GRANT'S
INTEREST RATE OBSERVER®

Vol. 39, No. 11b | 233 Broadway, New York, New York 10279 • www.grantspub.com | JUNE 11, 2021

Bet on the lady

Evan Lorenz writes:

Since May 13, the Goldman Sachs index of loss-making tech stocks has leapt by 21.4% and the *Grant's Interest Rate Observer* SPAC Index by 51.5%, but the speculative rager has yet to jump the Atlantic. At least, there's no sign of it in the shares of a certain maligned German steelmaker cum industrial conglomerate. In preview, *Grant's* is bullish on ThyssenKrupp A.G. (TKA in Germany and TKAMY in the United States).

Let there be no mistake: Our pick to click in no way resembles a Treasury bill, and the ensuing analysis may or may not scatter the bears. Recent disclosure of surprisingly strong earnings for the March quarter triggered not a rally but a three-day 16.1% plunge. "There are a lot of people who, because of the past, effectively write it off," Alan Spence, who rates the stock a buy for Jefferies International Ltd., tells me.

It's the recent past that investors would rather forget. ThyssenKrupp came into existence on March 17, 1999 through the merger of Thyssen A.G. and Fried Krupp A.G. Hoesch-Krupp, but the underlying businesses trace their roots back to the start of the 19th century. From such technologically humble origins as barrel-hoop making, the founding companies went on to steelmaking and parts manufacturing for railroads (1847), guns (1859) and diesel engines (1906). Krupp was an HR pioneer (its pension fund dates from 1855, a company-owned hospital from 1870), and Thyssen, much the larger of the two, built an international trading network to source raw materials and ship finished products, armaments included.

While ThyssenKrupp is best known for its steel division, that business unit generated only a quarter of the January-March top line. Five other subsidiaries do business under the corporate roof: material services (32% of sales), which sources, warehouses and manages inventory and raw materials; automotive technology (13%), which creates parts and systems for axles, steering assemblies, camshafts and auto bodies; industrial components (7%), which makes bearings and forged products such as crankshafts and axles; marine systems (8%), which manufactures non-nuclear submarines and surface vessels for both civilian and naval use; and a miscellany of businesses designated for sale or closure (16%), about which more later. In the fiscal year ended Sept. 30, 2020, the company employed 104,000 workers and generated €28.9 billion in revenue from continuing operations.

ThyssenKrupp was once the fourth-largest maker of elevators in the world, but the lift unit fetched €17.2 billion, or 18.7 times trailing Ebitda, in a sale to the private-equity shops Advent International and Cinven Ltd. last summer.

As to the chronic underperformance of the TKA share price, look no further than the missteps of the ThyssenKrupp front office. Foremost among these errors was a mistimed entry into the Western hemisphere's steel market—at a cost of €12 billion, double the company's current market cap—in 2005, two years before the Great Recession. Huge losses and an overencumbered balance sheet were the principal returns on that investment.

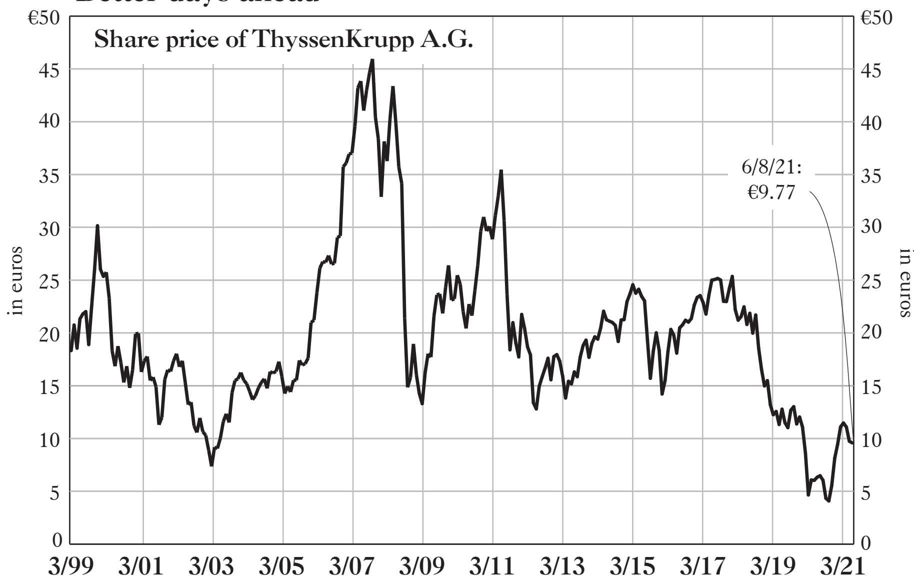
In its first decade as a combined company, ThyssenKrupp generated €4.7 billion in free cash flow. In the subsequent 11.5 years, which takes us to March 31, 2021, the same company suffered a free-cash-flow deficit of €11.2 billion, including the costs of exiting those ill-fated steel operations, one in Mobile, Ala., the other in Rio de Janeiro.

