Equity Risk Sciences

A Quantum Leap in Investment Technology

Coca-Cola (KO) Report

September 10, 2019

COCA-COLA OVERVIEW

From December 31, 1984* through June 30, 2010, Coca-Cola ("Coke") had robust annual revenue growth, averaging about 5.9% per year. Coke's total liabilities were far less than their annual revenues, averaging less than 60%. Given Coke's average revenue growth and their net margin, this debt load was prudent and easily managed.

In 2012, an abrupt change occurred. Coke's revenues peaked at $48.02 billion.
From December 2012 through June 2019, Coke's revenues declined significantly, falling -30.6% to $33.3 billion.
In March 2010, Coke had total liabilities of $22.3 billion with revenues of $31.4
In June 2019, Coke's total liabilities were $69.7 billion with revenues of $33.3
In March 2010, Coke had tangible equity of $12.6 billion, and its market cap was $121 billion.
By June 2019, Coke's tangible equity was eliminated, falling to negative –$8.7 billion.
Yet on September 10, 2019, their market cap rose to $232 billion!

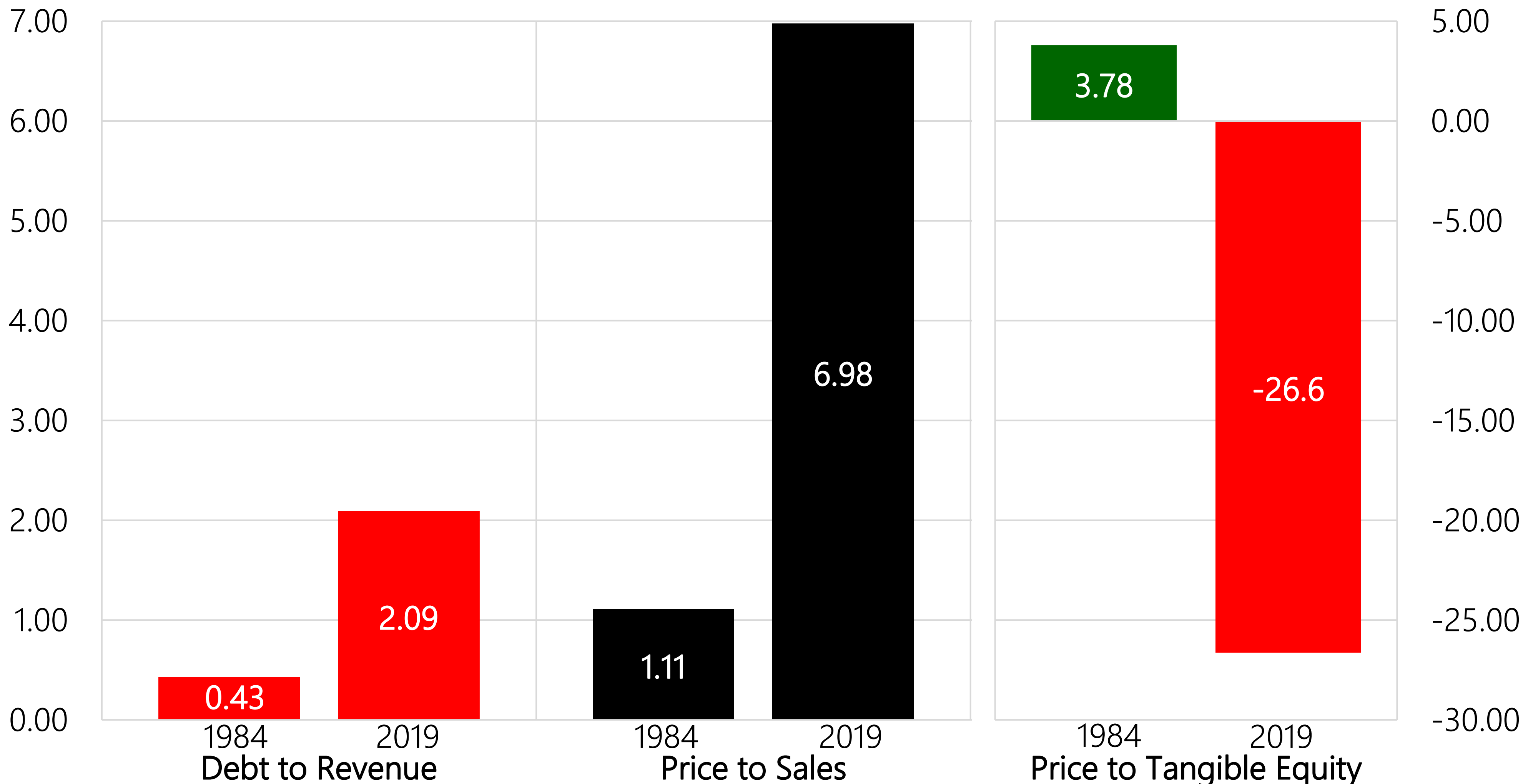
Coke's total liabilities now exceed annual revenues by a staggering $36.4 billion. In Coke's hey-day their revenues always exceeded total liabilities by a very wide margin.

