GRANT'S

INTEREST RATE OBSERVER

Vol. 18, No. 2b | Two Wall Street, New York, New York 10005 • www.grantspub.com | FEBRUARY 4, 2000

Pariahs' club

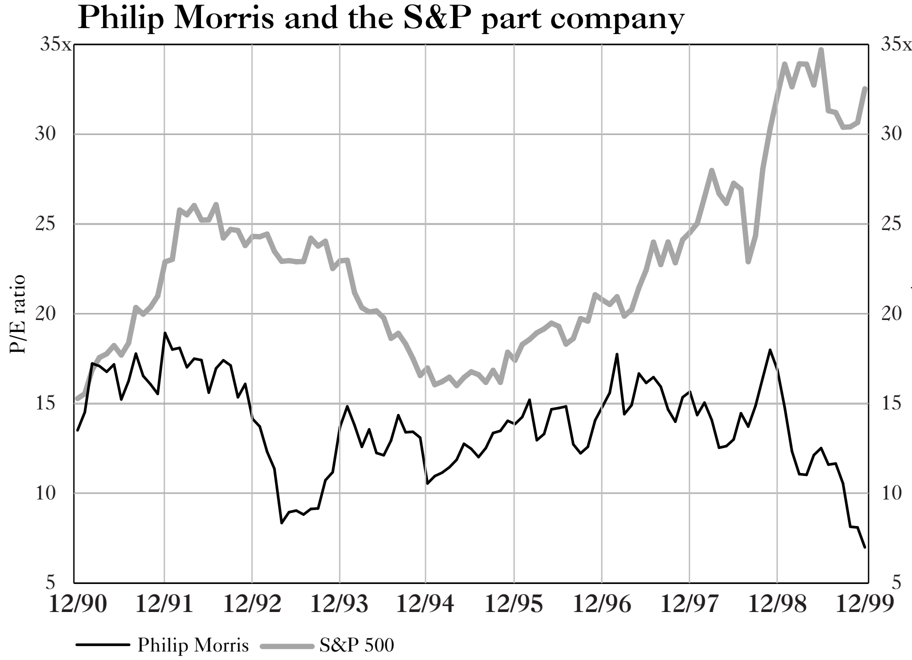
The stock market is, by our lights, absurd, but it is becoming slightly more symmetrically absurd. There is a growing list of cheap valuations to complement a considerably larger number of extravagant ones. Possibly, there can be no safety in value until the speculative bubble bursts, but it might be useful to chronicle the arrestingly low valuations attached to some of the companies that, for one reason or another, have been in their own individual bear markets.

We herein offer up three with the understanding that none is an obviously brilliant investment candidate. Each, however, has been badly mauled in the stock market, and each, by some measure, is cheap. Two of the three—Lockheed Martin Corp. and Raytheon Co.—may legitimately be regarded as indispensable to the national defense. As for the third, not many Dow stocks carry a 9% dividend yield and a mid-single-digit P/E multiple. Then, again, few are branded enemies of the people, as Philip Morris has virtually been. We began our investigation into the tobacco behemoth with a contrary, bullish bias—the valuation vital signs are enticing—but the more we investigated, the less bullish we became. (Maybe that is the truly bullish aspect of the story, although we think we will not dwell on that possibility.)

The maker of Marlboro cigarettes, Miller beer and Kraft cheese, which, astoundingly, earned almost $2 billion last quarter, spent $902,000 on political lobbying and campaign contributions in New York state in 1999. The size of these outlays was reported in *The New York Times* last Friday, it also being noted that Philip Morris Cos. had been fined $75,000 and seen its chief Albany lobbyist banned from working in New York for violations of lobbying laws. The same edition of the *Times* reported a "startlingly high" incidence of smoking among middle- school students nationwide.

Here, in a nutshell, is the cigarette business. It earns more money than it knows what to do with by making a product that makes you sick. (Possibly, cigarettes have retained their popularity with America's youth because they do make you sick.) It enjoys that rare thing in the year 2000, pricing power, and no matter how high the returns it generates, it is unlikely to elicit new competition. There is no future in smoking—neither for the smoker nor for the tobacco companies—and Philip Morris has been turning the surplus money, after lobbying fees, of course, back to the stockholders. Last year, it paid out

