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Spin cycle

Ingenious humans can produce better products at lower prices. They can likewise transform low GAAP earnings into high non-GAAP earnings. Such intellects appear to have found a home at Whirlpool Corp. (WHR on the New York Stock Exchange).

Deflation, profit margins, white goods, technical progress and accounting retrogression are the topics of the essay now unspooling. As to the corporate centerpiece of the analysis, the pride and joy of Benton Harbor, Mich., *Grant's* is bearish on it.

We don't mind saying at the start that Whirlpool (which incidentally declined to give us the time of day) is an American manufacturer par excellence. Its North American operating margins attest to the fact. They reached 11.5% last year, roughly double the average margins of the global competition and 38% greater than the 20-year average margin earned by Whirlpool itself in Canada, Mexico and the United States.

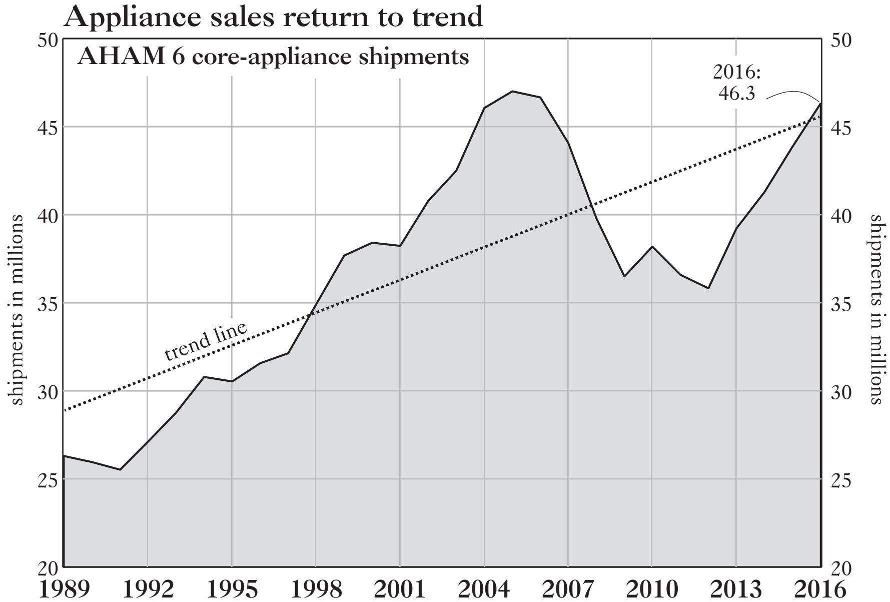
We're not the only ones who notice this yawning, golden disparity. Foreign white-goods makers, too, observe what riches the top American appliance maker plucks from North America. On form, they will try to move in, fat profits being the red carpet to determined competition. "Which is why," colleague Evan Lorenz observes, "over the course of a cycle, producers in a commodity business tend to earn their cost of capital and not much more. And the appliance business is increasingly commoditized." It's no paradox that lush margins constitute the heart of the bearish argument.

The appliance business was anything but commoditized when Lou Upton, eponym of the Upton Machine Co., tried to affix a motor to a manual washing machine in 1911. Not at first succeeding, he tried again. By 1916, Upton was selling mechanized washers to Sears, Roebuck & Co. It was the beginning of a beautiful relationship, as Upton—later, Whirlpool—would become Sears' biggest appliance vendor.

Nowadays, Whirlpool—doing business under such brands as Maytag, KitchenAid, Jenn-Air, Amana, Bauknecht, Indesit, Brastemp and, of course, Whirlpool itself—ranks as the world's largest home-appliance manufacturer by revenue. It would perhaps astound Lou Upton to know that his evolved creation last year sold 71.7 million units, garnering $20.7 billion of top-line income. Washing machines still dominate—we are now quoting 2015 figures—with laundry-related appliances generating 29% of total sales, followed by refrigerators and freezers, 28%; cooking appliances, 18%; and all the rest, 25%.

Back to 2016: North America chipped in 53% of Whirlpool's revenue; Europe, the Middle East and Africa, 25%; Latin America, 15%; and Asia, 7%. This geographic breakdown actually understates the importance of the NAFTA countries to Whirlpool's bottom line. Outside North America, the company earns margins of a mere 4.5%, less than half the aforementioned 11.5%. In consequence, last year the United States, Canada and Mexico delivered 75% of operating profits before corporate expenses.