Until 2012, Coke had consistent revenue and equity growth and used debt conservatively.

In 2019, Coke is struggling to survive, with falling revenues and rapidly accelerating debt that has consumed ***all*** their tangible equity.

**December 31, 1984 is the earliest date for which we have complete financial data on Coke.*

Coca-Cola – Financial Ratios 1984-2019



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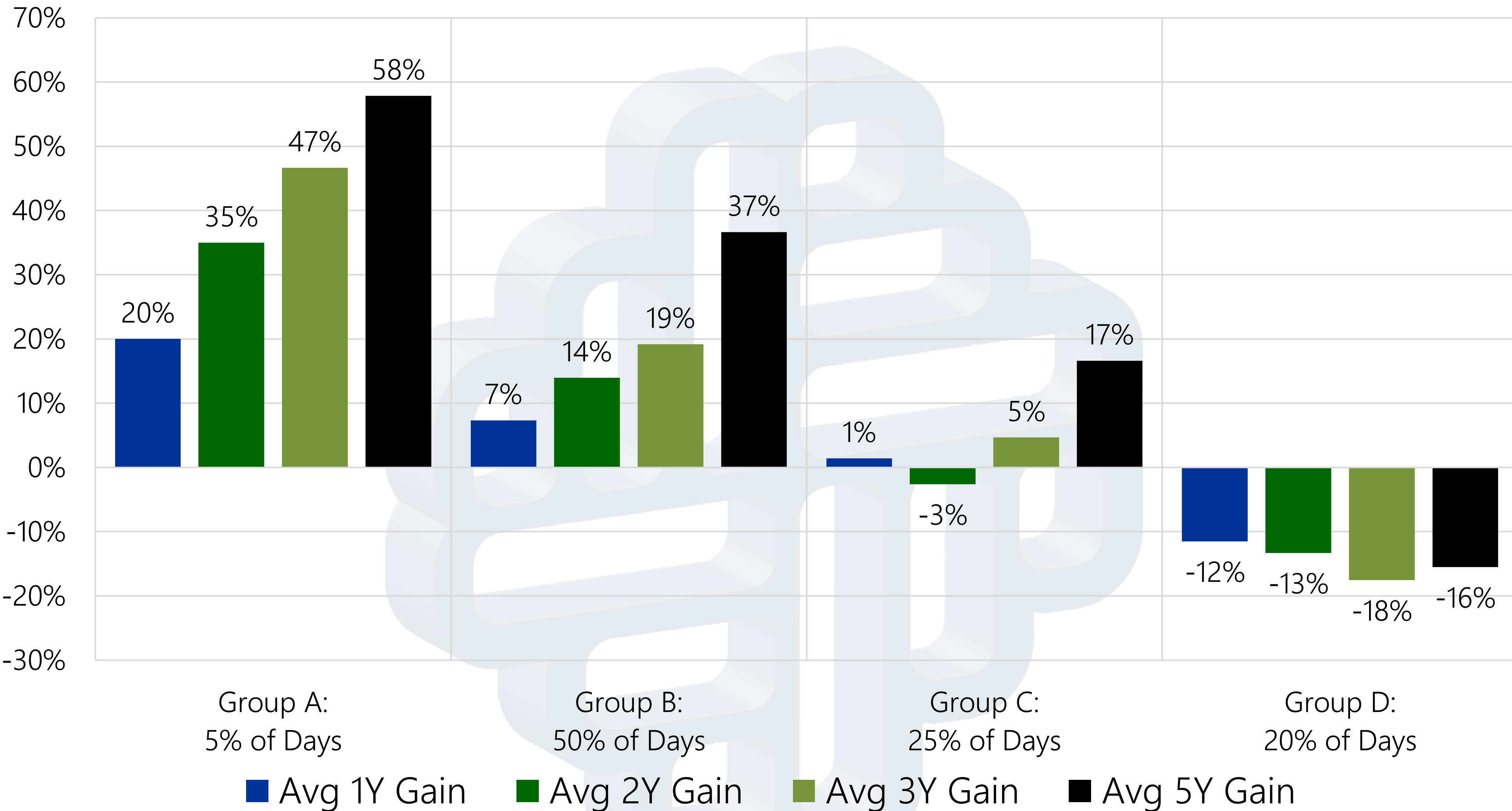
Coca-Cola (KO) - Results Grouped by "Factor A"

