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High debt may amplify current problems of the US packaged food market

by [Alexander Engeln]

The [earnings announcement made by US packaged food producer Kraft-Heinz (NASDAQ:KHC) on February 21, 2019], came as a shock to investors: a quartet of bad news, composed of lower-than-expected earnings growth, a slashing of dividends, an accounting investigation by the SEC and, perhaps most strikingly, a USD 15.4bn write-down on brand goodwill, led share prices to fall by an unprecedented 27 percent on the day following the announcement. However, the business problems that led Kraft-Heinz to this state are present for other competitors in the US packaged food industry as well.

One factor that may act as an amplifier of Kraft-Heinz's business problems could be an overutilization of debt: since the merger in mid-2015, the company has increased its long-term debt load by roughly USD 6bn to its current level of USD 31.29bn. One common measure of the ability of a company to pay its interest and principal on debt is its Total-Debt-to-EBITDA ratio. Kraft-Heinz's Total-Debt-to-EBITDA ratio sits at 5 as of the end of 2018 (Fig 1a), meaning its total debt is five times as large as its earnings before interest, taxes, depreciation and amortization in 2018. Furthermore, while the company's debt-to-equity ratio might not seem overburdened at 50%, it is noteworthy that over 80% of its assets are intangible at the time of writing – although this is not unusual for this industry, it is partly why the write-down of goodwill had such a big impact on investor confidence.

The high amount of leverage, goodwill and intangible assets present in the US packaged food industry comes in part from the fact that the past years have seen a large number of acquisitions, not only from Kraft-Heinz (the latest being Primal Kitchen in January 2019) but from close competitors like Campbell Soups and General Mills as well (both of whom are key players in the industry, with a respective >USD 11bn market capitalization far above the industry median of USD 4.3bn, and each offering a diversified packaged food product portfolio).

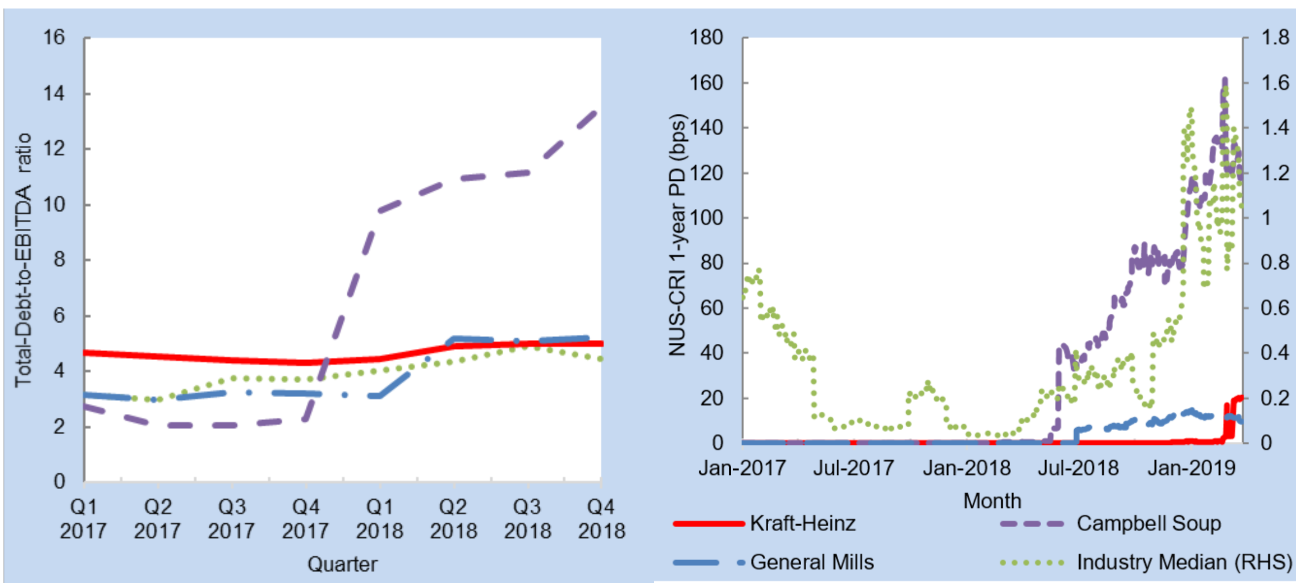

Fig 1a & 1b: Recent development of Total-Debt-to-EBITDA ratio (left) and NUS-CRI 1-year Probability of Default (PD) (right) for Kraft-Heinz with selected competitors (LHS) and median US packaged food industry (RHS). Legend applies to both figures. *Source: Bloomberg (left), NUS-CRI (right)*

