Barry Callebaut

12th Feb, Piri Muthu
Issuer: BARY; Baa3/BBB-; Stable

12th Feb; the larger concerns we do have

- **Unforeseen weather events** - 70% of global Cocoa comes from west Africa (Ivory coast 44%, Ghana 14%, Cameroon 6%, Nigeria 6%). Poor weather for crops has been one of the largest drivers already.
- **Industry invests more on cocoa-free chocolate alternatives** (while Barry has little room for R&D). Hershey CEO last week; "*We have been seeing some increased global demand across the market for cocoa alternatives*" and re. cellular agriculture "*It's something we're watching very closely. I don't think it is necessarily near-term, but I think it can be a game-changer and it's certainly getting a lot of investment right now. So I think it's something to watch*."
- **Threat of insourcing** - i.e. clients like Mondelez process the Cocoa themselves. It says this is happening with some big clients but is being offset by outsourcing from clients who struggle more in this volatility. Net net it sees it balanced.
- Supply does not do its part and **demand falls more than the low-single digit volume decrease** it has guided to (and is currently experiencing). This could start pressuring the guidance for double digit EBIT growth.

12th Feb; common questions we get

Barry has taken a view on Cocoa and it has not played out

- **Barry does not take a view on Cocoa**, it simply buys, processors and then sells the finished product. In that process the amount of money it needs to initially buy the Cocoa and hence the amount of capital that is tied up in inventory (the 'capital base') is dependent on cocoa prices. This is what has increased and this is why it has been tapping debt markets for funding.

Barry 29s widened because Cocoa price increases eat into profits

- **Actually the opposite**. If you open Barry's financial statements and only look at the income statement you will see a healthy company. If you then look at analyst or rating agency forecasts you will see revenue growth and EBIT margin expansion forecasted for the year ahead. This is the power of pass-through contracts it has with most (~70%) of clients - paired with hedging on inventory held till it sells. Again the issue is on the balance sheet - a large increase in value of inventory and associated debt funding to purchase it. These are still relevant for credit and they do creep into the income statement from higher interest costs.

Barry's leverage is too high so it may be downgraded

- In fact as of December, **Moody's had leverage in CCC territory and interest cover in single-B**. It's holding onto IG ratings because raters believe that the market will autocorrect supply and demand to bring cocoa prices down. Paired with this is company's guidance for double digit adj. EBIT growth (adjusted for costs related to efficiency program). **We see FY25 leverage if Cocoa remains elevated at £9k/t at net 7.5-10x (upper end if you assume no earnings growth)** (all including the CHF200-250m it will spend on cost efficiency programme).

If Cocoa stays flat at ~£9k/t working capital/FCF will reverse positive and it will be fine

- **No the WC reversal will only occur if Cocoa prices fall. Otherwise it will need to maintain the higher capital base** to continue buying Cocoa at the elevated prices. What it will mean though is no more negative FCF - it will revert to normal operating cash flows minus the more elevated interest costs. This can be a tool it uses to delever net leverage (we see ~CHF0.5b in FY26).

22nd Jan: 1Q25 (to Nov) earnings

It was shy of giving any new guidance apart from revising down FY volume guidance to an LSD fall (from previous flat). EBIT guidance was left unch for double-digit growth – most of this will be from the cost saving programme beginning to come to fruition (targeted €250m/yr in run-rate savings). Still the unch guidance is a vote of faith in its cost-plus pricing. Reminder EBIT is before interest cost on the rising debt load (which it will attempt to pass on).

It was less shy of views on Cocoa prices which it says is being swung around on low volumes and by hedge-funds; *"we do believe that the price levels we have in the bean price right now are artificially oriented artificially or inflated, we expect them to come down*". The damage regardless of driver may be done as it adds "*this spike happened in the largest bean buying period, which is the main harvest period that we're now trailing out of*".

