The Stock Catalyst Report

Newell Brands (NWL)

Trouble Ahead

Sometimes, investors get lulled into making the mistake of thinking a company and their brands they know and use make a good investment. That can be a big mistake.

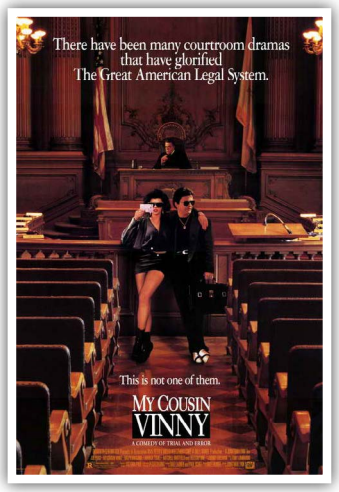
They may get even more excited when that company acquires another company whose brands they also know and use. They often think the combined companies will create a juggernaut to be reckoned with. Frequently, they're wrong.

Quite often, acquisitions occur so both companies can solve a growth problem. And often, management teams of the acquirer are incentivized to make acquisitions because in many instances their compensation is tied to growth targets.

The problem arises for shareholders of the combined company when those targets come at any cost. A short-sellers dream occurs when two companies who perennially destroy ECONOMIC shareholder value join forces - it is a disaster waiting to happen.

I think Newell Brands is one such company. If you own it, I would be very careful. If you don't there are ways to profit from what I think will be a very rough road ahead for the company.

AN INTRODUCTION



Much to my wife's chagrin, I am a connoisseur of big-screen "stupid" (wife's words not mine) comedies. One day I'll reveal my top-10 favorite comedy movie list. Until then, I'll reveal what is likely my favorite of all time - My Cousin Vinny. Vinny, the stereotypical brash New Yorker (I can say that as I am a born and bred New Yorker, though thank goodness, I am not brash, nor do I fit the stereotype).

For a refresher on the plot, William (Bill) Gambini and Stanley Michael Rothenstein are two friends from New York University who just received scholarships to UCLA. They decide to drive through the South. Once they arrive in Alabama, they stop at a local convenience store to pick up a few snacks. But, no sooner than they leave the store, they are arrested. They had thought that they were arrested for shoplifting, but they were arrested for murder and robbery. Worse, they are facing execution for this crime.

Bill and Stan do not have enough money for a lawyer, so the good news is that Bill has a lawyer in his family, his cousin, Vincent Laguardia Gambini.

The bad news is that Vinny is an inexperienced lawyer who has not been at a trial. So, Vinny must defend his clients and battle an uncompromising judge, some tough locals, and even his fiancée, Mona Lisa Vito, who just does not know when to shut up, to prove his clients' innocence.

After meeting in the state penitentiary with Vinny, Stan is horrified by his brash manner. He tells Bill that he is going to use the public defender. But Bill knows his cousin, has faith in him, and urges Stan to use him.

Bill: "At my cousin Ruthie's wedding, the groom's brother was that guy Alakazam. You know who I'm talking about?"
Stan: "The magician with the ponytail?"

Bill: "Right. Well, he did his act, and every time he made something disappear, Vinny jumped on him. I mean, he nailed him! It was like, "it's in his pocket", or "he's palming it", you know? Or, "there's a mirror under the table." I mean, he was like, he was like, "wait a second, wait a second, it's joined in the middle, and there's a spring around it, it pops it open when it's inside the tube." It was like Alakazam's worst nightmare. Vinny was just being Vinny. He was just being the quintessential Gambini."

Vinny had his work cut out for him. He had to reconstruct the crime and prove Bill and Stan were the victims of mistaken identity. A tall order in a small town in the deep south where they were accused of killing a local.

After a series of disasters early in the trial, Vinny became the quintessential Gambini (whatever that is) that Bill promised Stan. He reconstructed the crime and, well, I won't spoil it for you, let's just say he was masterful and he was the prosecutor's worst nightmare. Not just Alakazam's.

Vinny would have made an exceptional short seller.

Short sellers come in all shapes and sizes. Some like to sniff out fraudulent companies, some like to short fads, others short companies with tremendous debt loads, you name the malady, there is a short seller betting against many companies and for myriad reasons.

Vinny's specialty would have been shorting those companies whose Achilles heel is hiding in plain sight but whose management teams are skilled at creating the illusion of strong results using liberal accounting estimates, serial acquisitions, well timed restructuring plans and mastery of how to manage investor expectations.

Vinny would have a field day as a short seller as there is no shortages of companies with the skills of Alakazm.

Company results are not as they always appear.

A very brief primer on some accounting stuff is necessary to understand our discussion. I promise it won't drone on.

The Financial Accounting Standards Board (FASB) has established guidelines designed to assure that all companies use the same method for reporting financial results.

These generally accepted accounting principles are commonly referred to as GAAP.

As well intentioned as FASB is, the boundaries are broad and there exists the opportunity for management teams to apply liberal interpretations of the use of estimates when determining what numbers to use for their reported results.

Therefore, not all reported numbers represent an accurate representation of the actual economics and performance of the business.

Management Flexibility with GAAP
No two sets of earnings are alike.

One company's reported earnings may not be of the of the same quality as another's because each management team uses its own judgment when recording business transactions.

No one knows the business better than a company's own management team. They have extensive knowledge of the economics of its business and are best positioned make judgments regarding the items that go into making expectations of future cash flow.

One would hope management uses its best judgment that accurately reflects the stated principles and qualities of accrual accounting. They have leeway in estimated things like;

- Estimating reserves to take for doubtful accounts,
- Estimating the value of inventory and allocating the overhead for it.
- Estimating the residual value of assets and the depreciation schedule for it.
- Estimating returns on plan assets, discount rate on liabilities and growth in wages and healthcare costs.

This is not an exhaustive list at all, but it gives you a sense.

Business can change on a dime and things don't always go as planned. So even with honest efforts to forecast the future, management will not always produce accurate accrual estimates. It happens. And you move on.

However, not all management teams give the most accurate picture of accrual estimates.

It doesn't mean they are lying. It means that they have a range of estimates they can use and may choose the most aggressive one, within limits, to affect the outcomes of earnings.

Again, not illegal, but it can have a big impact on the direction of earnings and cash flow.

So why would they do that? Like I always do, I focus on the power of incentives.

Aggressive use of estimates usually means there is incentive waiting on the other side.

That could be management bonuses tied to stock price performance, or certain cash flows, earnings, or a host of other things.

And it is often not highlighted and is recorded deep in the footnotes of the financial statements.

That requires a lot of digging through the footnotes and other parts of financial documents to find these items.

I'll tell you more in a moment about why that may not occur as much as you think.

Management Flexibility – "Adjusted" or "Normalized" Results

In addition to having flexibility with what estimates to use while staying within the accounting guidelines, the SEC permits companies to present certain results to investors that may deviate from GAAP – with a caveat.

Companies can present non-GAAP numbers, often known as "adjusted or normalized", if they highlight to investors that they are doing so and present a reconciliation of the numbers.

These adjustments, in theory, are designed to back out of reported results items that the company considers to be unusual in the ordinary course of business.

The theory goes that by backing out certain one-time items and other extraordinary items, the adjusted/normalized results provide investors with a picture of the ongoing operations.

In theory that may make sense. If the adjustments are truly one-time in nature and extraordinary.
A lot of things make sense in theory, until they are put into practice.

Over the years, companies have become bolder with what they exclude to arrive at adjusted/normalized earnings.

The list can be exhaustive about what is included, but some of the more common items are restructuring charges, foreign currency movements, legal fees for certain lawsuits and so on.

Here is where it gets interesting. Just look at those items I just listed. As I said, they're just a few of what some companies back out of reported results.

Let's take restructuring charges for an example. If it is uncommon for a certain company to restructure and is one-time in nature, then perhaps it accurately reflects an unusual charge and is reasonable to exclude the charge. However, if the company is a perennial restructurer, it doesn't seem reasonable.

After-all, it may just be a bad business that needs to restructure constantly to try and get it right. In this instance, it would not be an accurate representation to include those charges to arrive at adjusted/normalized results.

