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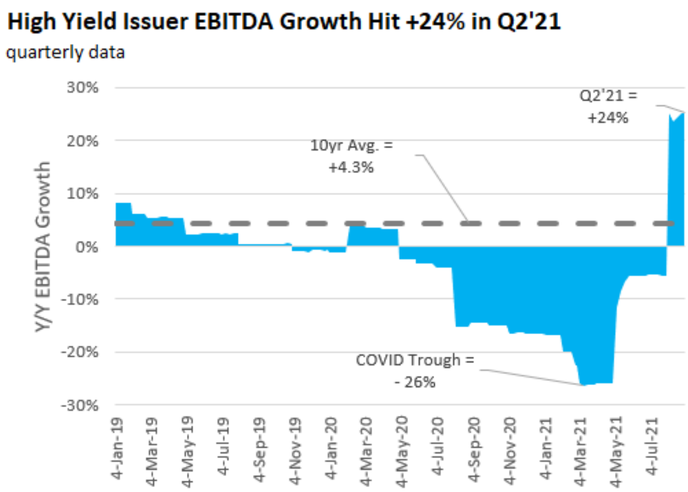
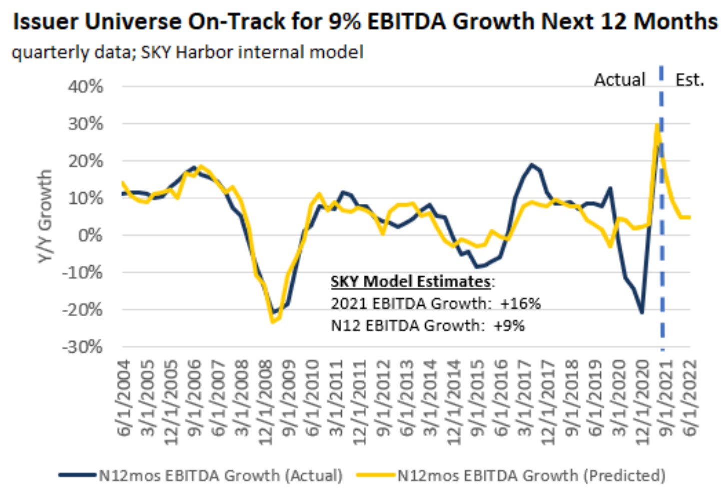
SKY Harbor Weekly Briefing

SKYView: Leverage Has Peaked

Pandemic-induced lockdowns materially impacted high yield issuer fundamentals, as leverage ticked up from both erosion in EBITDA and an influx of new debt to address operational cash burn. An inflection, however, has been reached, with leverage now moving down after credit metric degradation peaked in the first half of this year. In this *Weekly Briefing*, we examine Q2'21 earnings, and project a path to leverage normalization as the economic recovery extends into the back half of the year.

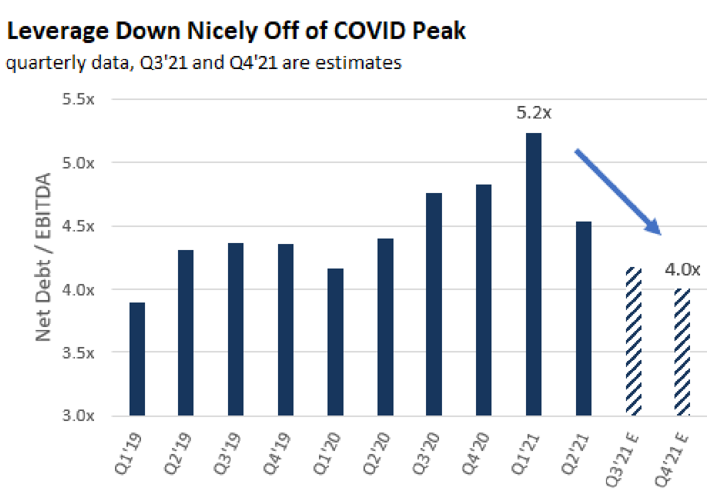
In a *Weekly Briefing* from June 2019, we highlighted our new earnings model, which utilized five key economic indicators to project the EBITDA growth potential of the high yield universe. We continue to employ the same drivers to the model which, at the start of this year, **projected EBITDA growth of ~ 16% in 2021 - the most significant gains coming in the second quarter on exceptionally weak prior year comps**. With most companies having now reported results for 2Q, actual EBITDA growth of +24% is impressive but modestly below our +29% projection, with lingering supply chain issues and delta variant disruptions largely driving the miss. Growth headwinds associated with supply chain constraints will, in our view, slowly subside, perhaps pushing some volumes into Q3 and Q4. As such, **we remain confident that full-year EBITDA growth remains on-track to hit our mid-teens estimate**, and put forth a new EBITDA growth estimate over the next 12 months of +9%.

