Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

Welcome to this week's Tortoise credit podcast. I'm John Heitkemper, portfolio manager for high yield bonds and leveraged loans at Tortoise.

Judging by the talk around my house, the school year is quickly winding down and summer is just around the corner. My wife, who teaches, is counting down the days until finals, and my kids are already sorting through their options for activities and camps this summer. But before the final bell of the school year rings, we thought it only appropriate to give our listeners a little end-of-semester final exam, and your test topic today… name that high yield bond issuer! Now, don't panic, these are both well-known companies that you've all heard of, and you may even be a customer. Let's get started.

Company A is a tech-driven media company with 2017 revenues of nearly $12 billion, up 32% from the prior year. Company A's stock trades at a whopping 70x projected 2018 EBITDA. During the first quarter, Company A added over seven million customers, but to achieve this growth, the company has outspent cash flow by over $2 billion in the last 12 months, funding the shortfall with additional borrowing in the high yield market. Management recently guided that Company A's cash flow burn will increase to $3-4 billion in 2018.

Company B has many similarities. It also posted sales of nearly $12 billion in 2017, an increase of 68% year-over-year as unit volumes jumped 35%. While not quite as lofty as Company's A's valuation, Company B also trades at an elevated multiple, over 40x projected 2018 EBITDA. Company B is also growing rapidly and burning cash, nearly $3.5 billion over the past 12 months.

Have you figured out who Company A and B are yet? Let's give a few more quick data points.

Company A's stock is up 68% year-to-date, and its unsecured bonds, rated B+ by S&P, trade in the in 4-5% range, depending on maturity. Conversely, company B's equity price is down about 20% since February and its most recently issued bonds, originated last summer with a B- rating, are down over 10 points and trade north of 7%.

Okay, time's up, please put down your pencils. Let's see how you fared. If you came up with Netflix for Company A and Tesla for Company B, you pass with flying colors.

We chose these two companies for our quiz because their stories are fairly unique for the high yield market, but as you probably gleaned from some of the stats we threw out, their paths have definitely diverged recently. Both Netflix and Tesla are rapidly growing companies with business models centered on disrupting their respective industries. Both are relying – at least in part – on the high yield market for billions of dollars to fuel their growth. While a high growth story is a plus in high yield, debt investors typically underwrite credit based on the level and sustainability of cash flow. That's how bond holders eventually get paid back.

Clearly, neither Netflix nor Tesla currently has a cash flow profile that suggests you'd want to lend to them, but investors can point to their rapid customer gains and lofty equity valuations to imagine a day when both companies are generating more cash than they're investing internally. However, the crux of the issue for lenders is how long must we wait to see them hit that milestone and in the interim, how many times will they be back to the high yield market? To get some clarity on these questions, high yield investors naturally focus on management guidance, and in this respect, Netflix and Tesla couldn't be more different.

Netflix recently reported Q1 2018 earnings with better-than-expected subscriber additions and margins; revenue and EBITDA jumped 40% and 69% year-over-year, respectively. Management's guidance for the second quarter customer

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additions also beat expectations. The company expects to spend $7-8 billion on new media content, which is key to attracting and retaining subscribers, but also the reason behind the $3-4 billion cash burn. To partially close this funding hole, Netflix yesterday issued $1.9 billion of new 10.5 year bonds at 5.875%, a rate slightly higher than it pays on its existing bonds due in part to the recent increase in U.S. Treasury rates.

Conversely, Tesla has repeatedly failed to live up to its guidance to investors, most recently with respect to the pace of production ramp-up on the new, more affordable Model 3. By the end of Q1, the company barely hit a rate of 2,000 per week, missing its already-lowered target of 2,500 a week. Despite the current manufacturing situation, which founder Elon Musk dubbed “production hell”, the company maintains it will reach a Model 3 production rate of 5,000/week by summer, although a recently leaked internal memo indicates that the real hurdle might be 6,000/week. Musk claims that Tesla won’t need to access external financing if production hits these levels. Investors remain skeptical, however, and unless the company can finally hit its guidance, Tesla may be effectively shut out of the high yield market, a situation that would surely hit the company’s equity valuation as well. To rebuild trust with the high yield market, investors may force Tesla to issue equity or convertible debt in tandem, a move that could boost investor enthusiasm across the company’s cap structure.

The bottom line is that Tesla’s guidance missteps means that it will face a much more difficult test with high yield investors over the next few quarters. Netflix, on the other hand, has earned passing grades so far, but its ability to continue accessing the high yield market requires living up to expectations and demonstrating a path to positive cash flow. If not, beware Netflix, high yield investors can be tough graders.

Thanks for listening and please tune in for future Tortoise credit podcasts.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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