Foreign currency adjustments. Suppose a company has foreign operations. They may sell their goods or services in one currency and their costs may be in another currency. There can be many machinations of this.

The reality is currency prices move around all the time. And if a company is doing business in other countries, well, that's a cost of doing business. Not a one-time event.

You get the point. Even within one-time expenses, it is open to interpretation.

Over the years, management teams have behaved like children in some sense. Kids push the boundaries and see what they can get away with until they get told no by their parents.

Well, the more familiar and comfortable investors became with these adjusted/normalized results, the more management teams would include in these numbers and like anything, too much of a good thing is too much of a good thing.

As you might imagine, these adjusted/normalized results are intended to create the rosiest of results and outlook.

They can also create a mirage that is not an accurate reflection of a company's true economic performance.

Adjusted/normalized results are a company's best effort to steer investors to the items and results they WANT them to focus on – not always what investors SHOULD be focused on.

So how do investors, especially professional investors, let management teams get away with this?

How do professional investors not detect the liberal use of estimates?

Ok. Listen closely. I am going to share a little secret with you about professional investors. Please pay attention.

Most professional investors are lazy.

There. I said it. And it felt good.

If I have offended any of them.-too bad.

I said most-not all. The one's who aren't lazy won't be offended. They'll know what I mean.

Early in my career, I worked for a legendary hedge fund manager. He had many terrific sayings and words of wisdom for his analysts. One of them was "never underestimate the laziness of portfolio managers and analysts".

I didn't quite understand it at the time as I and many people I knew were working 18-hour days, 7 days per-week. What I missed was the universe of people I knew as a new analyst was just a handful. And they were all young and eager like I was.

What I have come to learn twenty-plus years later, having gotten to know many hundreds of professional investors, is to never underestimate the laziness of portfolio managers and analysts.

It requires a lot of work to find and interpret the information required to get to the numbers that accurately reflect the business. It's painstaking and tedious.

Analysts have countless numbers of positions they must follow, same with portfolio managers. They don't have a lot of time to devote to any one position.

The job is a 24/7 endeavor. There are so many things that can impact a company's stock price that often analysts are putting out fires on many companies at once and tracking down information.

The documents filed with the SEC are often very long. And despite the standard methodology of reporting, the information within the filings can be incredibly complex for even the most seasoned analysts.

If companies can present results a certain way and make it easier for analysts and portfolio managers to understand, key word EASIER – than many will take the adjusted/normalized results as a given and won't bother to dig into the financials to better understand the use of estimates.

And herein lies the opportunity for a short-seller or helps educate someone who owns the stock.

Opportunities hiding in plain sight. You just need know where to look, to do it, and how to interpret what you see. I endeavor to enlighten you on that.

So, without further ado, let me share one such company with you.

Newell Brands. (NWL)

Current Price	$50.25	Forward P/E	14.3
52-wk Range	$43-$55	EV/EBITDA (TTM)	17.6
Shares out (mm)	486M	Short % of Shares O/S	4%
Market Cap	24.42B	LT Debt	11.39B
Shares Short	17.3M	Cash	780M
Enterprise Value	35.03B		

Newell is an egregiously overvalued consumer products company (I never short overvalued companies based on valuation. I short them because they are fundamentally flawed- read on) that recently added a huge amount of debt to its balance sheet to acquire an even more overvalued and fundamentally flawed consumer products company- Jarden Corporation (JAH).

Both businesses, when looked at through the lens of detailed analysis and not company and Wall Street hyperbole, are slow growing businesses with very low returns on capital – a key measurement of value creation.

Despite the true economic shareholder value destruction that has occurred underneath the surface, the adjusted/normalized results of both companies have painted a far rosier picture over the last several years. A picture that heretofore has created significant stock price returns for shareholders of both companies.

Shareholders of both companies have benefitted from numerous accounting adjustments, restructurings and other items that have masked the poor state of both businesses. All legal by the way.

But being legal doesn't mean it paints the true picture. That's' just the nature of how reporting works. It comes in many shapes and sizes. I already discussed that.

I'll sift through all the noise for you.

My job is to separate the adjusted/normalized results and point out pieces of the puzzle that aren't obvious so that I can identify and illuminate the real economic value creation or destruction for shareholders.

And then, marry that with the **WHEN** the true operating performance should begin to appear.

This is a critically important point.

Just look at Newell's stock price performance (blue line). It returned 238% over the past five years and on an absolute basis it trounced the competition.

Newell Rubbermaid – 2011, A New Beginning
Since the arrival of Newell's CEO Mike Polk in 2011, as I just highlighted, the company's valuation and stock price have appreciated meaningfully.

As I will walk you through in our discussion, this massive valuation expansion is on the back of hyperbole and unsustainable business drivers, not fundamentals. I think that is about to change.

Formerly known as Newell Rubbermaid. The company changed its name to Newell Brands after it consummated its acquisition of Jarden Corporation in the middle of 2016.

You know the brands, you likely even use some of them. **But don't mistake a brand you use for a stock you should own.** On the contrary, I think an opportunity exists to benefit from what I expect to be a series of disappointing results over the next year or two.

I believe the combination of Newell Rubbermaid and Jarden Corporation create a combined business that creates a scenario where 1+1 = ½. Not the 1+1 = 3 that many investors hope for. Much more on the combined companies later.

Before the Jarden acquisition, Newell was a slow growing, low return on capital business which had gone through numerous CEO's who all tried to turn around the company through a series of restructuring attempts.

They all disappointed.

Newell's business has been, at best, stagnant over the past decade. Those who believe the acquisition of JAH will create a juggernaut are ignoring the failed history of most acquisitions.

Since 2000, the company has made numerous acquisitions.

Newell's current return on invested capital (ROIC) of under 4%, is the same return earned in 2000.

Worse yet, which I will explain further in more detail below, Newell's economic earnings, the true cash flows available to equity investors, have been negative throughout the company's history.

Another Restructuring Attempt

Early in Mike Polk's tenure, he announced a major restructuring program called "Project Renewal".

Given the strong stock price return over the last five years, one might think the economic fortunes of the business have turned.

Not even close. A look below the surface reveals a company that is reeling and had no choice but to overpay for a major acquisition. It needed something to try to show growth and to also cloud the picture with a lot of noisy restructuring charges and divestitures etc.…