Since its retreat from the Americas, ThyssenKrupp has resolved to do better. It has restructured and transformed itself, or tried to, including in 2018. That anticipated transformation would have merged the European steel business with Tata Steel Ltd. at an expected cost savings of €500 million a year. There were going to be two ThyssenKrupp public companies, one for the automotive-technology, industrial-plant-construction and elevator segments of the business, the other for material services, marine systems and remaining assets, including a 50% stake in the Tata joint venture.

But the European Commission blocked the Tata merger in 2019 and thereby scuttled the plans to divide the company. September of the same year delivered the one-two punch of TKA's eviction from the DAX blue-chip index, of which ThyssenKrupp had been a founding component, and the discharge of CEO Guido Kerkhoff ("terminated by mutual agreement"), who had come up with the aborted Tata strategy and oversaw no fewer than four profit warnings in just 14 months on the job.

Then there's the matter of ThyssenKrupp's pension liabilities, which totaled €10.6 billion as of Sept. 30, 2020 compared to plan assets of just €2.5 billion. The U.S. Pension Protection Act of 2006 requires single-employer plans to fund pension obli-

Better days ahead



source: The Bloomberg

gations fully over time, but there's no such requirement in Germany. "It's this weird thing with the German companies," says Spence. "I've heard [German executives] refer to the pension liabilities as silent debt, and they're totally comfortable with it."

So, although net cash summed to €3.8 billion as of March 31, ThyssenKrupp is rated B1 by Moody's Investors Services and double-B-minus by S&P Global Ratings on account of those post-retirement obligations. Low pension-funding levels mean that (after a pension service charge on earnings) the company pays benefits primarily out of current income; for the time being, the annual cash pension outlay amounts to €400 million per year, but, as three-fifths of obligations are owed to retirees with an average age of 77, the mortality tables point to a gradually shrinking burden.

Taking one thing with another, then, you can hardly blame European investors for giving the fisheye to Thyssen-Krupp's latest attempt at corporate reinvention. For us, we judge that the stock trades at a commandingly cheap valuation and that management may finally be taking the steps required to set things right.

On Oct. 1, 2019, Martina Merz, 58, became the new CEO. Merz had joined the steel conglomerate 10 months earlier as chair of the supervisory board. She previously served as the CEO of Chassis Brakes International and as an executive vice president of auto supplier Robert Bosch GmbH.

The base salary of the "most powerful woman in the German economy" is set at €1.34 million but can rise to €9 million if she hits performance targets that would please most readers of the proxy statement. Short-term incentives are based 35% on net income, 35% on free cash flow before M&A and 30% on overall strategy. Longer-term incentives are 30% weighted to ThyssenKrupp's stock performance versus the Stoxx 600 Basic Resources index, 40% to return on capital employed and 30% to sustainability goals. As CEO, Merz is required to buy shares equal to one times her base salary.

Bullish things started to happen right out of the gate, including, in November 2019, revocation of the dividend in the interest of conserving cash. Here was a diplomatic coup as well as a financial improvement, as the Alfried Krupp von Bohlen und Halbach Foundation, owner of 21% of the shares outstanding, counted on that income to fund its charity work.

