The Kraft Heinz Co. (KHC)

The BBBubble Is Bursting

Lower KHC to UW as we expect the credit to be downgraded to HY. We see FV as 5% (~300bp) for the long end and high-3% (220bp) in the 10y, though levels are likely to overshoot. Key drivers of our expectation include no change in the dividend and a lack of commitment to asset sales, which point to a longer time to de-lever.

CORE
#bbbubble

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Trade ideas: Sell 2029s/sell KHC 5y CDS; sell high-dollar-price KHC 2032s, 6.875s of 2039, 7.125s of 2039, 6.5s of 2040; Buy 2026s and 2045s.

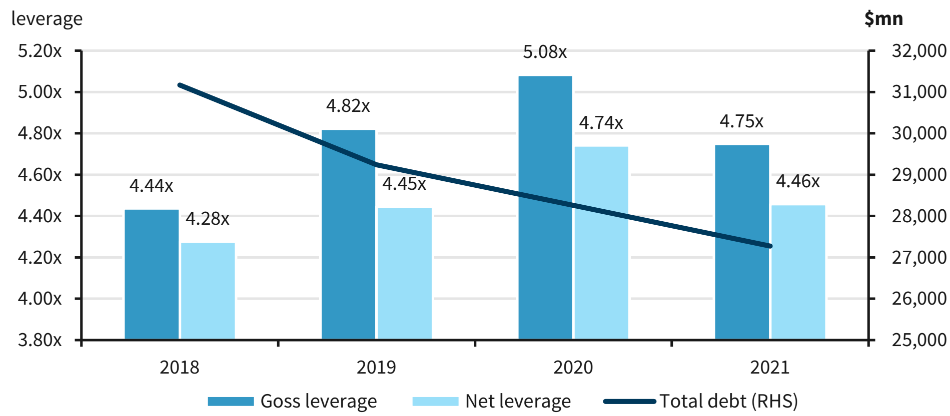
We lower our rating on Kraft Heinz to Underweight as we expect downgrades from at least S&P and Fitch, given that the company is now unlikely to meet the deleveraging objectives that each had previously outlined. We also expect leverage to tick higher in 2020, which when coupled with the aforementioned, and a strategic review date in early May, points to a higher likelihood that the agencies could act sooner rather than wait until May.

Barclays Rating: Underweight (from Market Weight)
Moody's/S&P/Fitch Rating: Baa3 (Stable)/BBB- (Neg)/BBB- (Neg)

Investment Summary

Management outlined a desire to get leverage "below 4x as soon as practical" but without asset sales (no committed timeline or hurry on asset sales at this point, per the CFO) or a cut in the dividend, it appears difficult to meet the expectations set by the aforementioned agencies. Fitch looked for leverage moving "towards 4x" on $5bn of asset sales in 2020 (with a downgrade threshold of leverage sustained above 4.25x in 2020 or beyond) while S&P had outlined a need for KHC to be below 4x by mid-2021. Further, each of the two agencies had been looking for some combination of dividend cut and asset sales to retain their current low-BBB ratings. The company ended FY19 with gross leverage of 4.8x and net leverage of 4.45x. Based on guidance for an 8% decline in EBITDA for 2020, and an assumption that only 2020 maturities are repaid, we estimate the company will end the year with leverage of 5.1x on a gross basis and 4.7x on a net basis, before potentially moving towards 4.75x gross/4.46x net in 2021, assuming modest EBITDA growth.

FIGURE 1. **Leverage expected to rise again in 2020**



Source: Company reports, Barclays Research

In our view, the commentary on the call also highlighted the ability to operate as a HY company, and demonstrated a recognition from management that while it valued IG status, it understood that the decline in leverage "may not come as rapidly as desired," with the last point implicitly acknowledging rating agency expectations. As we discussed in Where the Ratings Risks Lie, operationally, we see limited hindrance to the credit as a HY credit and estimate that the company should be able to generate sufficient cash flow to cover its maturities through 2020-21, which should limit refinancing risk until 2022. To the latter point, CFO Basilio noted on the call that it expected to pay down 2020 maturities with cash on hand, having ended the year at a balance of $2.3bn.