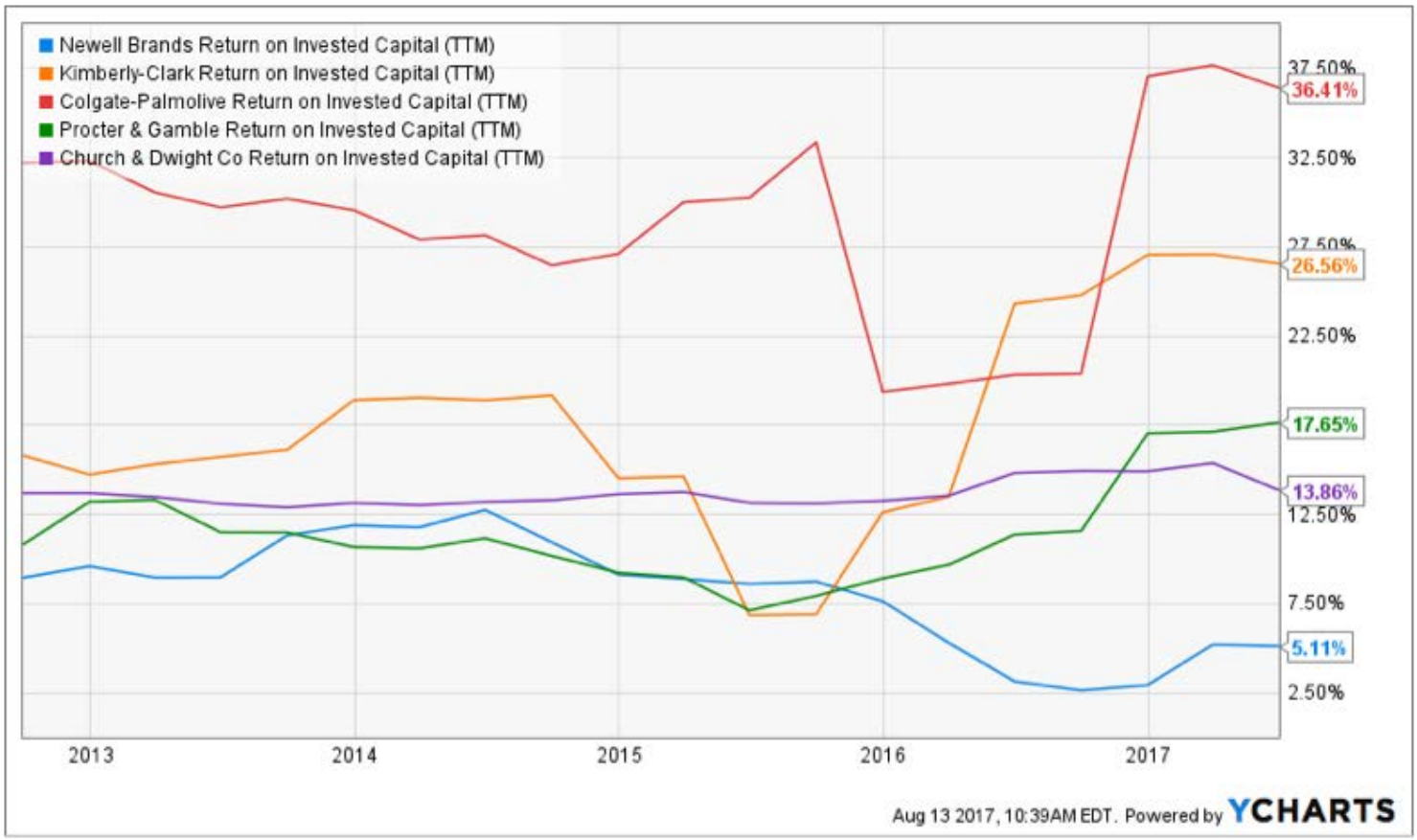
Return on Invested Capital (ROIC) – The Shining Light

One of the key ways that I judge company performance is ROIC.

ROIC looks at all the money invested into the company, both by shareholders and lenders, to measure how well management uses all that cash to generate profits.

Generally, the companies with the highest ROICs are making more profits out of every dollar invested, and not surprisingly, they often show the biggest share price gains.

As you can see, Newell's ROIC is dramatically lower than its peers.



Results That Move Stocks

To over simplify it, stocks basically move up or down based on their growth trajectory of an income stream and if the company results have beaten or missed investor expectations.

Results can be created different ways. And have dramatic consequences.

You'll recall our discussion on liberal use of estimates to derive GAAP numbers as well as my mini-tutorial on adjusted/normalized earnings.

To put adjusted/normalized earnings into perspective, let's turn again to My Cousin Vinny.

To paint the scene, Vinny has just slept through the prosecutor's opening statement and is asked to give his statement – with prodding from the judge who needed to wake him.

Judge: Counselor, do you wish to make an opening statement? Counselor?

William: Vinny?

Vinny: (waking up) What?

William: Come on, it's time to make your opening statement. C'mon, Vin.

Vinny: Everything that guy just said is bullshit. Thank you.

Prosecution: Objection, your Honor. Counsel's entire opening statement is argumentative.

Judge: Objection sustained. The entire opening statement, with the exception of "thank you" will be stricken from the record. The jury will please disregard Counselor's entire opening statement. And you, Mr. Gambini, you will not use that kind of language in my court. Do you understand me?

Vinny: Yeah, yeah, yeah.

Now, that might be a bit of an exaggeration about adjusted/normalized earnings. But not by much. And the same can be said for liberal use of accounting estimates.

They're allowed. But often they don't reflect true economic reality of the business.

So, What Does Reflect True Economic Reality?

Economic earnings tell the true story of what is going on at a company. To derive real economic earnings, 30+ changes must be made to accounting earnings. These adjustments remove items hidden in the footnotes and MD&A of annual filings and close loopholes within GAAP accounting.

As you can see, there are many items that need to be adjusted for to really get a true picture of a company's true earnings. The earnings that better reflect the economic reality of the business.

These adjustments are tedious, time consuming, buried in the footnotes and management discussion section of

Income Statement Adjustments	Balance Sheet Adjustments	Stock Valuation Adjustments
Asset write-downs	Off-balance sheet reserves	Employee stock option liabilities
Hidden non-operating expenses	Off-balance sheet debt	Preferred stock
Hidden non-operating income	Discontinued operations	Minority interests
Change in reserves	Other Comprehensive Income	Adjusted total debt
Discontinued operations (except for REITs)	Asset write-downs	Pension net funded status
Implied interest	Deferred compensation	Net deferred tax
Non-operating tax expenses	Deferred tax	Net deferred compensation
Historical adjustments: Goodwill amortization and ESO expense	Over-funded pensions	Discontinued operations
Reported non-operating items	Excess cash	Excess cash
	Historical goodwill	Unconsolidated Subsidiaries
	Midyear acquisitions	

Source: New Constructs

financial filings, **and because of that, are quite often overlooked by investors**.

And it is there where the juicy stuff is found. The place where the true economic condition of the company can be found.

I find value in accounting analytics firm New Constructs to aid me in my own proprietary analysis. I use their work as a sanity check to mine. New Constructs makes the adjustments listed above.

Going back to what I said about what makes stocks move, if companies can convince investors to focus on adjusted/normalized earnings, the "economic" earnings, as poor as they may be, won't cause the stock to go down.

There needs to be a catalyst. I will discuss shortly why I think that time is near for Newell.

This is where the rubber hits the road.

Scouring these items enables one to put into practice the old Russian proverb, made famous by President Reagan, which says "Trust but verify!"

One must read the fine print. But some companies will put very dubious items in there for exclusion. Items that are not one-time in nature but should be considered ongoing.

Ok, so what's this got to do with Newell? A lot!

Newell has mastered the art of aggressive estimates and Alakazam.

Newell's stock price outperformance would lead one to think its results saw dramatic improvement in both absolute terms and relative to its peers.

Yeah, not so much. Not much at all.

NWL	2011	2012	2013	2014	2015	CAGR
Total Sales as Reported	$5,864.6	$5,902.7	$6,085.1	$5,751.6	$5,921.7	0.2%
"Core Sales"fx adj/less acquisitions/divestitures			$5,677.5	$5,848.5	$6,255.8	
"Core"Sales growth rate			3%	3%	5.5%	
"Normalized Operating Income(M)	815.0	823.0	845.1	876.9	938.5	3.6%
"Normalized Earnings" per share	1.59	1.70	1.83	2.00	2.18	8.2%
Shares Outstanding	296.2	293.1	286.7	275.6	268.1	-2.5%
Operating Cash Flow	561.3	618.5	605.2	634.1	565.8	0.2%
Free Cash Flow	338.4	441.3	467	472.2	354.4	1.2%
Free Cash Flow Per Share	1.14	1.51	1.63	1.65	1.32	3.4%
Earnings to FCF conversion	41.5%	53.6%	55.3%	53.8%	37.8%	

Above are a few metrics from 2011, the year Mike Polk took over, to the end of 2015. I stop at 2015 because 2016 is the year of the major transformational Jarden acquisition that clouds the results. I will dissect 2016 separately a bit later.

As you can see, on an absolute basis, the numbers have been less than impressive. Sales have grown at a compound annual growth rate (CAGR) of 0.2%. This is total sales which does not include certain effects of foreign currency, acquisitions and divestitures/planned divestitures.