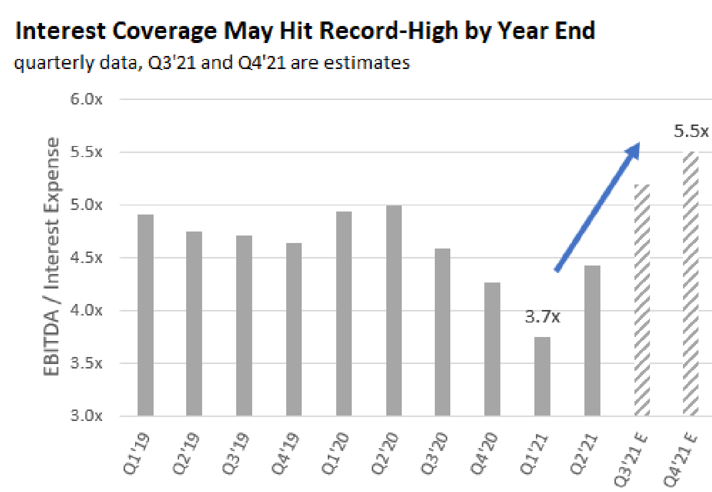




Source: SKY Harbor, BofA Merrill Lynch, Capital IQ, Bloomberg, and company filings

Despite coming in slightly below our internal expectation, Q2'21 EBITDA growth of +24% is still impressive, and registers as a quarterly record in our data set (which goes back to 2003). As a result of this growth, **net leverage declined to ~ 4.6x, well below the pandemic peak of 5.2x, and marks the most aggressive deleveraging of the index in any quarterly period over the last two decades**. Furthermore, incorporating our estimate of high yield issuer EBITDA growth in the second half of 2021 – along with internal expectations for free cash flow generation and change in debt among high yield constituents – we now estimate that index net leverage will improve to ~ 4.0x by the end of this year, below pre-pandemic net leverage of ~ 4.2x. By virtue of low interest rates and a healthy primary market that has allowed issuers to retire high-coupon bonds, we also see interest coverage metrics improving to 5.5x by the end of 2021, also better than pre-pandemic levels and the strongest metric in our two-decade data set.



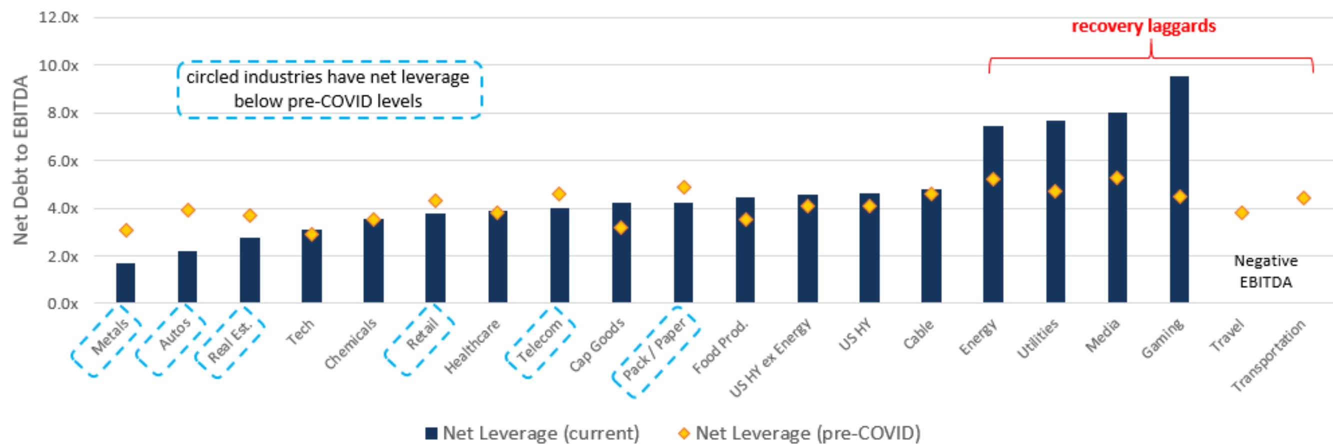


Source: SKY Harbor, BofA Merrill Lynch, Capital IQ, Bloomberg, and company filings

The pace of the recovery, however, has varied significantly across the index. Industries faring the best in recent months include Metals & Mining and Autos, which by our estimates have enjoyed average EBITDA growth of over 100% relative to pandemic trough levels in Q2'20. The rebound in Travel and Utilities has been far more muted, with persistently negative EBITDA generation for some of the most exposed issuers. Given the heightened disparity, we calculated Q2'21 industry net leverage in comparison to pre-pandemic levels, with results shown below. Note that **six industries have more than recovered from COVID disruptions, with credit fundamentals in better shape now than they were in early 2000**. In particular, commodity price inflation, low interest rates, and a rise in e-commerce activity have provided significant tailwinds to Metals & Mining, Real Estate, and Packaging credits, respectively. At the same time, **a partially delayed re-opening due to the delta variant, along with more onerous travel restrictions, have prevented airlines, casinos, and companies contained within several media sub-industries from achieving the same degree of balance sheet repair**. Looking forward, we maintain a favorable view on Media and Transportation, and anticipate a more rapid catch-up in issuer deleveraging in the near term. At the same time, we are a bit more cautious on some issuers in the Metals & Mining space as several commodities may have peaked in price after an historic run-up.

