From hunger

Until its stumble one week ago, the S&P 500 was generating its lowest volatility readings since either January 1994—or October 1968 (thank you, Arbor Quantitative Analytics). Peace and quiet had seemed the winning investment theme of 2016 as more money poured into the dedicated low-volatility ETF than into the big Vanguard Total Stock Market Index Fund.

Now unfolding is a bearish appraisal of Post Holdings, Inc. (POST on the New York Stock Exchange), one of the beneficiaries of this love affair with boredom. We frame the Post investigation in the context of our previous downbeat analyses of such packaged-food giants as Kraft Heinz Co. (KHC on the Nasdaq) and Campbell Soup Co. (CPB on the Big Board) and Kerry Group plc (KYG in Dublin). Highly valued and slow-growing, Big Food faces a host of problems, some of which have harried Post. (It has not escaped our attention that the bears on Big Food have suffered slings and arrows of their own. Kraft Heinz, Warren Buffett’s favorite ketchup company, is up by 15.4% since our bearish advisory of March 25. The stock changes hands at 35.7 times adjusted earnings.)

Telltale troubles include the Sept. 1 earnings miss from Campbell, which cited carrot-production problems at the Campbell Fresh division, among other difficulties. The soup-maker, having strained to please the taste of health-conscious consumers, took a $141 million impairment charge on Bolthouse Farms, a business that Campbell bought in 2012 for $1.6 billion.

Earnings guidance for the current quarter came in for downward revision last week at General Mills, Inc. and at the grocers SuperValu, Inc. and Sprouts Farmers Market, Inc. Sprouts had this to say: “The prolonged deflationary environment, competitive landscape and industry dynamics have prompted heavy promotions across the industry, adversely impacting retail deflation and traffic generation.”

Like a besorred swain at the Harry Winston jewelry counter, the low-vol fan club has decided that no price is too high to pay for shares that refrain from falling out of bed. Or rather—a

### Post Holdings, Inc.

All figures in $ millions except per share data

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<tbody>
<tr>
<td><strong>Net sales</strong></td>
<td>$5,075.8</td>
<td>$4,648.2</td>
<td>$2,411.1</td>
<td>$1,034.1</td>
<td>$958.9</td>
<td>$968.2</td>
</tr>
<tr>
<td><strong>Cost of goods sold</strong></td>
<td>3,572.5</td>
<td>3,473.8</td>
<td>1,789.9</td>
<td>609.2</td>
<td>530.0</td>
<td>516.6</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>1,503.3</td>
<td>1,174.4</td>
<td>621.2</td>
<td>424.9</td>
<td>428.9</td>
<td>451.6</td>
</tr>
<tr>
<td><strong>Selling, general and admin. expenses</strong></td>
<td>805.8</td>
<td>734.1</td>
<td>459.5</td>
<td>298.2</td>
<td>274.5</td>
<td>239.5</td>
</tr>
<tr>
<td><strong>Amortization</strong></td>
<td>152.2</td>
<td>141.7</td>
<td>70.8</td>
<td>14.6</td>
<td>12.6</td>
<td>12.6</td>
</tr>
<tr>
<td><strong>Impairment of goodwill/ intangibles</strong></td>
<td>60.8</td>
<td>60.8</td>
<td>295.6</td>
<td>2.9</td>
<td>0.0</td>
<td>566.5</td>
</tr>
<tr>
<td><strong>Other expenses</strong></td>
<td>6.3</td>
<td>25.1</td>
<td>3.0</td>
<td>1.4</td>
<td>2.7</td>
<td>1.6</td>
</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td>478.2</td>
<td>212.7</td>
<td>(207.7)</td>
<td>107.8</td>
<td>139.1</td>
<td>(368.6)</td>
</tr>
<tr>
<td><strong>Interest expense</strong></td>
<td>334.9</td>
<td>287.5</td>
<td>183.7</td>
<td>85.5</td>
<td>60.3</td>
<td>51.5</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>220.4</td>
<td>92.5</td>
<td>35.5</td>
<td>0.0</td>
<td>(1.6)</td>
<td>10.5</td>
</tr>
<tr>
<td><strong>Profit before taxes</strong></td>
<td>(77.1)</td>
<td>(167.3)</td>
<td>(426.9)</td>
<td>22.3</td>
<td>80.4</td>
<td>(430.6)</td>
</tr>
<tr>
<td><strong>Taxes</strong></td>
<td>(38.3)</td>
<td>(52.0)</td>
<td>(83.7)</td>
<td>7.1</td>
<td>30.5</td>
<td>(6.3)</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>(38.8)</td>
<td>(115.3)</td>
<td>(343.2)</td>
<td>15.2</td>
<td>49.9</td>
<td>(424.3)</td>
</tr>
<tr>
<td><strong>Preferred stock dividend</strong></td>
<td>26.0</td>
<td>17.0</td>
<td>15.4</td>
<td>5.4</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Net income to common</strong></td>
<td>(64.8)</td>
<td>(132.3)</td>
<td>(358.6)</td>
<td>9.8</td>
<td>49.9</td>
<td>(424.3)</td>
</tr>
<tr>
<td><strong>Earnings per share</strong></td>
<td>(1.14)</td>
<td>(2.33)</td>
<td>(9.03)</td>
<td>0.30</td>
<td>1.45</td>
<td>(12.33)</td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>1,033.2</td>
<td>841.4</td>
<td>268.4</td>
<td>402.0</td>
<td>58.2</td>
<td>1.7</td>
</tr>
<tr>
<td><strong>Debt</strong></td>
<td>4,508.9</td>
<td>4,527.4</td>
<td>3,856.1</td>
<td>1,408.6</td>
<td>945.6</td>
<td>784.5</td>
</tr>
<tr>
<td><strong>Net Debt</strong></td>
<td>3,475.7</td>
<td>3,686.0</td>
<td>3,587.7</td>
<td>1,006.6</td>
<td>887.4</td>
<td>782.8</td>
</tr>
</tbody>
</table>