12/31/98 - 9/10/19 (~5,233 trading days)



Over the past 5,233 trading days, Coke's "Factor A" was at or above its current level on 513 days.
The average gain/loss from each of those days was: -23% after 1 year, -21% after 3 yrs. and -15% after 5 years.
At todays price, Coke appears very speculative *at best*. Historic data suggests a 60% price decline is possible.

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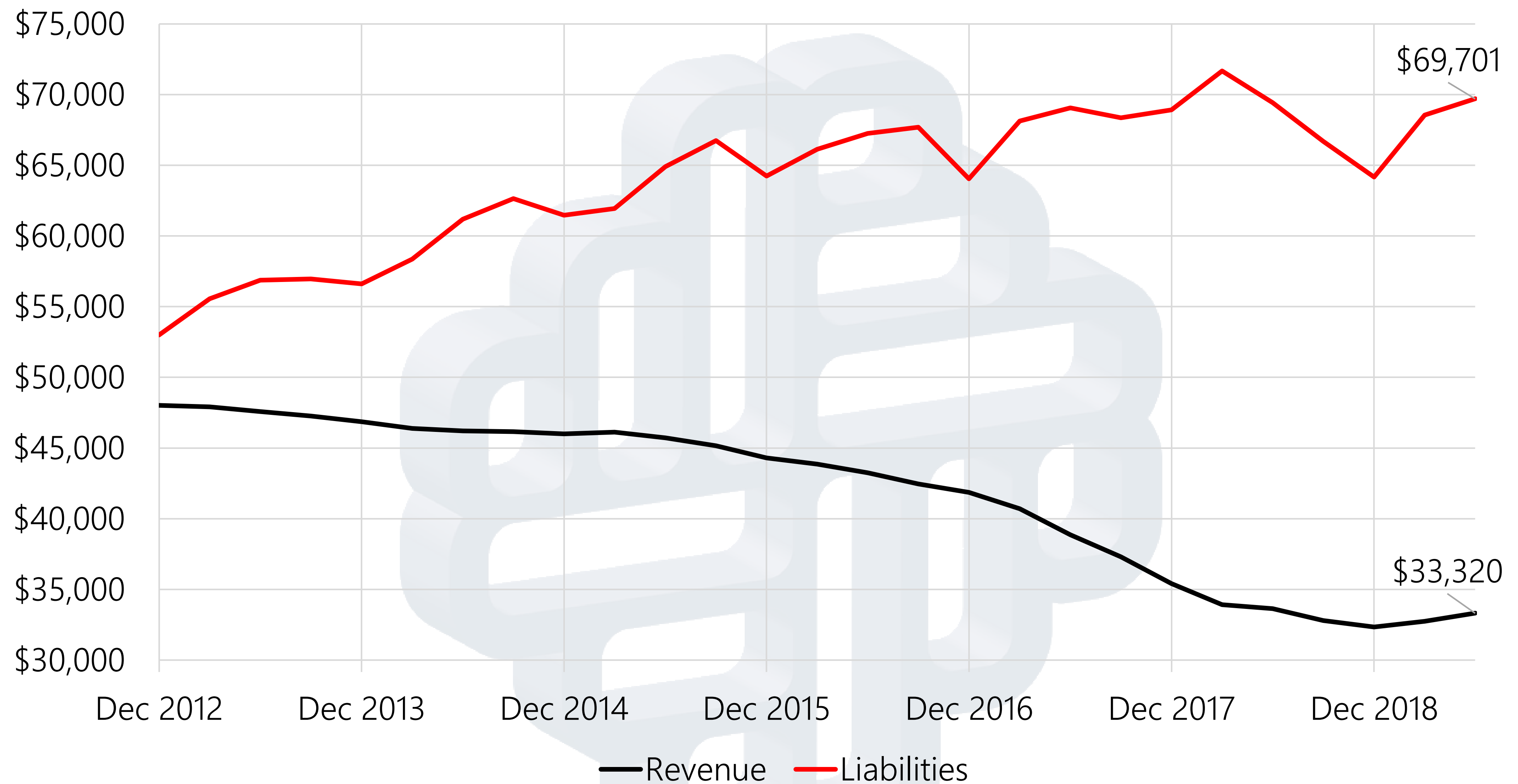
Coca-Cola – Revenue and Liabilities

