GRANT'S
INTEREST RATE OBSERVER®

Vol. 36, No.22d | Two Wall Street, New York, New York 10005 • www.grantspub.com | NOVEMBER 16, 2018

Returns to adversity

From the Great Depression till the Great Recession, nothing was more certain than the GE dividend—it would never be cut, the world believed. Last month's reduction in the quarterly payout to one lonely penny from 12 cents a share was the third such reduction in a decade. It was symbolic of a new seeming certainty, namely, that Thomas Alva Edison's corporate brainchild is sick unto death, that perhaps nothing can save it or its dividend and that the once unthinkable possibility of the extinction of the great General Electric Co. (GE on the Big Board), original 19th-century component of the Dow Jones Industrial Average (but ejected in June), is in fact a looming probability. We write to sing the praises of one particular high-yielding security: the GE 5%, Series D perpetual preferred stock (CUSIP: 369604BQ5); $5.7 billion is outstanding.

Longtime readers have not encountered an upbeat line on General Electric in these pages since Jay Diamond correctly concluded 28 years ago that Jack Welch's company was riding for a fall (see the issue of *Grant's* dated Sept. 14, 1990). If we were early, we were persistent. "The most imperfect investment," we called Jeff Immelt's company in 2002.

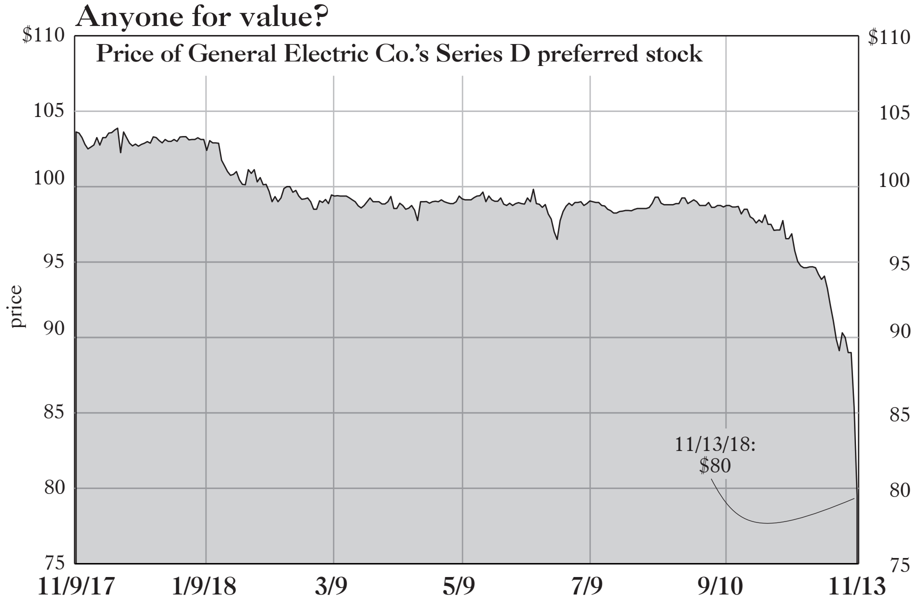
News of a $50 million payment to the Securities and Exchange Commission to settle charges of book-cooking in 2009 (in the service of those many splendid years of certain stair-step rises in quarterly earnings) ran out under the headline, "Under the cloak of respectability." The then-triple-A-rated GE had refinanced its imprudently immense commercial paper outstandings only by the grace of the U.S. Treasury. "Some day," we ventured,

> financial historians will try to make sense of it all: the mere existence of a $100 billion GE commercial paper program (the number today seems incredible); the ideal of "shareholder value" carried to the point of alleged institutionalized fraud; an industrial company recreating itself as a highly and precariously leveraged financial institution with nary a peep of protest from the stockholders; the close brush with insolvency of a company still bearing the imprimatur, triple-A. Finally, the historians of the future will scratch their heads to understand why Jack Welch and Alan Greenspan, icons of the late 20th century, put so much stock in an idealized "stability" that can only appear to exist in a dynamic world but can never be present in fact.

