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Doormats of Wall Street

The Campbell Soup Co. 3.8s of 2042 debuted in July 2012 at a price of 99 and change. This was 5½ years before the soup maker, straining to grow, decided to mount its leveraged acquisition of snacks vendor Snyder's-Lance, Inc. Today, in the wake of that five-course, soup-to-nuts, debt-financed feast (no snack was Snyder's-Lance), the Campbell 3.8s trade at 87.

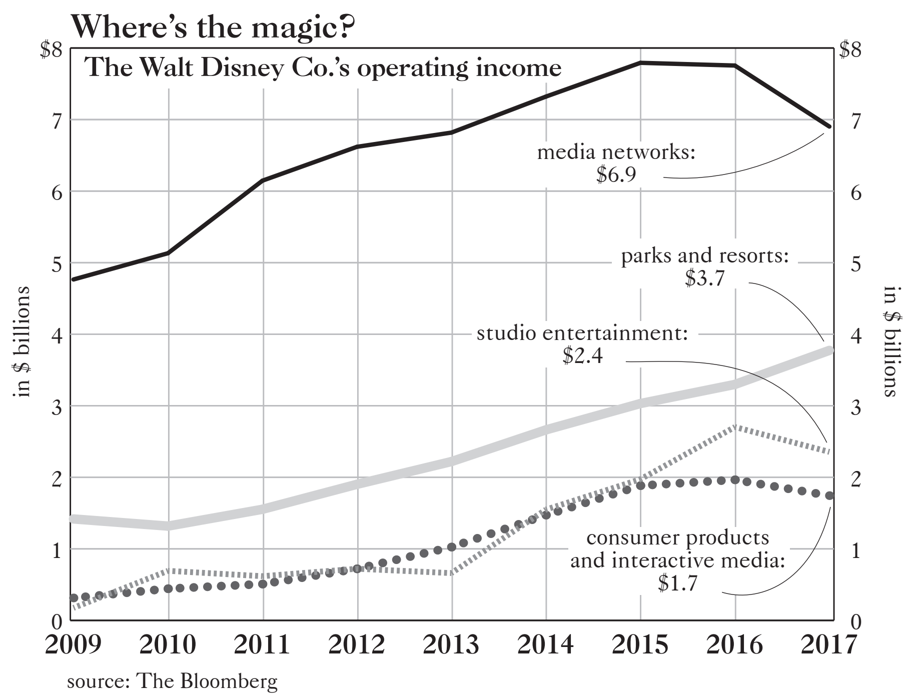
Now in progress is a study of the mispricing of investment-grade corporate debt. Low interest rates and tight yield spreads condemn the creditors to mediocre returns (that's the upside) or outright loss (not so much the downside as the base case). We write to remind the bondholders that they have become the doormats of Wall Street.

A bond is a promise to pay money, but—problem No. 1—the value of money forever diminishes. As deflation is off the monetary-policy table, the price level goes up and up. Then, too, "senior securities" are junior in all the ways that count in a solvent enterprise. Stock options, not bond options, incentivize the managers. Earnings per share is the corporate end all, be all—problem No. 2.

We creditors can't change the world, but we can politely ask for a raise, and, if refused, we can take our business elsewhere (just where that might be in this overvalued world is a topic for the speakers at the April 10 *Grant's* Conference—*advt.*). In none of the three cases that follow—The Walt Disney Co. (DIS), The Coca-Cola Co. (KO, both on the Big Board) and Mondelez International, Inc. (MDLZ on the Nasdaq)—are the bondholders earning a return commensurate with the risks they are bearing.

The A2/single-A-plus-rated Walt Disney Co.'s 2.95s of 2027 are the first specimens under the *Grant's* lens. At a price of 96, they yield 3.47% to maturity, or 72 basis points more than a comparable Treasury. Generous credit ratings and tight yield spreads are nothing new for the world's second-largest media conglomerate, behind Comcast: In 1993, Disney sold 100-year bonds, callable in 30 years, that were priced to deliver a 95 basis-point premium to the longest-dated Treasury. Regarding the durability of the Disney franchise, Mickey Mouse will be 95 years old if the bonds are called away in 2023, 165 years old if they run to maturity in 2093.

