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Sell Coke

The Coca-Cola Co. is ubiquitous and lucrative, and the world, in which it operates is prosperous and welcoming. If there is one essential, late-century, bull-market, American enterprise, Coke is it. It is a great stock in a great stock market, and it is trading at a great price. Furthermore, it is owned by Warren Buffett, a great investor.

Recently, Roberto C. Goizueta, Coke's chairman and chief executive, referred to "our virtually *infinite* opportunity for growth." He himself provided the italics, just as the company frequently deploys an infinity symbol as an "unregistered trademark of our growth potential," in its own words.

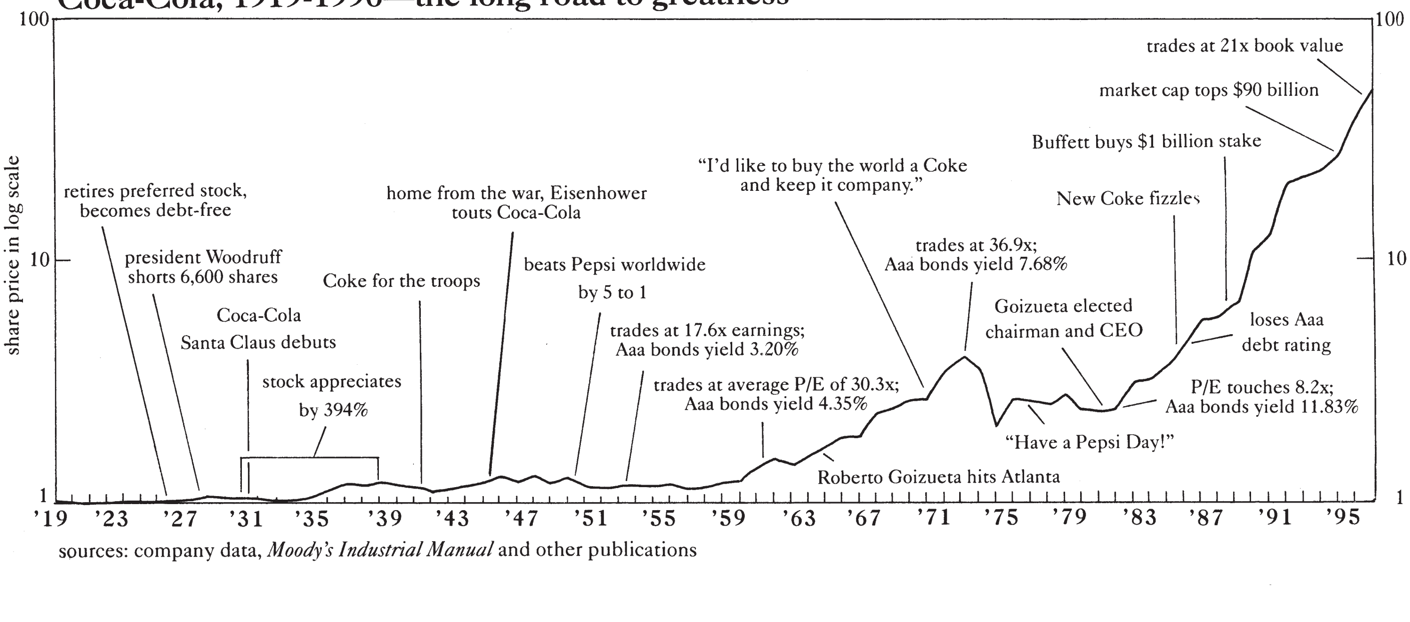
"Is there ever a time you wouldn't consider buying your own stock?" Coca-Cola management asked itself in a question-and-answer exchange in the 1995 annual report. "Yes," it answered directly, "whenever securities laws say we can't. Otherwise, we've yet to encounter a time when we felt our stock wasn't a long-term investment bargain for us."

