GRANT'S
INTEREST RATE OBSERVER®

Vol. 38, No. 2d 233 Broadway, New York, New York 10279 • www.grantspub.com JANUARY 24, 2020

Plastic refuse

Evan Lorenz writes:

Junk-bond yields touched a record low last week—5.08% on the ICE BofAML Index compared with 7.12% only one year ago—but the investor's loss is private equity's gain. To the p.e. promoters, sitting on $1.5 trillion of idle or callable cash, debt is almost irresistibly cheap.

At the intersection of minuscule interest rates and money-burning-a-hole-in-the-deal-doers'-pockets stands Berry Global Group, Inc. (BERY on the Big Board). Besides holding a leading position in the worldwide plastic-packaging-manufacturing business, Berry is a debt-financed roll-up of roll-ups. In preview, *Grant's* is bearish on Berry, its common stock and second-lien bonds alike. As to the open-handed credit and interest-rate environment in which Berry has made hay, let history be the judge.

Imperial Plastics, founded in 1967 in Evansville, Ind., assumed its current identity when a Florida citrus-and-real-estate titan named Jack Berry Sr. bought the company in 1983. Bolt-on acquisitions began shortly thereafter. Since 1988, Berry has completed more than 40 of them.

Indeed, Berry itself is a stock figure in the M&A news of the past 20-odd years. In 1996 came the first of what would prove to be a 16-year succession of sales to private-equity investors. First Atlantic Capital, Ltd. was buyer No. 1. JPMorgan Chase & Co. and Goldman Sachs Group, Inc. followed in 2002, and Apollo Global Management, Inc. and Graham Partners succeeded Morgan and Goldman in 2006. Having completed the private circuit, Berry went public in 2012.

Based on annual revenues in excess of $12.5 billion (crediting recent acquisitions), Berry today is the world's second-largest plastic-packaging manufacturer, behind only Amcor plc. It employs 49,000 people at 293 facilities in 39 countries. Consumer packaging—bottles, canisters, containers, etc.—is a Berry mainstay. Plastic films, pharmaceutical packaging, can liners, retail bags, stretch wrap, hygiene and specialties, surgical drapes, diaper components and cleaning wipes convey a sense of the scope and variety of the company's product line.

Counting their blessings, the bulls start with valuation. Based on Street estimates, Berry is trading at 11.8 times fiscal 2020 earnings per share and offers a projected 2020 free-cash-flow yield (FCF divided by market cap) of 12.6%. For comparison, the S&P 500 is priced at 22 times trailing 12-month earnings and shows a 3.8% trailing FCF yield.

Plastics are far from a growth industry—of which more in a moment—but the bulls contend that the demand for water bottles and liners is, at least, stable and, therefore, supportive of predictable cash flows and lots of leverage. The company uses this foundation to scoop up smaller plastic makers. A buyer of 7 billion pounds of plastic resin per annum enjoys certain undeniable economies of scale, and Berry can typically improve the margins of the businesses it acquires to the tune of 4%–5% of the acquirees' sales. For reference, in fiscal 2019, Berry's adjusted earnings before interest, taxes, depreciation and amortization as a percentage of sales weighed in at 17.2%.

The strategy would seem to be working. Between fiscal years 2012 and 2019, Berry compounded sales and adjusted Ebitda by 86% and 98%, respectively. Since the 2012 initial public offering, the stock has generated a 217% return compared with a 164% return for the S&P 500.

And the cheerful story continues with

Berry Global Group, Inc. at a glance
all figures in $ millions

	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
sales	$4,881	$6,489	$7,095	$7,869	$8,878
adjusted Ebitda	815	1,210	1,327	1,380	1,530
net income	86	$236	340	496	404
cash	228	323	306	381	750
debt	3,685	5,755	5,641	5,844	11,365
total assets	5,028	7,653	8,476	9,131	16,469
cash flow from operations	637	857	975	1,004	1,201
capital expenditures	180	288	269	336	399
acquisitions	3	2,283	515	702	6,079

source: company reports

Berry's purchase of the Rushden, UK-based RPC Group plc in July for $6.1 billion, its largest acquisition to date. In its independent existence, RPC was a kind of spitting image of Berry: Both were dominant plastic makers in their respective markets. In fiscal 2018, North America accounted for 82.3% of Berry's sales; Europe generated 77.8% of RPC's sales. Post-merger, Berry is a more globally diversified company, with North America, Europe, Asia Pacific and parts unknown accounting for 51%, 40%, 5% and 4% of pro forma trailing sales, respectively.