Key points from the call:

- IG status remains important but decline in leverage may not come as rapidly as desired
- Get leverage to below 4x as soon as practical, while maintaining the current dividend, with cash flow generation and any divestiture proceeds going to debt reduction
- No hurry to execute on divestitures, and no timeline, though they expect to be explored opportunistically, with the company remaining disciplined on price
- For 2020, the company forecasts that it can generate FCF after dividends of at least $500mn
- Company expected to discuss strategic review in early May

Relative value as a HY credit

While bonds widened as much as 60-70bp in the higher dollar/off the run long bonds and are now about 10-15bp off the wides, we think that selling pressure will pick up again once releases comes through from the rating agencies. At these levels, pricing reflects one downgrade to HY in our view, but not two. As we consider the comp set (see Figure 2) we think that bonds are likely to widen further, potentially overshooting where FV would lie by as much as 50bp as they migrate from IG to HY. In our opinion, as a full HY credit (ie, at least two of three agencies), we see fair value in the high-3% area (or 220bp) in 10y and about 5% (or around 300bp) in the long end given a large amount of longer-dated paper (see Figure 2 for where KHC is trading versus the comp set).

Typically, higher dollar long bonds are likely to perform the worst on the curve, with fallen angels priced below $98 and/or less than 10 years to maturity seeing the best outperformance vs. HY after the downgrade. Given the move today, KHC is trading on average at a profile of $106 with just under 16y maturity, and while the on the run long bonds (2042s, 2046s, 2049s) are trading within a few points of par, there are still a number of off the run/high coupon bonds with dollar prices in the 120s, which are likely to underperform more on a relative basis.

We expect most of the downside to the credit to be borne in the IG world, and outperformance likely if it enters the HY universe. Given that the company is looking to establish a foundation from which it can ultimately grow the business, asset sales coupled with EBITDA growth in out years, could help KHC return to IG in a relatively short time frame, and elicit greater investor comfort post a potential downgrade. We estimate that if part of the HY universe, KHC would represent 41.5% of the food and beverage sector and 1.73% of the HY Index, which would bring food and beverage to 4.18% of the HY Index (see Figure 3). This is likely to provide strong investor demand on the HY side, once levels get closer to the peer set.

As discussed in Large Angels Fall Harder but Bounce Higher, issuers with large cap structures on average widen 189bp into the downgrade and tighten 60bp in the six months after entering the HY universe (see Figure 4). While we do not expect KHC's widening to be as extensive if it becomes HY, we do note that the name only underperformed the Credit Index by 19bp from early August (pre-2Q19 earnings) to yesterday (Figure 5), pointing to continued room to widen despite the move today.

Trade ideas:

- **Sell KHC 5y CDS:** In 5y CDS, KHC was quoted 90/100 versus 79/87 for Newell, and 107/115 for Kohl's and Nordstrom. We think that while modest widening is possible as clarity on ratings occurs, given the comp set, investor bias should be to sell as that occurs. Fundamentally, KHC should continue to trade tight to KSS and JWN.

- Sell 2029s (quoted 176/168)/sell KHC 5y CDS (quoted 90/100) - as discussed above, we view CDS as closer to the wides, while KHC 29s still have room to widen 50bp to get to fair value and could likely widen further as they migrate to HY. They are also 7pts higher than the 2030s.

- Sell high-dolla-price KHC 2032s (quoted 255/240, $124), 6.875s of 2039 (quoted 290/280, $123), 7.125s of 2039 (quoted 295/284, $126), 6.5s of 2040 (quoted 299/289, $118), as we expect these bonds to underperform the most. While the yield is closer to FV, the high dollar price on these is likely to make them less appealing to the HY buyer base.

- Buy 2026s (quoted 156/148, $100) and 5.2s of 2045 (quoted 282/272, $104) - we see these bonds as having the least downside relative to FV (about 20bp on the 26s and 10bp on the 45s).