Whether the new broom, H. Lawrence Culp, Jr., the first outsider to lead GE since Edison's time, can draw a line under the financial failings and moral squalor of the old regime remains to be seen. We focus on the narrower question of ways and means.

Those 5s, which change hands at 80 cents on the dollar, are callable in January 2021 at the $1,000 a share par value. Late on Tuesday, the securities yielded 16.2% to call, or 1,335 basis points over Treasurys. If the issue is not called in two years, the coupon would reset semiannually to three-month Libor plus 333 basis points. In such a case—using today's price and the market's best guess of the

Anyone for value?



source: The Bloomberg

2021 Libor rate, which is 3.2%—you, the intrepid speculator, would earn 8.2% in current yield.

And that 8.2% is reckoned before tax. The preferreds are eligible for qualified dividend-income treatment, meaning they are taxed at the long-term capital gains rate, rather than the higher, ordinary income rate (*Grant's*, May 4). Hence, a high-earning New Yorker subject to the marginal tax rate of 53.5% on regular corporate fixed income (37% to President Trump plus 8.82% to Gov. Cuomo plus 3.88% to Mayor de Blasio plus 3.80% to the Treasury for the Obamacare surtax) would instead face a 36.5% tax rate. To match the aforequoted, hypothetical 8.2% on the GE 5s, you would need a 11.1% yield on a security not so advantaged. We judge that the preferred is amply covered by assets from the dominant aviation business as well as by management's declared commitment to debt reduction.

The tape is crowded with GE analyst recriminations, including, last Friday, the broad suggestion that $9 billion in cash plus $40 billion in revolving credit is a somehow inadequate level of corporate liquidity. It is more than adequate, we think. However, there's no gainsaying the trouble embedded in certain contingent liabilities, in the run-off insurance operations and in the faltering power segment. In the light of these vulnerabilities, we continue to give wide berth to GE common.

At a yield of 5.3% over eight years, we find the GE debt uninteresting as an investment, though eloquent as a reminder of the impermanence of earthly things. Rated triple-A since 1956, GE was still at the top of the tree in 2008 when—except for the intercession of the federal Commercial Paper Funding Facility, the Temporary Liquidity Guarantee Program and the Federal Deposit Insurance Corporation—the then-illustrious blue chip may have failed. Now, after the misadventures not only of the past decade but also of the two decades preceding the past decade, the debt is appraised triple-B-plus; $110 billion is outstanding.

Besides GE Capital, there are seven business segments. They produce, among other things, gas and steam turbines, generators, onshore and offshore wind turbines, oil and gas services and equipment, jet engines, X-rays, MRIs, CT scans, locomotives and light-emitting diodes. In the nine months ended Sept. 30, the company, GE Capital included, collected $88.3 billion in consolidated revenue, up 2% year-over-year, but showed a loss of $23.3 billion against a year-earlier profit of $2.1 billion. A $21.9 billion goodwill impairment, and other supposed one-off restructuring charges, did the damage.

"Even a would-be bull may feel inundated and discouraged by GE's mind-numbing 220-page 10-K," relates colleague Fabiano Santin, who has actually studied it. "It's filled with an awkward mixture of vastly different businesses, each with its own intricate accounting methodology, not to mention the less-than-welcoming three-page introduction to the section on management discussion and analysis packed with jargon, definitions and non-GAAP metrics. Same with the 10-Q: Reading it, you wonder how the accountants assembled, within 30 days of quarter-end, a balance sheet that now foots to $312 billion. About a third of those consolidated assets belong to GE Capital, the balance to what is known as GE Industrial. It's a sort of pointless exercise to look at consolidated financial metrics given all the moving parts and the changes that the business is undergoing.