12/31/12 – 6/30/19



From 12/31/2012 to 6/30/2019, Coca-Cola's liabilities **increased** by 31% ($53.0 to $69.7 billion).
From 12/31/2012 to 6/30/2019, Coca-Cola's revenues **decreased** by -31% ($48.0 to $33.3 billion).

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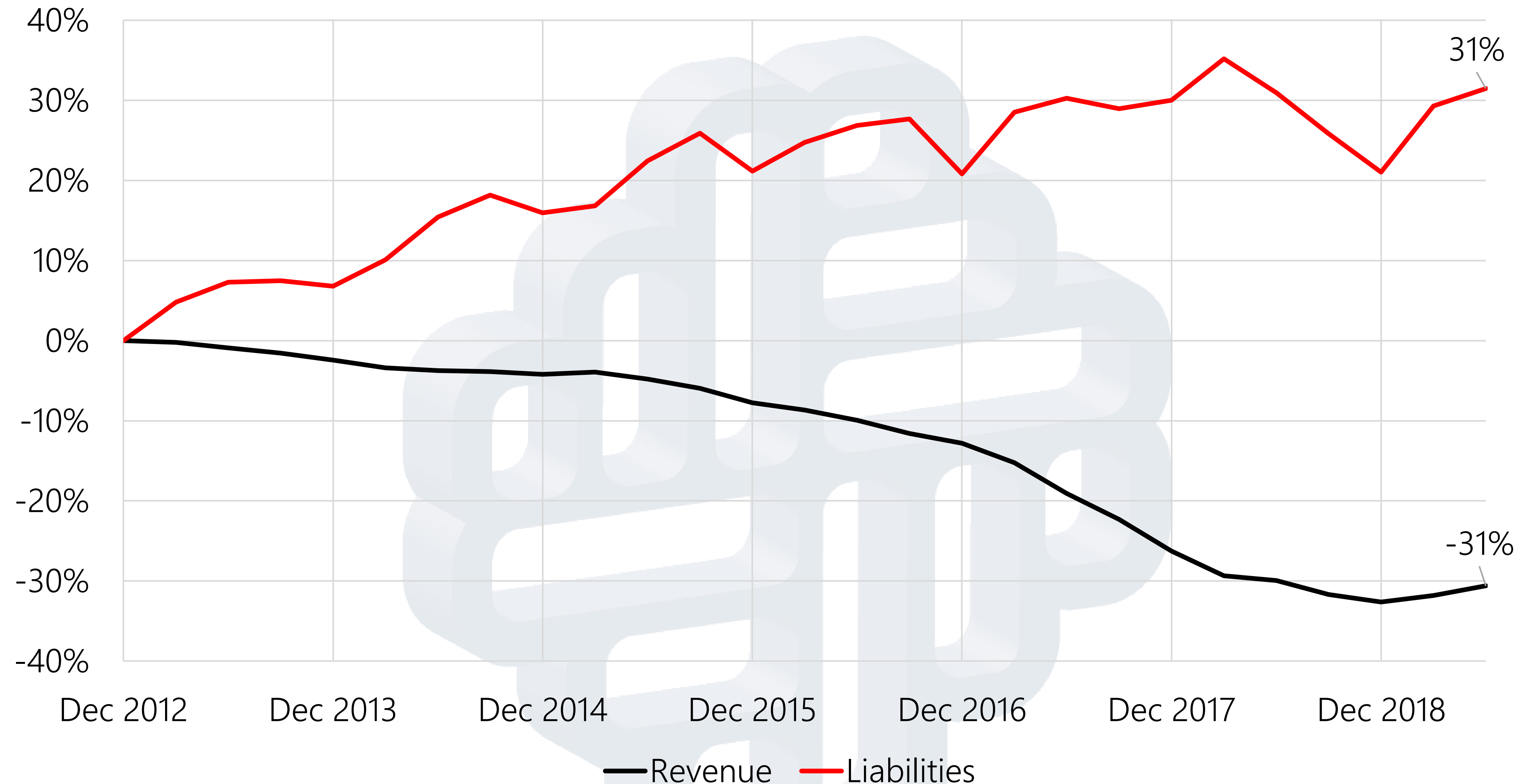