Appliance sales return to trend



source: Association of Home Appliance Manufacturers

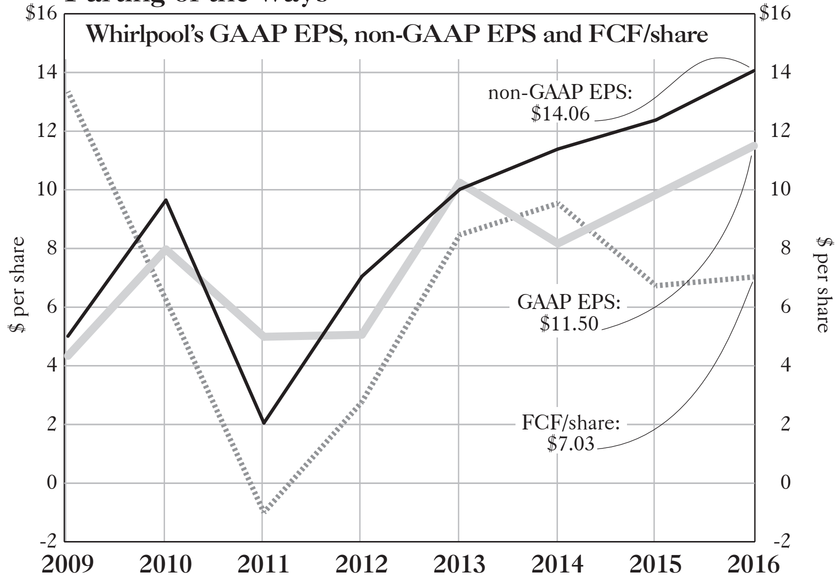
The bullish case for Whirlpool could begin with the cheerful fact that 2016 operating earnings covered interest expense by 8.4 times; or that—at the year-end statement date—net debt summed to only 2.2 times trailing earnings before interest, taxes, depreciation and amortization (EBITDA); or that the ratings agencies assign the company a place at the lower end of investment grade (Baa1/triple-B).

And then? A bull would likely posit that today's slow-growth recovery and sky-high margins will afford the company plenty of time to harvest what its front office is pleased to call earnings. The building of homes will accelerate (supported by low mortgage rates), the bullish narrative continues: While the United States needs 1.5 million starts a year to meet the twin demands created by growth and obsolescence, the past two years produced little more than an average of 1.1 million starts.

Not to mention, the bulls go on, white-goods replacement demand. Appliance purchases boomed as house prices bubbled in the mid-2000s. In the peak years of 2005 and 2006, Americans bought no fewer than 47 million washers, dryers, dishwashers, refrigerators, freezers and cooking ranges, according to the AHAM 6 Index (a production of the Association of Home Appliance Manufacturers). By 2016, appliance sales had very nearly recovered to the old highs (46.3 million units were bought last year). "We see three years of low- to mid-single digit steady growth in the repair and replacement spending levels, which means a protracted recovery path," Robert C. Wetenhall, a RBC Capital Markets analyst who rates Whirlpool a buy, tells Lorenz. "We are not going to see anything explosive, but we are not going to see anything detrimental or a pronounced negative dip."

There's no denying the importance of replacement purchases: They account for no less than 50% of overall appliance sales (purchases related to new homes deliver just 20%). So you can expect that a boom would be followed by a kind of echo-boom. And so it has proved recently. The average major appliance lives for eight to 12 years. So the big spending years of 2001 through 2005 have whistled up a second bulge in appliance purchases. Indeed, AHAM 6 shipments grew at a compound annual rate of 6.6% in the four years through 2016, a brisker pace than even the 5.3% registered in the four years through 2005. (In fact, the 2016 AHAM 6 shipments figure is above the trend line in growth dating back to 1989, even with the go-go years included.)

