INSIGHT

VIEWPOINT

Any of the Above

Carnac's Take on Current Rating Agency Accommodation of M&A Activity

MARIE H. CHOI | JULY 2, 2018

Carnac the Magnificent, dressed in a bejeweled turban and robe, was one of the most popular characters played by the King of Late Night Johnny Carson. Carnac was an "omniscient soothsayer" with ability to "divine answers to questions that were hermetically sealed in envelopes." This foresight would be handy in the current credit market environment, particularly knowing future answers to balance sheet questions of today. This is critical as future success is predicated on making the correct decisions to these questions.

One of our recurring credit market observations is the pro-cyclicality of ratings criteria, where the rating agencies' view towards balance sheet leverage becomes more lenient as the credit cycle seasons. During the early stages of a cycle, the agencies approach credit underwriting with a skeptical eye toward management attempts to secure the most favorable rating by framing optimistic pro-forma plans. In contrast, as witnessed with more frequency of late, those pro-forma deleveraging targets and business plans routinely have become the 'base' case scenario during ratings agency evaluations. This dynamic echoes previous periods late in credit cycles where excess optimism results in overly-indebted balance sheets, all with the blessing of diluted agency criteria. One example is the recent transaction of Keurig Dr. Pepper.

Background

In January 2018, Keurig Green Mountain (KGM) and Dr Pepper Snapple Group (DPS) announced plans to combine to create Keurig Dr. Pepper (KDP) Inc. The merger brings many of the leading North American soft drink and coffee brands under one roof with the aim of leveraging DPS' strong distribution platform to gain better channel exposure for KGM brands on supermarket shelves. KDP's vision is "...to become a beverage for every need, available everywhere people shop and consume."

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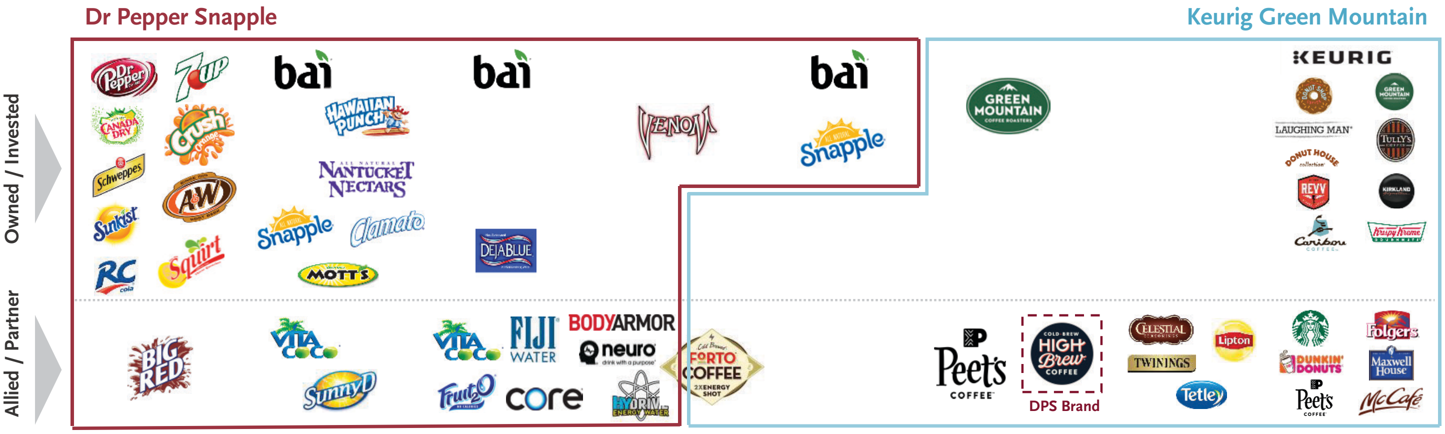
Ms. Choi is a Credit Analyst in the Fixed Income group responsible for credit research in the health care, food/beverage sectors. Ms. Choi joined TCW in 2009 through the acquisition of Metropolitan West Asset Management LLC (MetWest). Since joining MetWest in 2001, she has concentrated on corporate credit research. She was previously a Senior Associate at Pacific Investment Management Company LLC (PIMCO) where she helped develop a proprietary bank loan tracking system. Ms. Choi holds a BS in Management Science from the University of California, San Diego, and an MBA from the University of Southern California Marshall School of Business.

Consumer Packaged Beverage Category, KDP Brands



Source: DPS/KGM Merger Presentation

To fund the transaction, KDP incurred approximately $12b of incremental debt, along with a $9b equity investment by JAB Holding Company. Pro forma leverage rose materially to nearly 6.0x from pre-merger DPS leverage of 2.8x. Surprisingly, rating agencies' responses were subdued with only one notch downgrades to Baa2/BBB. The agencies acknowledged the more aggressive financial policy but took comfort by incorporating optimistic quasi-promises of future balance sheet direction to mitigate more onerous downgrades. These post-merger commitments include:

1. Debt reduction to below 3.0x debt/EBITDA in two to three years
2. Working capital improvements of $1.3b
3. Achieving cost synergies of $600m by year three
4. Annual growth of +2-3% of revenues and +11-12% of EBITDA from 2018 to 2012. Bear in mind, some of KDP's product lines compete in the categories with flat to negative growth trends as seen below.