FIGURE 2. **KHC vs HY comp set shows 25-40bp widening to get to FV, but levels likely overshoot on migration from IG to HY**

Security	Bid Px	Ask Px	Bid Yield	Ask Yield	Bid GSpd	Ask GSpd	Moody	S&P
KHC 3.0 26	100.0	100.5	3.00	2.92	149	143	Baa3	BBB-
LW 4.875 26	105.5	106.3	2.94	2.51	151	108	Ba2	BB+
SMG 5.25 26	106.3	107.3	3.11	2.57	168	114	B1	B+
ARMK 4.75 26	104.6	105.1	2.88	2.50	143	105	Ba3	BB
NWL 4.2 26	105.1	105.6	3.47	3.38	200	191	Baa3	BB+
POST 5 26	104.3	104.8	3.78	3.37	224	191	B2	B+
Average (ex KHC)	**105.2**	**105.8**	**3.24**	**2.87**	**177**	**142**		
KHC 4.625 29	109.4	110.0	3.38	3.30	179	171	Baa3	BBB-
KHC 3.75 30	102.6	103.3	3.43	3.35	182	175	Baa3	BBB-
PBH 5.125 28	105.0	105.8	3.99	3.83	257	241	B3	B+
ARMK 5 28	105.8	106.5	3.73	3.48	234	208	Ba3	BB
POST 5.625 28	106.6	107.1	4.06	3.87	264	246	B2	B+
CENT 5.125 28	105.3	106.3	4.02	3.67	263	227	B1	BB
SMG 4.5 29	103.8	104.8	3.93	3.78	239	224	B1	B+
POST 5.5 29	106.4	106.9	4.52	4.42	299	298	B2	B+
JBSSBZ 6.5 29	112.6	113.4	3.91	3.73	248	230	Ba2	BB
JBSSBZ 5.5 30	109.8	110.5	3.82	3.66	238	223	Ba2	BB
VVV 4.25 30	101.3	102.0	4.07	3.96	252	241	Ba3	BB
POST 4.625 30	100.8	101.3	4.51	4.44	294	286	B2	B+
Average (ex KHC)	**105.7**	**106.4**	**4.06**	**3.88**	**259**	**242**		
KHC 5 35	108.0	109.0	4.27	4.19	252	244	Baa3	BBB-
NWL 5.375 36	110.5	111.5	4.67	4.58	293	285	Baa3	BB+
KHC 4.375 46	94.9	96.3	4.72	4.62	264	254	Baa3	BBB-
KHC 4.875 49	101.5	102.3	4.78	4.73	271	266	Baa3	BBB-
NWL 5.5 46	109.25	110.25	5.08	5.02	311	304	Baa3	BB+

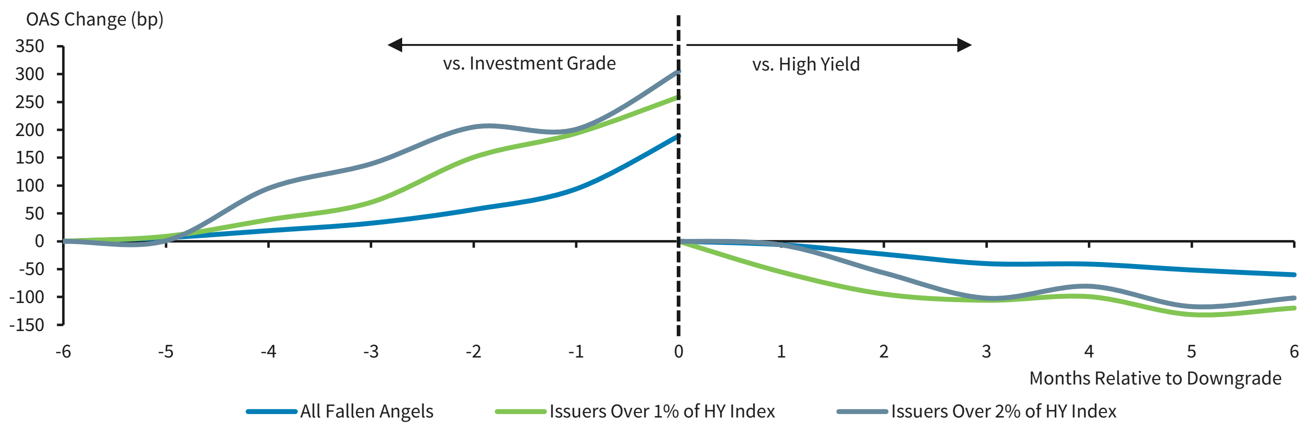
Source: Barclays Research

FIGURE 3. **KHC would be the largest issuer in HY food and beverage if downgraded, with $23.3bn of eligible HY debt**

