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Something to Think About

OAKWORTH
CAPITAL BANK

COMMON CENTS

One of the bigger business headlines this week has been the liquidation of Hostess Brands, Inc., the company which heretofore made Twinkies, Ding Dongs, Wonder Bread, a host of other snack cakes and breads. As you can imagine, there was some measure of discomfort about the iconic Twinkie brand, a symbol of all that is both right and wrong in the United States, vanishing. What is the world coming to these days? Can the US not even produce snack cakes and bread anymore?

The dern Chinese, huh?

In truth, the company had been on the ropes for years. It first declared Chapter 11 bankruptcy all the way back in 2004, when it was known as Interstate Bakeries. That process dragged on through 2009, when Hostess Brands officially came into being. However, the problems weren't over, as the company again declared Chapter 11 in January 2012. So, none of this should have come as a surprise to anyone paying attention. What was surprising was how it all went down at the end, with the baker's union basically calling the company's bluff when everyone else knew the company wasn't bluffing.

What was shocking was how cavalier some of the members of the bakery union were. Consider this snippet from an article by Chris Isidore from CNNMoney on November 16:

> Mike Hummell, a receiving clerk and a member of the Bakers' union working in Lenexa, Kan., said he was making about $48,000 in 2005 before the company's first trip through bankruptcy. Concessions during that reorganization cut his pay to $34,000 last year, earning $16.12 an hour. He said the latest contract demands would have cut his pay to about $25,000, with significantly higher out-of-pocket expenses for insurance.
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> "The point is the jobs they're offering us aren't worth saving," he said Friday. "It instantly casts me into poverty. I wouldn't be able to make my house payment. My take-home would be less than unemployment benefits. Being on unemployment while we search for a new job, that's a better choice than working these hours for poverty wages."

While I can certainly understand Mr. Hummell's frustration from seeing his wages contract over the years, I have a hard time understanding the concept of: "...the jobs they're offering us aren't worth saving." In so many ways, if Mr. Hummell can't have what he wants, no one can have it.

Unfortunately for Mr. Hummell, and a lot of other American workers, the situation at Hostess Brands, while an extreme, is playing out across the country in any number of companies and industries: the global economy is telling US unskilled and moderately skilled labor the value of their toil, and it isn't what it once was. When you boil it down, it is a numbers

Inside this issue:

When people are taken out of their depths they lose their heads, no matter how charming a bluff they may put up.

F. Scott Fitzgerald

Something to Think About, *cont.*

game, plain and simple, and US labor can't keep up. Consider my submission to the Montgomery Advertiser for my Sunday column this week:

Hostess Brands has made a lot of headlines recently. To the outside observer, it seems as though the unions are forcing the company into liquidation. What is the real story? Are unions really to blame?

Hostess' management is correct when it says the company has to slash sales, marketing, and administrative costs (SG&A) to keep the doors open. After all, the company seems to be in and out of bankruptcy. On the flipside, the bakery union has a point when it argues poor management decisions and massive debts are the real reasons the company is in trouble, not the workers.

Who is most right? Frankly, as in most cases like this, it doesn't really matter. Finger pointing is a no win situation, particularly when the real problem is this: Hostess Brands sells low margin products for which there is elastic demand in a highly competitive industry. That is a fancy way of saying, you don't really need Twinkies, Ho-Ho's, or even Wonder Bread, particularly when there are other options available.

Ask yourself: how much are you really willing to pay for a package of Twinkies or a loaf of bread? Just how important are these things to you? Would you pay $5 for two cream filled cake snakes? Most people probably wouldn't, and this means the profit potential per unit, in absolute terms, is pretty limited. After all, Nature's Own bread looks pretty attractive at $2.79 per loaf when Wonder Bread is north of $3.00, doesn't it? Or how about a package of Oreo's instead?

When you remove all the noise, arguments, and garbage, and get down to the brass tacks, from the outside it appears as though the bakery union doesn't understand what it is Hostess actually does, even if it has a point. It bakes, markets, transports, and sells bread and snacks, period. These things don't cost a lot of money, so the company has to move a lot of units to cover its overhead and variable costs.

Consider this:

Prior to all heck breaking loose, a package of 10 Twinkies cost roughly $5. Therefore, each Twinkie would run you around $0.50. Of that $0.50, about half is what accountants would call Cost of Goods Sold (COGS), or the amount the flour, eggs, milk, sugar, etc., cost. So, the company is left with no more than $0.25 per Twinkie to cover SG&A, and any other costs associated with running the business like the depreciation and interest.

From what I have read, the average Hostess baker makes around $30,000 per year. So, if we use this number, the company has to move 120,000 Twinkies per employee per year just to cover that one individual's salary, let alone benefits and all other corporate costs. That works out to be about 328 Twinkies per day, or 33 packages of 10 every day of every year, again, just to cover one worker's salary alone!