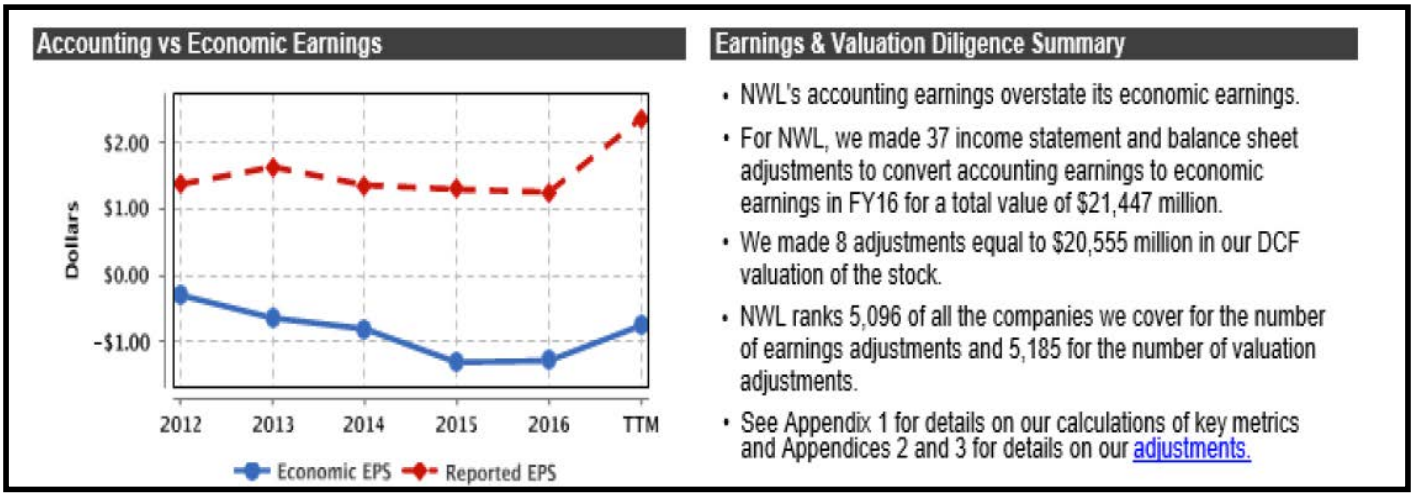
To incorporate those, the company guides investors to a "core" sales rate. Newell has so many moving parts with acquisitions and divestitures and the timing of those, the core number excludes them and uses a "fixed" foreign currency number (interesting) and excludes acquisitions and divestitures.

"Normalized" operating income, as Newell refers to its adjusted results, the non-GAAP measure than excludes the things the company doesn't want to include (so this is putting their best foot forward in terms of representing the numbers) have grown just 3.6%.

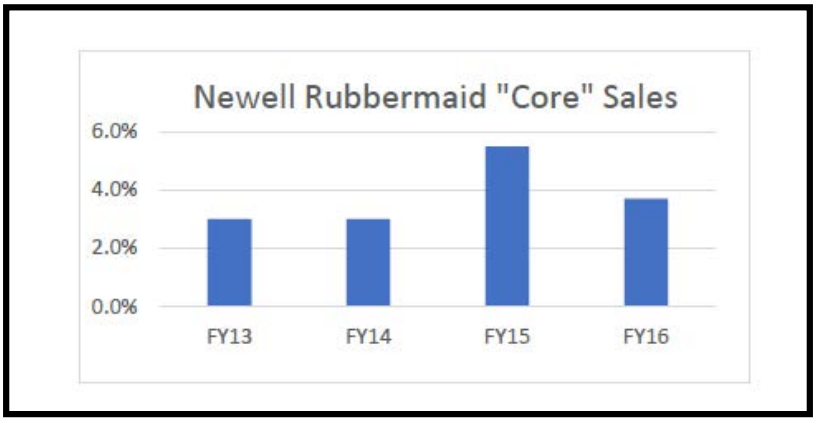
Earnings per share have grown 8.2%, not terrible, but aided by a share buyback which reduced share count 2.5%. And oh, by the way, that's "normalized" eps. Not even close to a true representation.

Economic earnings per share (eps) paint a far gloomier picture than NWL's reported "normalized" eps, as you can see, it's economic eps is value destroying.

Using some of the adjustments that are required to make a true representation of economic earnings reveals a far different picture. I won't go into the adjustments, I will provide a summary.



Source: New Constructs

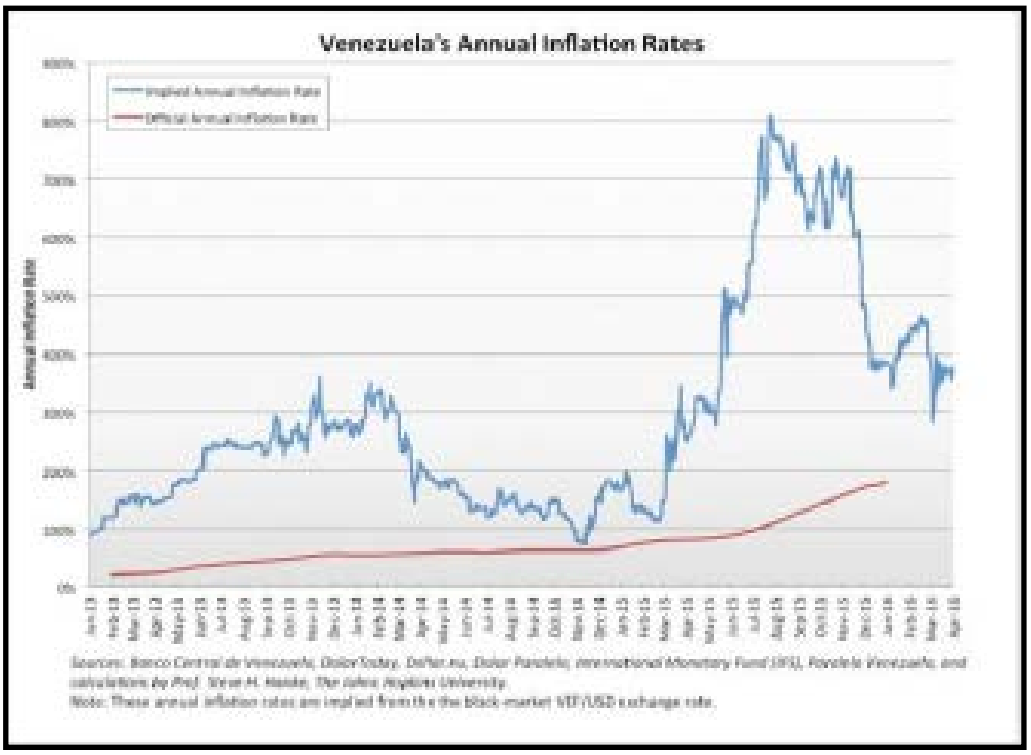


These "CORE SALES" non-GAAP, are as presented by the company. They don't look too bad on the surface.

Core Sales Growth Explained

"Core Sales" is a company term. It excludes the impact of currency fluctuations as it uses a fixed currency rate (hmm), acquisitions and planned and completed divestitures from the period the intent to divest is determined through the date of sale.

I will show in a moment how these sales do not represent the dramatic positive impact on these numbers from the impact of its **Venezuelan** business, which accounted for less than 1% to just 2.2% of sales of the overall company during this time.



Alakazam #1 – Venezuelan Sales – Hyperinflation Style.

Huh? Less than 1.0% of sales to 2.2% of sales matters to the overall company?

Yep! And a lot!

If you stay abreast of current events, it should be no surprise that the Venezuelan government and economy is in disarray. And it has been for a while. The country has been suffering from dramatic hyperinflation.

Despite the hyperinflation, the country's leaders had refused to devalue the official currency for a long time.

Up until February 2015, there were 4 rates in Venezuela;

1. The official rate: 6.3 Bolivars to the US Dollar
2. SICAD 1: 12 Bolivars to the US Dollar
3. SICAD 2: 50 Bolivars to the US Dollar
4. Black-market rate: 200 Bolivars to the US Dollar

The black-market rate is the actual rate that people transact at when they walk into a store and buy something. It's the real rate.

The gap between the black-market rate and the "official" exchange greatly exaggerated many company's reported results.

Many multi-national companies received the benefits of hyperinflation (in Local Bolivar terms).

What does this have to do with Newell? A lot!

For starters. It helped Newell's core growth rate quite a bit. Venezuela, which by the way the company deconsolidated at 12/31/15, was a major drive of the "core sales" growth for overall Newell Rubbermaid from 2012-2015.

