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Corporate mystery meat

Kerry Group plc (KYG in Dublin), a worldwide gastronomic giant in flavors, ingredients and packaged foods, is Ireland's fourth-largest company by market cap. Don't be chagrined if you've never heard of it. The stockholders don't know much about it, either.

"Sell Big Food," exhorted the [March 25 edition of Grant's](#) in a reference to the fast-rising shares of Kraft Heinz Co. (KHC on the Nasdaq) and Campbell Soup Co. (CPB on the Big Board). Kerry, a top supplier to the packaged-foods industry, is just as overvalued as its big-name customers, in our opinion.

Kerry makes and markets emulsifiers, texturants, enzymes, proteins, hydrocolloids and fermented products. They infuse and flavor the kinds of packaged foods and beverages that the stock market seems to crave more than on-trend shoppers do. Taking the shoppers' part, we remain bearish on Kraft Heinz and Campbell. We are newly bearish on Kerry, a black box of an acquisition machine whose earnings do not make up for in quantity what they lack in quality.

Kerry Group, with €13.4 billion (\$14.7 billion) of market value and €6.1 billion of 2015 revenue, was founded in 1972 as a joint venture of the Erie Casein Co., the Irish state-owned Dairy Disposal Co. and a federation of dairy cooperatives. Only for so long was the new creation content to hew to the legacy business of extruding protein from raw milk. By the early 1980s, it was diversifying out of dairy products. In 1986, it went public. The cows became financialized.

Ingredients, via Kerry's taste and nutrition division, delivered 76% of last year's sales (the company reports semiannually, so the most recently available results come from fiscal 2015). Packaged foods—Cheestrings, LowLow, Dairygold, Bisto, among other brands of cheeses, meats and frozen meals, sold principally in Ireland and the UK—chipped in 24%.

The Americas account for half of ingredient sales. Europe, the Middle East and Africa (33%) and Asia-Pacific (17%) furnish the rest. The United States is Kerry's single most important market and contributed 39% of taste and nutrition revenues in 2015. Top ingredient end markets are beverages (24% of the division's sales), meats (18%), dairy (9%), bakery

Kerry Group plc All figures in € millions except per share data

	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>
Revenue	€6,104.9	€5,756.6	€5,836.7	€5,848.3	€5,302.2
Trading profit	700.1	636.4	611.4	559.0	500.5
Amortization	37.4	28.0	28.1	23.4	19.3
Non-trading items	(9.4)	(0.0)	393.8	158.0	1.8
Operating profit	672.1	608.4	189.5	377.6	479.4
Interest expense	(69.3)	(52.9)	(67.6)	(62.1)	(46.0)
Profit before taxes	602.8	555.5	121.9	315.5	433.4
Taxes	77.4	75.7	37.5	54.8	72.7
Net Income	525.4	479.8	84.4	260.7	360.7
Shares outstanding (mns)	176.1	176.0	175.9	175.8	175.6
EPS	2.98	2.73	0.48	1.48	2.05
Cash	236.4	283.7	245.8	215.4	237.9
Debt	2,049.9	1,573.7	1,325.6	1,500.1	1,598.9
Net debt	1,813.5	1,290.0	1,079.8	1,284.7	1,361.0
EBITDA	828.5	742.2	722.7	675.9	603.8
Net debt/EBITDA	2.2 x	1.7 x	1.5x	1.9x	2.3x
Op. profit/Interest exp.	9.7	11.5	2.8	6.1	10.4

source: company reports

goods (9%), cereal and bars (6%) and soups, sauces and dressings (6%).

Kerry grows by acquisition. It has closed on 160 transactions since 2000, at a cost of €4.6 billion; in 2015 alone, it spent €893.2 million. Over this acquisitive decade and a half, top-line growth has averaged 5.8% per annum. Bottom-line growth, as measured per share, has weighed in at 9.5% per annum.

One might have expected a bigger revenue bang for the euro. Then, again, Kerry has had to confront a competitive UK grocery market as well as dimming consumer interest in foods that come in cans, boxes or pouches. In consequence—and on account of Kerry's decision to exit lower-margin businesses—sales at the consumer-foods division have declined at a 1.8% annual rate since 2010. Over the same span, annual growth in sales in the taste and nutrition business has risen at a 6.7% rate.

Bulls contend that the painful adjustments in the consumer-foods business are old news and that better days lie ahead. "The primary reason that we are invested in Kerry is because of the taste and nutrition business," Paul Moroz, a portfolio manager at Mawer Investment Management, Calgary, which owns shares in Kerry, tells colleague Evan Lorenz. "They have grown through acquisitions and created a supermarket of brands. If you are a big consumer-food company and you want to tweak the taste of any sort of product, you are really outsourcing a lot of that R&D to Kerry Group. One of the nice things about their business is it is dependent on innovation and competition. The more they are able to innovate and help the customer, the better they are going to do over time. The idea is that it is going to drive margins."