"The sanest way of analyzing GE," Santin goes on, "is to separate the industrial business from GE Capital. Aside from financing new and used aircraft to hundreds of customers in more than 75 countries, GE Capital is also providing financing for renewable energy and power-plant projects around the world."

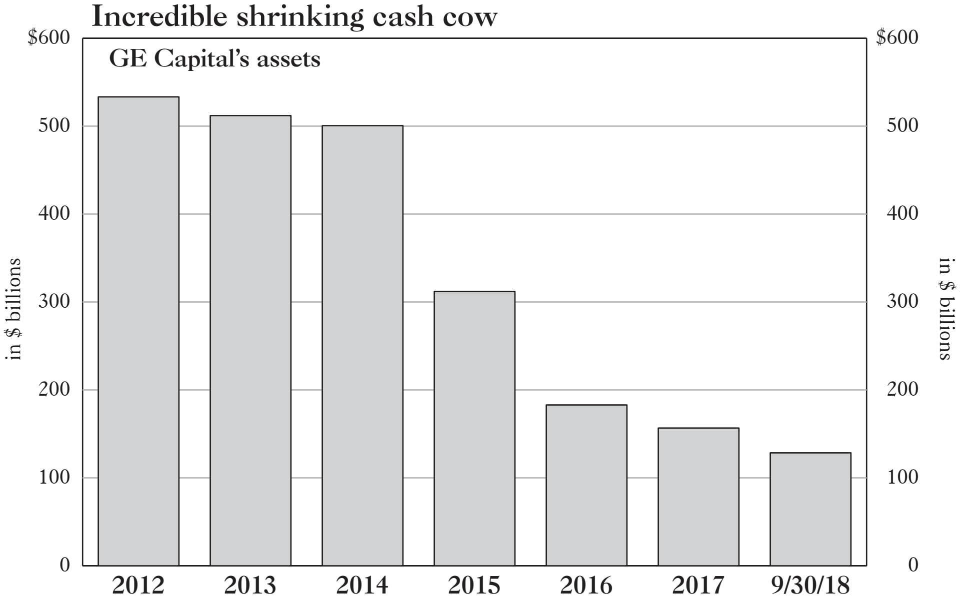
Customer finance is unobjectionable enough. Other financial business lines have proved more than objectionable. One such rotten apple is what remains of WMC, the now discontinued subprime-mortgage-issuing subsidiary. WMC is a defendant in pending lawsuits for alleged breaches of representations and warranties on loans it packed into now defunct residential mortgage-backed securities. The former subsidiary is likewise in the sights of the U.S. Justice Department in connection with an investigation into possible fraud under the Financial Institutions Reform, Recovery and Enforcement Act of 1989, a.k.a. FIRREA.

WMC has reserved $245 million to repurchase deficient mortgages and $1.5 billion against a future settlement of the DoJ probe. You'd suppose that, after installing its second CEO in less than two years, the front office would take a conservative approach in making such calculations. Anyway, $4.7 billion in assets support $1.9 billion in WMC liabilities, including the aforementioned reserves.

The company's run-off insurance operations constitute a less tractable problem. When the parent peeled off a clutch of insurance holdings in 2004, calling the IPO "Genworth Financial Corp.," it retained liabilities for long-term-care insurance policies. Now—with adverse-claims experience piling up in an old block of policies—it dearly wishes it had retained nothing. Last year brought a near doubling in reserves against those claims, to $19.6 billion from $10.7 billion at year-end 2016.

Not surprisingly, then, the old GE cash cow has run dry. From 2015 through

Incredible shrinking cash cow



source: company filings

2017, inclusive, Capital paid dividends to the parent of more than $29 billion, while the parent turned around and spent $52 billion on share buybacks and dividends, even though the pension plan remained substantially underfunded. "This is a situation where these issues may have always been there," observes John Inch, senior analyst at Gordon Haskett Research Advisors, concerning GE's mess in toto. "It's only [because] they've decided to shut and shrink capital, that all of the real bad stuff is starting to come out of the woodwork."