It is a numbers game. How many low margin units can Hostess get the American public to buy, and at what price? If the company could sell Twinkies and bread at double the current price, it would, and you wouldn't be reading this column. However, it can't, which means it has to sit on costs somewhere. Unfortunately, for the workers, that means SG&A, which is the one thing the company can truly control.

That is where we are. Management? Union? It doesn't matter. The company can't compete given its current cost structure, and Americans aren't willing to pay up for its products. To that end, in my opinion, it doesn't seem as though the union gets it.

Now, due to word constraints, I didn't put in the salaries of the receiving clerks, truck drivers, etc., which those same Twinkies have to support. So, let's imagine bakers make up one-third of the total workforce at Hostess, and everyone's pay is slashed to $25,000. That means the Twinkies the baker makes has to support $75,000 worth of salaries. As such, the company has to move an amazing 300,000 Twinkies per baker just to cover salaries alone.

Of course, Hostess sells more products than just Twinkies, but the point remains: the company has to move a lot of lower price items to cover its costs, and the numbers are significant. Even in the best of times, when it was Interstate Bakeries, the company had relatively low margins, and the only way to make money in absolute terms was in volume. To illustrate, the company had a net income available to shareholders of $126.15 million in 1999 on sales of $3,459.38 million. That works out to be a net profit margin of 3.64%. In that year, you could have made more money in a 3-Month Treasury Bill, the so-called "risk-free rate."

Unfortunately, revenue didn't grow much from that time while other costs did. As a result, the company started losing money, and then it started losing revenue. By 2008, Interstate had seen its annual revenues fall to $2,798.34 million, a 19.1% decline from 1999 or $661.04 million. However, the operating expenses of the company, read SG&A, fell only $197.86 million from $1,599.52 million to $1,401.66 million, or 12.4%. That is no way to run a railroad, or a bakery for that matter.

In order to maintain that 3.64% profit margin in 2008, the company would have had to cut operating costs an additional $250 million, as it reported a $143.68 million loss that year. So, while Mr. Hummell was ticked off about having his salary slashed from $48,000 to $34,000, he was probably lucky to have the job. Why do I say that?

Well, according to old financial statements, Interstate Bakeries employed about 35,000 people in 2004, before the first bankruptcy, and operating expenses per employee were around $49,465. By 2008, it appears as though the company employed roughly 22,000, and the operating expenses per employee had swelled to $63,712. So, it would appear as though the company attempted to eliminate "redundancies" among its lowest paid labor, or its unskilled workforce. The fact Mr. Hummell saw his take home pay decline sharply while it appears employee related expenses soared suggests the company didn't value his work as highly as perhaps some others, and if he was willing to work for $34,000, then so be it.

In fact, during that first bankruptcy restructuring, 2005-2008, worker productivity appears to have soared, as actual sales be employee increased from $99,073 in 2004 to $127,197 in 2008. That is a huge leap, which further suggests the company got rid of a lot of dead wood, even IF it still couldn't control its cost structure relative to sales.

However, because he once had that $48,000 salary, that is the value Hummell puts on his work, even IF the company now says he is worth $25,000 per year. That is a cold glass of water, isn't it? Who wouldn't be bitter about that? As Bill Clinton might say: "I feel your pain."

In the end, it all comes down to volume and revenue, and while Hostess was restructuring and getting more efficient, its competition was eating its lunch, particularly Flowers. In its originally announced 2004 numbers, Flowers had revenue of $1.551.31 million and operating expenses of $689.60 million, In 2008, revenue had ballooned to $2,414.89 million while operating expenses increased to $968.11. So, Flowers was able to put an additional $863.58 million in sales on the books while variable costs increased only $278.51 million. That is

Important Economic Releases

Release	Survey	Actual	Prior	Comments
Existing Homes Sales (Oct)	4.74M	4.79M	4.69M	With a holiday interrupted week and a dearth of meaty economic reports, there wasn’t a lot of action, and even less real news. So, nothing to see here folks, keep on moving.
Initial Jobless Claims	410K	410K	451K	
U of Michigan Confidence (Nov F)	84.5	82.7	84.9	

Tables & Data Points

STOCKS	**Dow Industrials**	**S&P 500**	**NASDAQ**	**Russell 2000**	**Nikkei 225 (¥)**	**DJ STOXX 50 (€) Price**
12/31/10	11,577.51	1,257.64	2,652.87	783.65	10,228.92	2,792.82
12/31/11	12,217.56	1,257.60	2,605.15	740.92	8,455.35	2,216.55
11/1/12	13,232.62	1,427.59	3,020.06	827.85	8,946.87	2,533.87
11/8/12	12,811.32	1,377.51	2,895.59	793.65	8,837.15	2,479.13
11/15/12	12,542.38	1,353.33	2,836.94	769.48	8,829.72	2,461.77
11/22/12	12,836.89	1,391.03	2,926.55	798.38	9,366.80	2,535.09

