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Attack of the killer BBBs

In 2007, less than 40% of Citigroup's U.S. Broad Investment-Grade Corporate Bond Index was rated triple-B, i.e., the last (whole) stop before speculative grade. Today, about 47% is so classified. In 2007, the index held $1.7 trillion in securities. Today it holds $5 trillion. The meaning of these figures for credit and discredit is the topic under discussion.

At the *Grant's* Fall Conference last week, your editor observed that boom-time equity prices coexist, somehow, with depression-level interest rates and graveyard volatility readings. How to resolve this incongruity? He put the question to Alan Greenspan, who replied with a smile: "Good luck."

Good luck to the creditors, we say. On Sept. 15, Adam Richmond and his fellow Morgan Stanley strategists pointed out that, though credit spreads have tightened (suggesting that credit risk has diminished), idiosyncratic risk has risen. Thus, the dollar value of speculative-grade debt trading above 1,000 basis points over the Treasury curve has leapt by 74% since March, to $70 billion from $40 billion or so. The analysts likewise concluded that dispersion—the difference in performance among rating tranches or sectors of credit—is increasing. Stock jockeys may liken these phenomena to a deterioration in the ratio of advancing to declining issues. A ragged A/D line is no bull's friend.

If the credit cycle has turned—if the good news is behind us and the bad news ahead—the bulging supply of triple-B-rated corporate bonds is a risk to mark. Moody's finds that debt so rated has a 18% chance of suffering a downgrade to junk within five years vs. just 3% for single-A-rated bonds.

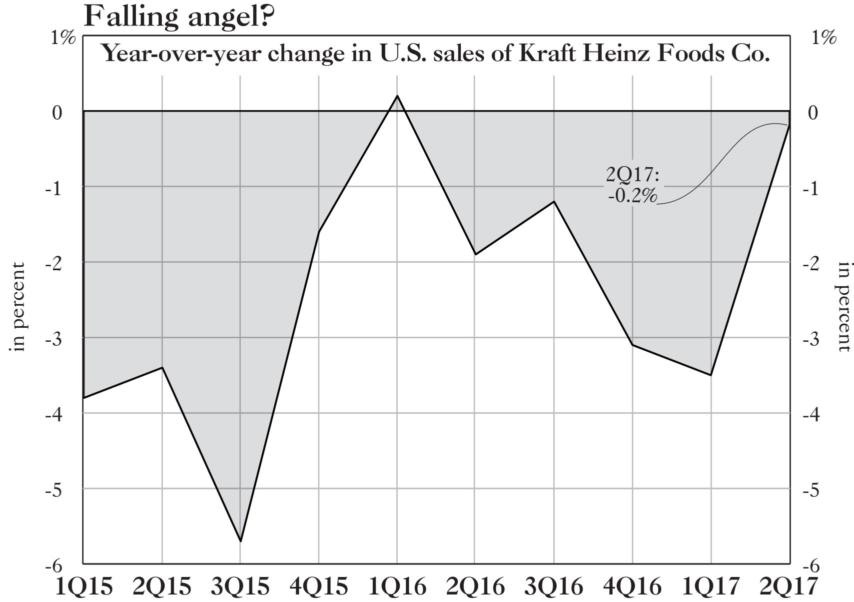
There's nothing secret about these observations, and a well-tempered market would reflect them in freely discovered prices. Following are profiles of a trio of triple-B-rated corporate bonds. We leave it to you, our noble readers, to decide if the ever-so-finite reward is worth the evident risk.

Our specimens are the Allergan Funding SCS 3.85% senior unsecured notes of 2024 (Baa3 by Moody's, triple-B by S&P), the Kohl's Corp. 4¼% senior unsecured notes of 2025 (Baa2, triple-B-minus) and the euro-denominated Kraft Heinz 2¼% senior unsecured notes of 2028 (Baa3, triple-B-minus).

The Allergan issue, of which $1.2 billion is outstanding, trades at 104.92 to deliver a 3% yield to maturity or an 85 basis-point spread from the U.S. Treasury's 2⅛s due 2024. The issuer is a subsidiary of Allergan plc, the famous maker of Botox (the source of one-fifth of corporate revenue), whose borrowings total $30.2 billion on a market cap of $66 billion.