Then, again, the deal really wasn't about geographic diversification. Berry estimates that the combination will deliver $150 million in synergies, or 3% of historical RPC sales, and that half of those savings will be realized in fiscal 2020. For reference, Berry generated $1.4 billion in adjusted Ebitda in the four quarters before the merger closed. The purchase price footed to 8.5 times RPC's trailing Ebitda, or 7.1 times adjusted for expected cost savings.

The all-cash RPC deal did, however, result in an increase in Berry's leverage, to 5.1 times Ebitda as of Sept. 28 from 3.8 times pre-announcement. (On the Nov. 21, 2019 earnings call, Berry stated that pro forma leverage amounted to 4.8 times, a calculation flattered by $150 million in anticipated synergies.) Adjusting for the recent sale of a Berry business unit, operating income covered interest expense by 1.4 times in the fourth quarter.

Of the 14 analysts who rate BERY, none says sell and 11 say buy. With short interest equal to 3% of the float, it can't be said that the bears have caught the scent of the prey just yet. Insiders sold 40,000 shares last year for net proceeds of $2.2 million, although no insider has transacted in the stock since last April.

A double-B-plus/Ba3 credit, Berry is situated in the upper echelons of junk. It's a curious thing, considering the truism that bondholders can expect no emolument greater than payment of interest (such as it is) and return of principal, but the credit analysts are just as bullish on the plastics maker as their equity counterparts are.

"With such size and scale, we believe Berry has multiple avenues for value creation," S&P Global Ratings analysts Daniel Lee and Michael Tsai enthused in May. "Over the next 12–18 months, we expect Berry to drive value by leveraging its size and scale to improve raw material procurement and by pursuing various cost-rationalization opportunities. Over the long term, we believe the combined entity will have the platform to drive modest market-share gains and better organic growth opportunities in otherwise mature end markets, particularly given the combined company's product portfolio." As for the targeted cost savings, the S&P duo wrote, "we believe there is upside given initial synergies guidance." Let us see about that.

. . .

Berry's problems begin with the core business: Plastics tick boxes neither for ESG-driven capital allocators in America, nor for the National Development and Reform Commission in China. As to the latter, on Sunday, it issued draconian new regulations to cut Chinese consumption of single-use plastic.

The People's Republic was formerly the top destination for America's plastic waste—indeed, since 1992, China has imported 45% of the world's junk plastic, according to the journal *Science Advances*. Deciding that enough was enough, China two years ago raised the bar on the kind of plastic refuse it would accept. This was no gambit in the trade wars, but a response to domestic environmental and health concerns. Following the Chinese initiative, India, Malaysia, Vietnam, Thailand and Indonesia put into place similar restrictions. In consequence, many U.S. municipalities now ship their water bottles, milk jugs and peanut-butter jars—still carefully sorted and deposited in blue recycling bins by a conscientious citizenry—to local landfills. "It's OK to put it in the garbage pile, put it in the landfill and feel OK about it," Thomas Kinnaman, an environmental economist at Bucknell University, told National Public Radio listeners last July. China doesn't want it, and it no longer pays to recycle it.

Inconveniently for RPC—and, of course, post-acquisition, for Berry and its shareholders and creditors—Europe is leading the charge to reduce plastic usage. Knowing an existential threat when it sees one, RPC produced a kind of CliffsNotes for European lawmakers, extolling the value of "post-use plastic" in today's "circular economy"—or, as NPR's authorities suggested, not so much a circular economy as a land-filling one. This was in 2018. Evidently unpersuaded, the European Parliament, in March 2019, voted to ban single-use plastics by 2021 and to require that 90% of plastic bottles be made from recycled materials by 2029.

. . .