BONDS	**3-Mo UST**	**6-Mo UST**	**2-Yr. UST**	**5-Yr. UST**	**10-Yr. UST**	**30-Year UST**
12/31/10	0.13	0.19	0.60	2.01	3.30	4.34
12/31/11	0.01	0.06	0.24	0.83	1.88	2.90
11/1/12	0.09	0.15	0.28	0.74	1.73	2.90
11/8/12	0.09	0.14	0.26	0.64	1.62	2.75
11/15/12	0.08	0.13	0.24	0.62	1.59	2.73
11/22/12	0.09	0.14	0.27	0.68	1.68	2.82

OTHER	**Prime**	**Fed Funds**	**3-Month LIBOR**	**Gold/troy oz.**	**Oil—WIT/brl.**	**$/Euro**	**JPY/$**	**$/GBP**	**CAD/$**
12/31/10	3.25	0.25	0.30	1,421.40	91.38	1.337	81.19	1.559	0.994
12/31/11	3.25	0.25	0.58	1,566.80	98.83	1.296	76.99	1.551	1.017
11/1/12	3.25	0.25	0.31	1,715.50	87.09	1.294	80.13	1.613	0.997
11/8/12	3.25	0.25	0.31	1,726.00	85.09	1.275	79.47	1.599	1.000
11/15/12	3.25	0.25	0.31	1,713.80	85.45	1.278	81.18	1.587	1.001
11/22/12	3.25	0.25	0.31	1,728.20	87.38	1.289	82.46	1.594	0.997

Disclosure

how you make money in absolute terms: you increase your revenue more than your expenses in both absolute and relative terms. Hostess Brands? Not so much.

Clearly, this is a competitive, mature industry. As a whole, there is absolutely no way the bakery industry can grow, say, even 5% with our population growing a little less than 1% per year. Is there some new bread or snack cake that will change that? Probably not, so significant sales growth HAS to come from stealing market share, and net margins HAVE to be maintained by constraining costs. Period. In such an environment, what hope did Hostess have of pulling itself up by its boot straps, what with basically no real access to banking or capital market financing, sluggish personal income growth in the US, a product line with relatively elastic demand, AND stronger, healthier competitors in a low margin industry. The answer: none, no matter how "iconic" Twinkies, Wonder Bread, and Ho-Ho's are.

Hostess' management can read an income statement and a statement of cash flows: the die was cast UNLESS it could get significant cost savings from the unions, significant. The Teamsters, who represent the majority of union labor at the company, understood what was going on, and played ball. However, the bakery union didn't, and its refusal to basically accept what management was proposing suggests its leadership doesn't know how to read financial statements. Calling management's bluff when, again, it was apparent to everyone management wasn't bluffing? Whew.

It doesn't compute. Doesn't the bakery union need, well, bakers to be relevant? One would imagine. So, how is it in the union AND the employees' best interest to force the company's liquidation? I am still at a loss. A union that apparently doesn't need unionized employees, and unionized employees who think their jobs aren't worth saving. Who is going to pay dues? And with what? I don't know. Are there so many bakery and receiving clerk jobs out there paying $48,000/year that it doesn't really matter if Hostess is around or not? Is the goal to get rid of Hostess' management AND hope some white knight buys the company?

I guess that must be part of the reason, but why would anyone buy the company and maintain the current cost structure? Why would anyone buy the company and not try to significantly reduce overhead and operating expenses? That is what happens in an acquisition; that is the very reason behind acquisitions: to reduce costs.

Yes, a firm named Sun Capital has said it is interested in buying the business, and wouldn't be as Draconian in its proposals as present management. However, it never said it wasn't going to cut operating costs. Further, it made an offer for the company back at the beginning of the year which Hostess' CREDITORS turned down. Obviously, it was a low ball number, and the creditors didn't want to eat that type of loss without exhausting all other opportunities. To that end, the powers that ultimately be at Hostess, management and the creditors, apparently believe the sum of the individual parts of the company is worth more than the whole, and they are probably right. If so, it makes the most sense to sell off the brands, and liquidate the company.

I mean, would a rival like Flowers be interested in buying the Twinkies brand? Sure, for a decent price, why not? However, would Flowers be interested in buying existing factories and union contracts, when it probably has reasonable capacity at its 44 bakeries across the country, with the overwhelming majority in so-called "right to work" states? Probably not.

In the end, this was and is a mess. We can finger point all day long, and it won't make any difference. The company needs to cut costs to stay afloat, and the union won't let it. Is it the union's fault the company is going under? Probably not, as declining revenue has more to do with it than anything. However, the straw that broke the camel's back was how the union apparently didn't know how to read an income statement, and placed too high a value on its members' labor. Hmm.

Why should the union be any different from the rest of the country, huh?