You might turn to Kerry, for instance, to develop a coating for chicken pieces. You would want to be able to claim that said coating was all-natural and that it was gluten-free. You would want to make sure that it tasted good and that it wouldn't stick to the side of a hopper. The strategy of selling complex solutions rather than individual products is the new, new thing in flavors and ingredients.

It's this approach—a "holistic" approach—in which Kerry is invested for the future, says William Lynch, head of investor relations at Kerry. "We've built out a platform for that for the

future. That's our view for the long term. That's what makes the model of what we are doing a little different. There is a degree of missionary work in this because it is different from what is the traditional model of selling single ingredients."

Kerry hardly has this market, or notion, to itself—Givaudan SA, the Swiss flavor and fragrance company, is always talking about "integrated solutions." Just the same, according to Lynch, no competitor fields more than 25%–30% of the immense Kerry product line.

For Wall Street's money, Kerry's best flavor is its steady-eddy predictability. It loves Kerry as it loves Big Food (now, admittedly, after our analysis, Bigger Food) and for much the same reason. Safety, or rather, we should say, perceived safety, is what investors seem to crave. Thus, the Street is looking for increases of 2.8% and 4.7% in 2016 and 2017 revenue, along with corresponding rises of 7.5% and 11.4% in EPS. "In these uncertain times," Ian Hunter, the analyst who covers Kerry at Investec Bank plc, tells Lorenz, "it is a company that is not going to surprise to the up- or the downside very markedly. You are not going to get profit warnings. It is going to keep providing a dividend although the yield at the moment is low. It is still higher than bond yields. It is just a safe bond proxy. That is why people are putting money into it. Whenever they see something crash, money comes back into this sector."

To judge by Kerry's stock price, investors must be especially fretful. KYG is quoted at 25.2 times 2015 earnings, at 23.4 times the 2016 estimate and at 18.3 times enterprise value (current market cap plus net debt as of Dec. 31) to trailing EBITDA. The shares yield all of 0.66%. Then, again, the Kerry triple-B-plus-rated, euro-pay senior unsecured 2³/₈s of 2025 change hands at 114.50 to yield 0.73%, not much more than the single-A-plus-rated Irish sovereign 10-year notes, which fetch 0.48%.

To the bulls, the Kerry stratagem is worth a premium valuation. Independent, niche ingredient-makers lack scale and a worldwide marketing platform. They gain both in the Kerry corporate fold. With a projected €1 billion in M&A outlays this year in their "upside" case, J.P. Morgan Cazenove

analysts Alberto Lopez Rueda and Celine Pannuti advised their clients on April 28, Kerry would be able to retain its fancy multiple while generating 15% EPS growth in 2017.

"You'd expect that Kerry, as both a supplier to packaged-food companies and as a manufacturer of off-trend foods itself, would be struggling to deliver the kind of robotic, never-miss results that the Street demands," Lorenz observes. "That it seems not to be struggling is a mystery that may owe as much to sparse disclosure as to substantive results."

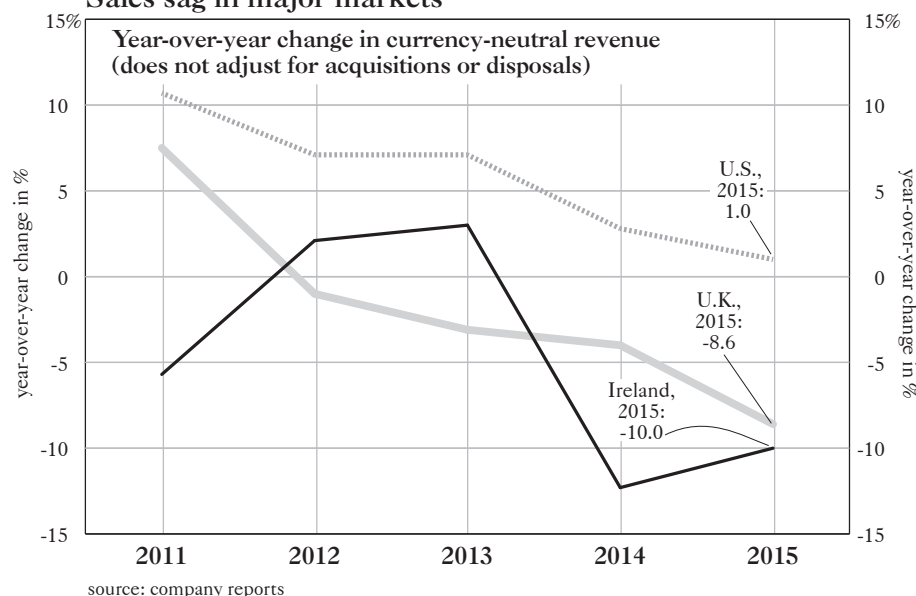
"Peruse the income statement," Lorenz proceeds, "and you'll notice some key items missing, such as cost of goods sold (which is needed to calculate the company's gross margin as well as working capital ratios like days inventory and days payable) or operating expenses. Instead, below the revenue line, investors are treated to a single line item called 'trading profit,' which is operating profits before the amortization of intangible assets, and 'non-trading' expenses, an opaque line item that typically includes restructuring- and acquisition-related expenses."