The necessary capital for these acquisitions were often secured using corporate borrowing, which is one of the factors leading to Campbell Soup's, General Mills' and the industry median Total-Debt-to-EBITDA ratio exhibiting an upward trend over the past two years, as can be seen in Fig 1a. When comparing its own ratio to these peers, Kraft-Heinz actually ranks at a relatively stable level below Campbell Soup and on a comparable level to General Mills, so the company is certainly not an exception in the industry. But the rise in leverage ratio has other causes than rising debt levels as well: the US packaged food industry is currently faced with a slowing earnings growth. Between Q4 2017 and Q4 2018, growing competition from generic brand substitute products and consumer trends like the move to a healthier lifestyle caused the industry median EBIT Year-on-Year (YoY) Growth to sink by 11.75%. Rising logistics costs have had a negative impact on the median operating margin as well, causing it to shrink by 20.55% in the same time period, as detailed in Table 1 below. The combination of these effects continues to place upward pressure on the companies' respective credit profile (Fig 1b).

	Kraft-Heinz (Q4 2017 → Q4 2018)	Campbell Soup (Q4 2017 → Q4 2018)	General Mills (Q4 2017 → Q4 2018)	Median US Packaged Food Industry (Q4 2017 → Q4 2018)
Total Debt / EBITDA (X)	4.33 → 4.98	2.27 → 13.53	3.18 → 5.23	3.71 → 4.46
Operating Margin (%)	23.85 → -204.22	11.15 → 0.70	16.89 → 12.40	11.19 → 8.98
EBIT Growth YoY (%)	3.8 → -30.43	18.54 → -92.18	-7.79 → -22.85	8.68 → 7.66

Table 1: Change in leverage level, operating margin and earnings growth for Kraft-Heinz with selected competitors and median US packaged food industry between Q4 2017 and Q4 2018. *Source: Bloomberg*

Looking at Kraft-Heinz, these business issues are also represented in the company's PD, which grew significantly by a factor of 1000 to 20.03 bps in the year between March 2018 and today. While this represents a stark relative growth, it is still not worryingly high in absolute terms. Yet equities were not the only victim of investor panic: the company's bonds were affected as well, and insurance derivatives for the company's most traded notes, Kraft Heinz 3% 6/1/2026, were trading at a six-year high. Despite the large amount of negative publicity surrounding this announcement, however, KHC bonds have so far managed to retain an investment-grade credit rating, albeit at the lowest level above junk-status.

When taking these current problems in combination with a generally slowing world economy and potential signs of a coming recession (such as the recent, though short-lived, inversion of the US bond yield curve), highly leveraged companies like Kraft-Heinz and others in the US packaged food industry will find themselves with growing problems of servicing and refinancing their debt. This credit risk, which is caused by slower economic growth, slimmer margins and the risk of rising interest rates, is represented in Fig 2, which shows the companies' Forward 1-year PD, a computation of the credit risk of a company or a portfolio of companies in a future period, which can be interpreted similar to a forward interest rate (for example, the 7-month forward 1-year PD is the probability that the firm defaulted during the period from 7 months onwards to 1 year plus 7 months, conditional on the firm's survival in the next 7 months). Should they survive the next year, Kraft-Heinz and the other big players are expected to be in a much riskier position than the median of their industry, especially in the short- to mid-term. But while Kraft-Heinz's Forward 1-year PD is at a higher level than General Mills', the company is still in a less risky position than its competitor Campbell Soup, which is in line with their respective current levels of Total-Debt-to-EBITDA ratios.

