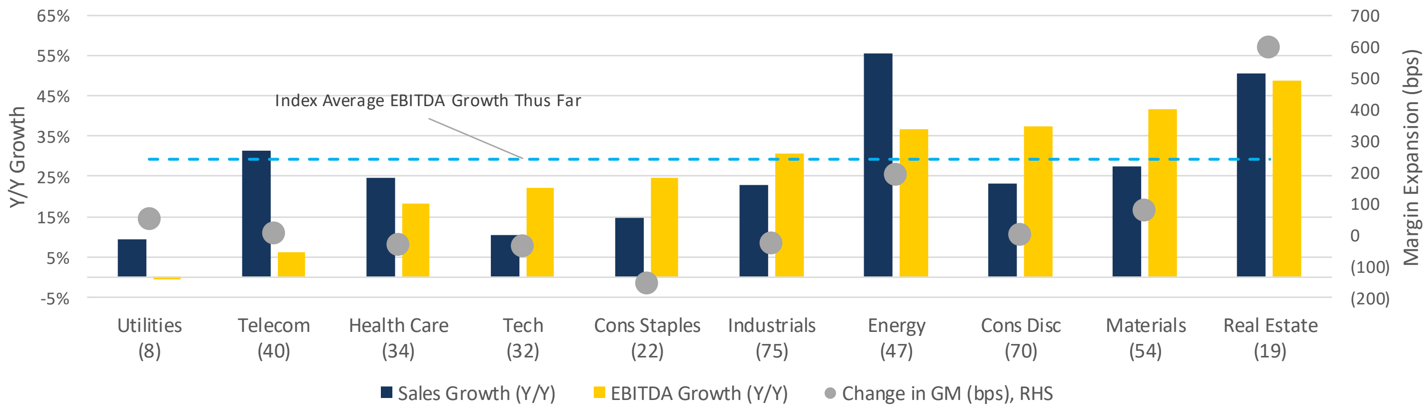


Source: SKY Harbor, Capital IQ, Bloomberg, company filings

Sector performance in this highly inflationary environment has been expectedly disperse, with Real Estate, Materials, Consumer Discretionary, and Energy the outperformers thus far, while Utilities and Telecom screen as laggards. **In general, rising raw material costs have been largely beneficial to more commoditized credits, consistent with historical observations during the initial stages of heightened inflation**. Across the index, gross margins have expanded by ~ 60 bps during the quarter, with Real Estate, Energy, and Materials showing the best ability to keep pace with rising input costs.

EBITDA Growth and Gross Margin Expansion Varies Widely in Highly Inflationary Environment

data through May 10, 2022; ~ 50% of companies have reported

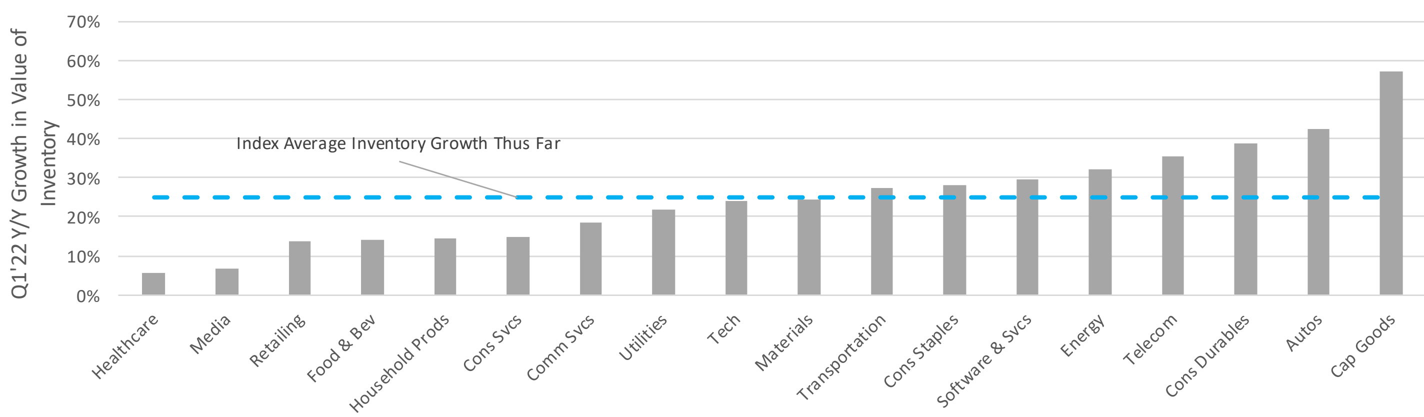


Note: The number of earnings observations are denoted in parenthesis under each sector
Source: SKY Harbor, Capital IQ, Bloomberg, company filings

One of the more prevalent themes of the earnings season thus far has been **volatile swings in working capital**, particularly evident in the filings of packaging and manufacturing credits. These companies – despite largely beating EBITDA growth expectations – have reported less free cash flow than anticipated. A deeper look into constituent working capital metrics shows little in the way of trade term degradation (often a harbinger of credit stress on the horizon), nor a rapid expansion of days inventory outstanding (indicative of product build-up due to an inability to push through volumes). Rather, **an absolute increase in the amount of capital tied up in inventory appears to be the driving force, largely stemming from the need to replenish inventory at ever-increasing costs, further exacerbated by typical seasonality**. As demonstrated below, the aggregate value of constituent inventory has been on the rise, with Capital Goods (which includes the aforementioned packaging and manufacturing sub-indices) and Autos feeling the most acute pressure.

Inventory Build Creating a (Temporary) Cash Drag for Some Industries

data through May 10, 2022; ~ 50% of companies have reported



Source: SKY Harbor, Capital IQ, Bloomberg, company filings

Q1'22 earnings season has thus far surprised to the upside, with issuers generally reporting higher than anticipated EBITDA growth and margin expansion despite inflationary pressures. That said, the market has punished earnings misses to a greater degree than we have seen in the recent past, and many management teams have become hesitant to supply guidance given a number of risks on the horizon. Fortunately, fundamental credit metrics continue to move in the right direction, and noise associated with working capital volatility – most prevalent in the capital goods sector – is expected to partially subside in the second half of the year. Overall, we are generally encouraged by issuer performance in an admittedly difficult operating environment, but remain cognizant that individual issuer handling of inflationary headwinds will become increasingly disperse in the coming quarters.

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