	CSDs	Juice	Water	Sport / Energy	RTD Tea	RTD Coffee	Tea	SS Coffee
Category Retail $ Trends[1]	(1%) to 1% Non-Colas +1 to 2%	(2%) to 0% Coconut +10%	3% to 6%	6% to 10%	6% to 10%	+10%	0% to 2%	+10%

1 McKinsey Retail Dollar Estimates for 2011 to 2016, based on Beverage Digest, Nielsen and Euromonitor; US + Canada; excludes non-packaged formats (e.g. CSD Fountain, Coffee Shop Retail locations)

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KDP 2018-2021 Outlook

$B USD, except per share data	2017[1]	PRO-FORMA 2018[2]	'18 - '21 CAGR[4]
Net Sales	$10.8	1 - 2%	2 - 3%
Adj. EBITDA	$2.8	7 – 8%	11 - 12%
Adj. EBITDA Margin	26%	+100 to +150 bps	+600 to +700 bps
Adj. Diluted EPS	N/A	$1.06 - $1.11[3]	15 - 17%
Preliminary Purchase Price Accounting (PPA) Adjustment	N/A	$0.04[5]	N/A
Adj. Diluted EPS After Preliminary PPA Adjustment	N/A	$1.02 - $1.07[6]	15 – 17%

[1] KGM actual results (52 weeks) plus DPS actual results
[2] 2018 reflects full year KGM management estimates for KDP on a pro-forma basis
[3] 2018 Adjusted diluted EPS burdened by full year pro-forma interest expense of ~$600M and assumes 1.4B shares outstanding and an effective tax rate of ~26%
[4] 2018-2021 CAGR reflects KGM management estimates for KDP and assumes 1.4B shares outstanding
[5] Preliminary PPA adjustment as shown in Proxy on 1/31/18 approximating $65M / $0.04 per diluted share; subject to final adjustment post merger closing
[6] Pro-forma 2018 Adjusted diluted EPS after Preliminary PPA adjustment

Note: 2017 Adjusted EBITDA metrics and Adj. Diluted EPS are non-GAAP financial measures. See Appendix for GAAP Reconciliations.

Source: DPS/KGM Merger Presentation

Ratings Agency Methodology

Despite more than a 3.0x increase in balance sheet leverage, the rating agencies lowered KPD's rating by only one notch. To properly understand the agencies' acquiescence, it is useful to highlight Moody's ratings methodology where certain criteria are weighted to come up with an overall rating. This methodology results in only a moderate effect following a significant increase in debt, irrespective of the company's ability to repay or reduce debt. In fact, only 21% of the final rating is affected by balance sheet capitalization, including debt levels, according to Moody's rating methodology scorecard simplified into four categories below. Another way to gauge the methodology is to highlight that a company's 'financial policy', or future commitments/promises, has nearly the same weighting (~16%) towards the final rating as actual balance sheet choices.

Moody's Methodology Summary - Factor Weighting

Criteria	Weighting	Description
Scale & Business Profile	56%	Bigger Is Better
Financial Policy	16%	Future Promise
Profitability	7%	Earnings Power
Leverage & Coverage	21%	Balance Sheet/Strategy Choice

For KDP's rating specifically, Moody's ratings incorporate the following assumptions:

1. An 11% annual EBITDA growth rate from 2018-20
2. A 6.5% EBITDA margin expansion by 2020
3. $4.3b of cumulative free cash flow available for debt reduction from 2018-20, achieved via full realization of company targeted synergies (~$600m) and working capital reductions (~$1.3b). The synergy target represents approximately 50% of standalone KGM EBITDA and the working capital reduction goal implies achieving a negative cash conversion cycle for DPS compared to an 18-day pre-merger working capital cycle, both of which are optimistic to achieve.

When compared, these ratings agency assumptions are indeed quite similar to KDP management's 'optimistic' pro-forma plans. Moody's estimates that KDP will achieve a leverage ratio of 3.6x by year 2020, similar to KDP management's goals. The similarities between company targets and rating agency assumptions imply that rating agencies are 'drinking the Kool-Aid' of KDP management's optimistic objectives rather than viewing the outlook through a skeptical lens towards the future.

What Would Carnac Say?

To meet its deleveraging target, KDP would need to achieve all of the commitments within a relatively short period time given its hefty pro forma leverage of nearly 6.0x. In addition, integrating two large companies with a minimal overlap typically introduces significant execution risks along with inevitable potential unknown developments in the future. In reality, a lot could happen along the way.

We envision our favorite mystic from the East stumbling back to his seat, holding a hermitically sealed envelope to its forehead and stating "Any of the above." Carnac then opens the envelope and reads the question:

Which of KDP's commitments/promises could prevent it from meeting the deleveraging target that its current rating is reliant upon?

Carnac's answer to the question says much about the current state of the credit markets, which are still predicated on abundant optimism, facilitated by the ratings agencies. ■

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