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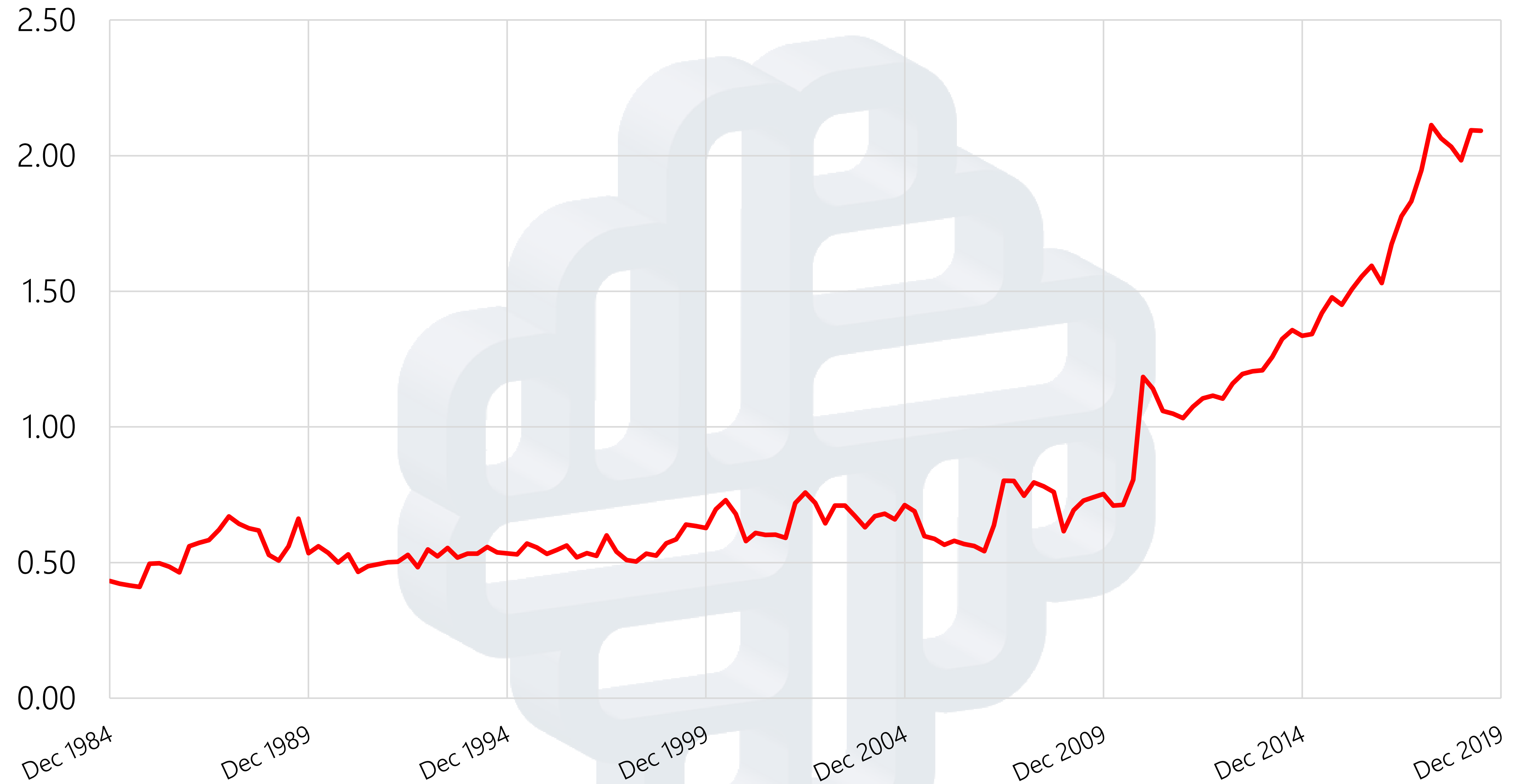
Coca-Cola – Debt to Revenue