Allergan (AGN on the Big Board)—you'll recall it fended off a takeover from our old friend Valeant Pharmaceuticals International, Inc. (*Grant's* Mar.7, 2014)—has racked up a long string of debt-financed acquisitions, in the process rendering its "adjusted" financials ever more obscure and achieving a ratio of debt to EBITDA (that's earnings before interest, taxes, depreciation and amortization) of 4:1.

Falling angel?



source: The Bloomberg

There is a short thesis on Allergan's debt, which an anonymity-seeking hedge-fund manager (he's short the bonds) conveyed to Fabiano Santin, a new addition to the *Grant's* staff. Allergan "is the poster child for acquisitions over the last five years," says the bear. "They paid close to $45 billion in acquisitions. Their biggest acquisition was Forest Labs, but they've bought a bunch of different businesses: Warner Chilcott and then some smaller acquisitions over the past several years. So this is a very large roll-up of different business lines."

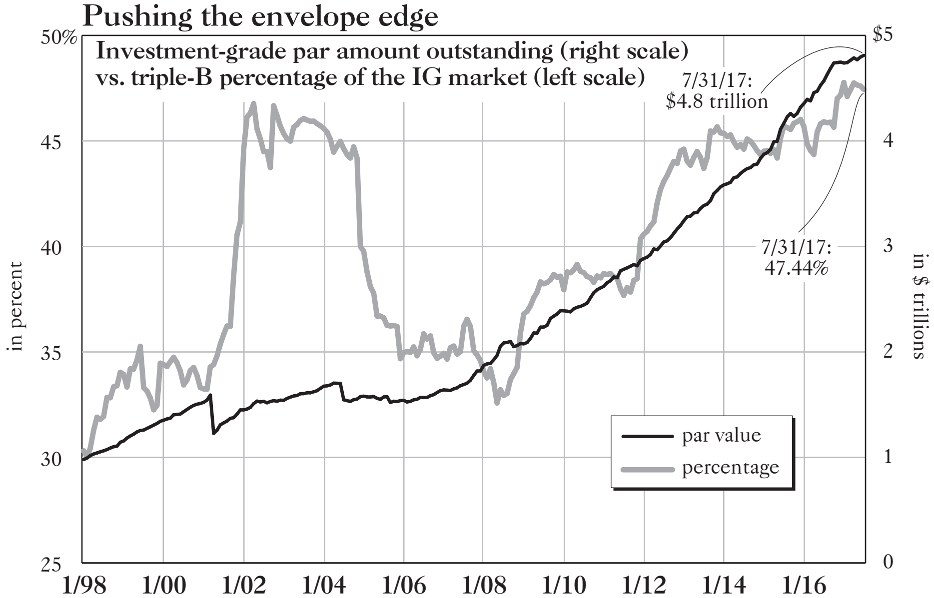
Competition is one concern (Botox is getting lots of company in the marketplace), accounting another. Fourth-quarter 2016 results, observes Carol Levenson, co-founder and research director of Gimme Credit, LLC, featured "adjustments" in 20 different line items, "mostly expenses resulting from acquisition accounting." Or consider the June quarter, in which a $902.4 million GAAP loss in operating income turned into $1.9 billion in "non-GAAP adjusted operating income" after tweaks for amortization ($1.7 billion), acquisition and licensing and other charges ($232 million), impairment/asset sales and other costs ($717 million), nonrecurring gain/losses ($174 million), legal settlements ($42 million) and other items. We're not the only curious onlookers. The Securities and Exchange Commission, too, in a letter to Allergan's CFO dated Jan. 11, searches for clarity.

"The specialty pharma landscape is mined with uncertainty," Santin observes. "Companies face infringement lawsuits, patents fall off cliffs, new products come to the market as substitutes and price hikes are under regulatory pressure—especially in the United States, which accounts for 80% of Allergan's sales."

All this can be yours, for a 3% yield to maturity.