Merz has reduced the number of consolidated subsidiaries to 331 as of Sept. 30, 2020, from 456 at the end of fiscal 2019. She has pledged to reduce headcount by 12,000, from 104,000, and expects that 60% of these layoffs will happen by Sept. 30. On conference calls, she says she's trying to make Thyssen-Krupp nimbler and more entrepreneurial.

"There is no denying that management has gone at this thing with a hatchet," Steven Grey, CEO and eponym of Grey Value Management, LLC, which holds a position in ThyssenKrupp, tells me. "They've made a tremendous amount of progress, and I think that is one of the reasons why they got the Krupp Foundation to sign off on the dividend cut."

Having sold the elevator division for a premium price in the middle of the pandemic (thereby substantially recapitalizing ThyssenKrupp's balance sheet), Merz is rebuilding the company around three core businesses: material services, industrial components and automotive technology. She has designated the steel and maritime business for sale or retention, and other corporate odds and ends (which deliver the aforementioned 16% of revenue) for sale or closure.

Of the 10 units in that last-named category, five are expected to be resolved soon, according to investor-relations spokesperson Rainer Hecker. They include a heavy-steel-plate division slated for shuttering as well as three subsidiaries marked for sale: an Italian stainless-steel plant, an infrastructure business (tools and components for heavy construction) and a mining business (heavy equipment). A May 20 report by a trio of Credit Suisse analysts led by Carsten Riek estimates that the stainless-steel and mining units together could be worth €1.1 billion to €1.6 billion.

ThyssenKrupp Uhde Chlorine Engineers could prove to be another trove of value, according to Riek et al. Though its top line reportedly sums to less than €100 million a year, it is the world leader in building plants to produce renewable, or "green," hydrogen—an energy source whose name alone commends it to 21st-century consumers and investors. The Credit Suisse team finds that this unit might command €2.8 billion based on where other promising green companies are trading. On the May 11 earnings call, Merz told dialers-in that she is actively pursuing a partial sale of the hydrogen business, of which ThyssenKrupp owns 66%, and is even considering selling a stake to a special purpose acquisition vehicle.

On that call, Merz also told analysts that the steel division "has better opportunities" to develop as an independent company. Cyclical problems are partially to blame for the unit's underperformance in recent years. "That division alone used to do €1 billion [in annual Ebitda]," Spence tells me. "This was considered a large-scale producer in the region with good margins and good-quality business and high exposure to flat steel and automotive, kind of the areas you want to be in. Then European auto demand rolled over for two years, and then 2020 was 2020."

The European Union's focus on the environment may benefit the steel sector. Reducing the carbon footprint of basic materials like steel is expensive, and the EU does not want domestic producers to lose business to exporters with lax pollution standards. On June 3, Bloomberg reported that the 27-country bloc is planning to slap levies on imported steel, cement and aluminum.

For European incumbents, this could hold a double benefit: First, the costs to upgrade steel mills to meet environmental best practices could force the closing of marginal facilities—a boon to an industry that has dealt with chronic over-capacity. Second, the proposed tariffs should protect European competitors from cheap, ungreen producers in places like China.

Interest rates, too, come into play with ThyssenKrupp; the company would gain from higher rates. As things stand, management is using the yield on local double-A-rated corporate bonds—0.88%—to discount its pension liabilities. For every half-point rise in rates, the pension deficit would shrink by €719 million, or 9% of the total.

While ThyssenKrupp's exact financial position is improving, the ongoing sale and restructuring of noncore businesses makes it hard to determine by just how much. As of March 31, net debt, including pension deficits, totaled €4.4 billion or 2.9 times the consensus estimate for 2021 Ebitda. Disposition of unwanted subsidiaries not only brings in cash, but also transfers the associated pension liabilities to the new owners. Businesses designated for sale or closure show a combined pension deficit of around €1 billion. As the steel unit alone carries €4 billion, the spinoff of that subsidiary would leave ThyssenKrupp with a balance sheet that even Moody's could admire.