	Current HY				With KHC			
	% of Food and Bev	% of US HY	Market Value ($ bn)	Amount Outstanding ($ bn)	% of Food and Bev	% of US HY	Market Value ($ bn)	Amount Outstanding ($ bn)
KHC	0.0%	0.0%	0.00	0.00	41.50%	1.73%	23.31	22.02
Food and Bev		2.5%	32.85	30.97		4.18%	56.16	53.00
US HY			1,320.88	1,282.91			1,344.19	1,304.93

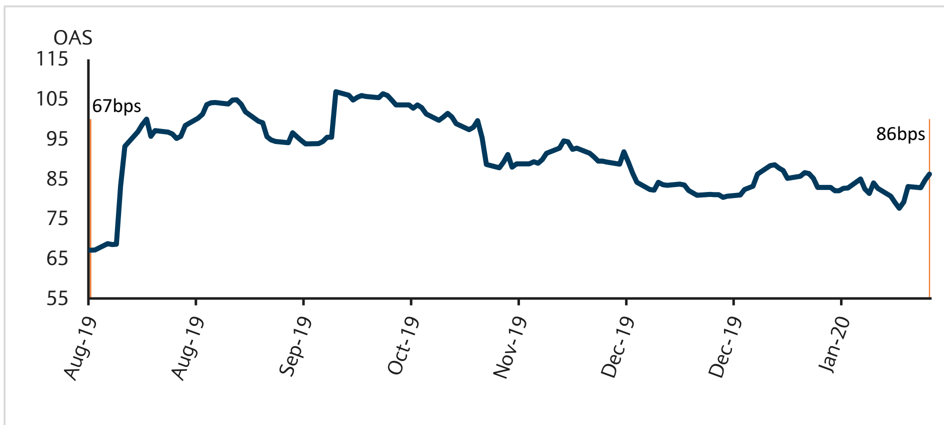
Source: Bloomberg Barlays Indices, Barclays Research

FIGURE 4. Larger debt structures underperform more before downgrade but outperform more after the downgrade; if downgraded, KHC would be 1.7% of the HY Index



Source: Bloomberg Barclays Indices.

FIGURE 5. Prior to today, KHC had only underperformed the Index by 19bp since early August 2019



Source: Bloomberg Barclays Indices, Barclays Research

Operational Highlights

KHC reported adjusted EPS for 4Q19 of $0.72, above consensus of $0.68, aided by below the line items as sales were a bit weaker than consensus while EBITDA was in line. Management acknowledged that 2019 had been a difficult year for the company.

- Net revenues of $6.5bn, were down 5.2% y/y and $69mn below consensus, while organic net sales decreased 2.2%, worse than consensus of down 1.33%.
    - US organic net sales declined 2.7% as pricing rose 3.1% due to higher list prices as well as higher key commodity costs. Volume/mix decreased by 5.8% due to a decrease in cheese, coffee, cold cuts, and bacon shipments, which were partially offset by growth in condiments and sauces.
    - Canada organic net sales declined 2.5%, due to a negative 21.4% impact from Canadian natural cheese divestiture. Pricing was down 5% due to unfavorable trade expense as well as higher promotional activity around the holidays. Volume/mix was up 2.5% due to consumption growth in peanut butter and pasta sauce, which was partially offset by lower cheese shipments coupled with continued weakness in coffee.

- EMEA organic net sales increased 0.3% due to favorable pricing led by the UK, which was partially offset by lower pricing in Russia. Volume/mix grew by 0.2% as the condiments and sauces segment grew in Russia.