Philip Morris and the S&P part company

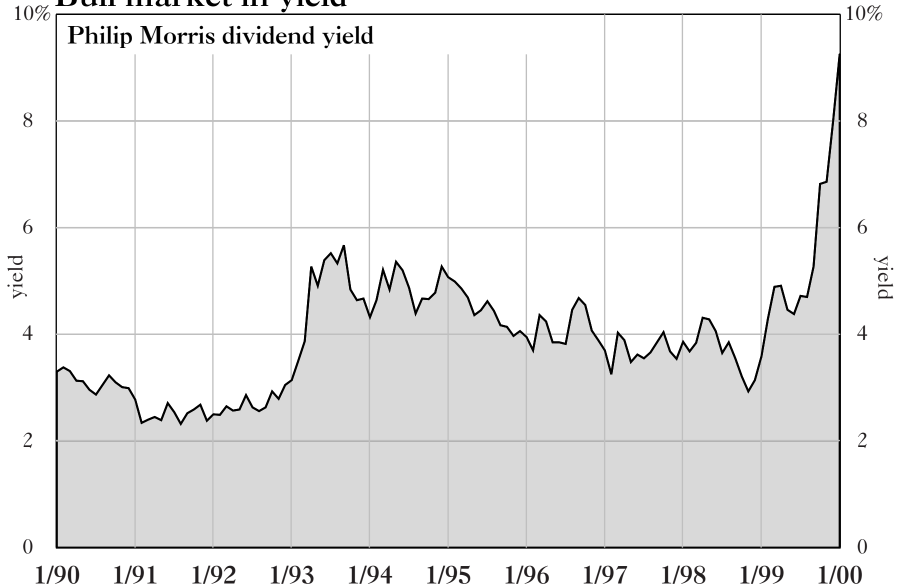


source: The Bloomberg

$7.7 billion in this way, $4.4 billion in dividends and $3.3 billion in share repurchases. As the tobacco team at Morgan Stanley observes, it was a sum equivalent to about 15% of the current stock-market capitalization. "MO," the stock symbol, is a cruel reminder of the lack of momentum in the share price; at Monday's close, the company was valued at about 6.4 times trailing net income and 0.8 times sales. The dividend yield was exactly 9.17%.

A very cheap stock, indeed, if one is prepared to overlook the risk of oblivion-through-litigation, which one cannot. The bulls contend that the peak litigation risk has passed. One hopeful sign, the argument goes, is the very scale of the Philip Morris share buybacks; unless the company had reason to believe that its legal ground were solid, it would be husbanding its cash. Possibly, but in the language of the old junk-bond prospectuses, there can be no assurance. It is open season on Philip Morris, along with the rest of the tobacco industry, and the companies have been sued by just about everybody, including the Clinton administration (of course), a big class of Florida plaintiffs and aggrieved smokers (or ex-smokers) in Nigeria and the Marshall Islands, among other places. The tobacco companies have won some legal battles, to be sure, but they have also lost some, and the losses only coax forth more litigation, in a pattern that will remind gold bulls of the periodic demoralizing sales of bullion by the world's central banks. In the case of tobacco, the overhead supply is of litigation, not ingots. It may well be that the solvency-threatening legal risk is over, but the risk of a damaging award by a wayward (or, for that matter, a sound and rational) jury is ever present. "Management is unable to make a meaningful estimate of the amount or range of loss that could result from an unfavorable outcome of pending legislation," says page 22 of the latest Philip Morris 10-Q. "The present legislative and litigation environment is substantially uncertain, and it is possible that the company's business, volume, results of operations, cash flows or financial position could be materially affected by an unfavorable outcome or settlement of certain pending litigation or by the enactment of federal or state tobacco legislation." A friend describes tobacco shares as the last remaining assessable stock on earth.

