GRANT'S

INTEREST RATE OBSERVER®

Vol. 35, No. 18c | Two Wall Street, New York, New York 10005 • www.grantspub.com | SEPTEMBER 22, 2017

Barrel roll

Greif, Inc., 140 years old, makes 55-gallon steel drums. We are bearish.

Greif (you say it "grife") makes more than metal barrels, and we have more to say than "steer clear." Dubious governance, environmental depredation, a stretched valuation and a vulnerable dividend fill out the bill of analytical particulars. Well do we know that most of the readers of these pages buy before they sell. Short-selling, in which the order of those operations is reversed, is an art to which few take naturally and at which fewer currently prosper. Still, we continue to find many more things to sell than to buy. What to do? We write about things to sell (while pledging that, when the risk-reward calculus flips, so will the analytical focus).

Founded in 1877, Greif is the largest manufacturer of steel and fiberglass drums in the world. It's the second-largest maker of plastic drums and the third-largest producer of intermediate bulk containers.

There's more: Greif is the world's No. 1 maker of the caps and closures that seal the drums. It owns two paper mills, six sheet-feeding operations and 244,548 acres of timber in Louisiana, Mississippi and Alabama. The forests date from the era in which Greif made its barrels from wood.

Greif has a $3.5 billion top line, of which the United States generates half. The drum business accounts for 70% of revenue, the paper-packaging unit 22% and the flexible-container subsidiary 8%. In the latest 12 months, $3.5 billion of revenue yielded $93.8 million of net income and $98.7 million in dividend disbursements. On the current stock price of $57.06, the $1.68 per-share dividend delivers a yield—to the class-A holders—of not quite 3%.

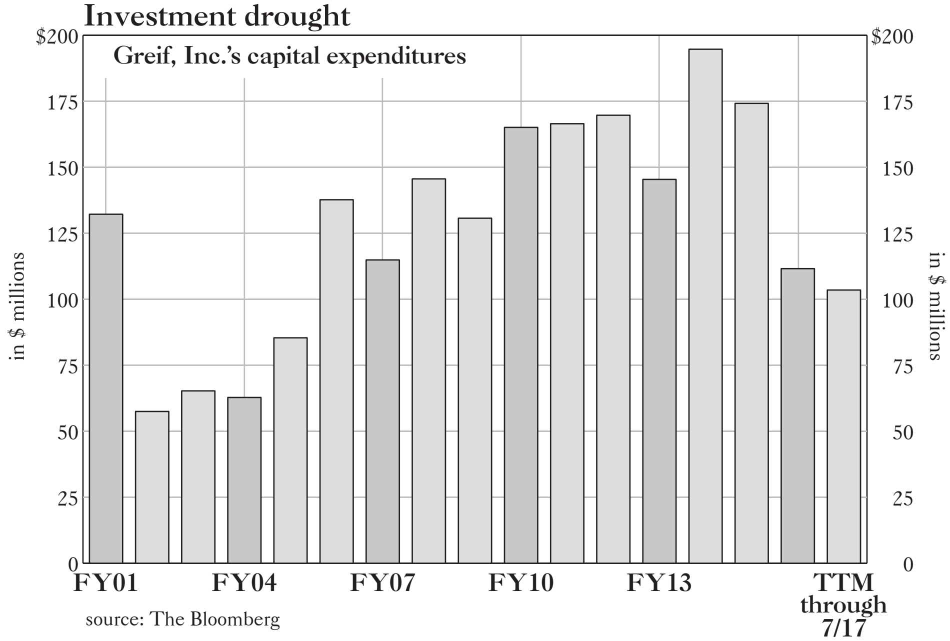
There are 25.8 million of the A shares, which have no vote. There are 22 million of the B shares, which do. Descendants of the founding family are the principal owners of the thinly traded B shares, which earn a 49% higher dividend than do the non-voting, publicly held A shares. The bifurcation dates to the IPO, which occurred when Calvin Coolidge lived in Donald Trump's house.

Making the things it does, and selling them the world over, Greif is a kind of one-company Purchasing Managers Index. There's not much technology in a 55-gallon steel drum, nor much intellectual property in the soft-sided luggage called an aggregates bag. So as industrial production goes, so goes Greif. It's the very stock not to own, and the very dividend yield on which not to depend, on the eve of a recession.

As to the next recession, its arrival is (as usual) unscheduled. Ninety-nine months into this peculiarly low-energy expansion, Greif changes hands at 29.1 times trailing GAAP earnings, 17.8 times trailing adjusted earnings and 9.9 times enterprise value divided by earnings before interest, taxes, depreciation and amortization (EBITDA). Each metric is near the highest of the past 10 years. Since February 2016, the Greif share price has more than doubled.

It can't be the lack of competition that drove it up. Greif's strong suit, steel and fiber drums, is losing share to cube-shaped receptacles—intermediate bulk containers, they're called—in which

Investment drought



Greif plays third fiddle to SCHÜTZ GmbH & Co. KGaA and Mauser Corp. So, despite the bounceback in commodity prices from their 2016 lows and the worldwide upswing in industrial production, Greif's "rigid"-packaging sales volume grew by only 0.4% year over year in the July 31 quarter. In the Asia-Pacific region, volumes fell by 14.1%.

Nor can the clarity of Greif's financial reporting explain the strength of the share price. "Restructuring" charges, and other such ostensibly nonrecurring blemishes, do, indeed, recur. They've amounted to 19.6% of cumulative adjusted pretax income since 2003. And in the Securities and Exchange Commission, the Greif front office has found an unwanted pen pal. Eight times since 2014, including once this year and twice last year, the SEC has written to demand that the management improve financial disclosure.