Given the size and number of its acquisitions, it's hard to say if Berry's roll-up strategy has succeeded or not. Around the 2012 initial public offering, the company boasted a $6.2 billion enterprise value. The cost of subsequent acquisitions runs to $10.2 billion. Subtracting that sum from the current EV of $17 billion yields $6.8 billion, or something close to Berry's enterprise value on the day it went public.

Organic sales and earnings growth

No growth here

source: company reports

are better measures of long-term M&A success. Excluding acquisitions, Berry has suffered volume declines every year since its public listing, by 3% and 1% in fiscal 2019 and 2018. Up through fiscal 2017, organic earnings were growing, but through the fourth quarter of fiscal 2019, the company has posted eight consecutive quarters of negative organic Ebitda growth. In the most recent three months, the year-over-year drop in organic Ebitda accelerated to 11.6% from declines of 7.2% and 0.6% in the third and second quarters. Nor can you attribute the fall-off in home-grown Ebitda in the three months ended Sept. 28 to a surge in deal-related costs; management does not forget to adjust Ebitda for "restructuring, business optimization and transaction activities."

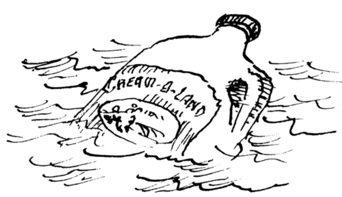
The slump in volumes last year came despite what appears to be a change in revenue-recognition protocols. Berry's 2018 10-K report says it recorded a sale when "title and risks and rewards of ownership pass to the customer, there is persuasive evidence of an arrangement, the sales price is fixed and determinable and collection is reasonably assured." Management took a blue pencil to that language for the 2019 edition, saying instead: "Revenue is recognized when performance obligations are satisfied….We consider the promise to transfer products to be our sole performance obligation." It's unclear exactly how much this benefited growth, but switching to a standard that records a sale when Berry promises to ship a product from one in which Berry booked a sale only when the title, risks and rewards were transferred to a customer may have brought forward a few days' worth of revenues last year.

In reply to my request for clarification, Dustin Stilwell, head of investor relations at Berry, replied by email: "There were some recent changes, that I believe began starting in 2019, to revenue recognition accounting standards by the SEC." Stilwell did not respond to follow-up questions on revenue recognition.

Then there is RPC itself. Like Berry, the British plastics maker was highly acquisitive, spending more than £2.5 billion ($3.3 billion at current exchange rates) in the eight years prior to the merger with Berry. RPC did push Ebitda to £584.6 million from £86.7 million between the fiscal year ended March 31, 2011 and the 12 months ended Sept. 30, 2018. However, the chasm between earnings and free cash flow only widened: Over the same period, FCF grew to £121.3 million from £26.6 million.

Paul Moran, an analyst at Northern Trust Securities LLP, and Fraser Perring, the founder of Viceroy Research, dug into the case and found a number of concerning signs at RPC, including management's use of provisions for off-market contracts. Under International Financial Reporting Standards, an acquirer can take provisions for contracts that are above or below market prices during an acquisition.

Say that RPC bought Widget Co., Inc. Our hypothetical acquiree has £100 in earnings, made up of £125 in income from profitable contracts and £25 in losses on unprofitable contracts. Once RPC acquires Widget Co., it recognizes the £125 in earnings from the profitable contracts but not the losses from the £25 of unprofitable contracts; these are provisioned for on the balance sheet and do not run through the P&L.



Concern by these skeptics, as well as news that the UK's Financial Reporting Council was looking into RPC's accounting in June 2018, sent RPC's stock down to £6.32 on Dec. 10, 2018, from £10.07 on Jan. 5, 2017. In the midst of this news, in the summer of 2018, Bain Capital and Apollo approached RPC for a potential takeover. While Bain dropped out of the process, Apollo made a bid to acquire RPC for £7.82 in January. On March 8, Berry announced it would pay £7.93 per share, or 1.4% above Apollo's bid. It was enough.