In other words, overvaluation has not yet become, nor plausibly will become, a relevant long-term investment consideration. No matter that the company has perhaps never sold at a greater premium to the S&P 500 than it does today; or that, at 39 times earnings, it commands almost twice the P/E ratio of Anheuser-Busch, maker of a non-caffeinated world-famous beverage; or that the rate of growth in Coca-Cola sales volume, at about 8%, is less than half the rate of targeted growth in earnings, at about 20%; or that this earnings growth is little more than half its P/E.

To listen to Goizueta, the stockholders face no meaningful risk from any contingent event because all relevant outcomes are under the control of the board of directors. By implication, the equity of any great company should never be sold because its value, except at absurd bull-market extremes (and this is not close to being one, in the bulls' opinion), is beyond earthly measurement. Between the chairman's optimistic lines, a reader may apprehend that the ups and downs of previous financial cycles have been superseded by a single cycle, which is up.

Not that the world is perfect. Far

Coca-Cola, 1919-1996—the long road to greatness



sources: company data, *Moody's Industrial Manual* and other publications from it, Goizueta admits. Human beings consume about 64 ounces of liquids a day. Yet Coca-Cola currently provides less than two of them. It is the job of closing the fluids gap that will carry the company into the next millennium, if not one or two beyond. To imply that Coke's current 47% share of the worldwide soft-drink market constitutes a potential ceiling to growth is to miss—by a mile—the grand strategic point. In contrast to "those who find doom in the trying circumstances that accompany everyday life," as the chairman puts it, all business problems are manageable.

This is an investigation of the circumstances surrounding the valuation of the corporate equivalent of Mount Rushmore, the hot dog, the Bureau of Engraving and Printing and Muhammad Au, all rolled into one. No one will dispute the business merits of Coca-Cola, which is generating growth in earnings at twice the market rate 110 years after its founding. The question is whether, a decade from now, the company will be as vast and rich as present growth rates—on which those paying 39 times earnings necessarily depend—would seem to imply. How should Coke's earnings be capitalized? For a perfect world or—the editor's choice—an imperfect one?

To ask the question in other ways: Is no price too high for the world's top brand name? For Fortune magazine's "Most Admired Corporation" of 1996? For the joint privileges of investing alongside Buffett and of living in an age of miracles? (As for this last point, communism and inflation are both laid low, and violent crime in New York City has entered a bear market. As recently as the Carter term, who could have dreamt such things?) Buffett, a conspicuous non-seller of ZOO million Coca-Cola shares, began to invest in the fall of 1988 at prices equivalent to about 15 times earnings and five times book value. At the current valuation of 39 times earnings and 21 times book value, has anything changed?

Something, surely. Our always latent skepticism has been activated by a reader who observes that Coke spent more than a decade clawing its way back to the peak price it attained in the Nifty Fifty market of 1973. Now, it is just as high as it was then. In the next bear market, our friend predicted, people will sell their best stocks first, because those will be the stocks they will be able to sell. (The "next bear market" gives away our friend as a traditionalist, if not a romantic; Goizueta would perhaps regard him as a cynic, croaker and ca-

The Coca-Cola Company—icon of a bull market
(in $ millions)