Venezuela Sales – The Impact of Hyperinflation on Newell's Sales – Staggering!

Newell Rubbermaid Venezuelan Impact to Core Sales	2012	2013	2014	2015
A) Newell Rubbermaid Sales	5508.5	5607	5727	5915
B) "Core Sales" Growth (not overall sales)	2.2%	3.0%	3.0%	5.5%
C) Venezuela as % of Overall Sales	1%	1.4%	1.4%	2.2%
D) Dollar amount of Venezuelan sales	$55	$78	$80	$130
E) Growth rate of Venezuelan Sales in Dollar terms.		43%	2%	62%
F) Bolivar Devaluation Impact		18%	48%	11%
G) Vz Dollar starting point post-devaluation =(C*1-F)		$45	$41	$71
H) Vz Sales needed to offset devaluation (C43/G43-1)		74%	96%	82%
I) Impact to core sales from Venezuela (C*G)		1.0%	1.3%	1.8%
J) Venezuela sales as % of core sales growth (H/B)		**34.4%**	**45.0%**	**32.9%**

From 2013-2015, Venezuela accounted for 1% to 2.2% of overall company Newell Rubbermaid sales.

Yet it accounted for between 33% and 45% of the overall Newell Rubbermaid's core growth rate.

That is simply stunning. It is also not obvious or discussed when the numbers were reported.

Frankly, it requires a lot of digging and thought.

Thought that I doubt a business that accounts for 2.2% of sales gets from most analysts.

How did this happen? The impact of hyper-inflation.

Another question to ask is how can stores who can't get products on their shelves generate so much in sales growth?

Let's look at 2014 for an example.

Venezuela represented 1.4% of sales. The same as in 2013. So, at first glance it appears sales were flat.

Digging deeper again we see it's not as meets the eye-again!

In the early part of 2014 there was a shift in the exchange rate used from 6.3 Bolivars to the dollar to 12 Bolivars to the dollar.

Think about that. To have flat dollar sales on a decline in the currency of about 48% means "core" sales in Venezuela would have had to have grown about 96%.

A 96% increase on 1.4% of overall company sales means Venezuela contributed about 130 basis points to the company's overall "core" growth rate, which was 300 basis points.

Said another way, Venezuela, at 1.4% of sales in 2014, contributed 45% of the company's overall "core" sales growth rate.

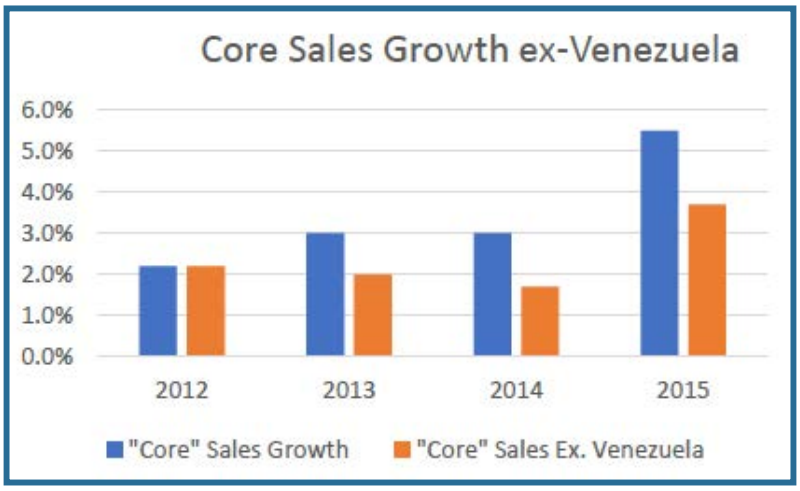
2015 had dramatic impact to core sales as well. The Bolivar was devalued from 12 to 13.5 Bolivar to the dollar. Following the same math as above, and shown in the table, Venezuela accounted for about 33% of the company's core sales growth rate.

Think about that! A country that has been teetering on the brink for years, not core to Newell or most other multi-national consumer products companies doing business there, was a major contributor to Newell's growth.

How can a consumer products company increase sales in an impoverished country whose economy is in tatters? Hyperinflation.

It's not the headline numbers that matter, it's what lies beneath.

The more peeling back of the onion done on the core sales growth during this time the more obvious it was that sales growth was not healthy –, hovering around 2%, except for 2015, where it increased to 3.7% - absent Venezuelan Hyperinflation.



Yet, Wall Street applauded and the stock marched onward as it believed that Project Renewal initiatives and other programs had delivered.

Alakazam!

Alakazam #2 - Venezuela Margin Impact

But wait, Venezuela's dramatic impact on the numbers gets even better – for margins.

The extreme inflation in Venezuela not only impacted sales, but also had an impact on margins.

The Venezuelan government would allow certain companies to import dollar denominated products at preferred foreign exchange rates.

Recall earlier I mentioned the different exchange rates. If for example a company had access to the 6 to 1 exchange rate (Cencoex) or the 12 to 1 exchange rate (SICAD 1), that means for every one-dollar worth of goods imports it would pay either 6 or 12 Bolivars.

Yet, when it sells those goods, it sells them at the real rate (think of that as what everyday people pay in the stores), uring the time frame of this discussion around 170 to 200 bolivars to 1. So, as hyperinflation rages on, the company's costs of goods are fixed while sales get the enormous lift of hyperinflation – and the company's gross margins see an enormous uplift.

Other costs were locally denominated so it wasn't all pure margin lift, but it helped a lot.

Had profits denominated in Bolivars bene translated back into dollars at the black-market rate of 200 to 1, or heck, even at 50 to 1 (SICAD2), it would have eliminated most of the profit growth benefit.

For illustration purposes of the impact on profits. In 2014, Venezuela had 39% operating margins versus 15.8% for the rest of the company.

Again, Venezuela, at 1.4% of sales, was not a core business.

Yet it was having a dramatic impact on the company's results.

From the beginning of 2013, Venezuelan sales increased from an annual run rate of $78 million in net sales and $34 million in operating income to an annual run rate of $130 million in sales and $51 million in operating income by end of '15.

Newell Rubbermaid VenezuelanOperating Income	2012	2013	2014	2015
Dollar amount of Venezuelan sales	$55	$78	$80	$130
Operating income in Venezuela	not disclosed	$34	$30	$51
Overall Operating Income	$651.00	$757.00	$792.00	$846.00
Operating Margin in Venezuela		**44%**	**38%**	**39%**
VZ Operating income as a percent of overall op income		**4.5%**	**3.8%**	**6.0%**

And it was barely, if at all, noticed.

As the saying goes, "all good things must come to an end".

During 2015, Venezuela began to move toward a more market driven exchange rate.

Given there were four exchange rates, it gave management's some flexibility as to what rate they would use. When management teams tend to have flexibility, they tend to favor what benefits the company's bottom line results the most. And in today's world, the majority focus on the here and now – the short term.

Had the market exchange rates been used, operating profits in would have been much lower.

So, what did the company do? It deconsolidated Venezuela effective the first quarter of 2016.

And the way that looks to those who had not been realizing the impact of a tiny 1.4% of sales in a country that hardly anyone pays attention to from an impact on results perspective, is it is met with a yawn by investors, a few notes in the financial and the company moves on.

Yet for Newell Rubbermaid, it could no longer rely as heavily as It did on Venezuela to boost its performance.

It needed to do something dramatic.

It needed a big acquisition.

Enter Jarden

On December 14, 2015, the company announced the acquisition of Jarden Corporation.

I think it significantly overpaid, at 13.7x EV/EBITDA. I think Jarden was worth maybe 8-9x EBITDA.

What better way to mask slowing growth and margin pressure post-Venezuela than to issue high priced stock and some cash to acquire another company in the same industry.

The pitch to Wall Street was the combined companies, with $16 billion in sales, would combine their portfolios, generate $500 million in cost savings, and be immediately accretive to earnings.

Rah Rah Rah.

Ok, so let us explain our view on big mergers. They hardly ever yield the results they promise for myriad reasons.

Sure, cost savings early on are easy enough to ring out. So, investors get excited, dream the little dream about earnings growth and send the stock higher.