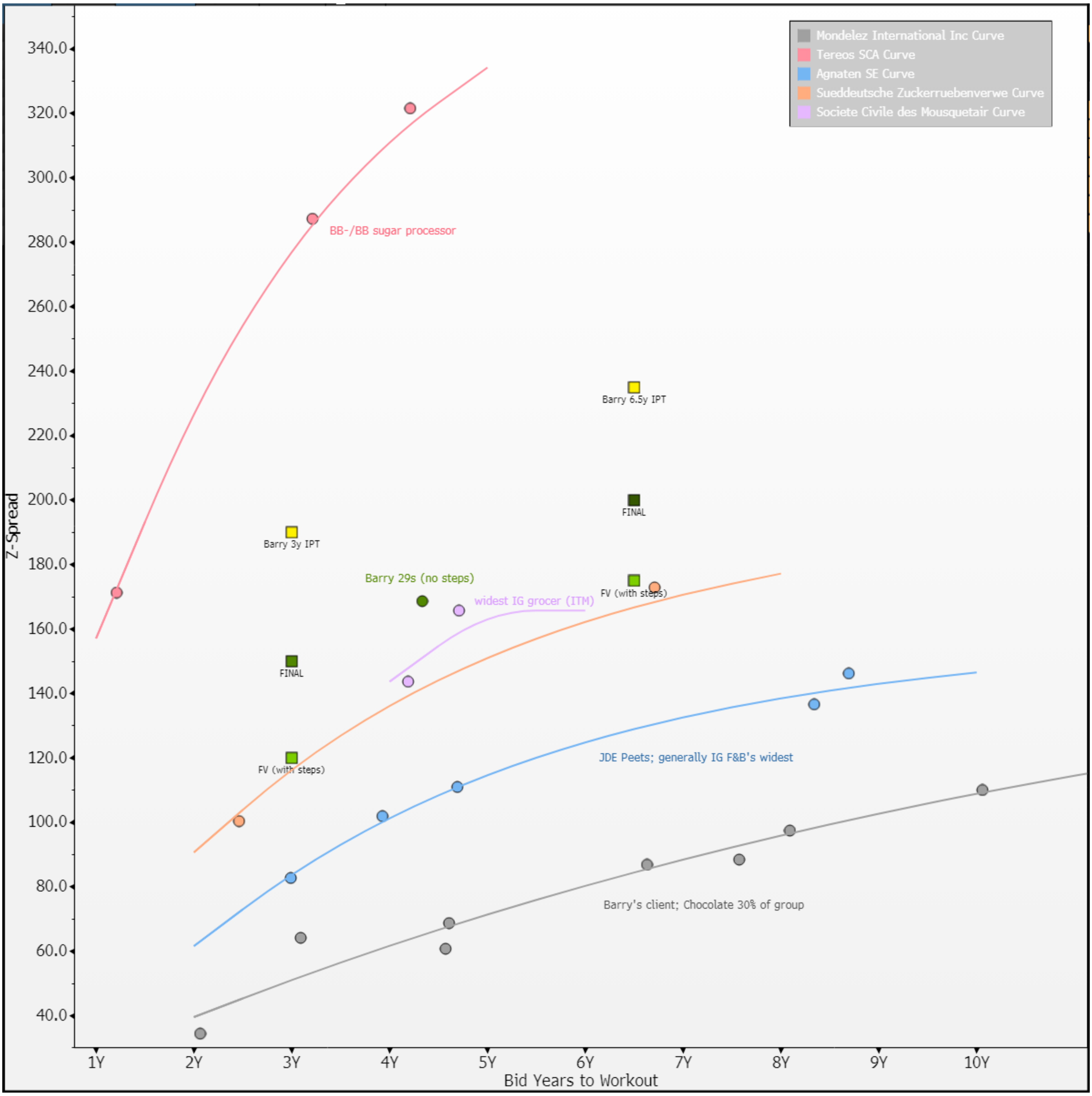
Re. Free Cash Flow it has implicitly said it is sensible to say **every £100 move in spot-cocoa moves NWC by CHF70-80m**. Based on last year's price **we could be looking at a another CHF2.1-2.4b swing in WC if spot holds at £9000/t through this year.** Reminder this is held in inventory and much of it will be classed as readily marketable (i.e. liquid source of cash). It reiterates this pointing out the rise in debt last year is nearly entirely netted out by the inventory on hand (or said alternatively net of RMI, leverage only increased from 0.2x to 0.6x).

Our larger concern is funding cost to handle the inventory purchases. The CHF300m issuance we flagged but it seems to have a €1b Term-Loan facility as well and a CHF620m revolver. That lines up with above back-of-the hand funding needs (circa 2b) – but again it would not confirm if it were funded for the year ahead. If we assume circa 4% rate on the additional debt, we are looking at additional CHF80-100m interest expense on-top of last year's CH231m taking total to up to CHF330m – this is still healthy cover on guided to adj. (or recurring) EBIT (>CHF770m) and some headroom on reported (446m). **That would move n/g debt to CHF 6.8b/7.5b and leverage to 9.2x/10.2x on last years unadjusted EBITDA.** Raters won't like this, and we see S&P the most surprised/wrong on this year's assumptions.

