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New Rec: Crown Holdings (CCK: $43.69) Mar 23, 2020

Position: Buy **Target: $75**

$MM	1Q20e	2Q20e	3Q20e	4Q20e	F2020e	F2021e
Revs	2672	2701	2776	2582	10,731	11,820
EPS (GAAP)	0.57	0.31	0.88	0.25	2.02	3.60
Cns Revs*	2757	3069	3164	2877	11,883	12,169
Cns EPS	0.93	1.59	1.78	1.21	5.52	5.98

*Consensus numbers do not appear to reflect recent COVID-19 developments.

Shares Out: 135.2 MM **Market Cap: $5.9B** **FYE: Dec**

For more information on this name, please email brian@offwallstreet.com, or call Brian Rogers at 617 868 7880.

Concept:
1. Investors appear to be indiscriminately selling companies with leveraged balance sheets (CCK has $7.3B of ND, or 4.3x TTM EBITDA), but, in the case of CCK, they appear to be overlooking the resiliency of its business.
2. CCK's core beverage can business (~80% of EBITDA) is highly defensible and has been growing volumes in the high single-digits Y/Y. In the nearer term, it should benefit from consumer stockpiling of food and beverage staples.
3. The transit packaging business (~20% of EBITDA), while more cyclical than cans, is highly diversified across end-markets, and sells primarily consumables in a "razor / razor blade" model.
4. In a disaster scenario where US GDP temporarily declines by -30% we project that CCK would still generate at least $500MM in FCF, or an 8%+ yield on the current market cap.
5. CCK appears to have $1.5B+ of available liquidity, and on Mar-10 announced its first stock buyback authorization since 2018 (for $250MM). We think shares could re-rate much higher once investors properly evaluate CCK's balance sheet risk.

Summary: Crown Holdings (CCK) is a global metal packaging company. It is the world's leading manufacturer of food and aerosol cans, and is the third largest producer of beverage cans. 2019 can revenues were $8.0B. CCK operates 139 can plants in 47 countries, and employs 24K people in its can business. Major customers include ABInbev, Nestle, Heineken, Gillette, Coca Cola, Unilever, and Kraft Heinz. No customer accounts for more than 1% of revenues.

In early 2018, CCK acquired the Signode transport packaging business for $3.9B. Signode produces an extensive array of products/solutions that protect and contain high-value goods during manufacturing, transport and warehousing. Products include steel and plastic strapping, industrial stretch film, edge protectors, container liners, and honeycomb products, among others. Signode operates 100 plants in 23 countries, and employs 9K people. Consumables make up ~88% of Signode's $2.3B in revenues, with an additional 7% from sales of recurring parts and service. Only about ~5% of Signode's revenues come from selling capital equipment.

CCK's share price has declined by -50% since February, substantially underperforming the S&P 500. On today's $6.0B market valuation, CCK's ~$750MM in TTM FCF represents a 12.5% yield. This hefty FCF yield would seem to imply that investors expect CCK's FCF to drop precipitately over the medium term. If so, we think investors are underestimating the resiliency of CCK's business.

More likely, investors may be indiscriminately selling companies with leveraged balance sheets. Although, in general, we agree that companies with leveraged balance sheets are more at risk than companies with excellent balance sheets, CCK may be a classic "baby with the bathwater" story, and we think shares could re-rate much higher once investors properly evaluate CCK's balance sheet risk.

We have successfully recommended the purchase of CCK shares three times, in 2011, 2014 and 2018. (Clients can request a copy of our 2018 initiation from brian@offwallstreet.com for more detailed background information).

Our fundamental view of CCK's can business has changed little over this time. Manufacturing beverage cans is a scale business and CCK is one of a small handful of very large players. Because there is a low value-to-volume ratio (CCK sells an 12oz aluminum beer can for only ~16 cents), shipping cans long distances isn't economic, and so can manufacturing is mostly a local business: hence CCK's vast network of manufacturing facilities (48 in the Americas, 60 in Europe, 28 in APAC). Barriers to entry are very high.

Global beverage consumption has been rising at a steady mid-single digit rate over time. Within this market, CCK has benefited from a secular shift away from bottles (which are heavier, more difficult to transport, and carry a carbon footprint ~20% higher) to aluminum cans (which are lighter, tougher, cheaper, and use 70% recycled content). Craft beer and, in a nascent trend, wine, are the most recent end-markets to begin shifting from bottles to cans.

As a result of this secular tailwind, CCK's can volumes have been growing at a high single-digit rate Y/Y. In the nearer term, CCK's can business (which accounts for ~80% of EBITDA) should benefit from consumer stockpiling of food and beverage staples that have superior shelf lives.