The tough part for combined companies comes in the form of revenue synergies. Those so rarely play out.

The pitch by companies to investors is usually the combined sales forces will have more in their sales tool kit and will have the ability to exert leverage over their customers etc.…

Yeah – No! rarely does this occur. Especially in consumer products companies.

Think of who their customer base is. Wal Mart, Target, Costco, Amazon, and the list goes on. There is little brand equity in pens, food containers, and other basic household items. The reality is, there is little pricing power for the manufacturer.

So, let's have a look at the Newell rationale for Jarden as presented by Newell.

The Combined Companies as Pitched to Investors by Both Management Teams.

NewellRubbermaid Brands That Matter	JARDEN corporation
"Brands That Matter"	***"The Brands of Everyday Life"***
• Diversified, global consumer products	• Diversified, global consumer products
• Portfolio of leading brands	• Over 120 trusted, authentic brands
• #1 or #2 positions in Writing, Tools, Commercial Products, Home Solutions and Baby	• #1 or #2 positions in a majority of its categories: Branded Consumables, Consumer Solutions, and Outdoor Solutions
• Accelerating growth and strong value creation track record (5 years)	• Strong growth and value creation track record (14 years)
• $6 billion in annualized sales	• $10 billion in annualized sales
• Sold in over 100 countries with about 30% of revenue outside the U.S.	• Sold in over 125 countries with about 36% of revenue outside the U.S.
• Strong management team	• Strong management team

Strategic rationale

- Strong, complementary portfolio of leading brands in large, growing categories
- Increases scale across key channels, retailers, markets and suppliers
- Expands global reach for both Newell and Jarden
- Enables cross-selling opportunities for the combined portfolio
- Strengthens capabilities in innovation, brand building, design and eCommerce
- Unlocks $500 million in cost efficiencies and synergies*

Financial implications of combination

- Strong, competitive core sales growth
- Immediately accretive to normalized EPS
- Strengthened margins; EBITDA margin over 20% post synergies
- Annual adjusted EBITDA over $3 billion post synergies
- Near term: capital allocation focused on deleveraging and sustaining dividend; Medium term: capital allocation strengthens portfolio and returns
- Strong, highly competitive returns for shareholders

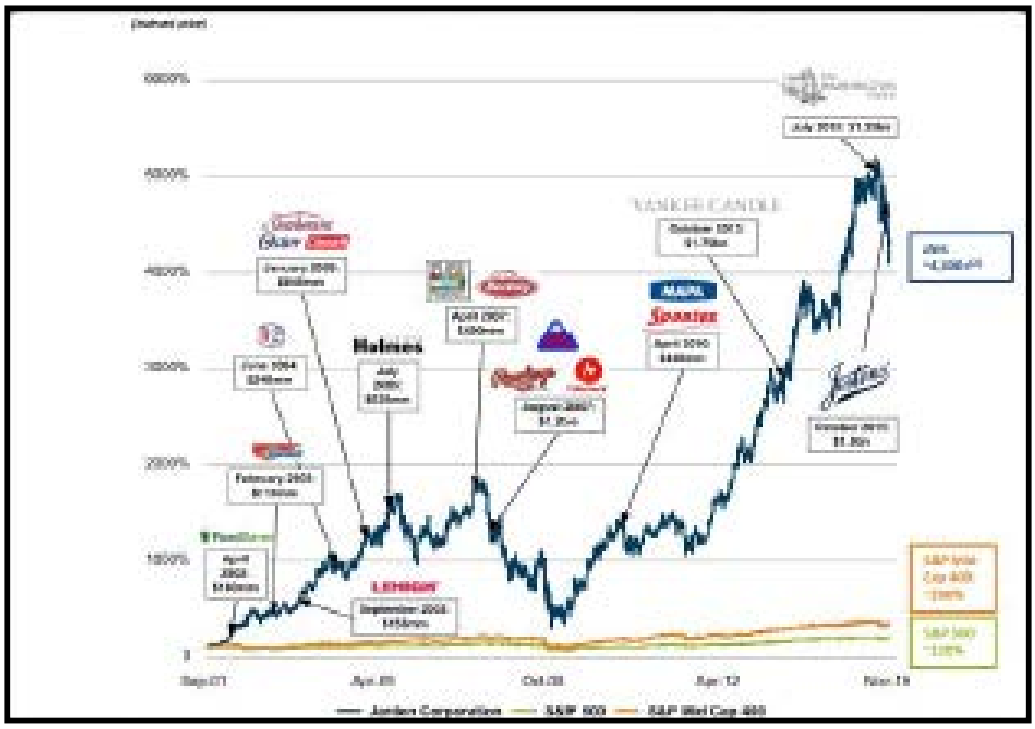
Wow – They seem to make a very compelling argument for the merger. What a powerhouse right?

Not even close!

Let us introduce you more closely to Jarden.

First off, management made their shareholders a fortune over the years. How? Roll-up 101.

Huh? A roll-up is a company that is a serial acquirer. In theory, they buy companies in the same industry, extoll their management expertise, cut costs and keep doing it to the point massive scale is generated.



Wall Street loves a good roll-up story.

Why? Wall Street loves growth. Plain and simple.

Jarden was a poster child for "adjusted" earnings. The adjusted earnings that investors have become accustome to seeing and accepting (well, the lazy ones anyway).

And good for them, laziness was profitable. They made a fortune. Jarden was the number one consumer staples stock over a 10-year period, returning 242%.

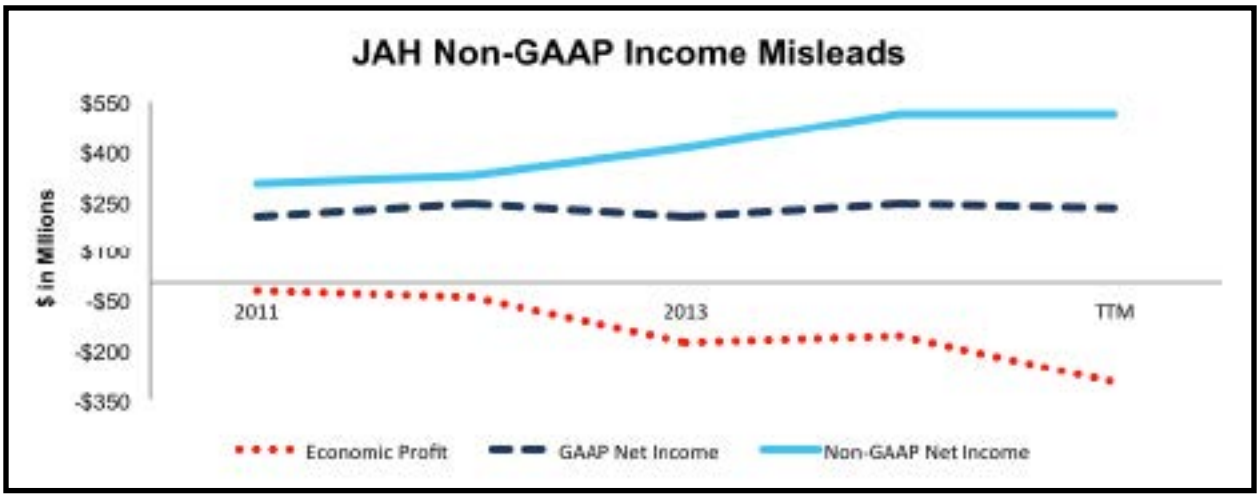
Jarden – A Low Quality Business

You see, Jarden has a similar business model to Newell, growth via acquisition.

The difference is Jarden has been even more aggressive in growth via acquisition. And this has destroyed shareholder value. Not shareholder returns, as Jarden shareholders did quite well (more on how this works a little bit later).

Despite growing revenues by 26% compounded annually over the past decade, Jarden's **economic** earnings have declined from -$27 million in 2004 to -$298 million over the trailing twelve months (TTM) through December 31st, 2015. Remember, Newell acquired the company in April 2016.

Since 2002, Jarden diluted shareholders to the tune of a 24% compounded annual increase in shares outstanding. At the same time, the company's debt rose 30% compounded annually.