The negative 1% per annum return on Disney common stock over the past three bull-market years is testament to the trouble in Disney's operating businesses. There are four of them: video properties, featuring ESPN, ABC and the Disney Channel; theme parks and resorts, including Disneyland, Disney World and the Disney cruise lines; studio entertainment, which houses film, music and theatrical productions; and consumer products, which licenses Disney's characters to game developers, retailers and clothiers. In the fiscal year ended Sept. 30, 2017, the whole produced $55 billion in revenue, $13.8 billion in operating income and $8 billion of free cash flow. For the equity investor, the trouble



is the lack of growth. For the creditor, the risk is rising leverage.

For all the diversity of its revenue sources, Disney is heavily dependent on its video segment, especially ESPN, of which it owns 80%. The video division contributes 50% of company-wide operating income, and ESPN accounts for most of that 50%. No cable channel but one earns as much as $2.10 per subscriber per month in fees from pay-TV companies, according to S&P Global Intelligence, and that channel—it's ESPN—delivers $7.86 per month.

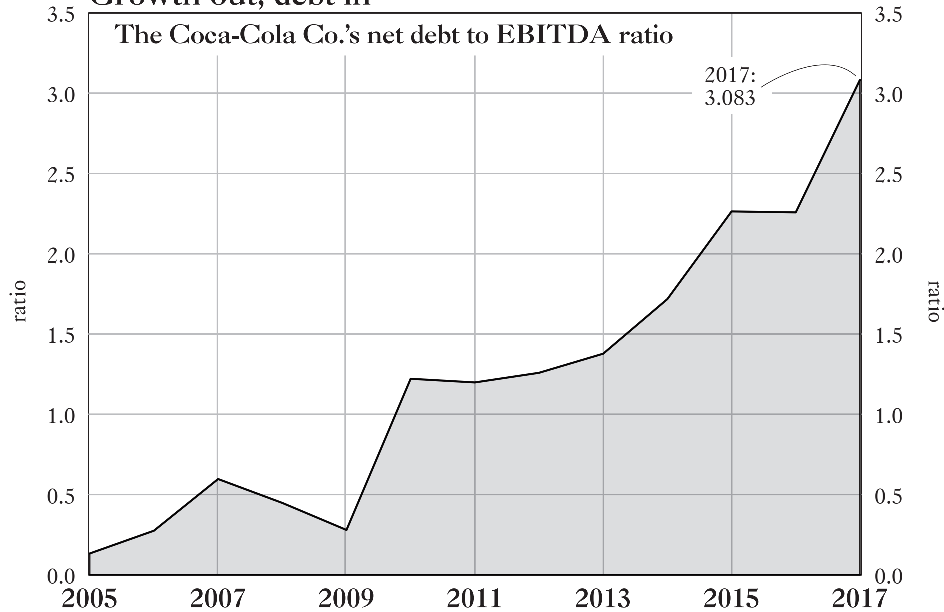
You'd call it a gold mine, if gold stocks weren't such dogs, though the analogy rings true in one sense. ESPN seems to be running through its richest ore bodies. Subscribers numbered 99 million in 2011; they stood at 88 million in September 2017, according to Nielsen Media Research. Pay-TV subscriptions are down; cheaper alternatives, like Netflix, are up. And those who still subscribe to ESPN are watching less of it. As for the observed fall-off in the advertiser-coveted 18-to-34 male age group, it's no hopeful augury that the athletic participation rate among American children aged six to 12 is on the skids (to 37% from 45% over the past decade, according to the "State of Play 2017" report). A couch potato should at least have tried to play the game.

Viewership may be dwindling, but the cost of content is resurgent. On the one hand, the demand has helped ESPN on contract renewals with pay-TV providers. On the other, that same demand has inflated prices for the transmission of professional-sports events.

"I've compiled data from 2006 to the present and, through the expiration of all major rights deals in the U.S. and if you look at it on any given 10-year basis, you'll calculate more than 10 percent annual increases on an annualized basis," Brian Wieser, senior analyst at Pivotal Research Group, tells colleague Fabiano Santin. "But competition is not getting lighter. Whereas, in the last round of renewals, you had Fox and Comcast becoming more aggressive competitors for rates, now you'll have Google and Amazon, and maybe Facebook (as soon as they get over their issues) . . . competing for national sports rights. So you then get this margin erosion that doesn't seem like it will go away any time soon."