12/31/84 – 6/30/19



From 12/31/1984 to 6/30/2010, Coca-Cola's debt-to-revenue ratio averaged 59%.
From 12/31/1984 to 6/30/2010, Coca-Cola's debt-to-revenue ratio increased an average of 2.0% per year.
From 6/30/2010 to 6/30/2019, Coca-Cola's debt-to-revenue ratio increased an average of 12.7% per year.

Coca-Cola – Price to Sales
12/31/84 – 9/10/19

From 12/31/1984 to 9/10/2019, Coca-Cola's price-to-sales ratio has averaged 4.6.

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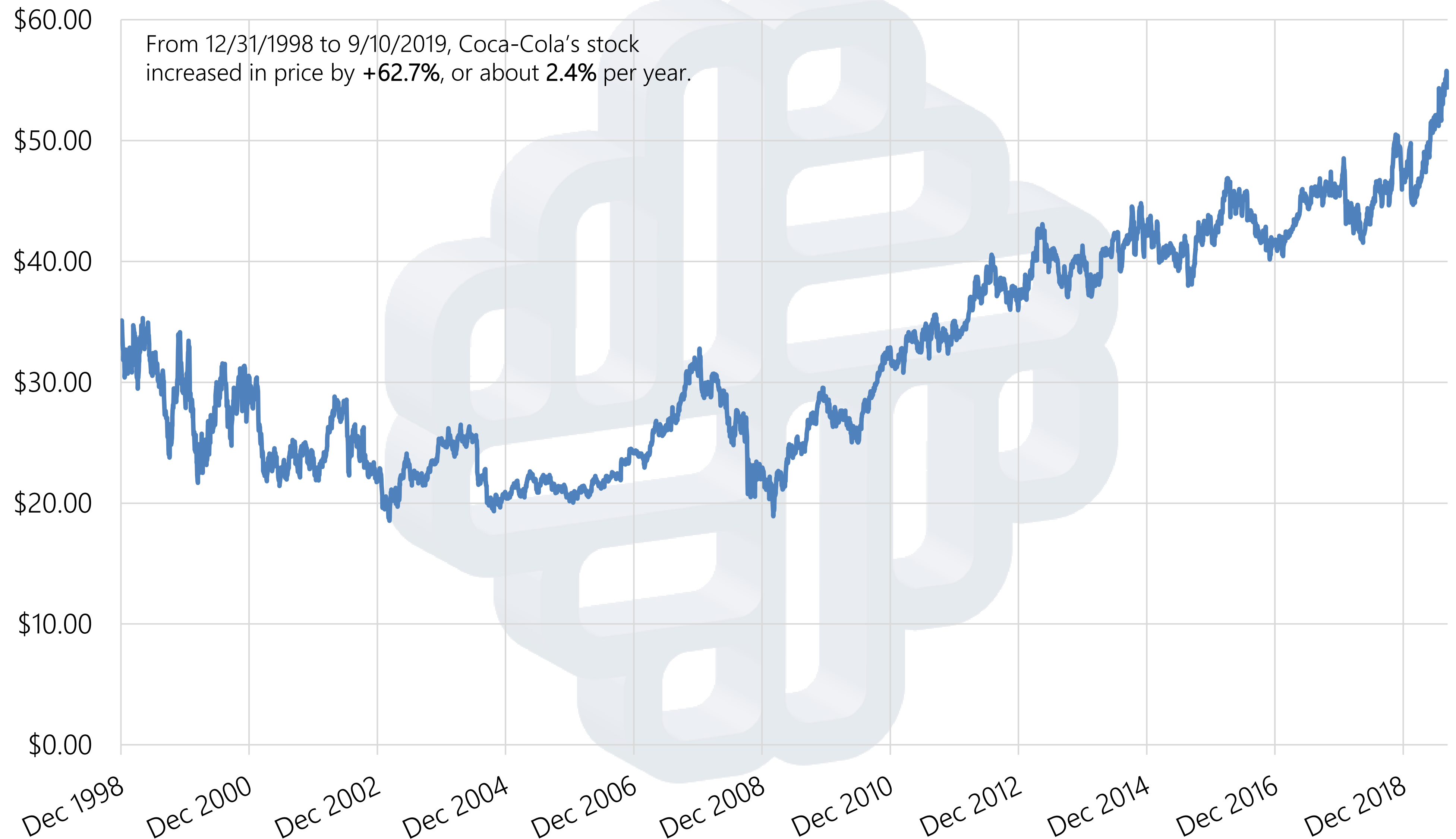
Coca-Cola's Price

1998 to 2019



Market Place; Buying Buffett at a Big Premium to the Sum of His Parts

By Gretchen Morgenson
Sept. 8, 1998
New York Times

It is well known that Warren E. Buffett is one of the world's smartest investors and one of the world's richest men. It is also well known that he did not get that way buying stocks at prices well above their asset values.

Yet that is exactly where the stock in Mr. Buffett's holding company, Berkshire Hathaway Inc., now stands. In spite of a stock market decline that has hammered many of the shares that Mr. Buffett famously owns, including American Express, Coca-Cola, the Travelers Group and Gillette, shares of Berkshire Hathaway have a gain for the year. Indeed, Berkshire is up 30.4 percent even as its portfolio of eight major stockholdings has lost 6 percent, net of credits Mr. Buffett could use for taxes.

The rise of Berkshire Hathaway has weakened in recent weeks with the broad market. Its A shares closed Friday at $60,000, down 26 percent from their peak in April. The B shares, which were issued two years ago at one-thirtieth of the A share value, fetched $1,990 on Friday.

But the recent outperformance of Berkshire Hathaway means that its stock is now trading at 2.4 times the value of its eight largest common-stock investments. At the end of last year, Berkshire stock fetched 1.4 times the value of its top eight holdings.

Call it the Buffett effect. Being able to invest alongside Warren Buffett has made Berkshire a cult stock, an issue that everybody wants to own and nobody wants to sell. Watching Berkshire Hathaway's A and B shares scale ever-higher heights in recent years has been a source of immense frustration to any investor who sold.

Betting against Warren Buffett and selling his stock is nobody's idea of smart investing. Indeed, the company has raised its book value an astonishing 25.5 percent in each of the last 10 years. Still, given that in his 1996 annual report, Mr. Buffett characterized his Berkshire Hathaway stock as ''not undervalued,'' one might well wonder: What would he call it now?