Source: New Constructs

Ok, Ok, I know you are still wondering how they diluted stock price returns if shareholder returns were so good. Geez, Jarden has been the number one performing stock in consumer staples since 2001. So, who cares about economic earnings?

Investors care about seeing a future stream of earnings or cash flow grow. When that begins to slow, and companies begin to run out of ways to make that happen, then investors will care.

Jarden was able to grow via acquisition by paying using its expensive stock with a combination of cash and debt.

Jarden was able to use adjusted results to show what appeared to be solid growth. That was beginning to slow as they were pushing the envelope on buying companies to help their growth profile.

My focus is on how Jarden's existing businesses can help Newell's growth profile going forward.

I don't think they can.

That will spell trouble for Newell. Newell does not have the financial flexibility, given the debt it added for the Jarden acquisition, to add much debt to make another big acquisition.

Now, for Newell Brands, they must grow organically. I don't think it can grow much. I think the true lackluster growth of the core business will be exposed.

The Power Of Incentives - Important to Understand

I have said it before and I will say it again, the power of incentives is critical in understanding people's motivations.

Let's look at this deal. How did the executives fare? Really well.

Jarden had long been known for having very generous executive compensation packages. Very generous! And they did exceedingly well on the acquisition with CEO Martin Franklin taking home about several hundred million dollars.

Under the terms of Newell Rubbermaid's executive compensation plan, the performance goals executives must meet to earn their bonuses consist of core sales, normalized EPS, and normalized gross margin.

Go figure, two of these items are the top financial implications highlighted in Newell's presentation of the acquisition. By acquiring Jarden, the new company can show sales growth and EPS growth with no regard to the economics, i.e. the costs, of the acquisition.

So, how much did Newell pay for Jarden and was it a good use of capital?

In 2014, Jarden earned $579 million in Net operating profit after tax (NOPAT), which Newell paid $13.2 billion to acquire.

That translates into a ROIC of just 4%, which at the time of the deal was lower than Newell's 5% ROIC. And it is below Newell's weighted average cost of capital of 5.1% .

In other words, the money Newell spent to acquire Jarden is costlier than the profits it provides.

Stunning!

The Combination
At its core, Jarden is a mystery. It is a hodgepodge of brands that were cobbled together. Once acquired, Jarden would notoriously underinvest in the brands.

Jarden 2015-Pre-Newell Deal

Business Segments as of Fiscal 2015	% of sales
Outdoor Solutions	32%
Consumer Solutions	25%
Branded Consumables	39%
Process Solutions	4%

Newell Rubbermaid Pre-Jarden Deal

Business Segments as of Fiscal Year '16	% of Sales
Home Solutions	29%
Writing	30%
Tools	14%
Commercial Products	14%
Baby and Parenting	13%

Post-Acquisition, the company changed the names of their reporting segments.

Re-Classified Business Segments in May 2017

	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17
Sales						
Live	322.1	1123	1450.2	1679.8	1067.8	1277.6
Learn	384.9	911.7	637.8	605	569.1	1011.4
Work	268.6	646.8	726.9	726.9	613.7	737.7
Play	61.1	685	596.5	528.5	628	782
Other	278.2	492.1	543.2	595.7	387.7	245.9
Total	1314.9	3858.6	3954.6	4135.9	3266.3	4054.6

New reportable business segments reported May 2017.

Business Segments in May 2017	% of Sales
Sales	
Live	32%
Learn	25%
Work	18%
Play	19%
Other	6%

Segment	Key Brands
Live	Aprica ®, Baby Jogger ®, Ball ®, Calphalon ®, Crock-Pot ®, FoodSaver ®, Graco ®, Holmes ®, Mr. Coffee ®, NUK ®, Oster ®, Rubbermaid ®, Sunbeam ®, Tigex ®, Yankee Candle ®
Learn	Dymo ®, Elmer's ®, Expo ®, Jostens ®, Mr. Sketch ®, Paper Mate ®, Parker ®, Prismacolor ®, Sharpie ®, Waterman ®, X-Acto ®
Work	Mapa ®, Quickie ®, Rainbow ®, Rubbermaid ®, Rubbermaid Commercial Products ®, Spontex ®, Waddington
Play	Berkley ®, Coleman ®, Contigo ®, Ex Officio ®, Marmot ®, Rawlings ®, Shakespeare ®
Other	Jarden Plastic Solutions, Jarden Applied Materials, Jarden Zinc Products, Goody ®, Bicycle ®, Rainbow ®, K2 ®, Völkl ®

Waddington and Yankee Candle under the old reporting structure were part of branded consumables. Under the new structure, they were separated into Live and Work.
Waddington was acquired by Jarden in July 2015 for $1.4 billion. Yankee Candle was acquired in 2013 for $1.75B. Yankee Candle was the company's largest ever acquisition. Jostens, Jarden's final acquisition in October 2015 for $1.5 billion, just two months before they were purchased by Newell, was included in the learn segment. Josten's makes class rings, graduation caps and gowns, and yearbooks.

Out with the old, in with the new. Gone were all the familiar segments of the last five years.

The company decided to segment its business by function instead of product solutions. Really? Come on. What's the point of that?

Why make it difficult for investors to understand? Why make them go back and redo all their reporting segment analysis? That will take forever to reconstruct those numbers. And frankly, there is not enough disclosure to even do it.

Hmmm. Let me take a guess at that. Most investors won't bother to do that. Why would they make it difficult to do?

Thankfully, (sarcasm) they made it easy for investors to get a sense of the categories and how they have done.

The company presented a breakout of the numbers back to January 1, 2016, as if the companies merged then instead of April 2016.

Recall what I said earlier about how companies present results to make it easy for investors to focus on what the company **WANTS** them to focus on not what they **SHOULD** focus on?

This is a perfect case in point. While on the surface it appears that the company was providing useful information, the reality is, it didn't. It only gives a one-year look-back. That is not nearly enough to discern trends.

The segment reporting shift is confusing and to try and reconstruct the segments with as little information provided back more than a year is exceedingly difficult.

So, to summarize on segment reporting, in 5 years, the company has showed investors three different reporting segments. As if that doesn't make it difficult enough to track the growth (or lack thereof) in each segment, the company has moved various businesses in and out of each segment.

A Deeper Dive into Jarden

Jarden is a serial acquirer of at best below average businesses, it had low-quality earnings as I have highlighted above with its ROIC.

But it is a roll-up story and fed investor's appetite for growth.

For years, the company acquired random consumer products brands and paid for a lot of it with the company's overvalued stock.

Jarden was also known to present "interesting" core growth numbers.

It was thought by many smart short-sellers that they would make small acquisitions and then categorize them as "complimentary to the core business and insignificant" and as such, treating them as "core, organic growth" rather than exclude them from the core number in the first year of acquisition.

Growth from within, called organic growth, is a good sign.

Buying growth with an inflated stock price could make the acquisition accretive to earnings, which investors like. The more growth, the higher the valuation investors are willing to pay – until they're not.