"Then," relates colleague Evan Lorenz, "there are surprises. In the first three quarters of fiscal 2016, Greif's tax rate came to 35.9% of pretax profits, less than the 44.3% rate in the first three quarters of 2015. Had Greif's tax rate declined? No. What had declined was the company's payment of what it lawfully owed. The shortfall was duly rectified in the fourth quarter of 2016, when taxes devoured 81.3% of Greif's pretax income.

How did Greif respond to this singular lapse? With a plea for understanding. CFO Larry Hilsheimer told dialers-in to the Dec. 8, 2016 earnings call that the commodity business is more complex than it may seem. Greif, he said, is "relatively complicated in structure because of the global nature of our business and us not having what we believe was appropriate controls on a worldwide basis in the tax area."

In the July 31 quarter, Greif reported $121.1 million in adjusted EBITDA, a 6.7% year-over-year rise but short of consensus expectations of $124.2 million. There was a footnote. Management said that the earnings growth rate was better than it appeared because the quarter a year earlier had gained from a $5.2 million insurance recovery.

It seemed that management had just remembered this particular $5.2 million benefaction. It had made no mention of it at the time. "I have never seen a company fail to disclose a material, nonoperational one-time benefit in one period," comments a short-seller who asks to go nameless, "and then have the audacity to selectively disclose that benefit a year later (and encourage investors to give them credit for lapping the benefit in the press release and conference call)."

Nor has the share price scaled the heights it has on account of Greif's delivering on its free cash-flow (FCF) predictions. Management, in fact, undershot for the second consecutive quarter in the three months ended July 31. "The Company maintained its fiscal year 2017 FCF guidance despite lower earnings and working capital expectations on account of lower capex and cash taxes; GEF's capex remains at very low levels," KeyBanc Capital Markets analyst Adam Josephson observes in an Aug. 31 alert.

Greif—GEF is the ticker—has indeed slashed capital outlays (see the nearby graph) but denies that it is underinvesting. On the Aug. 31 call, the CFO himself told Josephson that it wasn't true: "We ain't pulling back on capex," said Hilsheimer, "but when the manufacturers can't get us the machines on the dates that they told us they would, we're not going to pay them till we get [them]. So that's what's driving the drop in capex."

"Suppliers," Lorenz observes, "may fumble for a quarter or two, but Greif's level of capital spending has decreased for multiple quarters. Over the past 12 months, the company spent $103.5 million on capex, below the $121.3 million in depreciation and amortization charges. It was the lowest level of investment since fiscal year 2005, a time when Greif's sales amounted to $2.4 billion vs. $3.5 billion today.

"With this low level of business investment," Lorenz goes on, "Greif generated $144.6 in free cash flow over the past four quarters. Cash flows were flattered by a $23.2 million increase in factoring of accounts receivables, i.e., Greif's operations generated $121.2 million in underlying free cash. This would seem to be sufficient to cover the $98.7 million in annual dividend payments. However, if capital expenditures returned to their 5-year average of $159.1 million, free cash flow would fall to $65.6 million, below the level needed to support the dividend."

Rated double-B, Greif's balance sheet is moderately leveraged. Net debt foots to $1 billion, or 2.5 times trailing EBITDA. Operating profit covered interest expense by 6.5 times in the quarter ended July 31.

Fanning suspicion that the company is underinvesting is the investigative reporting of *The Milwaukee Journal Sentinel* in conjunction with *USA Today*. A long series of 2017 stories shone a harsh light on Container Life Cycle Management (CLCM), a company 80%-owned by Greif.

CLCM empties and refurbishes steel drums. Federal law defines an "empty" drum as one harboring no more than one inch of gunk on the bottom. CLCM, so the stories say, violated that rule. It likewise accepted barrels whose contents were too hazardous to allow for lawful shipping. And if that weren't enough, the published reports go on, workers in the CLCM plants dumped the waste down a floor drain, potentially contaminating local water and certainly not enhancing the health of workers, U.S. Environmental Protection Agency inspectors and neighbors.

The charges, many of them, stem from recorded conversations on CLCM property. The man with the recording device, Will Kramer, was a consultant to CLCM. He supposedly turned on his client upon deciding that plant managers, though alert to the bad practices, refused to fix them. Kramer has filed a whistleblower suit with the SEC.

The company says that the articles contains inaccuracies but declined to identify them. Securities analysts, mildly curious after the first *Milwaukee Journal Sentinel/USA Today* story broke on Feb. 15, asked no CLCM-related questions on the Aug. 31 call. A pair of EPA investigators became ill after investigating a CLCM plant in St. Francis, Wisconsin—*they*, at least, want some answers. The Wisconsin Department of Natural Resources and the U.S. Occupational Safety and Health Administration have opened investigations, and Senator Tammy Baldwin has made CLCM and Greif a pet cause.

If the share price seems slow to react, that may be a byproduct of the investor base. The passive investing giants Vanguard Group, BlackRock, Inc. and State Street Corp. hold 28.3% of Greif's outstanding shares. Greif is a component of such funds as iShares Russell 2000 Growth ETF, iShares Russell 2000 Value ETF and the Vanguard Equity Income Fund. Few are the analytical eyes searching the pages of the *Milwaukee Journal Sentinel*.

Greif faces two immediate sets of problems, at least. Environmental infractions could lead to fines and litigation. And as Greif's fortunes rise and fall with global industrial production, a bout of dollar strength or a slowdown in Chinese-led industrial activity could gnaw into volumes, margins and earnings.

The Street is friendly, though hardly bullish, with Bloomberg tallying three buys, three holds and one sell. Short interest amounts to 5% of the class-A shares. Over the past year insiders have net sold 18,833 class-A shares for proceeds of $1 million and purchased 13,396 class-B shares at a price of $803,863.

You wonder where Greif will be in another 140 years.

•