Parting of the ways



source: company reports

"However," Lorenz observes, "while appliance purchases are slightly below the 2005–06 peak, it isn't clear that the bustling days of the housing boom are a good metric for recurring demand. After all, as New York Fed president William C. Dudley described in a speech last month, between 2004 and 2006 consumers turbocharged spending by borrowing $200 billion a year against their (soon to evanesce) home equity ([*Grant's*, Jan. 27]). In the year ending Sept. 30, households made a net paydown of $20 billion against home-equity lines of credit."

All of which raises the possibility of a meaningful downshift in appliance demand beginning right about now. Because AHAM 6 shipments declined by 24% from 2005 to 2012, it stands to reason that there will be fewer 10-year-old devices to replace in the years to come. Do you wonder about new home building? It would have taken an incremental 333,700 starts to bring 2016 residential construction up to the 1.5 million unit level. Assuming that each house were fully loaded—washer, dryer, dishwasher, refrigerator, oven—the AHAM 6 Index would have tacked on 1.7 million units. Between 2005 and 2012, the index declined by 11.2 million units. It would take a lot of home building to lift the trend line of appliance buying.

. . .

"Every geography is stressed," a short-seller of Whirlpool stock tells Lorenz, summing up the bearish case. "Margins are peak. The U.S. appliance cycle is peak. Interest rates are going up. We've got raw material headwind. They [i.e., Whirlpool] masquerade as being 'Made in America' but don't pay much in the way of taxes. They don't benefit from Trump. This whole idea of protectionism—they've been supported by protectionism for years."

People used to say that 5% would "pull money from the moon." Today, the fat North American appliance market is pulling competitors from South Korea. In the four years through the last quarter of 2016, LG Electronics' share of American dollar sales of household appliances climbed to 14.6% from 10.2%. Over the same span, Samsung's sales jumped to 17.4% from 10.1%, according to the Stevenson Company's TraQline Survey. While all this was happening, Whirlpool's slice of the American market shrank to 27.8% from 30.5%. (The biggest share donor over this time was Sears' Kenmore brand, whose market foothold collapsed to 10.2% from 16.8%—another source of amazement for Lou Upton as he gazes down from heaven.)

While Whirlpool is no slouch at innovation, the Koreans are beating the Michiganders to the punch. "Samsung and LG are taking the lead," Alan Wolf, senior editor of the biweekly *TWICE* magazine (meaning "This Week in Consumer Electronics"), tells Lorenz. "Just flashy stuff that is really eye-catching to the consumer. LG has a refrigerator that has a black glass LCD display, and you tap on it and it becomes clear so you can see what is there before you open the door. On the laundry side, Samsung is doing interesting things with a separate machine on top of the main washing machine where you can put delicates or sweaters or whites. You can have two loads going on simultaneously. In cooking, Samsung has innovated a compartmentalized oven. Pop in a turkey and a casserole together. Cook both simultaneously, each at the appropriate temperature."

To date, LG and Samsung have shipped their goods from Asia. And because shipping costs money, the Koreans have concentrated on the so-called mass premium end of the American market, rather than the pure mass market in which Whirlpool dominates. Perhaps that is about to change. On Feb. 2, Reuters reported that LG and Samsung could soon be building factories in America. "Thank you, @Samsung!" President Trump tweeted in response to that intelligence. "We would love to have you!"

Whether the Trump corporate-tax agenda—in particular, the mooted 20% border adjustment tax (BAT)—would help Whirlpool is another question. "Yes," Lorenz points out, "Whirlpool manufactures most of its products for the American market within the 50 states—82% of them, according to CEO Jeff M. Fettig. But Whirlpool's effective 2015 tax rate on profits generated within the U.S. was just 12%, less than half the statutory 35% rate and below the House Republicans' goal of 20%. Nor is enactment of the BAT a sure thing. Indeed, if the recent recovery of the peso-dollar exchange rate is any indication, the tax might be in some trouble. After selling off by as much as 5.6% against the dollar between Dec. 31, 2016 and Jan. 19, 2017 the Mexican currency has rallied to the point at which it is up against the dollar for the year."

The roster of potential foreign competitors for Whirlpool numbers many more than two. On June 6, Qingdao Haier Co. Ltd., the big Chinese white-goods maker, bought GE Appliances for $5.6 billion. Like Whirlpool, GE had suffered a loss of market share to the Korean competition. Then, again, the appliance division was always a small part of General Electric's overall business. Under Haier, a pure-play white-goods company, the old GE sub could be refocused and reanimated.