In the first quarter of fiscal 2018 (ended Dec. 30, 2017), Disney's company-wide revenues grew by 4%, to $15.3 billion, and operating income by 1%, to $3.9 billion. The growth was no thanks to ESPN, the Muppets or to Disney-licensed Donald Duck T-shirts; more than 100% was attributable to parks and resorts, as profit elsewhere slumped by 7%. It was a sturdy showing by Disney World and the rest, though they seem unlikely to carry the parent to Disney's former heights. In the past decade, park and resort revenue has risen by an average of 5.3% per year—i.e., one percentage point more than nominal GDP—yet they still represent only a quarter of the total. (Might margins at Disneyland and Disney World soon be coming under pressure on account of rising wages? The workers hope so. A Feb. 27 survey of union employees at Disneyland in Anaheim, Calif., is said to show that paychecks have fallen by 15% in real terms since 2000, findings which Disney disputes.)

Growth out, debt in



source: The Bloomberg

"As of Dec. 30, 2017," Santin notes, "total debt footed to $26 billion. Add in $3.2 billion from the pension deficit and $1.1 billion from redeemable non-controlling interests, and the tab rises to $30.3 billion. Using $18.5 billion for the past 12 months of earnings before interest, taxes, depreciation and amortization (EBITDA), we get a total leverage ratio of 1.6:1. Disney holds $4.7 billion in cash and $3.2 billion in investments, but management has no plans to use that cash to pay down debt. Though Disney has generated $8 billion or so of free cash flow a year for each of the past three years, it has spent an average of $10 billion a year on dividends and stock buybacks, driving leverage higher. The Dec. 14 offer for most of the assets of Twenty-First Century Fox, Inc., to be financed with to-be-issued Disney equity and the assumption of $44 billion of debt, would stretch leverage to near three times EBITDA.

"Or more," Santin continues, "if there were a bidding war for some of the Fox assets that Disney would like to acquire, including pay-TV provider Sky plc. Sky is 39.1%-owned by Fox, which, on Dec. 15, offered £11.7 billion ($16.4 billion) for the remaining 60.9% of the shares. Ultimately, Disney would end up paying the tab by assuming Sky's purchase price. Comcast decided to ignite the war by offering £22 billion for 100% of Sky on Feb. 27, which means that Disney would need to pay at least £1.7 billion more for it (£13.4 billion value for a 60.9% piece). In an orchestrated effort to assuage UK regulators' concerns over whether Fox would be gaining too much editorial influence in the country, Fox proposed on April 3 to ring-fence and operate Sky News independently for 15 years, or Disney would be committed to buy the channel even if Disney's acquisition of Fox assets doesn't go through."

Yes, to maintain its credit ratings, Disney has promised "synergies" to deleverage the merged entity within two to three years. But it has likewise promised $20 billion in share buybacks to offset the deal-related stock issuance. "They were always under-levered," comments Wieser, an equity-oriented analyst, on

Disney's historical credit profile. "From where I and most equity investors sit, more leverage is positive."

Not so positive from where a creditor sits or, figuratively speaking, kneels in supplication. Downgrades could well follow any significant boost in leverage, thus demoting Disney to the bulging ranks of the triple-Bs. If, for instance, the yield on the Disney 3s of 2046 rose by 100 basis points, creditors would be out of pocket by 16%, or more than five years worth of coupon income. Although the 2.95s of 2027 have a shorter duration, they, too, are at risk of unscripted events. Something well short of an apocalypse—a couple of Disney credit downgrades superimposed on a rise in the general level of interest rates—would deal a substantial loss of creditor principal. Disney is a company built on fantasy. Who'd have thought that the cold-hearted creditors would have so completely given into it?

Specimen No. 2 takes the shape of the double-A-minus-rated Coca-Cola Co. senior unsecured 2.9s of 2027, which are priced to yield 3.3%, a 64 basis-point pickup to Treasurys. The longer-dated, euro-denominated $1\frac{5}{8}$s of 2035 yield all of 1.6% to that distant maturity, or 73 basis points to the bund. The "junior" claimants, Coke shareholders, earn a dividend yield of 3.66%.

This publication had its say on Coca-Cola's equity more than two decades ago. Then the shares traded at 39 times earnings, management was trumpeting its intention to repurchase those shares regardless of valuation and *Fortune* magazine was crowning the Atlanta singularity its "Most Admired" company (*Grant's*, Oct. 11, 1996). Since that not-quite apogee (the stock subsequently more than doubled), KO has returned an average of 5.4% per annum, including dividends, compared with 10% per annum for the S&P 500, also including dividends. Today, we judge, it's Coke's credit spreads, even more than its stock price (quoted at 20 times earnings) that constitute the outstanding corporate-valuation eyesore.