source: company reports
critical distinction—have refrained over a recent measured investment interval from falling out of bed. Just how this exemplary past performance will play out in the future is something that not even the great economists know.

Some facts and figures: That low-vol ETF, called iShares Edge MSCI Min Vol USA ETF (USMV on NYSE Arca), has attracted $6.2 billion in investor flows since the start of the year, lifting its assets to $14.4 billion. The aforementioned Vanguard fund, which boasts assets of $64.6 billion, has garnered just $3 billion. As for the stocks that fill out the low-vol portfolio, they trade at 25.5 times trailing earnings, a 28% premium to the fully-valued S&P 500.

“As an educated guess,” Rob Arnott, founder and chairman of Research Affiliates, tells colleague Evan Lorenz, “the amount of funds [like USMV] tied to low volatility is probably north of $50 billion by now. But it is like an iceberg. The hidden part is jumbo pensions and sovereign wealth-fund investments, which, at this stage, probably exceed $200 billion. We are looking at something on the order of a quarter of a trillion dollars.”

Low-vol is a cult for this age of low growth and zero-percent money-market interest rates. In the 1960s, the object of Mr. Market’s desire was growth. It was nearly priceless, the new thinking went. So up and up went the so-called Nifty Fifty (Coca-Cola, Wal-Mart, Disney—and Eastman Kodak, Polaroid and Simplicity Pattern, to name a few). Then came the bear market of 1973–74. Growth slowed and stock prices broke, even the nifty ones.

The low-vol phenomenon resembles the Nifty Fifty in one respect, observes Christopher Cole, founder of Artemis Vega Fund. The connecting thread is the misconception that a margin of safety is inherent in some business or market characteristic of a given investment asset rather than in its price and value. In the particular case of Post Holdings, a speculative-grade credit, the enthusiasts are paying 32.6 times trailing adjusted net income and 30.8 times the fiscal 2017 estimate, not for top-line growth (of which not even the bulls expect very much) but for the hope of an accretive acquisition, for the perceived virtuosity of a deal-making C-suite and some successful managerial navigation around the avian flu outbreak that stressed the company’s 2015 egg production.

We suspect, though, that the principal cause of the 31% spurt in the Post share price this year is the vogue in low volatility and the shared belief that central banks will do nothing to rock the boat. New rumblings in the bond market may put this proposition to the test. If bonds do enter (or have entered) a bear market, what will become of the demand for bond-like equities, especially the leveraged ones?

The Post Holdings story has appeal for another reason. It is one of the purer contests between, on the one hand, the sell side of Wall Street and, on the other, the sell-short side. Out of 10 analysts who follow the company, nine are bullish, according to Bloomberg. Yet short interest in POST amounts to 8.8% of the float. Let us investigate.