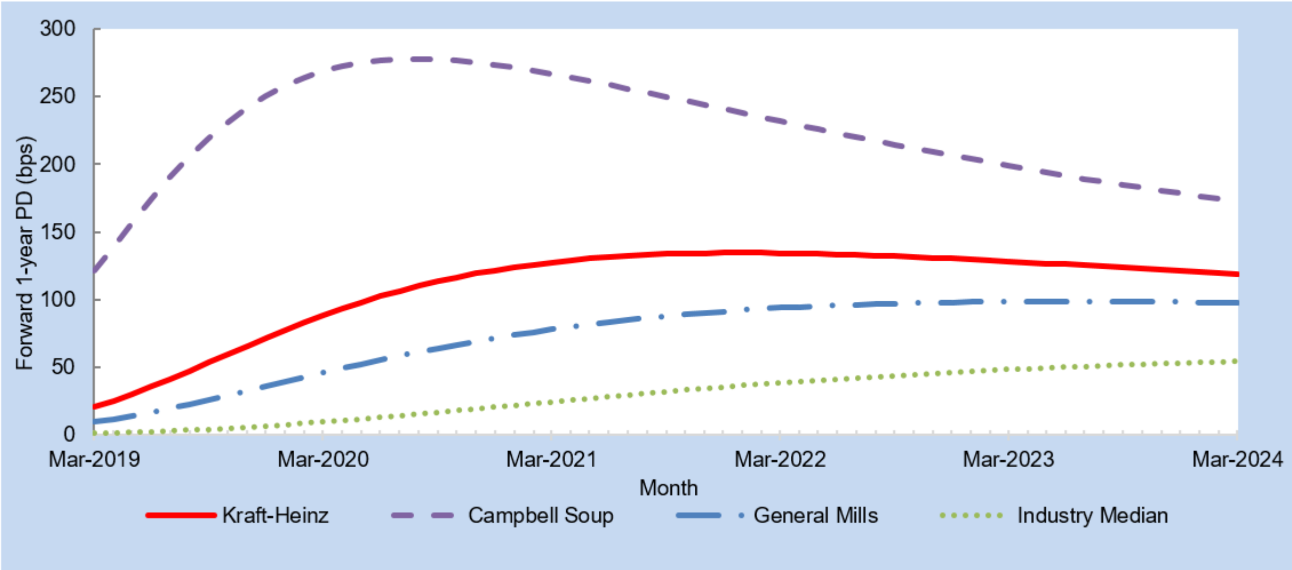

Fig 2: Forward 1-year PD (in bps) of Kraft-Heinz with selected competitors and median US packaged food industry as calculated on March 29, 2019. *Source: NUS-CRI*

Overall, while the high amounts of corporate debt may not necessarily be the main cause of the current problems in the US packaged food industry (or even a problem in itself at all), the associated credit risks could very quickly act as an amplification of recent negative market developments and become the source of future issues. Even though the Federal Reserve Bank has so far backed off from hiking interest rates, this is unlikely to persist in the long-term. A worsening credit market could also potentially lead to a realization of the risks posed by high leverage. Ensuring a healthy balance sheet could therefore not only offer Kraft-Heinz a way to combat its upward PD trend, but offer any other highly leveraged company some much needed stability in the face of an economically uncertain future as well.

Credit News

US customs demands bigger bonds as trade tariffs rise

Mar 29. After facing steep customs bills for tariffs imposed by the Trump administration on incoming Chinese goods, US importers took additional hits as the cost of the guarantee – a US customs bond – shot up. Since the customs bonds are set at 10% of the importer's total estimated annual duties, fees, and taxes, the Trump's USD 32.5bn annual tariff bill on Chinese goods has required an additional USD 3.25bn in customs bonds. The more costly customs bonds mean higher underwriting fees and collateral obligations, further complicating finances for importers and increasing the importers' default risk on payment obligations. Importers are not only facing surging bond requirements but also facing demands of quicker repayment from custom brokers. (Channel News Asia)