Arcelik A.S., the Turkish conglomerate that makes appliances under the Beko brand—they are the No. 2 seller in Europe—likewise has American ambitions. A September pledge by Arcelik's CEO, Hakan Bulgurlu, to bring "the Beko brand to new markets in America" was no doubt audible in Benton Harbor. The Midea Group Co. Ltd., another large Chinese appliance maker, already manufactures under its own brand in this country and operates as an original equipment maker for what had been the GE subsidiary. Having been outbid by Haier for that very GE unit, Midea, in December, bought Electrolux's small-appliance brand, Eureka.

The hotting up of competition may already be taking its toll. Despite a modest gain in fourth-quarter revenue, Whirlpool's non-GAAP earnings per share of $4.33 came in six cents light on account of a decline in margins. (On non-GAAP adjustments, more later.) Most importantly, margins in the North American division declined to 11.1% from 11.7% between the fourth quarters of 2016 and 2015, a 12.4% year-over-year gain in unit sales notwithstanding. In their respective conference calls, Electrolux and Whirlpool each remarked on the high level of fourth-quarter promotions.

It makes life no easier for the appliance makers to be operating in a mildly deflationary environment. According to the Bureau of Labor Statistics, the average price of major appliances fell at a compound annual rate of 1.84% in the decade ended December 2016, even as, over the same span, the CPI rose at a compound annual rate of 1.81%.

Whirlpool's stock price slipped by 8.6% on Jan. 26 after management fessed up to the miss. "Our Q4 margins in North America were at the low end of our guidance," Marc Bitzer, Whirlpool's chief operating officer, told dial-

Whirlpool Corp.
All figures in USD millions, except per-share data

	2016	2015	2014	2013	2012
Sales					
North America	$11,147	$10,732	$10,634	$10,178	$9,631
Europe, Middle East and Africa	5,148	5,601	3,905	3,024	4,950
Latin America	3,191	3,349	4,686	4,928	2,874
Asia	1,424	1,417	816	807	847
Other/eliminations	(192)	(208)	(169)	(168)	(159)
Consolidated sales	20,718	20,891	19,872	18,769	18,143
Operating profit					
North America	1,284	1,252	1,072	1,070	846
Europe, Middle East and Africa	158	188	59	(4)	476
Latin America	207	184	475	557	(51)
Asia	74	80	(21)	34	37
Other/eliminations	(369)	(419)	(397)	(408)	(439)
Consolidated operating profit	1,354	1,285	1,188	1,249	869
Interest and sundry income	(79)	(89)	(142)	(155)	(112)
Interest expense	(161)	(165)	(165)	(177)	(199)
Profit before taxes	1,114	1,031	881	917	558
Taxes	186	209	189	68	133
Income after taxes	928	822	692	849	425
Minority interest	40	39	42	22	24
Net income	888	783	650	827	401
EPS	$11.50	$9.83	$8.17	$10.24	$5.06
Non-GAAP EPS	$14.06	$12.38	$11.39	$10.02	$7.05
Diluted shares (mns)	77.2	79.7	79.6	80.8	79.3

source: company reports

ers-in on the earnings call. "Now you've also seen, we have given a guidance for next year which is above the 2016 actuals, and we're strongly convinced we can drive volume growth above market growth and expand our margins. It's obviously at a more modest pace compared to a couple of years ago, but it is a margin expansion. I also want to emphasize that this is not based on some irrational hopes about certain competitors becoming all of a sudden completely different. We do believe we have opportunities on cost productivity. We have a number of product introductions which help us on price/mix, and we took certain other actions. So we are strongly convinced we can expand margins and drive above-market growth."

Bitzer had better be right, as North American operating margins make all the difference in Whirlpool's bottom line. "Consider," Lorenz observes, "that 8.3% is the 20-year average margin of the North American division. If Whirlpool had earned that average margin, rather than the 11.5% it did report in 2016, company-wide operating income would have plunged by 26%."