Now the money will flow in the other direction—from the parent to GE Capital—given estimates that the old Genworth policies will require $15 billion in additional funding over the next seven years. A modicum of good news is that the industrial segment is expected to be on the hook for no more than $3 billion of this expected capital call (of which more below).

The shock of the insurance revelations knocked down the GE share price by 45% in 2017, wiping out $125 billion in market value and igniting a wildfire of lawsuits. Plaintiffs allege that the company made false and misleading statements that led to a delayed appraisal of proper reserves. The Securities and Exchange Commission, too, is investigating "GE's revenue recognition practices and internal controls over financial reporting related to long-term service agreements," in the words of the new 10-Q.

At this early stage it's not clear whether plaintiff shareholders will ultimately prove that GE defrauded them by knowing and not disclosing the information earlier. "[Plaintiffs] largely rely on circumstantial evidence to support knowledge allegations," Holly Froum, Bloomberg Intelligence litigation analyst, tells Santin. "Their witnesses don't say they communicated with anyone in management or even close to management regarding alleged accounting problems."

Shareholder losses could top $100 billion, based on GE's plunge in market value over the relevant period of 2013 to late 2017. More-reasonable estimates put a hypothetical judgment closer to $2.5 to $5 billion, says Froum, based on historical data compiled by litigation consultant Cornerstone Research, Inc. A Swedish public pension fund, Sjunde-AP Fonden, is the court-appointed lead investor in the suit and alleges losses of only $21 million.

Leverage metrics as of Sept. 30, 2018

GE Industrial*

debt	$39,900 mn
pension deficit	22,271
operating lease	3,700
total debt	65,871
cash	-9,062
net debt	56,809
planned debt reduction	25,000
pro forma net debt	31,809

GE Capital

assets	$128,503 mn
liabilities	116,831
equity	11,672

* Excludes debt and operating lease of Baker Hughes.
source: company filings

Deleveraging is the action plan for GE Capital. As it is, the unit owes $70.3 billion against $11.6 billion in equity for a 6:1 debt-to-equity ratio. To reduce that ratio to 4:1 over time, GE says it plans to contribute the aforementioned $3 billion next year, though there can be no ruling out a call for additional long-term-care reserves, with a concomitant demand on the parent for still more capital. "To its credit," Santin comments, "GE did hire two outside consultants to develop the latest insurance reserve model. Auditor KPMG and the Kansas Insurance Department, which oversees the business, have blessed the calculations. Potential fines by the SEC, or the shareholder lawsuits, neither of which have been reserved for, would most likely fall on the shoulders of GE Industrial."

"Hence," Santin concludes, "based on the latest financial estimates, which include the already noted reserves but not the upcoming $3 billion capital injection, GE Capital is solvent with $11.6 billion in equity. Nor is liquidity a problem: Capital shows $13 billion in cash plus $34 billion in investment securities (mostly from corporate bonds, as you would expect from an insurer or financing company with long-term liabilities) to cover $11 billion in short-term borrowing."

The industrial half of the business alone owes $40 billion, which, with the $22 billion pension deficit, makes $62 billion. Add another nearly $4 billion from operating leases, and the grand total reaches $66 billion. Omitted in this tally is the $5.9 billion in preferred stock outstanding (including $250 million in Series A, B and C preferreds that weren't exchanged into the Series D in January 2016). From the vantage point of the preferred investors, what's of interest is the debt above them in the pecking order of the capital structure, as well as the asset coverage that would remain after the senior creditors take what's rightfully theirs.

The $9 billion cash balance on Sept. 30 brings net debt on the industrial side to $57 billion. Liquidity seems reasonable given the cash on hand and the $40.8 billion available from committed revolving-credit facilities (half due in 2020 and the other half due the following year). If needed—the credit lines are undrawn—bank debt could be used to pay down the $3 billion in remaining commercial paper outstanding; GE is effectively shut out of the paper market after the latest round of credit downgrades.