While Berry undoubtedly knows the plastic-packaging market well, it had no special edge on RPC's accounting issues. "Also regarding the synergy guidance," Adam Josephson, who rates BERY a hold for KeyBanc Capital Markets, Inc., wrote to clients in March 2019, "RPC did not permit BERY sufficient access at either a divisional, business unit, or manufacturing site level to enable BERY to formulate detailed plans regarding the acquisition's impact on the respective businesses, per the regulatory statement."

It might be noted that Berry's previous acquisition of a roll-up was not entirely successful. In June 2015, Berry purchased Avintiv, Inc. for $2.3 billion from The Blackstone Group, Inc. In the two years prior to Berry's purchase, Avintiv had spent $635 million buying other plastic makers. When presenting the deal to shareholders, Berry touted Avintiv's position in a fast-growing hygiene market and especially in emerging markets.

Berry's health, hygiene and specialties (HH&S) division, which largely consists of the former Avintiv, has, even more than its parent, suffered falling volumes, with declines of 5% and 2% in fiscal years 2019 and 2018. Worse yet, adjusted Ebitda margins at the HH&S division have declined to 16.4% in 2019 from 19% in 2016.

Since Avintiv, Berry has refocused on cost-cutting, particularly on the money-saving possibilities of lower resin prices. The trouble is that the production of this all-important plastics input is a regional business and RPC's plants and Berry's plants show small geographical overlap. Such may explain why the projected synergies for Berry's largest acquisition only amount to 3% of sales vs. 5% for previous bolt-ons—as well as to underscore the significance of CFO Mark Miles's reply when the question arose of how RPC would affect Berry's currency exposure. "There's not a lot of transactional FX in the combined business, and most of it's just translation of earnings as most of our businesses are local made, local sale," said Miles.

Besides, Berry reported a 16.5% adjusted Ebitda margin on acquired revenues in the fourth quarter, matching the overall corporate Ebitda margin of 16.5%. If there are no underlying problems at RPC, it appears that the latest acquisition is already as profitable as the rest of Berry's businesses.

Early on, Mr. Market took a properly skeptical view of the RPC deal. Between April 15 and Oct. 2, Berry's share price slipped by 36%, to $37.37. Yet BERY rallied by 10.9% on Nov. 21 after reporting full-year free cash flow of $802 million, up from $668 million in 2018 and surpassing prior guidance of $670 million. On the earnings call, Miles attributed the surge "to falling raw-material prices." Resin prices did, indeed, go down (e.g., polypropylene dropped to $0.62 from $0.85 per pound between the fourth quarters of 2018 and 2019), and lower inventories added $99 million to cash flows, but an even more important driver deserves more scrutiny than yield-besotted investors have so far accorded it.

The unsung helpmeet was this: Between 2018 and 2019, factored receivables rose to $284 million from $162 million, providing a $122 million boost to cash flows or 91% of the year-over-year improvement in FCF. Nevertheless, in the wake of this low-grade earnings surprise, the Berry share price has zipped to $48.19.

As of Sept. 28, Berry showed $8.9 billion in first-lien loans and notes and $2.6 billion in second-lien notes. The first-lien obligations carry gross leverage of 4.3 times trailing pro forma Ebitda, the second-lien notes, gross leverage of 5.5 times trailing pro forma Ebitda. An extraterrestrial credit analyst would probably assume that the second-lien holders would earn an additional increment for the marginal risk they bear, but E.T. would be in error. The first-lien 4⅞% notes of July 15, 2026 and the second-lien 5⅝% notes of July 15, 2027 (both callable in 2022) change hands to deliver near identical yields-to-worst of 3.5% and 3.6%. Even so, those dollar-denominated rates tower over the miniature 1.01% yield attached to Berry's 1% euro-pay secured notes of Jan. 15, 2025.

The 5⅝s of 2027, rated double-B/B2, change hands at a spread of 200 basis points over Treasurys, in line with the average 190 basis points at which double-B-rated junk trades today. Over the past 24 years, however, double-B-rated debt has recorded an average spread of 364 basis points. If the 5⅝s repriced to the long-term spread on double-B bonds, their price would tumble by $5.63, wiping out more than a year's worth of income.

At that, such a small inconvenience might almost be considered the upside case. If Berry's organic earnings continue to decline, look out below.

•