	12 mos. to 6/30/96	1995	1994	1993	1992	1991	1990
Net operating revenues	$18,675	$18,018	$16,181	$13,963	$13,074	$11,572	$10,236
Cost of goods sold	7,055	6,940	6,168	5,160	5,055	4,649	4,208
Gross profit	11,620	11,078	10,013	8,803	8,019	6,923	6,028
Gross profit margin	62.2%	61.5%	61.9%	63.0%	61.3%	59.8%	58.9%
Earnings before interest and taxes (EBIT)	4,937	4,600	3,927	3,353	2,917	2,575	2,245
EBITDA minus capex[1]	4,548	4,117	3,460	2,913	2,156	2,044	1,896
Free cash flow[2]	2,369	2,102	2,146	1,623	873	960	844
Interest expense	289	272	199	168	171	192	231
Net income	3,213	2,986	2,554	2,176	1,664	1,618	1,382
Net income margin	17.2%	16.6%	15.8%	15.6%	12.7%	14.0%	13.5%
Current assets	6,570	5,450	5,205	4,434	4,248	4,144	4,143
Total assets	16,523	15,041	13,873	12,021	11,052	10,189	9,245
Current liabilities	8,140	7,348	6,177	5,171	5,303	4,255	4,297
Short- and long-term debt	4,472	4,064	3,509	3,100	3,207	2,288	2,537
Equity	5,936	5,392	5,235	4,584	3,888	4,239	3,662
Shares outstanding[3]	2,499	2,524	2,580	2,604	2,634	2,666	2,674
Price[4]/sales	6.72x	5.28x	4.04x	3.89x	4.21x	4.25x	3.12x
Price[4]/earnings	39.08	31.86	25.57	24.98	33.04	30.43	23.10
Price[4]/book	21.15	17.64	12.47	11.86	14.14	11.62	8.72
Return on assets	19.4%	19.9%	18.4%	18.1%	15.1%	15.9%	14.9%
Return on equity	54.1	55.4	48.8	47.5	42.8	38.2	37.7
EBIT/interest expense	17.08x	16.91x	19.73x	19.96x	17.06x	13.41x	9.72x
Debt/total capitalization	43.0%	43.0%	40.1%	40.3%	45.2%	35.1%	40.9%
Dividend yield	0.94	1.17	1.54	1.63	1.34	1.30	1.68

[1]EBIT plus depreciation and amortization less capital expenditures
[2]defined by company as net cash provided by operations less net cash used in investing activities
[3]shares outstanding and per-share amounts have been restated to reflect a 2-for-1 stock split in May 1996
[4]price as of October 7 for most recent period, and as of the end of January following calendar years

lamity howler. We ourselves deplore these characteristics.)

On September 25, *The Outlook*, published by Standard & Poor's, presented the bullish case in numbers: "We estimate per-share earnings will climb more than 19% to $1.40 in 1996 from 1995's $1.18, and look for an 18% gain to $1.65 next year. The company's net profit margin, which has risen steadily for more than a decade, could reach 20% in 1996, up from 16.6% in 1995. Return on common equity, which has also advanced for more than a decade, could reach 60% in 1996, up from 56% in 1995." Over the piece was the headline, "Coca-Cola a Buy Despite High P/E."

"We exist for one reason," the company's latest annual report affirms, "to maximize shareowner value over time." Buffett, for one, would seem to feel himself being maximized. Eric T. Miller, writing in last week's Donaldson Lufkin & Jenrette strategy piece, paraphrased the sage of Omaha: "He said that he would not mind if Coke and Gillette were delisted because he is not trying to predict their market prices, but just enjoys owning such wonderful businesses. Both give you major exposure to emerging markets, because 80% and 70% of their earnings, respectively, come from abroad. Many observers were aghast when Coke announced last spring that it was repurchasing its shares, but Buffett said he thought such repurchases were a good idea unless the price was above the shares' intrinsic value. Admittedly, the tough part is calculating intrinsic value, but he does not think that conventional P/Es or book value relationships are relevant to Coke. He was just glad to see Coke adding value for existing shareholders."

For decades under previous management, Coca-Cola was debt-free. The company seemed to reason that the world held mortal danger as well as big opportunity (there was, for example, a near-brush with disaster following the collapse of world sugar prices about 1920) and that financial flexibility was paramount. Today, long-term debt constitutes some 16% of total capitalization (up from 5.7% in 1981, Year One of the Goizueta term). Coke relinquished its triple-A debt rating in 1986; following its second downgrade, in 1992, its senior debt is rated at Aa3. Even so, the company still retains some of the aspects of a full bank vault. Cash flow—i.e., earnings before interest and taxes—covered interest expense in the latest available 12 months by 17 times.