The industrial portion of the business has its own problems. GE Power, vendor of gas turbines and generators, reported $20.5 billion in revenues for the first nine months, down 21% from a year ago. This was the segment responsible for the aforementioned $21.9 billion non-cash goodwill impairment mostly due to the 2015 acquisition of assets from rail-transportation multinational Alstom Holdings S.A. of France. The Justice Department has expressed an interest in this massive goodwill charge.

Even excluding this impairment, GE Power saw operating income drop to $64 million in the year to date, down from $1.9 billion in the equivalent period of 2017. The segment had generated $5.1 billion in operating income in 2016 before stumbling to $2.8 billion in 2017 and the abysmal showing this year. Nor has GE Renewables exactly shot the lights out, producing just $220 million in year-to-date operating income, down 51% from the same span in 2017.

Then, again, much of the bad news is already out—including, lest we forget, the $913 million that GE set aside in 2015 as a reserve against the future costs of settling bribery allegations against the Alstom businesses in various jurisdictions from a time before GE acquired them. And it appears that the front office does understand the gravity of the problems. More to the point, it is, indeed, addressing them.

"In June," Santin notes, "then-CEO John Flannery announced a plan to simplify the company by divesting various businesses and focusing only on selling jet engines (GE Aviation), wind turbines and blades (GE Renewables) and power-plant turbines (GE Power). The strategy is, first, to fix the power and renewable-energy businesses while milking the marvelous aviation segment. Assets on the block are expected to cut net debt of GE Industrial by $25 billion in two years and drop its net leverage to 2.5 times from 3.9 times adjusted earnings before interest, tax, depreciation and amortization (EBITDA). Management furthermore declares its intention to regain a single-A credit rating."

To deleverage, GE plans to spin off 80% of GE Healthcare, the standout maker of diagnostic imaging equipment that pocketed $2.5 billion in operating income for the first nine months of this year; the spun-off entity would carry with it $16 billion of GE Industrial debt. Another $9 billion in debt would be erased by cash extracted from divestitures and internally generated funds. As to the former, GE's $16 billion stake in majority-owned Baker Hughes (BHGE on the Big Board) is one potential candidate. If the grand plan is properly executed, net debt would drop by at least $25 billion in the next two years, to $32 billion from $57 billion on Sept. 30.

In a Monday interview with CNBC's David Faber, Culp reiterated GE's intention to prioritize deleveraging through asset sales. The 6.8% plunge in the price of the common that day attests to the clarity of his message, which included the possibility of monetizing a 49.9% stake of GE Healthcare instead of the 20% previously announced. On Tuesday, GE and Baker Huges disclosed the release of lock-up restrictions that had prevented GE from disposing of BHGE stock prior to July 2019; 20% of GE's holdings are expected to go on the block within six months.

Hardly had Flannery found his way to the executive wash room when, on Oct. 1, H. Lawrence Culp Jr. came on to replace him. The CEO of Danaher Corp. from 2001 to 2014, Culp ingratiated himself to that company's shareholders by helping to bring about a 465% total equity return over the course of his tenure, compared with 105% for the S&P 500.

Accident-prone as it is, GE can't claim the benefit of the doubt about much of anything. Let us assume, then, for the sake of argument, that the power and renewables businesses are worthless. Even so, one can make a plausible case that the world-beating aviation segment could itself service GE Industrial's debt. GE Aviation designs and manufactures jet engines for commercial and military aircraft worldwide. The corporate stratagem is to sell these units at low margins while generating cash from decades-long maintenance contracts.

