Tortoise QuickTake Podcast

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

Welcome to the Tortoise Credit Strategies weekly podcast. I'm John Heitkemper, portfolio manager for high yield bonds and leveraged loans. As your outdoor thermometer is probably telling you, we're well into the dog days of summer, as this time of year is known to all the baseball fans out there. It's also prime season for summer vacations, and my family's recent time away from home highlighted one of the ways that travel has changed in recent years. Like many of you, we chose not to rent a car and instead, we utilized Uber and Lyft to get around. Later in the call, we'll talk about how these ride-hailing services, as well as other trends, are impacting rental car companies in the high yield bond market. But before we get to that discussion, let's get a mid-year update on the U.S. high yield bond market.

As measured by the Barclays U.S. High Yield Corporate Bond Index, the high yield market returned 2.17% in the second quarter, pushing the year-to-date return through June to a solid 4.93%. The high yield Index spread tightened 45 basis points to 364 basis points during the first half, touching a 3-year low of 344 bps in early March. Yields reached a recent low of 5.42% in mid-June, the lowest level since August 2014, before widening back out at the end of June as oil prices and Treasury rates caused some volatility in credit markets.

In what has generally been a risk-on environment to start 2017, high yield's nearly 5% return in the first half outpaced investment grade credit's 3.68% gain and the 2.01% return for leverage loans. The riskiest segment of high yield – Triple C rated bonds – led the market in the first half, posting a 6.6% return, outpacing double B's at 4.8% and single B's at 4.3%.

With credit fundamentals demonstrating general improvement thus far in 2017, it is not all that surprising to see outperformance from the bottom of the credit spectrum. The high hield default rate declined over 2% from the start of the year to just 1.5% at June 30th, reflecting a substantial decline in bankruptcies in the energy and metals & mining sectors as compared to the beginning of 2016. With first quarter earnings now in the books – and Q2 results just starting – credits trends are positive to start the year. Among high yield issuers, revenue and EBITDA growth accelerated in the first quarter, even if you back out the commodity sectors that continue to recover from trough conditions. The growth in EBITDA also translated into a decline in leverage, although on historical basis, leverage does remain elevated.

Solid returns were broad-based across high yield industries. The best performing sectors through the first half included the banking, manufacturing, healthcare, and pharma industries, which all returned in excess of 7%. With oil down over 14% in the first half, the high yield exploration & production sector was the only one to post a negative return through June 30th, declining 1.4%. The retail sector was another laggard, returning just under 1%, as it faces secular challenges that we've discussed on a prior podcast.

Outside of energy and retail, one of the worst performing issuers during the first half was Hertz, the company that exemplifies many of the challenges facing the rental car industry. Like the retail industry, the rental car industry is experiencing structural change that threatens the business model going forward. The rapid growth of Uber and Lyft has left rental car fleets bloated, which has in turn pressured industry pricing. Hertz's average revenue per day on its rental fleet has declined consistently over the past few years, dropping a cumulative 12% in the eight quarters ending in Q1 2017.

Again, like the retail industry, it appears that the rental car companies must face the reality that the industry needs to reduce capacity in order to survive the secular headwinds, and in fact, Hertz has discussed its strategy on this front in recent earnings calls. Unfortunately, shrinking a rental car fleet at this point in the cycle entails selling into a weakening used car market.

In what is a more of a cyclical than secular challenge, a surge of used cars coming off of lease has pressured used car pricing. According to Mannheim, the number of off-lease units more than doubled between 2012 and 2016 and is expected to increase by another third by 2018. Pricing data from that same consultant shows price declines for used cars accelerating to a negative 8% year-over-year in recent months.

At this point, let's take a quick step back and think about the very basic rental car business model. A company like Hertz buys a new car with the intent on selling it back into the used car market in a few years. In the intervening time, it tries to rent that car out as often as possible for as high of a rate as possible. In the current environment, challenges from ride sharing companies are depressing rental rates, while cyclical weakness in the used car market is hurting the value of Hertz's existing fleet. This is a double-hit to profitability, and indeed, consensus estimates are for Hertz to generate just $350 million of EBITDA in 2017, down from about $550 million last year and $1.5 billion in 2015. The decline in EBITDA has pushed leverage to very elevated levels, pressuring the company's ratings as well as its equity and bond valuations. Through early June, Hertz bonds were down nearly 5% while the equity is off 70% in the last year.

Hertz is attempting to address these challenges by right-sizing its fleet and cost structure, and bolstering liquidity by issuing second lien notes to repay near-term maturities. Unfortunately, for rental car companies, Uber and Lyft aren't the only threats on the horizon. Farther out, Hertz and its competitors will have to contend with the autonomous vehicle movement. On this front, there may be a sliver of hope, with Avis and Hertz having recently cut deals, albeit very small in scale, with Waymo (Google's self-driving car project) and Apple. Unsurprisingly, these announcements drove a sharp bounce in the equity and bond values of both Hertz and Avis.

Is this just false hope that the rental car companies have a place in the future autonomous vehicle world? Only time will tell. Whether we're renting from Google, Apple or Hertz, we probably have at least a few more summers before our vacation trips include driverless cars.

Thank you for listening, and please join us for next week's Tortoise Credit podcast.

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@tortoiseinvest.com.

The Bloomberg Barclays U.S. Corporate High Yield Bond Index is composed of fixed-rate, publicly issued, non-investment grade debt, is unmanaged, with dividends reinvested, and is not available for purchase. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility and Finance, which include both U.S. and non-U.S. corporations.