There's nothing fizzy in the corporate vital signs. Revenues fell to $35.4 billion last year, from $41.8 billion in 2016 and $44.2 billion in 2015. Excluding divestitures of bottling operations in the United States and China, revenues grew by 2% in 2017 and 1% in 2016, in the face of stagnant volumes. Annual per capita consumption of carbonated drinks in the United States has declined to 145.9 liters from 175 liters in 2008. Coke's free cash flow sunk to $5.4 billion in 2017 from $6.7 billion in 2016 and $8 billion in 2015.

When Coca-Cola was ascendant 20-odd years ago, we asked a leader of the value-investing tribe what could possibly go wrong with it. "Well," the sage replied, "it's not really good for you." And such was the story of the sea change in consumer attitudes in America. Inasmuch as Coke sells 81% of its liquid volume outside the United States, it would be better for Coca-Cola if those health concerns were not now exported.

"U.S. GAAP reported operating income has steadily fallen to $7.5 billion in 2017 from $10.2 billion in 2013," Santin relates, "though the company wants investors to think that the setback is temporary, owing to the divestiture of bottling operations. Adding back various supposedly non-recurring charges such as 'asset impairment/restructuring,' 'productivity and reinvestment,' 'transaction gains and losses' and 'other items' (which together averaged $1.5 billion in the past five years) brings operating income to $9.7 billion in 2017 versus $11.3 billion in 2013."

"We remain committed to growing the dividend, marking the 56th consecutive year of annual dividend increases," Kathy Waller, Coca-Cola's CFO, told participants of the 2018 Consumer Analyst Group of New York conference in February. There was no such pledge concerning, for instance, the ratio of operating income to net interest expense, although, at 45 times, Coke covers with room to spare.

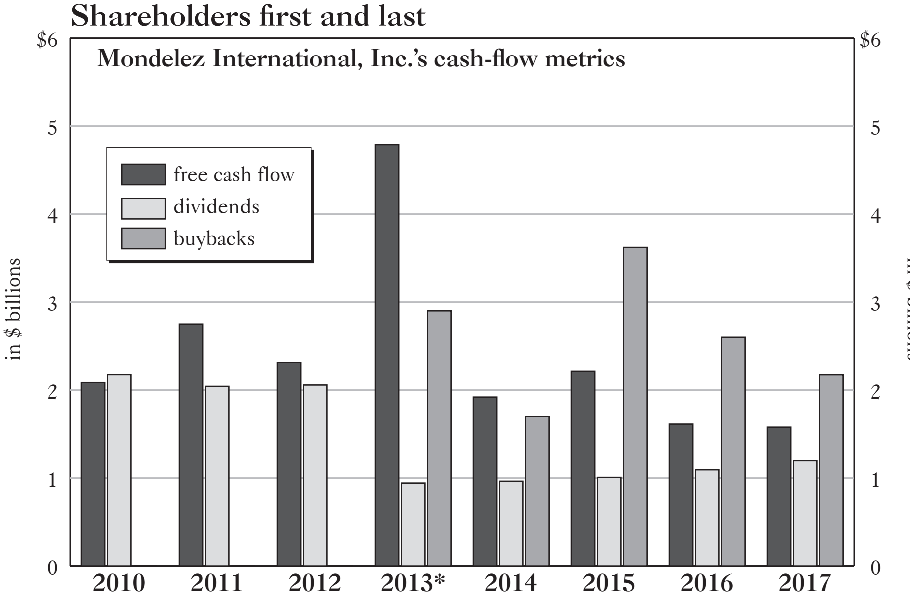
A creditor may wonder about the future. Total debt reached $47.7 billion in 2017, up from $9.3 billion a decade ago, far outstripping growth in adjusted EBITDA to $12.1 billion (adding in $1.8 billion in supposedly non-recurring charges), from $9.7 billion. Hence, overall leverage ticked up to 3.9 from under 1.0 in 2007. Add another $4.6 billion in tax payments due to the tax reform, and leverage rises to 4.3 times.

"It may be said, concerning Coke's $20 billion in cash and marketable securities," observes Santin, "that *net* leverage falls to 2.7 times. It's not a conservative way of looking at things, since most of that cash is required for working capital or is 'non-remittable because of local regulations,' as the company's 2017 10-K report puts it.

"If yields rose by 100 basis points on the 2.9s of 2027," Santin proceeds, "bondholders would lose 7.5% of their principal, whereas they could profit by only 5% if the 2.9s ever traded on a par with Treasurys. Owners of the $1\frac{5}{8}$s of 2035 stand to lose 13.5%, or more than eight years of coupon income, if yields increased by 100 basis points. And if the yield on bunds and the credit spread *to* bunds each jumped by 100 basis points, the euro creditors would lose 25% in principal value, or 15 years of coupon income."