"This selective approach to disclosure is also evident on Kerry's investor-relations website," Lorenz goes on. "You can download and save to your computer the annual reports from 2011 through 2015. The 2010 annual? Available only 'on request.' While you can open PDFs containing the annual reports from 2008 and 2009, you cannot save these documents to your computer; the company disabled that feature."

"An industrious analyst," Lorenz continues, "can peel down to the third footnote in the 2015 annual report to find some disclosure on operating expenses. Some line items in the note are easy to understand, e.g. 'raw materials and consumables' and 'staff costs.' Others are enigmatic, e.g. 'other external charges' and 'other operating charges.' In fact, to make sense of most line items on Kerry's financials, a reader must excavate the information from footnotes."

Lorenz took his complaints to Lynch, the IR man, who replied, *inter alia*: "When we would look at ourselves from a peer analysis from what we disclose for companies in this part of the world, we would see ourselves as being in the—we wouldn't be be-

Sales sag in major markets



hind the curve—we may not be at the top of the curve, but we are not behind the curve.”

Still—this is your editor speaking—it takes more than obfuscation to defeat Lorenz. He finds, upon digging into footnotes and tables, that sales to regions accounting for 65% of Kerry’s top line registered a 4.9% year-over-year decline last year. Ex-acquisitions and dispositions, sales to these markets—America, Britain and Ireland—would have fallen by 3.1%.

Asked to explain why, Lynch replied that sales are growing “on a volume basis.” Which would seem to suggest that Kerry is selling more products at lower prices. What differentiates the likes of Givaudan, Symrise AG, International Flavors & Fragrances, Inc. (IFF) and Novozymes A/S is their ability to sell fewer (or, if they choose, more) products at higher prices.

It’s in this commercially aristocratic cohort that the bulls would place Kerry. And, to be sure, the Kerry business portfolio does contain some of the moated products in which it is possible to raise prices. According to an insider’s estimate (by Frutarom Industries Ltd., a Haifa, Israel-based flavor and fragrance business), as much as a fifth of Kerry revenue sources might answer the description of “differentiated.” However, the remaining 80% would seem to put Kerry more properly in the company of the producers of commodity-like packaged-food ingredients such as Tate & Lyle plc, Koninklijke DSM

NV and Corbion NV. There’s nothing so exotic about V8 vegetable juice, or even V-Fusion Smoothie Mix, which product, for instance, Kerry scooped up in its September acquisition of Island Oasis.

As you might expect, upper-echelon companies post above-average profit margins. To earn them, they commit to above-average research and development spending. Thus, on average in 2015, Givaudan, Symrise and IFF generated an average EBITDA margin of 22.9% and spent an average of 7.7% of sales on R&D. Compare and contrast Tate et al., which produced an average EBITDA margin of 13.5% and earmarked 3% of sales for R&D. Kerry’s vital signs—EBITDA margin of 13.6% and R&D outlays equivalent to 3.8% of sales—place it squarely in the Tate cohort.

“In fact,” Lorenz observes, “the principal way in which Kerry resembles high-end flavor companies is valuation: The trio of more differentiated companies trade at an average of 17.2 times enterprise value to EBITDA, while Kerry trades at 18.3 times. As for the less differentiated trio, they’re quoted at 11.7 times.”

. . .

Kerry treats its acquisitions almost as if they were state secrets. Are you curious about post-acquisition accounting adjustments? The front office has vouchsafed details on only one of last year’s 10 company purchases

(that of Red Arrow Products, a Manitowoc, Wisc., maker of smoke flavors for meats). It lumped the other nine together like so much pizza dough.

Analysts should count themselves lucky that management saw fit to disclose the fact that newly acquired businesses contributed €133 million to revenues in 2015. Concerning the €121.5 million of acquisitions completed in 2013, the C-suite sounded as if it were too tired to convey the relevant facts: “Due to the rapid integration of the acquired businesses into the Group’s current structure, involving all aspects of business activities such as manufacturing, commercial, finance and IT, separate disclosure of the acquisitions’ revenues and profit or loss is impracticable.”

In the way of roll-ups, Kerry assigns most of its purchased assets to goodwill and intangibles to minimize the impact of the new accessions on the income statement (*c.f. Grant’s, June 17*). In 2015, it so classified €786.6 million of the aforementioned €893.2 million spent on acquisitions.

