SKY HARBOR
CAPITAL MANAGEMENT

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Weekly Briefing

SKYView: A Surprisingly Good Start

Q1’21 earnings season has begun, with ~ 40% of S&P 500 constituents having reported quarterly financial results at the time of publication. Similar to trends in the second half of 2020, earnings continue to surprise to the upside, providing a positive read-through for high yield issuers that typically report results several weeks after their large-cap competitors. Though upside surprise has been the dominant outcome thus far, rapidly rising raw material costs have featured prominently in management team commentary and analyst Q&A sessions. In this *Weekly Briefing*, we identify what we view to be sector mis-pricings based on earnings trends thus far in the quarter, and focus on key beneficiaries of raw material inflation, a trend that is expected to persist in the coming months.

Despite a focus on below-investment-grade issuers, our analyst team actively monitors earnings trends among larger corporates that reside outside of our target market. These entities, typically found within the S&P 500 and Russell 2000 indices, provide valuable insights into macro supply and demand trends given superior reach across global markets. Additionally, S&P 500 constituents often report quarterly results earlier than the balance of high yield issuers, offering an early preview of things to come in the leveraged credit universe given positively correlated earnings trends between the two markets over time. As demonstrated below, 40% of S&P 500 and 19% of the Russell 2000 constituents have released Q1’21 results thus far, and on average those corporations have reported earnings 23% and 49% above consensus expectations, respectively. Trends vary by sector (Healthcare, Telecom, and Financials have been notably strong) but in aggregate the earnings surprise magnitude is trending well above levels seen in the prior three years, and augurs well for the high yield market.

S&P 500 Index (SPX): Current Quarter

Q1'21 Earnings Summary (40% have reported through publication)

Sector	Q1'21 Earnings Growth	Q1'21 Earnings Surprise
Energy	57%	147%
Materials	134%	23%
Industrials	-30%	11%
Consumer Discretionary	9%	17%
Consumer Staples	10%	10%
Healthcare	25%	10%
Financials	195%	40%
Technology	21%	11%
Comm. Svcs / Telecom	52%	34%
Utilities	-49%	5%
Real Estate	4%	-5%
All Securities	49%	23%

Russell 2000 Index (RTY): Current Quarter

Q1'21 Earnings Summary (19% have reported through publication)

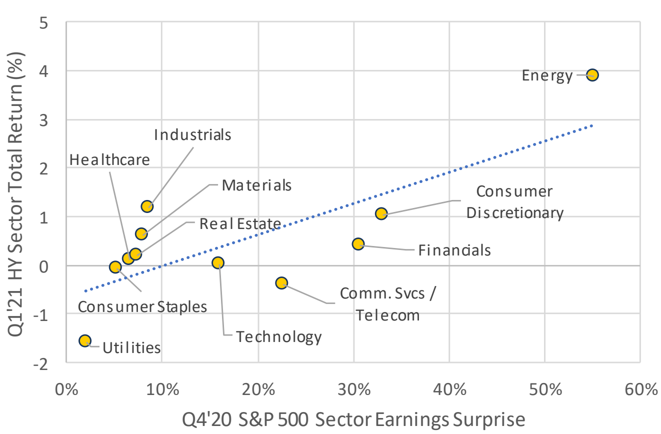
Sector	Q1'21 Earnings Growth	Q1'21 Earnings Surprise
Energy	NM	NM
Materials	332%	60%
Industrials	9%	18%
Consumer Discretionary	106%	48%
Consumer Staples	-17%	23%
Healthcare	15%	117%
Financials	181%	50%
Technology	197%	75%
Comm. Svcs / Telecom	NM	121%
Utilities	59%	7%
Real Estate	25%	28%
All Securities	133%	49%

Source: SKY Harbor, Bloomberg

As noted in a November 2020 *Weekly Briefing* entitled “Earnings Surprise,” quarterly S&P 500 EBITDA growth has been highly correlated to EBITDA growth in the US High Yield universe over the last 10+ years, the two tracking closely in both up and down markets. Furthermore, S&P 500 sector-based earnings surprises – more so than absolute earnings growth – are highly correlated to subsequent period US high yield sector total returns, as demonstrated in the scatterplot below (left side). While only one period is presented (Q4’20 S&P 500 surprise vs. Q1’21 US HY total returns), the relationship is similarly linked on an historical basis. With this in mind, and under the assumption that sector trends will remain consistent as the balance of the index reports financial results, we note that HY Healthcare and Industrials appear attractive as total returns have undershot their implied earnings surprise magnitude (right chart).