Prospective fallen angel No. 2 is the Kohl's Corp.'s 4¼s of 2025, quoted at 101¾ for a 4% yield to maturity. It's no front-page news that Kohl's is one of the many retailers not called Amazon. It earns its living by selling apparel, footwear, accesories, etc. through its network of 1,154 mid-tier department stores. Gross margin, which ran at 36.1% in 2016, has been admirably stable over the past five years, though selling, general and administrative expenses have trended higher, to 23.7% of 2016 sales from 22.1% in 2012. Operating income fell to $1,183 million last year from $1,689 million in 2014. Interest coverage, defined as operating income divided by interest expense, was 3.8 times, down from 5 times in 2014.

Pushing the envelope edge



source: The Bloomberg

In January, S&P dinged the company with a one-notch demotion to triple-B-minus (with a negative outlook). Still, it's no small achievement to remain investment grade in the Bezosian world. Kohl's debt and capital leases stand at $4.6 billion, while the maturity profile stretches from 2021 to 2045. Liquidity rests on $552 million in cash supported by $1 billion in an available revolver due June 2020. The revolver has a leverage limitation, against which limit Kohl's is not yet knocking.

Bondholders may be senior claimants in the capital structure, but they don't stand at the head of the queue for corporate emoluments (not at Kohl's and not anywhere else we know of in stockholder-centric corporate America). Thus, since the start of 2014, the front office has spent $2.5 billion on share buybacks and $1.2 billion on common dividends. You wonder about the kind of spending that keeps the stores fresh. "Even Amazon spent 5.4% of its trailing 12-months revenue on capital investment, a full percentage point higher than Kohl's," Santin notes.

All that for 4%.

Likewise teetering on the cusp of sub-investment grade are the euro-pay Kraft Heinz Foods Co.'s 2¼s. Constant readers are fully briefed on the corporate issuer (e.g., *Grant's* March 25, 2016 and March 24, 2017). The corporate equity (KHC on the Nasdaq) is a Wall Street darling. Perhaps the bonds are Mario Draghi's darlings. They trade at 103.8 for a 1.8% yield to maturity, 148 basis points over the German Bund 0½% due 2027.

Kraft Heinz's balance sheet shows $31 billion in debt. Bloomberg consensus estimates 2017 adjusted EBITDA at $8.1 billion, indicating a leverage ratio of 3.8:1. It is not so farfetched to imagine that operating results will pressure EBITDA. Last quarter's sales showed a 1.7% year-over-year decline, and not even the cheapskates from 3G Capital Management can wring blood from a stone. Then, too, grocers, waging a price war, have begun to lean on suppliers, especially the ones in the declining packaged-foods industry—Kraft Heinz, for instance.

Last year, after stretching its suppliers, KHC directed most of the free cash flow to dividends, in the sum of $3.6 billion, up from $1.3 billion in 2015. For the first six months of 2017, free cash flow fell to $201 million from the $1.6 billion generated in the same period in 2016. According to the second-quarter 10-Q, the plunge was owing to the "timing of payments related to customer promotional activities, income taxes and employee bonuses, as well as increased inventory costs, primarily driven by higher key commodity costs in the U.S." Interest coverage was ample at 5.6 times during the first half of 2017.

Event risk continues to loom. Kraft Heinz's failed $143 billion bid for Unilever plc prompted S&P to reduce the KHC ratings outlook to stable from positive. No more, said the agency, did 3G Capital appear committed to maintaining debt leverage below 4:1 over the next two years. "A simple re-rating in credit spreads (erupted either by the ECB stopping corporate-bond purchases or by the market re-evaluating the company's prospects) would damage this 8.7-year-duration bond," Santin notes. "A 100 basis-point, credit-spread-widening event would cause a 8.7% decline in the bond value, erasing nearly four years of interest income."

Yours for 1.8%.

A coda, courtesy of Graham and Dodd: "The soundness of straight bond investment can be demonstrated only by its performance under unfavorable business conditions; if the bondholders needed prosperity to keep them whole, they would have been smarter to have bought the company's stock and made the profits that flow from prosperity."

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