Bull market in yield



source: The Bloomberg

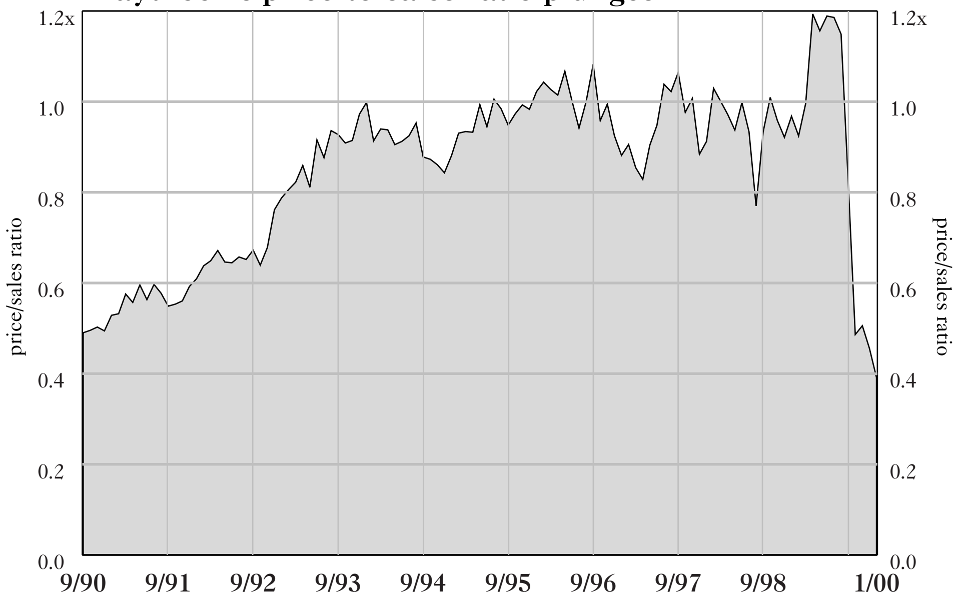
At a price, we at *Grant's* firmly believe, there is value in almost everything, including tobacco companies. In this context, we are glad to be able to observe that shares in General Cigar Holdings, the subject of a bullish piece in the November 5 issue, recently vaulted after Swedish Match tendered for 64% of them. Cigars are no more health-giving than cigarettes, but General Cigar, at the rock-bottom price at which a kind reader called it to our attention, was selling for less than its net current assets.

Philip Morris, as cheap as it is, is not that cheap. Besides, it swims against the tide of the demonstrated tendency of people, when faced with the consequences of their own bad decisions, to hire a lawyer. Nor is this inclination uniquely American. On December 8, a French court held Seita, the maker of Gauloises cigarettes, partly to blame for the death of one of its very loyal ex-customers; so the culture of victimization, if we may use a loaded election-year term, has spread to Europe. The greater *Grant's* family has never been united by politics, and the editor does not mean to impose his philosophy of individual responsibility on the paid-up subscribers. The principal point, of course, is the financial one. It seems rash, not to say unprofitable, to attempt to call a top in the bull market in global litigiousness.

As a purely financial exercise, it is interesting to compare the potential risks and rewards of MO common with those of the tax-exempt bonds of the Tobacco Settlement Asset Securitization Corp., a legal creature of the City of New York. The TSAC's debt is backed by the billions of dollars of future payments earmarked for 46 states (and various other public entities) under the so-called Master Settlement Agreement of 1998. The benchmark $6^1/_4$s of 2033, currently priced to yield 6.62%, are rated Aa2 by Moody's, A-plus by Fitch and single-A by Standard & Poor's. Philip Morris, a single-A-rated credit, boasts a taxable 9% dividend yield, as noted—the after-tax equivalent to a well-to-do New Yorker of about 4.5%.

Which to choose? If someone held a cigarette lighter to our head, we

Raytheon's price-to-sales ratio plunges



source: The Bloomberg

would pick the common. The bonds, fully exposed to interest-rate and credit risk, have no claim on a potential bullish turn in MO's fortunes. Alas, so thick is the smoke and haze of litigation that no such surprise is visible, to us. We therefore end this investigation with the same not-quite original observation with which we began it: Philip Morris looks like a very cheap stock.

Next come Lockheed Martin (LTM) and Raytheon (RTN/B), respectively the nation's largest and second-largest defense contractors, and rare examples of high-tech businesses whose share prices have somehow managed not to go up. Indeed, each company has serially and comprehensively disappointed its investors across the range of its capitalization structure, debt as well as equity. Each has choked on a big merger (Raytheon with the defense business of Hughes Electronics, in 1997, and Lockheed with Martin Marietta, in 1995); each has produced massive earnings disappointments; and each has brought anxiety on its creditors. Late last year, Lockheed Martin was found unfit, by dint of poor credit ratings, to issue commercial paper; it turned to its banks and the bond market instead. As for Raytheon, its year-end statement showed a sharp rise in short-term debt, up almost $2 billion from a year earlier. "Thus," comments Carol Levenson, of *Gimme Credit*, who has been insightfully bearish on the creditworthiness of Raytheon (and of Lockheed Martin, too), "at the same time debt protection measures are slumping (and are expected to slump even further next year), the company is becoming more and more dependent upon its banks for both financing and lenience. This is a worrisome state of affairs, and leaves the company exposed to increasing liquidity risks."