The risk of a Sears bankruptcy, especially a Chapter 7 liquidation, constitutes another amber light for the Whirlpool shareholder. Sears is hardly the customer it used to be at Whirlpool. In 2011, the once iconic retailer generated 8% of company-wide revenue, which is as recent a figure as Whirlpool has vouchsafed. Still, Sears Holding Corp. sells one out of every five appliances purchased in America (hhgregg, Inc., another retailer with a worrying stock chart, accounts for 3% of national appliance sales). Recall that Sports Authority, Inc., by going out of business one year ago, set off a chain of events that caused Nike, Inc. and Under Armour, Inc. to miss sales estimates.

To be sure, other retailers could try to fill the void that Sears would leave, if leave it does, though it isn't clear that the hypothetical newcomers would satisfactorily serve Whirlpool. J.C. Penney Co., which exited the appliance business in 1983 and reentered it only last year, carries products by LG and Samsung but not by Whirlpool. Let us only say that a Sears bankruptcy could have messy and unanticipated consequences.

What are, exactly, Whirlpool's earnings? Let's have a look.

In 2010, the company began to publish a non-GAAP earnings metric. Flatteringly, the in-house profits figure excludes restructuring and acquisition-related costs.

Restructuring charges first. "Whirlpool," Lorenz observes, "treats these restructuring costs as if they were one-offs—special, nonrecurring. They are in fact recurrent. Household-appliance prices these days tend to fall, not rise, as we noted. How can a manufacturer protect its margins in a deflationary setting? Why, through constant investment in production processes. It's a cost of doing business. In only three years of the past two decades (1998, 1999 and 2000) did Whirlpool not incur one of these recurring, nonrecurring costs. Restructuring charges totaled $136 million in 2014, $201 million in 2015 and $173 million in 2016. As for 2017, more would seem to be in the offing. The near doubling of steel prices in the past year is putting pressure on Whirlpool's margins. On the Jan. 26 earnings call, management estimated that high input prices will increase the cost of goods sold by $150 million in 2017—for reference, GAAP net income was $888 million in 2016. To offset high commodity costs, said management, it will be out taking costs. Translation: Prepare for further restructuring expenses.

"On to acquisition-related costs," Lorenz continues. "Thus, Whirlpool bought Indesit Company S.p.A. for $1.4 billion in December 2014. It purchased a 51% stake in Hefei Rongshida Sanyo Electric Co. Ltd. for $551 in October 2014. In short, in both cases, it closed the transactions more than two years ago. Yet the acquirer was still marking up operating profit in 2016. Citing 'acquisition costs,' Whirlpool lifted non-GAAP operating profit by $33 million in the fourth quarter of last year and by $82 million for the full 12 months. You wonder if a statute of limitations ought not to apply.

"Factoring in these and other adjustments," Lorenz winds up, "Whirlpool's non-GAAP earnings per share totaled $14.06 in 2016. Its GAAP earnings per share weighed in at $11.50. Depending on your point of view, then, Whirlpool's stock is trading at either 12.3 times earnings or 15.1 times earnings. Since 2000, the shares have changed hands at an average of 11 times trailing earnings, a multiple befitting a cyclical and competitive business. While both GAAP and non-GAAP earnings are growing—albeit not to the same extent—free cash flow has declined to $543 million in 2016 from $759 million in 2014."

Management teams push non-GAAP earnings because, they say, the adjusted figures give a truer measure of a company's earnings power than the GAAP numbers. However that may be, you can't service debt with non-GAAP dollars. Free cash flow pays the bills—that is, cash provided by operations less the capital expenditures required to keep the business running. At Whirlpool, free cash flow per share has dwindled to $7.03 in 2016 from $9.54 in 2014, a period in which the non-GAAP figures climbed to $14.06 from $11.39. Thus, the optical rise in non-GAAP earnings power has not been corroborated with a corresponding rise in FCF. More concerning, GAAP EPS, which rose to $11.50 in 2016 from $8.17 in 2014, has become increasingly separated from FCF per share, raising questions about overall earnings quality.

With six buys, four holds and no sells, Whirlpool is liked, if not loved, by the Street. Over the past 12 months, insiders have sold a net $30.1 million worth of shares. Nothing unusual about that. The insiders have been heavy net sellers of shares since at least 2003, which is as far back as Bloomberg data reach.

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