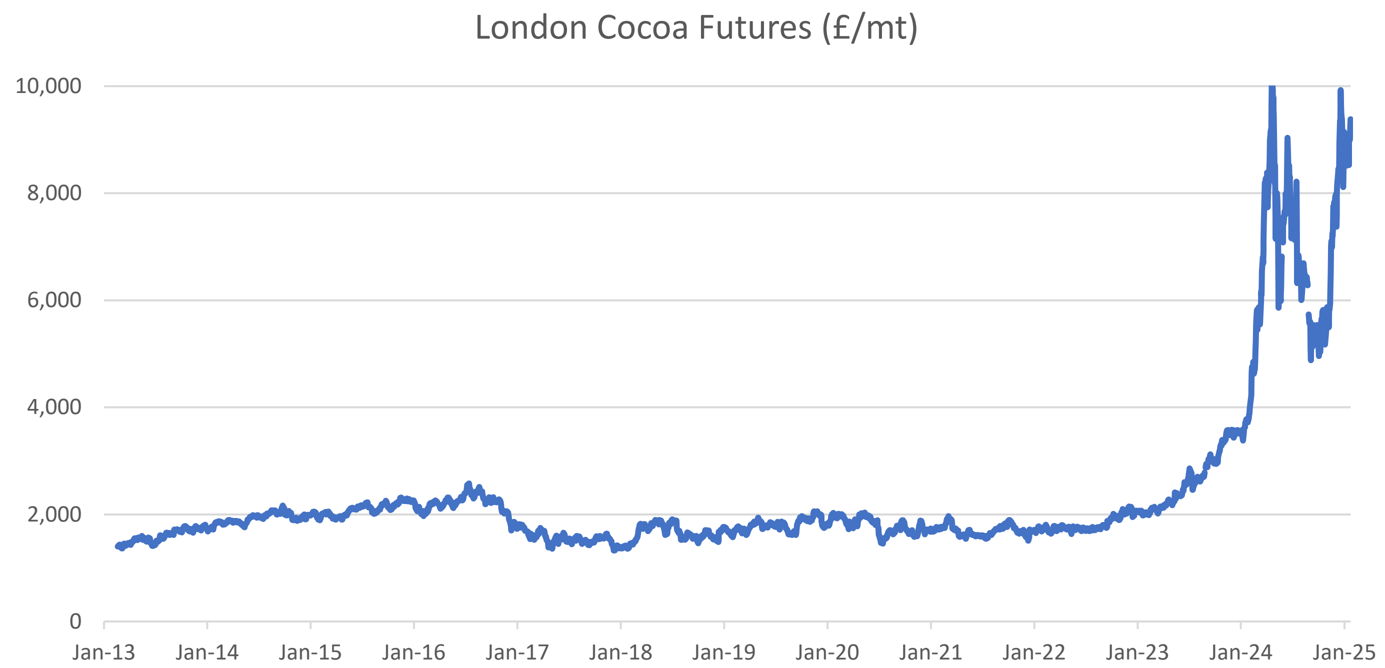
Still, the reality is this is temporary and operationally it is not guiding to any weakness (only in volumes which is in-line with market). It would also not be far-fetched to assume Barry, as the largest cocoa processor, is gaining market share through this volatility. 29s have now widened +40bps this year and +50bps from issuance. We don't believe peak negative news is over (rating action is likely, 1H earnings will give first look at size of WC swing). Particularly on the edge of IG, 29s may struggle to find firm support till former is out of the way (something we have historically found to be true).

- Revenues +63% (ex. FX) on cost-plus contracts (vs. +72% rise in Cocoa)
- Volumes -2.7% which it says is in-line with market (-2.6%)
  - Global Chocolate (70% of group) -3.4%. Within that Food Manufactures down -3.8% (it says they are passing through to retailers a +10% increase in prices). It also saw Gourmet volume weakness (-1.5%) - this is end-product clients like restaurants & bakeries and was seeing double-digit volume growth last year (15% of group revenues). It is blaming weakness here on one-offs.
  - Cocoa segment (30% of group) was more resilient +0.3%
- By region (within Global Chocolate), EM (APAC, ME, Africa and LATAM) were firmer - double digit volume growth ex. China. Interestingly even Barry is flagging lingering China weakness; "remains challenged due to the overall economic slowdown which puts pressure on large food manufacturers in several categories". US and Europe were LSD to MSD down.
- FY guidance (to August) lowered from flat to LSD volume decrease but guidance for double-digit adj. EBIT growth (ex. FX) left unchanged
  - last year adj. EBIT was CHF704m (+7% yoy)
  - statutory was €260m lower as it adjusted out the costs involved in efficiency program "next level". It was guiding to another CHF200-250m in final capex for that program this year.
- On financing note it notes the CHF300m issuance we covered but also a €1b Bridge Term Loan (seems to have taken in December) and a €620m revolver (unclear if drawn)

1H results come **April 10th** - we will get a look at the bottom-line then



Source: MNI, Bloomberg



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