Venezuela restructuring options emerge among creditors and officials

Mar 29. Legal advisors to Venezuela sovereign bondholders in the US have released a paper to decide the restructuring options of the country's debt in the event of a possible ouster of President Nicolas Maduro. The two options, either the White House takes action against creditors or enact a Venezuelan restructuring law that is recognized by US bankruptcy courts, would stop creditors' rights to enforce repayment. Parties backing opposition leader Juan Guaido have not responded to the paper's proposal but have lobbied to protect PDVSA's (Venezuela's state oil firm) US refining arm, Citgo Petroleum Corp from being seized by creditors. (WSJ)

Supercycle in US debt helps to curb Treasury borrowing costs

Mar 29. As Treasury issuance outstrips crisis-era records, the rising share of government bonds in market-weighted fixed-income indexes is pulling in more global investors. Some market watchers fears that benchmark-centric investors buy more Treasuries at the expense of other riskier sectors, leading to a crowding out effect. But this risk of crowding out is debatable as corporate bonds has risen due to companies stepping up bond issuance to lock in low interest rates. However, the feedback loop of fund investments into Treasuries has helped curb the cost of the government's borrowing. (Bloomberg)

PG&E bondholder proposal faces headwinds in bankruptcy court

Mar 29. Bondholders of PG&E, mostly New York-based hedge funds, proposed a wildfire damage claim plan that includes a USD 14bn to cover damages. Lawyers for the official committee that represents wildfire victims and another large group of fire victims said the bondholders have not talked to them about the plan and they will not accept the plans that puts an arbitrary cap on disaster damages before those claims are assessed. Victim claims and bond debt share equal ranking in bankruptcy payment priority, so bondholders cannot force victims to go along with their proposal. (WSJ)

Aramco plans USD 10bn bond, casting light on its finances for first time

Mar 28. Saudi Aramco plans to issue a first-ever USD 10bn bond to help fund its acquisition, shining a light on the financial performance of the world's largest oil company for the first time. Saudi Arabia has long kept secret Aramco's finances, only sharing details with banks that have lent it money. A bond would be a logical step on the way to a listing and cheaper than a large loan from banks, analysts say. A bond will also bring less scrutiny to Aramco than an IPO, which would force Aramco to publish public earnings on a quarterly basis, allow analysts to examine executive spending and decision-making and potentially open the company up to lawsuits. (WSJ)

Bond yields on the canvas, Turkey's lira on the ropes (Reuters)

Jet Airways misses paying USD 109mn loan (Bloomberg)

Danish bankers seek interest-rate cap after loan made at 760% a year (Bloomberg)

Regulatory Updates

EBA risk dashboard confirms continued improvements in EU banks asset quality but also low profitability levels

Mar 29. Non-performing loans (NPLs) to total loans ratio for European banks (EU) continued to decline and reached a value of 3.2%, its lowest level since the NPL definition was harmonized across the EU/EEA. Furthermore, EU banks' capital ratio remains high, but it has slightly decreased when compared to 2017 due to an increase in total risk exposure amount. However, the profitability for EU banks only showed a small sign of improvement as its return on equity (RoE) increased to 6.5% compared to 6% in 2017. Lastly, the

leverage ratio for EU banks remains stable, standing at 5.3% in Q4 2018 compared to 5.4% in Q4 2017. (EBA)
Federal Reserve Board releases document providing additional information on its stress testing program **Mar 28.** The Federal Reserve Board on Thursday released a document providing additional information on its stress testing program. Stress tests ensure that banks have adequate capital to absorb losses and retain their ability to lend to households and businesses even in a severe recession. The document is intended to improve public understanding of the Federal Reserve's stress tests. The document provides significantly more information on the stress test models that are used to project bank losses, compared to disclosures from past years. In particular, the additional information on loss rates is provided for the models used for corporate loans and credit cards. (Federal Reserve)
EU enforces focus on new IFRS standards and non-financial information (ESMA) **Central bank risk tool gets IMF endorsement amid easy money** (Business Times)

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