As recently as last July, Raytheon was trading near 1.3 times sales; the current quotation—no less than three disastrous earnings warning announcements later—is 0.38 times sales. To be sure, both Raytheon and Lockheed Martin are leveraged; even adjusting for their debt, however, the valuations are strikingly low—on an enterprise value-to-sales basis, 0.87 and 0.73 times, respectively, for RTN/B and LTM. Raytheon trades at 0.71 times book, Lockheed Martin at 1.12 times book.

Lockheed Martin, itself well practiced at letting the air of hope out of its investors' tires, last month halved its quarterly dividend and reiterated its downward revised earnings forecast of $1 a share for 2000 (about half of what the Street was expecting as recently as last October). Commented *The Washington Post*, "Even at that pessimistic level, the company included a handful of assumptions that could still go sour, such as a contract to sell about $7 billion worth of F-16 fighter planes to the United Arab Emirates. The deal has been in the works for more than a year, with no resolution."

Yet—still—we are inclined to be bullish. Our No. 1 reason is that the companies' main customer needs the companies just as much as the companies need the customer. Senior officials of the Defense Department, indeed, have criticized Wall Street for marking down the companies' share prices; they say they can't understand the market's preference for the kind of high-tech company that has no earnings, precious little revenue and no multibillion-dollar backlog of government business. (The order backlog at Raytheon, in fact, stands at a record $28.4 billion; the backlog at Lockheed Martin, though not a record, is $45.9 billion.) Obviously exasperated, they sound like value investors.

It's not as if the bears were imagining things, of course. However, we agree with the tacit bull argument of the officials' criticisms. Unlike e-Toys, for instance, there will always be a place for Lockheed Martin and Raytheon. Defense spending has plunged over the past decade—according to Under Secretary of Defense Jacques S. Gansler, defense procurement is down by 70% since the Evil Empire shut up shop—but it will, we believe, come back, regardless of who wins the White House next fall. Criticisms of the companies' financial affairs are on the mark, and the two shamed managements can hardly be deaf to them. But even if no new leaf is turned over anywhere, the risk of insolvency, we believe, is insignificant. In techno-talk, the "space" that Raytheon and Lockheed Martin occupy is even more vital than the space occupied by Amazon or

Akamai.

We turned to Ed Walsh, longtime authority on the defense industry and owner and editor of *Naval Systems Update*, Occoquan, Va., for a technical briefing on the plight of the two defense giants. Walsh's considered opinion, in brief: Raytheon and Lockheed Martin are unique and irreplaceable; things will get better for the companies, in part because they have to.

"The conventional wisdom in the financial community," Walsh observes, "appears to be that Raytheon and Lockheed Martin have become dinosaurs of the post-Cold War world, trying to postpone an inexorable decline, if not extinction, by resorting to poorly planned acquisitions and ham-handed lobbying. The conventional wisdom is based on facts, but only some of the facts, those almost certain to be overtaken by hard-to-recognize developments in defense systems engineering and systems integration, in which both are the unmatched experts at home and worldwide."

By "systems integration," Walsh says he means the design of the fundamental software and hardware linkages among the combat components of a Navy warship, a Navy or Air Force fighter aircraft, or an Army or Marine Corps land vehicle. A successfully integrated shipboard computer system, for instance, is one that can track an incoming enemy missile at 3,000 miles an hour and communicate that information to a shipboard gun mount or antimissile system. The sound of success is an explosion that occurs in midair as opposed to inside the ship's hull. To be sure, there have been some embarrassing misses in the business of shooting missiles out of the sky, but the Theater High-Altitude Area Defense System of Lockheed Martin did hit the bull's-eye as recently as last August. Raytheon is the prime contractor for the Navy's ballistic missile defense program, to be deployed on Ticonderoga-class cruisers and Arleigh Burke-class destroyers.

Naturally, in the Information Age, there will be information-based warfare, and the 1997 Quadrennial Defense Review, which forms the foundation for next-generation defense planning, directed the Pentagon to pursue a "joint vision of information superiority—the ability to collect and distribute to U.S. forces throughout the battlefield an uninterrupted flow of information."

This information arena, Walsh winds up, "is dominated by Lockheed Martin and Raytheon. Their roles in defense systems engineering and systems integration are based on the evolution of years of institutional expertise in managing not only weapons-systems production but also the engineering, testing, and logistics services that support highly complex computer-driven systems."

Too big to fail? Never mind Citigroup. Lockheed Martin and Raytheon may just succeed in spite of themselves. •