- Rest of the World segment organic net sales decreased 1.6% as pricing grew 0.7% mainly due to higher pricing in Latin America and China partially offset by lower pricing in Australia. Volume/mix decreased 2.3% due to lower shipments in Australia and New Zealand partially offset by growth in Indonesia and Brazil.

- Gross margin declined 40bp to 32.1% due to supply chain costs and low project preparation of SKUs.

- Operating margin increased 80bp, to 20.0%, as a result of gains from cost savings initiatives as cogs and SG&A expenses decreased $211mn and $19mn, respectively, coupled with a $355mn decline in total revenue.

- EBITDA for the quarter totaled $1.56bn, a decrease of 6.6% y/y but $13mn above consensus, resulting in LTM EBITDA of $6.1bn.

- Gross leverage decreased by 0.1x to 4.8x and net leverage decreased by 0.2x to 4.4x as total debt decreased by $1.4bn sequentially.

- Free cash flow was $886mn, versus $702mn in 4Q18 as capex and dividends were lower by $45mn and $273mn, respectively, partially offset by a $134mn decrease in cash from operations. LTM free cash flow came in at $831mn, owing to the seasonal cadence in the company's cash flow generation.

- Cash returned to shareholders totaled $489mn through dividends as the company continues to not repurchase shares.

- Cash stood at $2.3bn, a decrease of $36mn sequentially.

FIGURE 6. **Select financial metrics - KHC**

	4Q19	3Q19	4Q18	4Q19	LTM
($mn)	Actual	Actual	Actual	Consensus	
Revenues	6,536	6,076	6,891	6,605	24,977
Gross Profit	2,101	1,968	2,245	2,128	8,138
Operating Profit	1,309	1,226	1,434	1,290	5,079
EBITDA	1,564	1,469	1,674	1,551	6,064
Gross Margin	32.1%	32.4%	32.6%	32.2%	32.6%
Operating Margin	20.0%	20.2%	20.8%	19.5%	20.3%
EBITDA Margin	23.9%	24.2%	24.3%	23.5%	24.3%
CFO	1,562	665	1,696		3,552
Dividends	(489)	(488)	(762)		(1,953)
Capex	(187)	(133)	(232)		(768)
FCF	886	44	702		831
Total Debt	29,244	30,672	31,168		
Cash	2,279	2,315	1,130		
LTM Credit Metrics					
Debt/EBITDA (x)	4.8x	5.0x	4.4x		
Net Leverage (x)	4.4x	4.6x	4.3x		
EBITDA/Interest Expense (x)	4.8x	4.9x	5.5x		
Total Debt % of Total Capitalization	36.1%	37.2%	37.6%		

Source: Company reports, Bloomberg, Barclays Research

Guidance

Kraft Heinz provided the following guidance for 2020:

- The company expects 50% fewer projects as it shifts from expansions to expansionary launches behind existing brands.
    - It expects to redirect funds disproportionately towards supporting flagship brands.
- Net sales are expected to face a 300bp headwind vs 2019 due to divestitures and business exits (175bp), commodities, distribution and supply chain (65bp), and FX (60bp).
- Adjusted EBITDA vs 2019 is expected to be $460mn (or 8%) lower y/y due to a $110mn hit from divestitures and business exits, a $140mn hit from incentive compensation, a $150mn decrease due to commodities, distribution, and supply chain, and a $60mn decrease due to FX.
- The company also expects ~ a $0.38 decrease to adjusted EPS vs 2019 due to a $110mn hit from stock-based compensation, a $270mn decrease due to other income, and a ~22% effective tax rate.
- The company expects to increase its spend in working media by 30%.
- It will maintain its $0.40/share dividend.
- Target leverage is expected to be below 4x “as soon as practical”.

Summary of Ratings

Bloomberg Barclays U.S. Credit Index		
	Old	**New**
U.S. HG Food and Beverage	Market Weight	Market Weight
KRAFT HEINZ FOODS CO	Market Weight	**Underweight**

Source: Barclays Research

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Primary Issuers/Bonds
KRAFT HEINZ FOODS CO, Underweight, A/CD/D/J/K/L/M

Valuation Methodology: We rate Kraft Heinz Underweight as we expect the credit to be lowered to HY by at least two agencies and see meaningful widening pressure as the bonds migrate from IG to HY.