Mr. Buffett makes it a rule not to discuss his investing strategy with reporters. So for his opinion, investors will probably have to wait until next spring, when he issues another of his homespun letters to shareholders.

In the meantime, the outperformance of Berkshire Hathaway stock compared with Mr. Buffett's eight favored stocks provides an intriguing example of market inefficiencies.

To be sure, Berkshire Hathaway is much more than just an investment vehicle for Mr. Buffett. It is also a property-casualty insurance company, and one with interests in newspapers, candy manufacturing and home-furnishings stores.

But equities represent 65 percent of Berkshire's total assets, and the eight big stocks account for nearly 90 percent of the equity holdings.

Market Place; Buying Buffett at a Big Premium to the Sum of His Parts

Insurance dominates Berkshire Hathaway's operations. The Geico subsidiary is one of the largest underwriters of auto insurance nationwide; the recent acquisition of General Re bolsters Berkshire Hathaway's reinsurance business, in which it shares exposure to large risks with other companies. Last year, insurance premiums accounted for 46 percent of the company's revenue.

Could it be that investors think Berkshire shares should trade at a significantly higher premium to its stock portfolio because the company's insurance business is growing astronomically? Perhaps, but that would be in stark contrast to what Mr. Buffett's expectations are for the insurance business.

In his annual report last year, he said that while Geico's performance was exceptional in 1997, its management expects the company's profit margins to return to more normal levels ''as losses increase faster than premiums.'' As for its other insurance operations, specifically catastrophe reinsurance, Mr. Buffett said that ''eventually, a large catastrophe event will occur that will produce a significant loss to the insurance group, although the timing of the loss cannot be predicted.''

In short, the insurance business has enjoyed a period of strong earnings and improving margins, which Mr. Buffett himself believes will not continue. ''Our rate of progress in both investments and operations is certain to fall in the future,'' he wrote.

The decline in stock prices that Mr. Buffett predicted last spring has occurred. The big-name stocks that he favors remained in the stratosphere much longer than the shares of small, lesser-known companies. But even these stocks have recently been trounced. As of last Friday, Coca-Cola is off 7 percent for the year; Gillette has lost 18.5 percent; American Express is down 17.5 percent. Travelers Group has fallen 27.6 percent; Wells Fargo has lost 13 percent, and Walt Disney is down 15.3 percent so far in 1998. The only stock up is that of the Washington Post Company, which has risen 4.6 percent. Freddie Mac is unchanged.

Of course, even at these shrunken prices, Mr. Buffett still has huge gains in his stocks. His cost basis for the eight holdings is roughly 20 percent of their current value.

Still, given the 36 percent premium between what Berkshire Hathaway fetches and what Mr. Buffett's stocks are worth, investors trying to mimic his results might be better off buying the stocks than Berkshire. Taxes are another reason this makes sense. Individuals pay taxes on long-term capital gains at a top rate of 20 percent, well below the estimated 35 percent corporate tax that Mr. Buffett must pay on Berkshire Hathaway's earnings.

Mr. Buffett has signaled for quite some time that stocks, including his own, may be overvalued. In his last annual report he warned that stock prices ''have materially eroded the 'margin of safety' that Ben Graham identified as the cornerstone of intelligent investing.'' And it is not surprising to anyone that in his recent acquisition of General Re, he used Berkshire Hathaway stock, not cash, as the currency for the transaction.

No doubt about it, Mr. Buffett is smart. His stock, however, may not be.

Summary

- We don't know if Coke's revenues and net income will rise or fall.
- We can't quantify how much Coke's debt load impairs their financial flexibility.
- We don't know whether Coke's future stock price will rise or fall.
- What we *do* know is: Coke's stock is very risky.

At Equity Risk Sciences we identify measurable risks and rate the risks of every stock, enabling investors to greatly reduce risk and avoid losses.

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- From June 2010 to June 2019…
  - Coke's net tangible equity fell from $13.4 billion to *negative* -$8.7 billion.
  - Coke's additional paid-in capital increased from $8.7 billion to $16.8 billion.

We don't know if these are the reasons Coca-Cola has acted financially in the ways it has.