There is some reason to think—Lynch himself suggests it—that American, British and Irish sales are more profitable than the ones that Kerry is booking in more rapidly growing markets. Sales to parts of the world excluding America, Britain and Ireland rose by 10% in 2015 (after adjusting for the impact of currencies, acquisitions and disposals). Curiously, Kerry’s reported profit margin reflects none of the diminution that that observation implies. Trading margin, i.e., trading profits divided by sales, has risen, not dwindled: to 11.5% in 2015, from 11.1% in 2014 and 10.5% in 2013.

No such improvement is evident in the quality of earnings. In 2012 and 2013, Kerry generated EPS of €1.48 and €0.48 a share, respectively. That was according to International Financial Reporting Standards, the global GAAP. Better, management suggested, to focus on adjusted earnings that exclude those unsightly expenses. Between 2012 and 2013, adjusted EPS rose to €2.58 from €2.34.

Big acquisition-related restructuring charges were responsible for the IFRS-calculated drop. The charges led to the buildup of provision accruals on the balance sheet. The release of those charges—in the sums of €53.5

million and €11.1 million, respectively, or €0.26 and €0.05 a share—gave a filip to IFRS-reported earnings in 2014 and 2015.

Asked about those releases, Lynch replied that Kerry embarked on a restructuring program in 2012 and 2013. He continued: “We wanted to provide [provisions] to keep it clear and, particularly, as we were coming out of 2014, we didn’t want any non-trading items [i.e., restructuring charges] in our figures thereafter because it was a two-year program.”

Only the most assiduous students of Kerry’s finances understood what was going on—the information was secreted in footnote 25 of the annual report. It makes you wonder what other riches the fastness of the fine print might conceal.

The corporate tax rate is another source of confusion and, indeed, mystery. In 2015, Kerry paid a rate of 12.8%. Ireland, Kerry’s home, is a famously low-tax jurisdiction, but Kerry makes most of its products in the countries in which it sells them. The United States, Kerry’s top market, is a famously high-tax jurisdiction. One might therefore expect a bigger tax bite than the one which Kerry reported.

“Be that as it may,” Lorenz notes, “the company’s cash tax rate has conventionally tracked the company’s accrual tax rate. In other words, the tax information on the statement of cash

flows has customarily squared up with the tax information presented on the P&L. Thus, in the years 2011, 2012 and 2013, the cash tax rate was within a couple of percentage points of the accrual tax rate. The pattern was broken in 2014 and 2015 when the cash tax rate was just 40% and 49% of the accrual rate, respectively.”

In reply to Lorenz’s query, Lynch said that the enigma can be explained by “the investments we have in terms of the global technology innovation center that we’ve rolled out in terms of Ireland which has been a €100 million investment.” He added that, “Over time you will see the cash tax and the effective tax converge again. It is a timing effect.” Beyond us is how such a sizable dip in the applicable corporate tax rate can be ascribed to an investment in the country in which Kerry books only 7% of its sales.

All you really need to know, a bull might say, is that Kerry generated a record €469.1 million in free cash flow in 2015 (that is, cash flow from operations less capital expenditures). To which we might say, that achievement may not be all it seems. From 2000 through 2014, Kerry spent billions on acquisitions, yet free cash flow stubbornly refused to grow, averaging €230.7 million; it ranged between €111.2 million in 2001 and €352.8 million in 2009. What accounts for the 2015 blowout is the aforementioned low cash tax rate and a seem-

ingly minor €64.8 million reduction in working capital.

“There was, in fact,” Lorenz relates, “a €144.1 million swing from the €79.3 million that working capital consumed in 2014. Footnote 29, which breaks the line item ‘change in working capital’ found in the cash flow statement, raises more questions. The note states that, in 2015, inventories fell by €45.4 million and trade and other receivables rose by €11.2 million. According to the balance sheet, inventories rose (not fell) by €32.2 million and trade and other receivables rose by €32.8 million in 2015. The acquisitions Kerry bought for €893.2 million in 2015 may explain the anomalies in cash flows, but they raise further questions about earnings quality.

“In sum,” Lorenz closes, “Kerry is increasingly reliant on acquisitions to compensate for sales declines in the core business and on earnings gimmicks to meet consensus estimates. Apropos of the bulls’ conviction that no earnings restatement is likely or even conceivable, we will have to wait and see. New sets of eyes will be reviewing Kerry’s books beginning in 2016. In is PricewaterhouseCoopers. Out is Deloitte, Kerry’s auditor since 1986.”

In March, insiders sold a net 77,523 shares of Kerry for €6.1 million in proceeds. It was the only insider activity in the preceding 12 months. An informed signal, we judge.

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