Grape-Nuts, a Post breakfast mainstay, debuted in 1897. Benjamin Graham, the father of value investing, ate the stuff as a boy—it must have been around 1900—and he relates in his autobiography that it hurt his sensitive teeth. We impart this history in the service of the fact that Post Holdings is a corporate entity only four years old. It emerged out of Ralston Purina Co. Three-and-a-half decades ago, Ralston was a sprawling conglomerate with businesses ranging from Jack in the Box, Inc. to the St. Louis Blues hockey team. When William P. Stiritz became the boss, he sold non-core businesses and spun off assets to shareholders. Post Holdings got the Stiritz treatment in 2012—and got Stiritz himself to become the CEO and executive chairman.

Since that 2012 event, Post Holdings has spent more than $5 billion on a dozen acquisitions. Stiritz, 82, is a deal-doer and a borrower, the signs of which are stamped on the company’s leveraged balance sheet. No longer the CEO or executive chairman—he became non-executive chairman in February—Stiritz remains the 13th-largest holder of Post shares with a stake worth $117 million (which happens to be half the size of his position in Herbalife Ltd.). He is the grand old man of capital allocation, the bulls will tell you. They are sure that he still has deals to do.

Post comprises four business segments: cereal, eggs and carbs, body-building supplements and private brands. Cereal and eggs are the corporate bread and butter.

You’ll know the top cereal brands: Honey Bunches of Oats, Pebbles, Great Grains and Post Shredded Wheat, in addition to Grape-Nuts. In 2015 came the acquisition of MOM Brands Co. (Malt-Ô-Meal and Better Oats). Post’s cereals are positioned at the lower price points in the breakfast aisle of your supermarket, an aisle that’s not so heavily trafficked as it used to be. In what, these days, is counted as a kind of cereal growth spurt, Post managed to deliver a year-over-year rise in comparable sales of 1.3% in the third fiscal quarter (ended
June 30). Cereal, the company’s most profitable division, chipped in 35% of revenues and 45% of operating income in the same three months.

The eggs and carbs unit is known as Michael Foods Group. In the fiscal year ended Sept. 30, 2015, eggs accounted for 66% of group sales, with cheese and potatoes (23%) and pasta (11%) providing the rest. Subsequent acquisitions have made the Michael division still more egg-intensive. It’s the second most profitable division at Post and the largest by revenue.

You look at the latest quarterly results at Michael—revenues down on a comparable basis by 11.4%, operating income up 36%—and you’re stumped until you recall the avian flu-induced bull market in egg prices. Eggs (with some potato and pasta on the side) generated 42% and 39% of company-wide revenue and operating income in the June quarter.

“Active nutrition” is the corporate term to denote protein bars, beverages, powders and gels under the brands Premier Protein, Dymatize, Supreme Protein and PowerBar. The division produced 13% and 11% of last quarter’s revenue and operating income. Premier Protein is the shining star of this subsidiary: The latest quarter brought a 39% jump in sales owing to new inroads at club stores, most notably Costco Wholesale Corp. The success of Premier Protein was offset by failures in Post’s other protein-related forays: Dymatize sales fell 22%, PowerBar sales declined by an undisclosed percent.

The private-brands segment makes peanut butter, other nut butters and granola and furnished the balance of revenues and operating income. In the third fiscal quarter, private-brands revenue grew 0.9% year-over-year to $137.9 million while profits dropped to $9 million from $10.5 million.

“Going through each of Post’s business lines, you may walk away feeling a little underwhelmed,” Lorenz observes. “Cereal, at best, generates only flat to slightly positive sales growth. Michael has struggled with growth. While Premier Protein is a leader in active nutrition, Post’s other protein-centric acquisitions are languishing. The private-brands division seems to lack an identity. The balance sheet is already levered.”

Bulls, viewing Post as a kind of public LBO with lots of embedded optionality, are hopeful that Stiritz will continue to work his capital-allocation magic, even within the lackluster private-brands division. “When they bought these businesses in one-off acquisitions, they were looking for pockets of growth where margins are reasonable,” John J. Baumgartner, a Wells Fargo Securities analyst, tells Lorenz. “Putting it together made sense, but how do you get to the next level? If they can do something where they make another acquisition in one of those categories where they can get scale, that could be an opportunity.”

Moody’s designates Post as an “investment holding company,” Lorenz observes that one might alternatively style it a “platform company,” i.e., a serial acquirer that the Street values not on its in-place businesses but on the synergies and earnings that the future might hold.