Commercial aviation traffic has grown at an average annual rate of more than 5% over the past decade, and bolder prophets than we forecast no drop-off over the next 20 years. Some, indeed, contend that 5% is paltry, inasmuch as, over the past seven years, growth has never been as low as that figure and has ranged as high as 8.1%, according to data from the International Air Transport Association. GE generated $27.4 billion in aviation sales in 2017, up from $24.7 billion in 2016. Sales rose to $22.1 billion in the first nine months, up 12% year-over-year. The Sept. 30 backlog measured $211 billion.

Just how gaudy a jewel in the GE crown is the jet-engine segment becomes apparent by noting its nine-month operating margin of 21.5%. Compare with the field: 8.6% for Rolls-Royce's aerospace segments in 2017, 6.6% for Pratt & Whitney in the year to date. The GE aviation division has delivered operating income in the following sequence: $5.5 billion in 2015, $6.1 billion in 2016, $6.6 billion in 2017, $4.7 billion in the first nine months of 2018 (compared with $4 in the like period of 2017).

"Inch estimates 2019 adjusted EBITDA for the segment at $5.8 billion," Santin relates. "Using a peer average multiple of 11 times enterprise value to EBITDA implies a business worth $64 billion on the hoof, twice the aforementioned $32 billion in net debt ahead of the preferred (this also illustrates the $32 billion in excess assets, just from the aviation segment, that exist to cover a potential shortfall in GE Capital). It's for others to decide whether the valuation multiple should be 8 times or 12 times. We aim only to show the strength of the asset coverage, not how much one should pay for an industrial stock at what is certainly not the cyclical low ebb.

"Today's interest coverage defined by adjusted EBITDA over interest expense stands at 3.3," Santin continues. "EBIT over interest expense, the better, more conservative (and, for that reason, less frequently cited) coverage metric, comes to 2.1."

Another way of evaluating the protection afforded the preferred is, of course, to observe the common beneath it, some $75 billion worth (down from a 2000 peak of $594 billion). Over the past 12 months, Loews Corp. has invested $59.8 million in those shares. Not coincidentally, the Loews CEO, Jim Tisch, holds a seat on the GE board. Culp himself bought $2.5 million worth in July and another $2.2 million, after one of the latest sell-offs, at an average price of $9.73 a share. Sell-side analysts' sentiment ranges from 9 buys, 12 holds and 3 sells, including Inch.

The dividend on the 5s is non-cumulative—should the directors eliminate the preferred payout, the arrearages would have no other significance than measuring the investors' disappointment. Then, again, the preferred dividend costs less than $300 million a year, about 5% of analysts' estimated 2019 free cash flow and less than the $347 million dividend bill for the common.

The GE directors have other incentives to stand by the preferred. If that dividend went unpaid for three periods, the aggrieved investors would be entitled to add two directors to the board, which currently numbers 11. Besides, suspension of the preferred dividend would force suspension of the common dividend, too. There was a reason that the directors chose to continue to pay a penny a share rather than nothing. It was to retain in the shareholder constituency the investors who may not hold non-dividend-paying securities (there are "a lot" of them, Santin was told).

"Since Flannery was ousted and Culp came on board," Santin winds up, "the triple-B-minus-rated preferred shares are down by 17 points to 80 cents on the dollar while the triple-B-plus-rated senior bonds trade on the verge of junk. Since the preferred is rated by credit agencies two notches below senior debt, a downgrade in the bonds would take the preferreds into junk territory. This could be a reason for the current weakness in these junior securities, as those who can't hold high-yield debt prefer not to wait around. The 5s' largest holder, the Vanguard Short-Term Investment Grade Fund, owned $490 million of face amount as of Sept. 30, or 8.5% of total outstanding, which was the fund's largest credit security exposure—although it represented only 0.8% of fund assets. Perhaps the Vanguard managers, having no stomach for the publicity that would attend a downgrade, have already trimmed their exposure. In any case, investors seem well-compensated with double-digit returns. Although Culp ruled out any equity raise at the moment, he could always change his mind and ask for the return of some of that $52 billion heap of cash with which the C-suite showered the shareholders over the past three years."

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