Risks that May Impede Achievement of the Rating: * Divestitures that generate sufficient proceeds to accelerate the pace of deleveraging

* A cut in the dividend with proceeds directed to debt paydown

* Faster pace of debt paydown/deleveraging than expected.

* Category growth below recent trends.

* Ratings agencies affording the company greater leniency and time to execute its plan

Representative Bond: KHC 4 5/8 01/30/29 (USD 111.36, 12-Feb-2020)

Materially Mentioned Issuers/Bonds
KRAFT HEINZ FOODS CO, Underweight, A/CD/D/J/K/L/M

KHC 3 06/01/26 (USD 101.57, 12-Feb-2020)

KHC 4 5/8 01/30/29 (USD 111.36, 12-Feb-2020)

KHC 5.2 07/15/45 (USD 111.44, 12-Feb-2020)

KHC 6 1/2 02/09/40 (USD 125.81, 12-Feb-2020)

KHC 6 3/4 03/15/32 (USD 128.70, 12-Feb-2020)

KHC 6 7/8 01/26/39 (USD 129.78, 12-Feb-2020)

KHC 7 1/8 08/01/39 (USD 133.34, 12-Feb-2020)

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be in line with the six-month total return of the relevant index.

Underweight (UW):

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be less than the six-month total return of the relevant index.

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To view sector definitions and monthly sector returns for Asia, EEMEA and Latin America Research, go to https://live.barcap.com/go/research/EMSectorReturns on Barclays Live.

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For all High Grade issuers covered in the US, Europe or Asia, and for all issuers in Latin America and EEMEA, the credit rating system is based on the analyst's view of the expected excess return over a six-month period of the issuer's index-eligible corporate debt securities* relative to the expected excess return of the relevant sector, as specified on the report.

Overweight (OW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to exceed the six-month expected excess return of the relevant sector.

Market Weight (MW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be in line with the six-month expected excess return of the relevant sector.

Underweight (UW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be less than the six-month expected excess return of the relevant sector.

Rating Suspended (RS): The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Investment Bank of Barclays Bank PLC is acting in an advisory capacity in a merger or strategic transaction involving the company.

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Overweight (OW): The analyst expects the six-month total return of the debt security subject to this rating to exceed the six-month expected total return of the relevant sector.

Market Weight (MW): The analyst expects the six-month total return of the debt security subject to this rating to be in line with the six-month expected total return of the relevant sector.

Underweight (UW): The analyst expects the six-month total return of the rated debt security subject to this rating to be less than the six-month expected total return of the relevant sector.

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Where a recommendation is made at the issuer level, it does not apply to any sanctioned securities, where trading in such securities would be prohibited under applicable law, including sanctions laws and regulations.

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27% have been assigned an Overweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Buy rating; 60% of issuers with this rating category are investment banking clients of the Firm; 78% of the issuers with this rating have received financial services from the Firm.

46% have been assigned Market Weight rating which, for purposes of mandatory regulatory disclosures, is classified as a Hold rating; 61% of issuers with this rating category are investment banking clients of the Firm; 83% of the issuers with this rating have received financial services from the Firm.

27% have been assigned an Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Sell rating; 44% of issuers with this rating category are investment banking clients of the Firm; 79% of the issuers with this rating have received financial services from the Firm.

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Market Weight (MW):
The analyst expects the six-month excess return of the country's index eligible bonds to be in line with the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.

Underweight (UW):
The analyst expects the six-month excess return of the country's index eligible bonds to be less than the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.

Rating Suspended (RS):
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Distribution of ratings assigned by Barclays Emerging Markets Sovereign Research at the issuer level:
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35% have been assigned Market Weight rating which, for purposes of mandatory regulatory disclosures, is classified as a Hold rating; 8% of issuers with this rating category are investment banking clients of the Firm; 83% of the issuers with this rating have received financial services from the Firm.

32% have been assigned an Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Sell rating; 9% of issuers with this rating category are investment banking clients of the Firm; 91% of the issuers with this rating have received financial services from the Firm.

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