“When one thinks of the type,” Lorenz goes on, “one thinks, first, of Valeant Pharmaceuticals International, Inc., but there are many others without the accounting and pricing drama. Post probably most closely resembles Nomad Foods Ltd., a chronic acquirer of slow-growth and/or of declining-growth food businesses in Europe. Nomad, which counts Bill Ackman’s Pershing Square Capital Management as its largest shareholder, was the worst-performing European consumer stock over the past 12 months, its share price having been sawed in half from its 2015 high.”

“From a strategic perspective,” Post CEO Robert V. Vitale advised dialers-in on the Aug. 5 earnings call, “I would encourage listeners to not equate quiet with inactivity [or not so inactive; the fiscal year had already delivered two acquisitions]. . . . With respect to our ability to execute M&A, we are better positioned both from a financial and operational perspective than at any time in our relatively brief history. I expect that we will take advantage of that positioning.”

Late in June, reports surfaced that Post was in the hunt to buy ConAgra’s big potato subsidiary, Lamb Weston, for around $6 billion. For reference, Post, a single-B/B2-rated credit, commands a market capitalization of $5.6 billion and owes $3.5 billion of net debt. It seems that the deal is off (if it was ever really on). Still, the rumors underscore management’s willingness to deal and its dependence on the hospitality of the junk-bond market.

Post’s debt (minus cash) is equivalent to 4.4 times trailing earnings before interest, taxes, depreciation and amortization (EBITDA). In the third fiscal quarter, operating income covered interest expense 1.8 times.

“Breakfast is the most important meal of the day,” Mother used to say. Today’s all-consuming hunger is for yield. Thus, on July 25, Post sold $1.75 billion worth of 10-year senior unsecured notes at par with a 5% coupon in an upsized deal—principal use of proceeds was to fund the tender offer for nearly as many 7½% notes of 2022.

“That is incredible,” Vicki Bryan, the senior analyst at Gimme Credit and who rates Post bonds as “underperforming,” tells Lorenz. “If you look at the spread, you are not even getting 100 basis points of spread per turn of leverage on these guys.” (Bryan measures leverage by calculating debt without subtracting the company’s cash balances; on this metric, the company is leveraged at just over five times.)

“What they’ve been able to eke out on profit gains,” Bryan continues, “has been synergies from acquisitions, cutting costs and favorable currency [a strong dollar benefits commodity purchasers like Post], favorable commodity costs, input costs. That was working in their favor. Those things may be peaking. Feed costs and input costs will change. [In the third quarter] SG&A was substantially higher as a percentage of revenue vs. a year ago. Marketing costs are increasing. They are trying to boost pricing supported by higher marketing costs, and they are not able to sustain volumes by doing that. That tells me that there is potential for weakness going forward. They are probably shopping around for a major acquisition to keep the carousel going.”

The vagaries of American egg production may have as much to do with the near-term performance of Post’s common shares as even the speech-making of the world’s central bankers. Michael Foods Group has been earning super-normal margins owing to the previously noted avian flu outbreak. In the second calendar quarter of 2015, the U.S. layer flock fell by 34.5 million to 274 million. The culling of the hens meant much lower egg volumes and much higher egg prices. In Post’s May 6 call, CFO Jeff
A. Zadoks told analysts that profits per pound in the egg business tipped over $0.30, vs. a historical average of around $0.15 to $0.16.

But now that the layer flock has recovered, egg prices have plummeted, to as little as $1.55 a dozen this summer vs. an all-time high of $2.97 a dozen last summer.

“Post management is guiding for egg margins to decline, and it appears that egg earnings may have already peaked,” Lorenz notes. “Based on the mid-point of Post’s fiscal 2016 guidance, the company expects to generate $205.6 million in adjusted EBITDA in the fourth quarter, a decline from the $247.8 million and $231 million in the second and third quarters respectively. Nonetheless, the Street is penciling in a 2.5% increase in sales and a 2.2% increase in adjusted EBITDA between fiscal 2016 and fiscal 2017. Post will be unable to meet these expectations unless adjusted earnings improve substantially from the level guidance implied for the fourth quarter, not to mention whether egg margins continue to fall. ‘Unless they have another acquisition, then we are dealing with the same store business and it is eroding,’ Bryan tells me.

‘The only business that is growing is protein shakes, but everything else is eroding.’”

Stiritz spent $35 million to add to his Post stake in February, but he did so at an average price of $63.65 or 21% below the current share price. The only other Post insider to buy or sell shares in the past 12 months was Richard R. Koulouris, president and CEO of the private-brands division, who sold shares worth $1.9 million at a price of $85.33 in August. We judge that Koulouris has the makings of an astute investor.

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