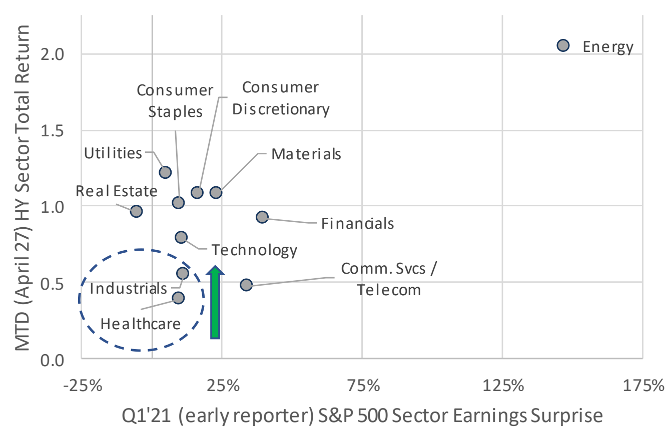
Q4'20 Earnings Surprise Drove Subsequent Sector Returns

Q4'20 S&P 500 Index earnings vs. Q1'20 US High Yield total returns



Q1'21 Early Reporters Imply Market Mispricing

Q1'21 S&P 500 Index earnings vs. April MTD US High Yield total returns

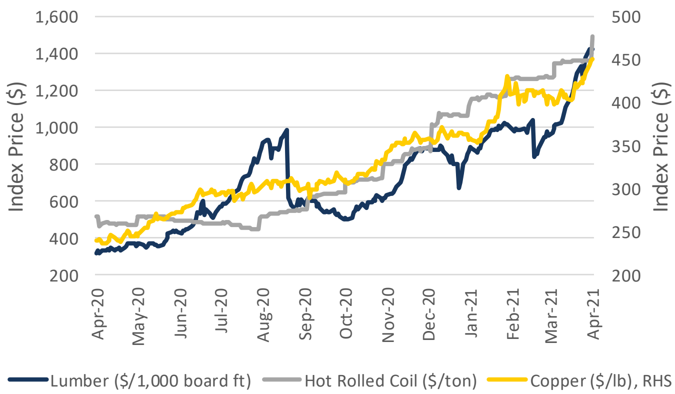


Source: SKY Harbor, Bloomberg, ICE Data Indices

Another emerging trend is raw material cost inflation, which appears pervasive across a variety of sectors and has dominated management team commentary in post-earnings investor calls. While lumber, steel, and copper price momentum have garnered the most attention (left chart below), re-opening momentum, labor shortages, and supply disruptions have served to increase the price of many other key raw material inputs (including corn, oil, and structural panels, as demonstrated in the right chart below). Though most companies conduct business under long-term contracts with input price escalators, the typical pass-through (most often one to six months) can prove detrimental to margins when commodity prices fluctuate as rapidly as they have thus far in 2021. As such, our confidence in underlying earnings projections have declined for issuers with extended contractual lags and those that satisfy a significant portion of their raw material needs in the spot market.