Exhibit No. 3 features triple-B-rated Mondelez International, Inc. and its senior unsecured notes, e.g., the 6½s of 2040, which change hands at 127 for a 4.5% yield to maturity or a 166

Shareholders first and last



* Including a $2.6 billion one-off from a Starbucks arbitration proceeding in free cash flow and a corresponding amount in buybacks.

basis-point pickup to Treasurys. The euro-denominated 2³/8s of 2035 trade near par for a 2.36% yield to maturity, or a 147 basis-point premium to the bund. Mondelez pays more to borrow than Disney or Coke, as befits a weaker credit, but does it pay enough, in view of the risks? In this market, to ask the question is to answer it.

With $25.9 billion in 2017 revenue (flat with 2016's), Mondelez is one of the largest consumer-packaged-goods companies in the world. You know it by its brands—Nabisco, Oreo, Ritz, Cadbury—as well as by its world-spanning reach. We know it by its debt, too, of which more in a moment.

Operating income is tilted towards Europe (43% of the 2017 total) and North America (29%). Pricing power appears negligible: Organic revenue rose by 0.9% in 2017 on a 0.6% fall in volumes. Gross profit marginally decreased to $10 billion in 2017 from $10.1 billion and $11.5 billion in 2016 and 2015, respectively. Gross margins run steadily at around 39%. Free cash flow dropped to $1.58 billion in 2017 from $1.6 billion in 2016 and $2.2 billion in 2015. "Today's environment is one of the most volatile and uncertain that I've seen in my 35 years in the industry," declared then CEO Irene Rosenfeld in February 2017. Before retiring in November, she implemented zero-based budgeting, the 3-G-popularized management system in which every cost, every human neck, is on the chopping block every year.

While adjusted operating income grew to $4.2 billion in 2017 from $3.8 billion in 2016, most of those gains stemmed from lower selling, general and administrative expenses. The top line is, at best, steady-eddy. Chopping doesn't breathe new life into big businesses selling yesteryear's products.

Net debt stands at $16.9 billion, or $19 billion including pension liabilities, up from $16.2 billion in 2015. Net leverage stands at 3.7 times adjusted EBITDA, up from 3.3 times in 2015. Operating income covers interest expense by nine times. Mondelez paid out $3.3 billion in buybacks and dividends in 2017, down from $3.7 billion in 2016 and $4.6 billion in 2015. On Jan. 31, the board approved a $6 billion increase in share repurchases, to $19.7 billion through December 2020.

A well-financed business shows a ratio of current assets to current liabilities of 2:1, according to an old rule of thumb. Mondelez inverts the standard with current liabilities of $15.8 billion and current assets of $7.5 billion. For backup, there's a $4.5 billion revolving-credit facility. Mondelez carries, besides, $6.3 billion in equity investments which it might turn into money.

"Given Mondelez's exposure to low-growth products," Santin winds up, "management is ever tempted to launch a leveraged acquisition. Witness the Mondelez bids for Hershey Co. in June and August 2016 (Hershey spurned each). The lagging Mondelez share price casts further doubt on the likelihood that management will deleverage. If the yield on long-term Treasurys and the credit spread on Mondelez each rose by 100 basis points, the bondholders of the 6½s of 2040 would see their holdings drop to 98 from 127 currently. A 100 basis-point boost in the yield of the 2³/8s of 2035 would cost those investors a drop in the quoted price to 87 from 100."

This just in: Mondelez is launching a non-binding tender for up to $1 billion in principal value of legacy notes, including the 6½s of 2040. But that is not the news. The news is that the tender includes a solicitation to amend the bond indenture dated Oct. 17, 2001 in ways that are calculated to set the creditors' hair on fire.

The amendments would eliminate the covenants that prevent Mondelez from issuing unlimited amounts of secured debt. They would extinguish the language that prohibits unlimited sale and lease-back transactions. They would remove the requirement that an acquirer of the company must assume the legacy notes. And they would erase the change-of-control covenant that requires Mondelez to repurchase the notes at 101 in the event of a credit-enfeebling leveraged buyout.

Creditors are the loneliest corporate stakeholders. Management disdains them. The Fed debases them. Give them this, at least (it's a kind of virtue, anyway): They never complain.

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