Excluding the pension deficit, the shares are valued at 1.5 times enterprise value to estimated 2021 Ebitda and 1.2 times to the 2022 guess. Including the pension obligation, the stock changes hands at 6.9 times 2021 Ebitda and 5.6 times the 2022 figure. Given the pace of asset sales and spinoffs, a value in the middle of those reckonings is probably reasonable. Of the 17 analysts who rate ThyssenKrupp, 12 say buy and one says sell.

On the May 11 earnings call, Merz declared that her focus is on "speed, speed and, again, speed. And, I do ask for your understanding that you will not hear much from us in the upcoming months. We simply are busy working, and our focus clearly is on doing rather than talking." At that, she sounded a little like Margaret Thatcher.

ThyssenKrupp at a glance

all figures in € millions except per share data

	TTM*	FY 2020**	FY 2019	FY 2018	FY 2017
sales	€28,922	€28,899	€34,036	€34,777	€33,993
operating profit	-4,434	-5,260	-515	472	684
net income	10,589	9,592	-260	60	-591
shares	623	623	623	623	566
earnings per share	16.95	15.40	-0.05	0.01	-1.15
cash	9,742	11,547	3,706	3,006	5,292
debt	5,522	6,502	7,415	5,376	7,256
non-controlling interest	439	364	469	468	515
pension obligations	8,151	8,560	8,947	7,838	7,924
total assets	136,134	36,490	36,475	34,426	35,686

* Twelve months ended March 31, 2021.
** Fiscal year ending Sept. 30.

source: company reports

. . .

Readers might wonder how this publication can be simultaneously bearish on AT&T, Inc., an overleveraged conglomerate that is selling off businesses to rightsize its balance sheet (see the issue of *Grant's* dated April 2), and bullish on ThyssenKrupp, which would seem to fit the same description. As a refresher, on Feb. 25, Telephone sold a 30% stake in its DirecTV unit to TPG Capital and, on May 17, announced a merger between the in-house TV and movie studios WarnerMedia and Discovery, Inc.

But there are two main differences between Ma Bell and ThyssenKrupp. First and foremost, AT&T's wheeling and dealing has scarcely dented the overall leverage ratio. At year-end 2020, the company showed net debt, including pension deficits, of $188 billion, or 3.6 times trailing Ebitda. "Despite reducing their debt load by a whopping $43B," Craig Moffett, who rates Telephone a sell and is one-half the nameplate of research firm MoffettNathanson, LLC, writes in a May 21 report, "the Warner Media transaction only reduces AT&T's leverage by 0.2x turns of Ebitda, leaving them levered at 3.9x, a level that is still above S&P's stated downgrade threshold of 3.7x."

Second, after the transactions close, AT&T will be focused on the secularly challenged mobile-phone business. The U.S. market is saturated—there are more phones than people—and upstart cable companies are taking share with their own cellular offerings. On top of this, T-Mobile U.S., Inc., which has long been the price leader in cell-phone plans, will be the fastest to deploy a nationwide 5G network, and at the lowest cost, thanks to the spectrum it acquired through purchasing Sprint Corp. in 2020.

In response to these competitive pressures, AT&T last fall began offering existing customers the kind of phone subsidies hitherto reserved for new signups. While this has slowed the company's customer churn, it has come at a cost: Average revenue per post-paid user fell 2.9% year over year in the first quarter. The disposal of stakes in DirecTV and of the WarnerMedia business also impacts Telephone's cash flow. The company expects to generate $20 billion in free cash flow after the asset sales versus prior guidance of $26 billion. Moffett, however, can't see AT&T producing more than $15 billion.

Unlike ThyssenKrupp, AT&T is so far refusing to suspend its long-sacrosanct dividend. While Telephone has said it will trim that quarterly payout to around $1.11 per share, from $2.08 following the WarnerMedia disposal, the dividend will nonetheless consume 40% of AT&T's guidance for free cash flow and 53% of Moffett's estimate. In either case, that leaves less cash at hand for debt reduction.

Meanwhile, competition appears to be hotting up, as Verizon Communications, Inc. last week began a promotional campaign that matches AT&T's. "Not going to be pretty, is it?" Moffett remarked to your correspondent via email.

•