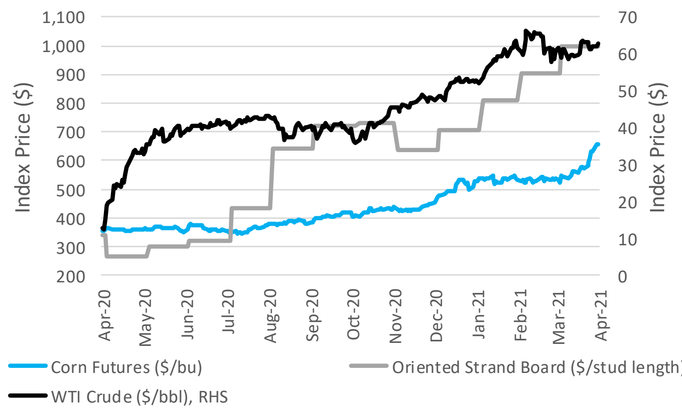
Raw Material Cost Inflation on the Rise

selected commodity prices, trailing 1 year



Cost Inflation Spans the Commodity Spectrum

quarterly data

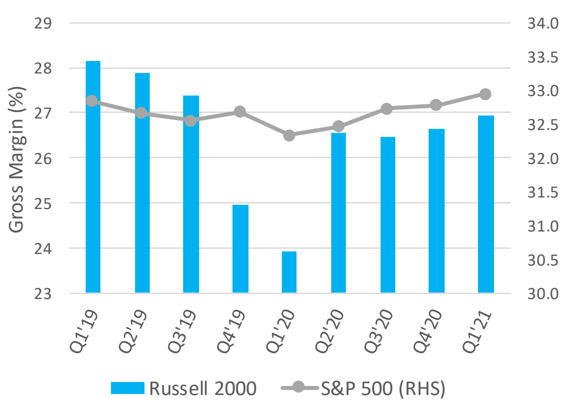


Source: SKY Harbor, Bloomberg

Fortunately for most companies, management teams have noted that improving sentiment and sharply rising re-opening demand have allowed for most (if not all) cost inflation to be passed along to consumers. As further evidence of this dynamic, S&P 500 and Russell 2000 constituent gross profit margins, as displayed in the chart below (left side), have improved on both a sequential and year-over-year basis thus far, with most maintaining or even boosting FY21 guidance. Earnings resilience, however, has not been universal. Below (right chart), we reference some of the more pronounced disparities arising between buyers and sellers of impacted commodities. With supply chain issues and re-opening momentum building, we believe these trends will likely remain in place over the coming months, creating a heightened degree of uncertainty as analysts project future earnings potential. For the time being, we suspect sellers of commodity products are likely better positioned to maintain or expand margins relative to their downstream customers, with pricing power dynamics reversing relative to 2020 trends.

Most Companies Successfully Passing Along Costs

quarterly data



Segment EBITDA Growth Favors Raw Material Suppliers

quarterly data

Commodity	Representative Seller	Representative Buyer
Lumber	**Resolute Forest Products** Wood Prods. segment EBITDA + 1,350% y/y	**Taylor Morrison Communities** Lumber is biggest offset to 1H'21 margin
Pulp	**Mercer** Pulp EBITDA + 18% despite maint. downtime	**Graphic Packaging** $34mm raw material drag in Q1'20
Steel	**US Steel** EBITDA +761% y/y, margins +1,100 bps	**Ford** Exp. $2.5bn increase in metal cost in Q2-Q4
Titanium Dioxide	**Tronox** TiO2 price +4%, volumes +16%, EBITDA +29%	**Sherwin Williams** double-digit raw material headwind
Polyethylene	**NOVA Chemicals** EBITDA +250% y/y	**Silgan** lag in passing through resin price hikes
Electrochemical Units	**Olin** Chlor-alkali EBITDA + 98% y/y	**KIK Custom Products** unhedged exposure to chlorine & caustic soda

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

Q1'21 earnings season is off to a strong start, with ~ 80% of companies reporting EPS figures that exceed consensus expectations. These trends bode well for high yield issuers, and we continue to expect positive fundamental momentum for the balance of the year. Given the strong correlation between earnings surprise and subsequent sector total returns, we see upside potential in high yield healthcare and industrials, as April performance to date has been more modest than Q1 beats would otherwise imply. Furthermore, talk of raw material cost inflation has been a recurring theme across the reporting universe. With supply chain disruptions and re-opening momentum unlikely to subside in the near-term, pricing power has shifted to commodity producers, with margins likely to expand over the next quarter. As such, we have increased exposure to several credits best positioned to benefit from tight market conditions.

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