Indeed, Coca-Cola possesses nearly every desirable corporate attribute on the business-school check list. It consistently generates excess cash flow with which it repurchases tens of millions of its common shares in a kind of tax-advantaged dividend program, the sky-high valuations of that stock notwithstanding. Its average return on capital is more than three times its average cost of capital. Its workers generate an average of $600,000 of revenue each.

As common as death and taxes, Coca-Cola outsells the two leading tea brands in England combined. Soon, it is expected to outsell the top bottled water brands in France. More Coke is consumed per capita in Budapest than in Southern California.

"Having a powerful brand can make for good financials," Goizueta reflects. "But having a powerful brand attached to a highly accessible and universally appealing product distributed through an unmatched business system can make for outstanding financials. By that I mean that our brands are not attached to luxury automobiles, computers or high-performance athletic shoes, items most of the world cannot afford on a regular basis. Our brands are attached to products that billions of people can afford to buy several times a day. "That's one of the reasons," the chairman goes on, "why I have never heard anybody say, 'I sure am glad my grandfather sold his Coca-Cola stock."

No doubt. However, at certain rare times, grandfather would have been advised to lighten up, if only for a decade. Inasmuch as the shares have attained a valuation fully equal to the one that preceded the 1974 break, this year (who knows?) might be one of those times. At the 1973-74 peak, the shares traded at 40 times earnings and 7.34 times book value (as against the current 39 times earnings and 21 times book value). By the fall of 1974, they had collapsed to the equivalent of 13.5 times earnings and 3.2 times book value. In January 1974, they yielded 1.62%; by September, 4.16%.

It will be said that the world today bears no resemblance to the year in which President Nixon resigned. Yet, it will be said right back again that the end of every bull market is accompanied by turmoil and upset. Technicians and fundamentalists will agree to disagree. Either circumstances force the price action, or the price action reveals the circumstances.

Did the world end in 1974? It did not, of course. *Forbes*, appraising the stock within weeks of what would prove to be the market's low ebb, struck a slightly hopeful note. "If you are really worried about a worldwide depression," it brightly suggested, "in which all but the strongest companies will face liquidity problems, then Coke is your boy .... Its cash items have doubled since 1970 to over $300 million, and debt for this $2.1 billion-sales giant is a mere $8 million."

Yet, the story could not help but observe, sales growth was flagging as inflation was surging and the Federal Trade Commission was litigating. Profit margins were under pressure.

But the magazine also saw that the company's woes were merely cyclical; regeneration would follow crisis. "Donald R. Keough, president of Coke's U.S. division," the piece wound up, "likes to tell a story about the parent company's new president, Lucian Smith,0 55: 'When Luke Smith joined this company in 1940, his father was very proud. He went to the local drugstore in West Point, Miss., to tell his friends. 'It's a shame,' one of them one-upped him, 'that Luke started after the growth is over."

Forbes was right about corporate growth: from 1973 to 1983, revenues would vault to $6.8 billion from $2.1 billion; earnings to $559 million from $215 million. However, the price of a share of Coke would fail to match its January 1974 high until the summer of 1984, two years after the beginning of the intergalactic bull market and the company's near-simultaneous uncorking of Diet Coke. (That billions of dollars of market capitalization were created by the simple substitution of NutraSweet for sugar in a 12-ounce aluminum can tells all that needs to be told about the alchemical properties of the Coca-Cola franchise.)

Never has Coke met a problem it could not eat, solve or outwait. It beat back a federal pure-food suit in 1911. It survived the Great Depression (1929-33), the Great Inflation (1971-80), New Coke (1985) and the motion-picture "Ishtar" (not so great a disaster, in fact: the Columbia Pictures division was sold to Sony Corp. in 1989 for a gain of about $700 million).