Similar to the can business, CCK's Signode acquisition (~20% of EBITDA) is a highly defensible, recurring revenue business that operates mostly on a local level. Like aluminum cans, most types of transport packaging (e.g. air bags, honeycomb and edge protectors, etc.) are produced close to the end consumer because it doesn't make economic sense to ship them long distances. This means that Signode enjoys a "moat" similar to CCK's can business, with similarly high barriers to entry. To wit: Signode generates $2.3B of revenues, but operates 100 manufacturing plants across 23 countries, an average of only $23MM in revenues per plant. 85% of Signode's revenues come from markets where it is the #1 or #2 player.

As noted, consumables make up 88% of Signode's revenues. With Signode's business diversified across more than 200K global customers, demand for these consumables will roughly track the physical volume of product (in particular, industrial products and certain commodities like steel and lumber) being stored and moved across the globe.

How bad can things get for CCK, given the COVID-19 shock?

At the trough in 1Q 2009 (when it was still owned by Illinois Tool Works), Signode's revenues declined by -30% Y/Y (or $200MM Y-Y), and the company posted a flat EBIT quarter (normal operating margins are in the low teens), versus EBIT of $70MM in the same quarter the prior year. This suggests that incremental operating margins in the business were something on the order of 35%.

In a 2020 disaster scenario where US GDP temporarily declined by -30% or more, we think that Signode's revenues could perhaps decline by as much as 60%-70%. In this scenario, we think Signode could generate an operating loss on the order of $100MM-$150MM annualized. However, we think operating cash flows would be breakeven or higher, given the drawdown of working capital (CCK management has noted that Signode generates high cash flows from working capital drawdown when revenues decline). We note, however, that this working capital benefit would not recur.

In such a scenario, we think CCK would generate something in the neighborhood of $1B in EBITDA-CapEx, which would foot to over $500MM in free cash flow to equity holders. On today's $6.0B market cap, that still represents an 8% FCF yield. Our $75 fair value estimate ($10B market cap) implies a 13x multiple on (pre-virus) 2019 FCF of $750MM. This compares to a historical FCF multiple closer to 17x.

CCK does not have any debt maturities until 2022 and has $1.7B available on its revolver. On March 10, the board announced a $250MM buyback authorization to take advantage of the share price decline, its first buyback authorization since 2018 (when we last recommended the stock). We think this represents a vote of confidence by CCK's management and board that balance sheet risk remains manageable, even under a disaster GDP scenario.

The biggest risk to our thesis is that sustained shutdowns cause industrial output to stagnate at very low levels for an extended time period.

Annual income projections

	2018	2019	2020e	2021e
Total Revenue	11,151.0	11,665.0	11,116.8	11,820.3
Gross Profit	2,123.0	2,316.0	1,862.3	2,162.3
SG&A	1,027.0	1,121.0	1,045.0	1,115.0
EBIT	1,096.0	1,195.0	817.3	1,047.3
Interest expense	384.0	378.0	370.0	350.0
Interest income	21.0	17.0	15.0	16.0
Other expense	(7.0)	49.0	0.0	0.0
Pretax income	740.0	785.0	462.3	713.3
Income taxes	216.0	166.0	97.1	149.8
Minority interest	(85.0)	(110.0)	(100.0)	(95.0)
Net income	439.0	509.0	265.2	468.5
EPS - FD	$3.28	$3.78	$2.02	$3.60
Average shares	133.9	134.9	131.0	130.0
EBITDA	1,521.0	1,685.0	1,317.3	1,567.3
FCF	635.0	770.0	520.0	660.0

% of Revenue	2018	2019	2020e	2021e
Gross Profit	19.0%	19.9%	16.8%	18.3%
SG&A	9.2%	9.6%	9.4%	9.4%
EBIT	9.8%	10.2%	7.4%	8.9%
Interest expense, net	3.3%	3.1%	3.2%	2.8%
Pretax income	6.6%	6.7%	4.2%	6.0%
Income tax rate	29.2%	21.1%	21.0%	21.0%
Minority interest	0.8%	0.9%	0.9%	0.8%
Net income	3.9%	4.4%	2.4%	4.0%
EBITDA	13.6%	16.3%	16.7%	16.9%
FCF	5.7%	6.6%	4.7%	5.6%

Y/Y % chg				
Total Revenue		4.6%	-4.7%	6.3%
Gross Profit		9.1%	-19.6%	16.1%
SG&A		9.2%	-6.8%	6.7%
EBIT		9.0%	-31.6%	28.1%
Interest expense		-1.6%	-2.1%	-5.4%
Pretax income		6.1%	-41.1%	54.3%
Income taxes		-23.1%	-41.5%	54.3%
Minority interest		29.4%	-9.1%	-5.0%
Net income		15.9%	-47.9%	76.6%
EPS - FD		15.2%	-46.4%	78.0%
Average shares		0.7%	-2.9%	-0.8%
EBITDA		10.8%	-21.8%	19.0%
FCF		21.3%	-32.5%	26.9%