Leverage Recovery Has Been Uneven Across Sectors

Current vs. Pre-COVID leverage



Source: SKY Harbor, BofA Merrill Lynch, Capital IQ, Bloomberg, and company filings

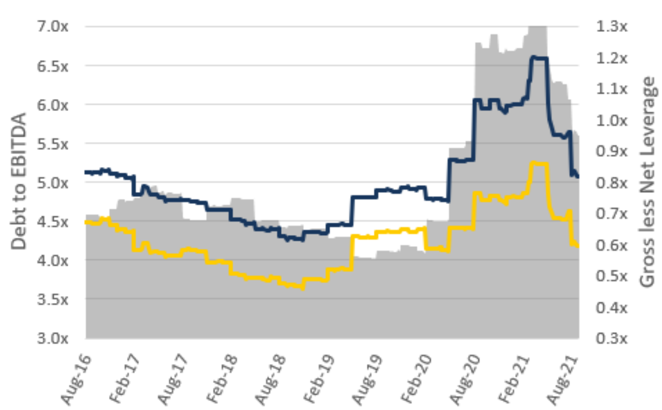
With balance sheet repair underway, our attention has naturally turned toward use of balance sheet cash. In our *2021 US High Yield Outlook* (a summary can be found here, contact us for the full report) we noted the following:

"Management teams were proactive in adding cash to balance sheets to protect against extended lockdowns amidst COVID-19 uncertainty, facilitated by strong investor demand for high yield in a relatively low interest rate environment. The resulting record-setting issuance in 2020 was largely driven by elevated GCP and refinancing, but a return to more normalized business conditions could compel management teams to embark on more aggressive and equity friendly initiatives (debt-funded dividends, LBOs, etc.). This type of behavior has been absent from the market over the last several years (dividends + LBOs made up 8% of issuance in 2020, well below the long-run average of ~ 25%) but remains a risk if corporate balance sheets do not remain a priority for management teams. The difference between gross and net leverage is quite elevated, and our optimistic view of fundamental credit metrics would diminish if excess cash was spent on things like dividends and share buybacks."

As demonstrated in the chart below (left side), net leverage remains meaningfully lower than gross leverage (~ 1 turn of EBITDA at Q2'21), but is down substantially from Q4'20. At the same time, **we find no meaningful evidence that management teams have dramatically increased dividend payouts or share repurchase authorizations. Rather, it appears as though funds are being reinvested back into businesses, with LTM capital expenditures on the rise for the first time since 2018**. In general, we view these trends as being supportive of bondholders, as such investments will ultimately improve an issuers' operating potential (whereas dividends and buybacks would not).

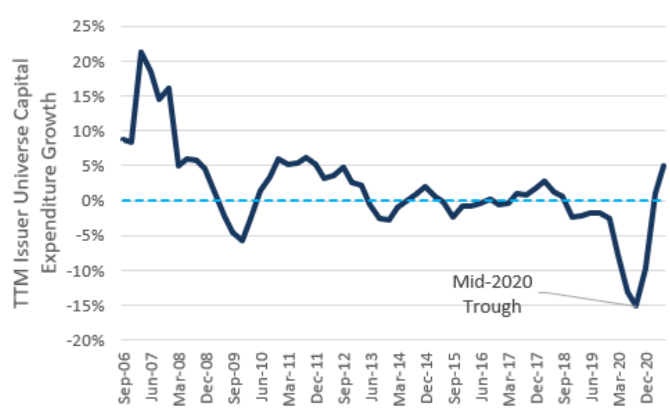
Balance Sheet Cash Coming Down But Still Elevated

last five years



Capex Growth Turns Positive for First Time Since 2018

quarterly data, last 15 years



Source: SKY Harbor, BofA Merrill Lynch, Capital IQ, Bloomberg, and company filings

A credit metric inflection has been reached, with index net leverage now moving down after a COVID-induced peak in the first half of this year. Given our outlook for continued EBITDA growth and free cash flow generation amidst a benign environment for net debt issuance, we project credit metrics at year end will be equal to or better than pre-pandemic levels. Furthermore, several lagging sectors – most specifically Media and Leisure – are experiencing a delayed recovery, but Q2'21 management commentary and further progress in the fight against the delta variant leave us optimistic for further normalization in the coming quarters. In the meantime, management teams have acted conservatively with elevated cash balances, and we view an uptick in capital expenditures – rather than an increase in shareholder dividends – as a substantial credit positive that will improve operating potential and reduce default risk in future quarters.

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