The uprising that greeted New Coke offers a small glimpse of the tidal power of the American public. As it welcomed Diet Coke, so it has warmed to equity mutual funds. Perhaps, in our lifetimes, it will turn against stocks, thereby causing the liquidation of Coke from funds that suddenly find the need to raise cash. What can be documented is that the market has rarely held a higher opinion of the greater Coca-Cola enterprise (or of the great investors who have proclaimed the company to be essentially priceless). The stock traded at 17.2 times earnings at the post-Crash top in 1930. It traded as high as 34.8 times in 1946, 16.7 times in 1956 and 30.3 times in 1961—all bull-market peaks. It changed hands at about 19 times earnings in the summer, of 1987.

As for the Great Depression, it was an unmitigated disaster for then-president Robert Woodruff, for he undertook what Goizueta would apparently never countenance or even imagine, let alone implement: short sales of the shares of his own resilient company. "The Boss," writes Coke historian Mark Pendergrast, referring to Woodruff, "knew that the entire stock market was due for a fall, and he was sure it would take his overvalued Coca-Cola stock with it. This runup had been too quick, too easy. Of course, he had faith in the ultimate future of the soft drink, but no stock soared up forever." Correct on the overall market, Woodruff sorely underestimated the recuperative powers of Coca-Cola, and he covered his sale (Pendergrast does not say exactly when) at a $400,000 loss. The bulls may call this the greatest investment parable of all time.

However, the bears may reply that Paul Fussell, in describing a series of botched night patrols in which he participated in France as a junior Army officer during World War II, indirectly matches the Woodruff story, or perhaps goes it one better. "I was learning from these mortal-farcical events," the former lieutenant relates in his new memoir, "Doing Battle," "about the eternal presence in human affairs of accident and contingency, as well as the fatuity of optimism at any time or place. All planning was not just likely to recoil ironically; it was almost certain to do so. Human beings were clearly not like machines. They were mysterious congeries of twisted will and error, misapprehension and misrepresentation, and the expected could not be expected of them." In other words, markets priced for the best possible outcome are, eventually, mispriced.

Buffett and his partner Charles Munger would no doubt rejoin that the true margin of safety in a unique business is the enormous amount of damage the business can withstand. It is this more than any mundane measure of valuation that protects the long-term holder against adversity (including the form of adversity known as getting out but later forgetting to get back in).

However, we keep on thinking, the issue is not so much the recuperative powers of the Coca-Cola Co. as it is the risks introduced by overvaluation, of which the price of Coke is only one glaring 1996 example. "In a slightly different environment," says a value investor we know, observing that the present environment could not be improved upon, even by Goizueta, "people would be writing about how amazingly good Royal Crown or store-branded cola is, how at the margin nobody really cares whether it is Coke or Pepsi at all. When was the last time you said, 'No, it's Pepsi I want; I won't have a soda with my hamburger'?"

The principal risk of a 39 times P/E ratio, it seems to us, is the risk of the unscripted event. Expecting greatness and pricing it into the stock, the market would be devastated by the unexpected lack of greatness, whether brought on by management or by the world outside. In 1996 and 1997, according to Street estimates, Coke's earnings per share will grow by about 18% (compared to 16.3% and 6.6%, respectively, for the S&P 500). If Coke's net income continued to grow at that rate for the next decade, taking 1996 as the starting point, it would reach $18.2 billion, or $7.28 a share, by the year 2006. If the company maintained its present P/E multiple, its 2006 market cap would total $709 billion. As for operating revenues—assuming that their growth matched earnings growth over the same 10-year span—they would total no less than $106.5 billion. As a point of reference, the average annual compounded rate of return of Coca-Cola common from 1919 to date, with dividends reinvested in Coke shares, is over 16%. If, on the other hand, an investor had squandered the dividends on food, clothing and shelter, his or her annual appreciation would have averaged just 11.6%.

In retrospect, Coke has always been a great company. Yet, only periodically has it earned the fulsome plaudits of Mr. Market. Is it purely an accident that the crowning moment of Coca-Cola in the stock market has coincided with the levitation of thousands of non-great stocks and not a few impostors? For the moment, Mr. Market happens to like nearly everything.

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