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Bond light

Because beer is an almost perfect food, brewing is a profitable industry. Recession-resistant and scalable, it has attracted both brew masters and leverage artists. In the foremost ranks of the latter are three famed partners of 3G Capital, Inc., controlling investors in Anheuser-Busch InBev S.A./N.V. (ABI:BB in Brussels and BUD, an American Depository Receipt, on the Big Board). This is a story about ABI's debt, mispriced, profuse and—from the point of view of refinancing risk—vulnerable.

When you think of the refinancing risk inherent in a hypothetical bear bond market, do not forget to think of ABI. The 2016 acquisition of SABMiller plc set back ABI by $65 billion. At the time, brewery multiples, expressed as a ratio of earnings before interest, taxes, depreciation and amortization, ranged from nine to 16 times. ABI paid 18 times EBITDA, but got no argument from the creditors. The acquirer borrowed $63 billion at an average coupon of 3.2% at maturities of between two and 30 years. All well and good, but more than $46 billion of ABI debt will mature in the next five years. *That* debt bears an average coupon of only 2.8%.

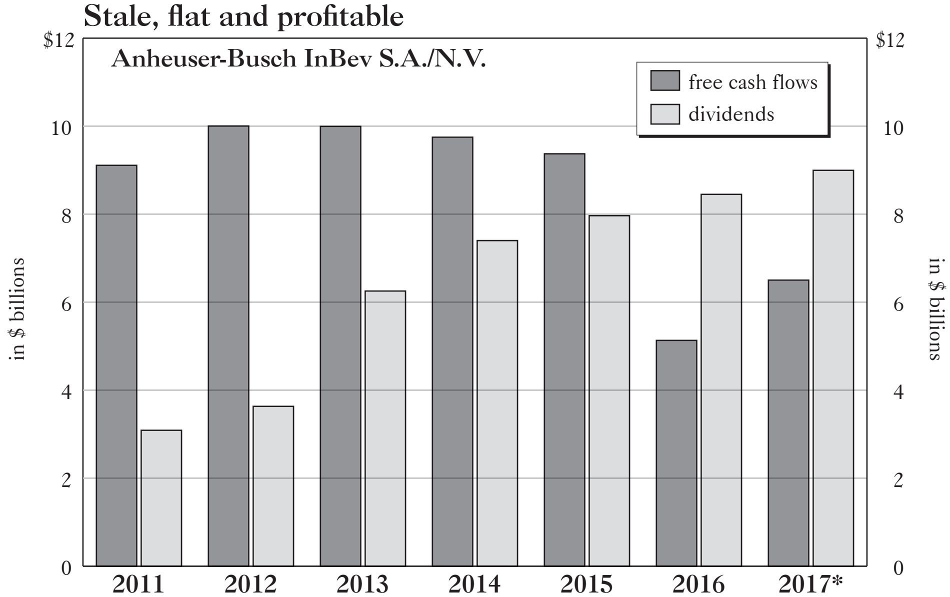
The bond bull market has been very good to the world's biggest brewer. "Consider, for instance," suggests colleague Fabiano Santin, "the ABI euro-denominated 2.7s of 2026. They trade at 111¾, yielding 1.2% to maturity (73 basis points over the bund with the same maturity), or the U.S. dollar-denominated 3.65s of 2026, which trade at 101¼ to yield 3.4% (a 75 basis-point spread from the relevant Treasury). Low in absolute terms, these rates and spreads may appear still richer in the light of ABI's credit metrics. Total debt on June 30, 2017 (based in Europe, the company reports balance-sheet data only twice a year) was $124.5 billion; cash footed to $14.8 billion. Leverage as defined by total debt to consolidated EBITDA last year was 5.7 times.

With respect to the pricing of ABI's debt, Mr. Market is not playing favorites. The gentleman is complacent about corporate credit in toto. The Bloomberg Barclays U.S. Investment Grade Corporate Index's option-adjusted spread ended Feb. 1, 2018 at 85 basis points, tightest in more than a decade.

ABI is a monument to the foresight and daring of Messrs. Lemann, Sicupira and Telles, who have turned a $60 million investment in a poorly managed Brazilian brewery (that was 29 years ago) into the magnificence of a $43 billion stake in the behemoth from which pours Bud Light. That formerly under-achieving Brazilian business is today called AmBev S.A., itself a mighty achievement (of which, as noted, ABI owns 62%).

ABI dominates the American beer market with roughly 45% volume share. Its brands—there are more than 500—rank first or second in 18 other countries. It is, in fact, the Goliath of the forgettable mass-market mouthwash that inspired the glorious revolution in craft beer.

Stale, flat and profitable



* Last twelve months ended June 30, 2017
source: S&P Capital IQ

On the face of things, ABI is operationally on the upswing. Third-quarter results featured gains of 3.6% in revenue and 13.8% in adjusted EBITDA, compared with the year-earlier period. Higher prices helped, as did cost savings realized from the SABMiller acquisition. Adjusted EBITDA rose by $691 million, reflecting a $604 million gain in gross profits on the back of record fat gross margins: 62.3%, up from 60.9% at the end of 2016. It's hard to find better margins. Global beer companies earn between 40% and 50%. The Coca-Cola Co., Diageo plc and Pernod Ricard S.A. (the latter two are worldwide producers of wine and spirits) posted 61.4%, 61.7% and 62.1%, respectively, for the trailing 12 months. ABI is still squeezing cost savings from SABMiller, but it has reached a size where meaningful additions would likely get the fish-eye from antitrust regulators.