Buying growth for growth sakes usually becomes a problem for the serial acquirer. Buying mediocre to below average businesses and then underinvesting in them will ultimately create a big problem for the company down

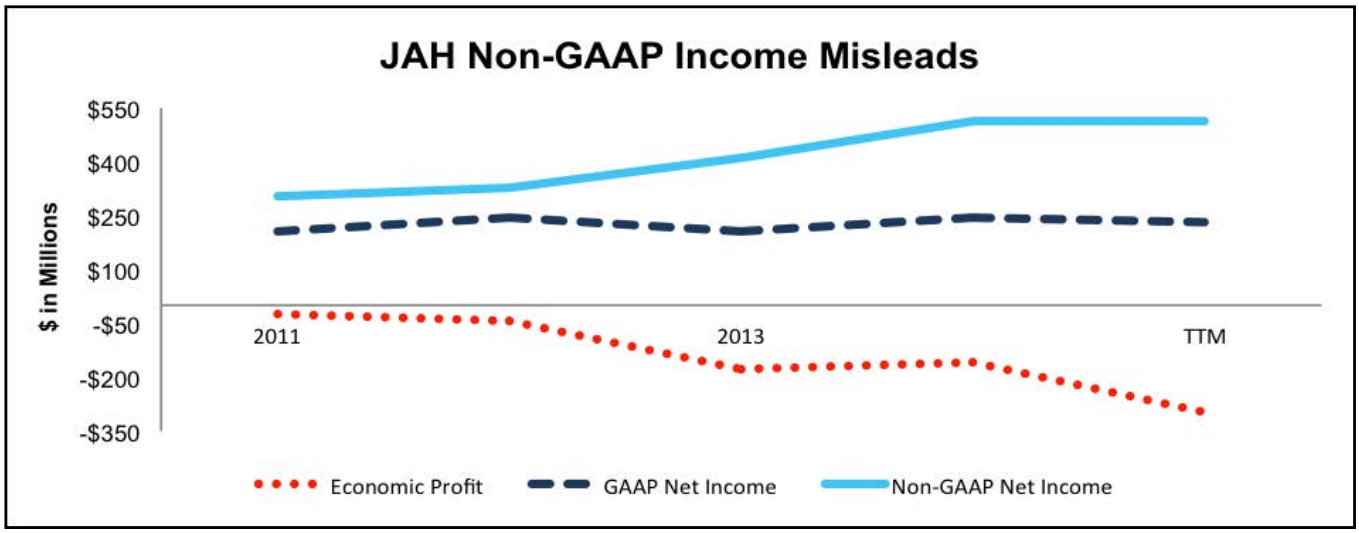
the road.

Identifying when problems will surface can be tricky. Sometimes actions speak louder than words. And a company's actions can offer clues.

In the case of Jarden, it had been buying low growing businesses, underinvesting in them, therefore not generating much growth, and using its stock price to acquire more growth. Geez.

All one must do is look at the economic earnings (those earnings one must dissect and make many adjustments to find) to see how value destroying Jarden had been.

I will show the chart again in case you forgot.



Source: New Constructs

I think 2015 was the year that Jarden was starting to run out of crappy businesses to buy with their inflated stock price. During the year they did two big deals, and they were buying very mundane, low growth businesses. As usual.

But this time, they were paying in the billions combined, those are big numbers for so-so businesses. And the valuations were not cheap for either.

Between July and October 2015, the company made two of its three largest acquisitions ever. For a reminder, it agreed to be purchased by Newell in December 2015.

On July 31st, the company acquired Waddington Group for $1.4 billion. It paid 9.2 x Enterprise value/EBITDA. Jarden also issued 18.4mm shares at $54, said another way, $1 billion of equity, to help finance the deal.

Just three months later, on November 2nd, the company acquired Visant Corporation, the holding company of Jostens, for about $1.5 billion, paying 7.6x EV/EBITDA.

Jarden issued 11.5mm shares at $49, or $563mm of equity to help finance the deal.

Think about this. And give credit to Martin Franklin, the CEO of Jarden, he paid almost $3 billion dollars in a little over three months to acquire two companies. He paid between about 7x – 9x or so EV/EBITDA.

Jostens generates about half their sales from yearbook sales, a business in secular decline. The company's overall sales are declining about 3% per year for the last ten years.

Less than two months later he sold the whole business to Newell for 13.7x EV/EBITDA.

Brilliant and excellent for Jarden shareholders.

I think Newell shareholders are left holding the bag.

Why?

In Jarden's third quarter reported on 10/29/15, the company reported disappointing results.

The company's guidance implied there would be zero core growth on a year over year basis.

To those of us who have followed Jarden, for at least as far back as one can remember, that simply didn't happen. Not with the acquisition machine the company had.

By the way, for the record, I had never been short Jarden. I respected its gamesmanship.

By the time of the earnings announcement, the stock had been under pressure, declining over 20% since the Waddington deal was announced.

Oh yeah, Waddington makes plastic forks and knives and stuff like that.

Jarden Sold the Company at its Peak

On December 15th, 2015, NWL announced that it was buying Jarden for $60 per share ($39 in stock based on the NWL share price of $48 and $21 in cash), or 13.7x EBITDA.

Newell paid a ridiculous price for Jarden.

It bought Jarden just as the Jarden was running out things to buy.

There was no asymmetry in that risk-reward.

Martin Franklin, the CEO of Jarden, has said he will keep half his stock he received in Newell after the closing of the deal. In March, he hedged himself through a collar that limits his downside. Nice. For him.

The company loaded its balance sheet with debt. Sitting now at a little over $11 billion. It basically bet the ranch that this deal will work as its balance sheet can't afford to do another transformational deal.

There is a ton of execution risk in the deal. It took Newell's revenue from about $6 billion to $16 billion but in doing so expanded its physical plant footprint from 40 to over 120 and broadened its geographical footprint as well.

So How Has It Done Since the Closing in April 2016?

Newel's stock price has increased from about $45 to $50.

It has reported four quarters of performance. Nothing exceptional. And it's usually in the aftermath of a deal that investors get real excited.

Given this liquidity fueled market melt up in the overall market, the $45 to $50 move seems rather tame.

The company's results have shown further weakening below the surface, aided by some more accounting niceties which include the addition of Josten's (school year books, caps and gowns-been declining 2% per year or so for years) and Waddington aiding performance in the short-term.

The results have also been fueled by a temporary children's fad called Slime. Yep, Slime. Kid's make it by using a few household items, one of them being glue. Newell owns Elmer's glue. It has helped recent results. I think this is fleeting.

Trouble Ahead for Newell
When to sell is always the hard part. Less so with Newell.

Newell has put itself in a corner. It has loaded its balance sheet with debt. It won't be able to do another acquisition that can move the needle much until it works down this pile of debt.

I think that will take a lot of good fortune to occur in enough time before the leaks start sprouting from the acquisition of Jarden.

The combination of two slow growing businesses who have had to buy their growth for more than a decade to keep their growth profile intact is the catalyst to reveal the true underlying poor quality of the business.

The inability to "buy" growth near-term will catch up to Newell.

The cost to invest in all the underinvested Jarden brands will catch up to them.

The pricing pressure that major retailers are putting on suppliers will likely lead to margin pressure.

Potential ways to play it:
I think the company will start to show real strains in its results over the next 6 to 12 months.

I would be very surprised if the company is able to show improving results from this point until then.

If I owned Newell, I would be a seller.

If I wanted to profit from it, there are some interesting put options that can be bought.

Buying puts is a way to profit from a price decline in a stock.

Buying a put option limits the amount of loss to the amount invested in the option should the option expire worthless. Any option speculating is for a sophisticated investor. It is important to understand the risks involved. One should educate themselves before doing so.

Given the time decay of puts, timing is important. I think Puts with an expiration period 9-12 months out are interesting as it gives enough time for the negative catalysts to appear.

Another way to potentially profit from a decline in the stock is to short the stock.

Shorting has a lot of risks. It is for sophisticated investors only. The losses in theory can be unquantifiable as opposed to being long a stock, where the loss is quantified at zero.

I can't emphasize enough that shorting stocks is only for experienced and sophisticated investors who have shorted before.

What's Newell Worth?

I think earnings in 2018 have the potential to be meaningfully lower than current analyst earnings estimates of $3.51 per share. The possibility exists for estimates to come down to $2.50-$2.75 per share. Should that occur, what would the market pay for that earnings stream? There is no correct answer, but I think for a low growth company that would be about 12x earnings. If that were to occur, the stock could trade around $30 to $33. It trades about $50 today.

Summary

Two of the best performing consumer stocks of the last several years have combined companies. Bullish investors think the combination is powerful and there is significant upside.

I think they are ignoring all of the signs that have existed over the past few years of two mediocre businesses - at best - with management teams doing all they can to keep results looking as stellar as possible.

I think that bulls will be quite disappointed sometime in the next year.

Risks: These are some of, but not an all-inclusive list, of the risks that could cause our view to be wrong.

- Merger with Jarden creates strong demand from the combines company customer base.
- Combined company excerpts exceptional pricing power over its customers.
- Raw material costs decline precipitously providing a margin tailwind.
- The company makes a materially accretive acquisition.
- The company is acquired.
- The company develops new product(s) that cause results to materially exceed expectations.

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