Tortoise QuickTake Credit Podcast

October 22, 2018

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.

If my voice falters during this podcast and reveals my lack of sleep in recent days, go ahead and blame it on how late these postseason baseball games are ending. The hometown Dodgers took 13 innings and over five hours to dispatch the Brewers in game four of the NLCS last week. Even the nine inning games seem to take four hours these days. To speed things up, they might have to start every batter with a 2-1 count like in my slow pitch softball games. The late nights are particularly painful during earnings season, which kicked into high gear last week as well.

Thus far, the most notable earnings release in the high yield market – maybe even in the equity market too – came from Netflix, which is a credit that we discussed in a podcast back in April. At that time, the company was coming off of a stellar Q1 report that beat expectations; customer additions and profitability were firing on all cylinders. The equity subsequently climbed to a record high – nearly $420 per share – on July 9th. A week later, Netflix released its Q2 results and laid the proverbial egg. Subscriber adds disappointed analysts, the market started to question the company's ability to maintain its pace of growth, and the stock dropped 25% by mid-August. Needless to say, the company's third quarter earnings, released after market close last Tuesday, were highly anticipated by debt and equity investors alike. And unless you were short the stock, they did not disappoint. Revenues jumped 34% year-over-year to $4.0 billion, EBITDA more than doubled versus Q3 2017 to $584 million, easily topping estimates, and maybe most importantly for the growth story, Netflix added almost seven million streaming subscribers, exceeding both the company's and Wall Street estimates. The markets reacted positively, sending both the stock and bonds higher.

While the Q3 numbers may have restored the equity market's faith in the Netflix growth story, for the high yield market, the conundrum remains that the company continues to fund its rapid expansion with debt. The original content that lures new subscribers costs money, lots of money. On the Q3 earnings call, management said they'll burn at least $3 billion of cash this year and probably the same in 2019. While the company is sitting on a $3 billion pile of cash, management won't want to draw that down too much and has a history of tapping the high yield market right after a good earnings release. In fact the company announced a $2 billion Euro and dollar offering for pricing this week.

With very little new issue in the market in the past few months, high yield investors will happily buy a new Netflix deal, and the only real question is at what yield, as investors know there's sure to be another bite at the apple in the not too distant future. Future debt issuance could certainly push Netflix's leverage higher, but the company's balance sheet – with about 4 times debt-to-EBITDA - appears easily manageable when measured against an equity market cap in excess of an eye-popping 70 times EBITDA.

As we progress through this earnings season, there will be very few high yield companies with financial results like Netflix. As we said back in April, Netflix is an anomaly in the market, growing rapidly but funding a massive cash burn with ever more debt. For the majority of companies, including those that issue in the high yield bond market, the third quarter is potentially setting up to be an inflection point. In the first half of 2018, earnings growth was exceptionally strong, with the S&P 500 posting 24% gains in both the first and second quarter. Specific to high yield, JP Morgan data show that issuers posted year-over-year EBITDA increases of 14.4% and 12.6% in Q1 and Q2, respectively. Granted, those gains have been helped in part by a continued recovery in commodity sectors, but even excluding that, high yield EBITDA growth exceeded 10% in two of the last three quarters, an acceleration from 2016 and early 2017.

Robust earnings growth enabled high yield issuers to de-lever their balance sheets over the past two years. Again, using JP Morgan data, high yield leverage has declined for eight straight quarters to 4 times in Q2 2018, down from a post-crisis peak of 4.6 times in Q2 2016. Using these figures, at current levels, the average high yield balance sheet is now better positioned than it was in early 2008 as the economy entered the great financial crisis. It would clearly be positive for credit fundamentals and thus high yield investors to see issuers improve leverage metrics even further in coming quarters, but this is where the earnings outlook may not paint quite as an encouraging outlook.

According to estimates compiled by Bloomberg, S&P 500 earnings growth is set to slow from the mid-20% range in the first half of 2018 to high teens by the end of this year and then to 7-8% in the first half of next year. This deceleration may cause concern for some investors, but it shouldn't be a major surprise as the November 2017 Tax Cut and Jobs Act that reduced tax rates for companies drove much of that temporary earnings momentum in Q1 and Q2, and that effect will dissipate in coming periods. For equity markets, the combination of slowing earnings growth and a higher interest rate environment could spell trouble. Take the case of United Rentals, a leading equipment rental company and a benchmark high yield bond issuer, which also reported last week and after management talked of slowing growth, the stock got hit by 15%. But from a credit perspective, the company is digesting recent acquisitions and applying free cash flow to debt reduction.

As Q3 earnings season progresses, we're likely to see more situations like United Rentals, but our view is that while earnings growth likely slows, as the estimates project, it doesn't necessarily mean that high yield corporate fundamentals are set to deteriorate. More moderate earnings growth actually works for debt investors, as long as management teams stay focused on their balance sheets, as high yield issuers have done in recent quarters. We don't see a change in the deleveraging trend so far in this earnings season, although we do acknowledge that there are several innings left before we know the final score.

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.