"What remains to be seen," Santin notes, "is whether consumers will pay higher prices for the same volumes (good for ABI) or higher prices for lower volumes (not so good). Third-quarter volumes fell 1.2% compared with the third quarter of 2016, after climbing by 0.3% year over year in the first half of 2017. Although geographically diversified, most of ABI's bottom line is driven by the mature U.S. market, which accounts for one-third of its EBITDA. Richard Schmidt, a former ABI holder and portfolio manager at Harding Loevner LP's Global Equity Fund, tells me that his 'problem with ABI is their inability to grow their market [share] and the lack of things that they can buy.'"

The success of the craft brewers is coming out of the hide of ABI. Its American market share fell by 80 basis points in the third quarter (the latest reported), after losing about 55 basis points per year from 2012 to 2016 and 85 basis points in the first half of 2017. North American (U.S. and Canadian) volume was lower by 6.1% in the third quarter—revenues and operating income tumbled 5.3% and 2.2%, respectively—a bearish exclamation point to the 2.6% decline registered during the first six months.

A roll call of the company's five top brands, collectively accounting for 77% of ABI's U.S. beer volume, shows heavy exposure to the mass market. They are Bud Light (38%), Budweiser (14%), Busch Light (8%), Natural Light (8%) and Michelob Ultra (9%). The four non-premium brands (all but Ultra) have been sliding for years. Bud Light and Budweiser volumes fell by 7.2% and 7.5% year over year, respectively, in the three months ended Dec. 2017, according to Nielsen data.

Somehow, America subsisted on 82 craft breweries in 1981. Now there are 5,500. "Those little breweries were able to get distribution fast, which you cannot do in a lot of other places," says Schmidt, referring to the unusually level playing field that craft breweries enjoy in the United States under the three-tier distribution system. Artisanal beer represents 14% of U.S. beer volume but commands 20% of sales, according to analyst Trevor Stirling at Sanford C. Bernstein & Co.

ABI missed the formative days of the India pale ale party but is hustling to catch up. After the purchase of nine specialty brewers in the past three years, ABI owns the second-largest craft portfolio in the United States, with 1.5 million barrels in annual production. Only Boston Beer, with 2.3 million barrels, is bigger, according to Stirling. Still, non-industrial beer accounts for only 1% of ABI's total volume and less than 2% of sales, by the light of our estimates. Complicating matters, the specialty-beer business is becoming more fragmented. In 2009, the top-10 bespoke brewers accounted for 50% of craft volume; in 2016, they generated only 36%. Goose Island is among the 10. It's the biggest brand in ABI's artisanal portfolio, representing half of the company's total craft volume. Goose Island had a growth spurt from 2011 to 2016—up by an average of 32% per year—but has lately fallen flat. In the final three months of 2017, volumes showed a year-over-year decline of 2%, according to recent Nielsen market data.

True to form, ABI is not suffering alone but is insisting that its suppliers partake in its difficulties, too. For instance, the company is taking more than seven months to pay its bills (on a consolidated basis according to financial statements for the 12 months ended June 30, 2017). "It's their textbook," Rodrigo Furtado, analyst at São Paulo–based XP Gestão de Recursos Ltda., tells Santin. "ABI takes 300 days to pay off suppliers here in Brazil." This is becoming common practice as competitors catch on: Heineken's latest data on June 30, 2017 shows 185 days of trade payables, up from 50 to 60 days to pay suppliers until 2012; similarly, Molson Coors Brewing Co. now pays in 80 days, up from 40 to 65 days until 2014. ABI seems to be approaching the limit on this type of financing and won't see much further benefit from it: Trade and other payables footed $21.4 billion versus $6.2 billion from receivables on June 30, 2017.

"Assuming," Santin supposes, "that Bloomberg consensus estimates are correct for 2018, free cash flow, after dividends, will weigh in at $4.5 billion, total debt at $120 billion and debt-to-EBITDA at 5.7 times. The latter could be higher if we were to include past income and VAT taxes in Brazil that authorities are claiming the company didn't pay ($15 billion, up from $7 billion at the end of 2015), which ABI still classifies as possible, but not probable and therefore is off the books."

Two ratings agencies are of two minds. From a Nov. 29, 2017 Moody's opinion: "ABI has a long track record of successfully integrating acquisitions. Importantly, senior management has articulated publicly that it will prioritize deleveraging, continuing to target net debt to EBITDA (company's definition) of 2x. This helps to support a relatively high rating despite leverage metrics that will be in speculative-grade territory for several years." Bottom line: A3 with a "stable" outlook.

Our convictions align a little more closely with those of Claire Mauduit-Le Clercq from S&P, who likewise rates ABI a weak single-A. However, sensibly, she also last year lowered the ABI credit outlook to negative, citing "higher-than-expected pro forma leverage at year-end 2016." As for us, we judge that there is a good chance of operational disappointment, therefore of ratings disappointment. As the market is seemingly willing to admit no possibilities but happy ones, the downside risks are palpable.

"What would happen," Santin muses, "if there were an unscripted rise in interest rates, or a surprise widening in credit spreads? Or if the emerging markets, which furnish half of ABI's EBITDA, were to run into the kind of economic trouble that translates into less beer-drinking?

A 200 basis-point spread widening would wipe out more than five years of income for the 2.7s of 2026 and three years for the 3.65s of 2026. And it's not like creditors demand much of a term premium. The ABI euro-denominated 3¼s of 2033 change hands at 117 to yield 1.98% (108 basis points wide to the bund)."

Artificially suppressed interest rates produce a feeling familiar to drinkers—weekend drinkers only, mind you—of more than a little fine craft beer. It's rapturous at first, and so it remains for a time. But finally you go home and go to bed, and then it's Monday morning. Monday is dawning for mispriced corporate credit.

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