GRANT'S

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EDITOR

Vacation delectation

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Sincerely yours,

James Grant

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Fiat-fest 2014

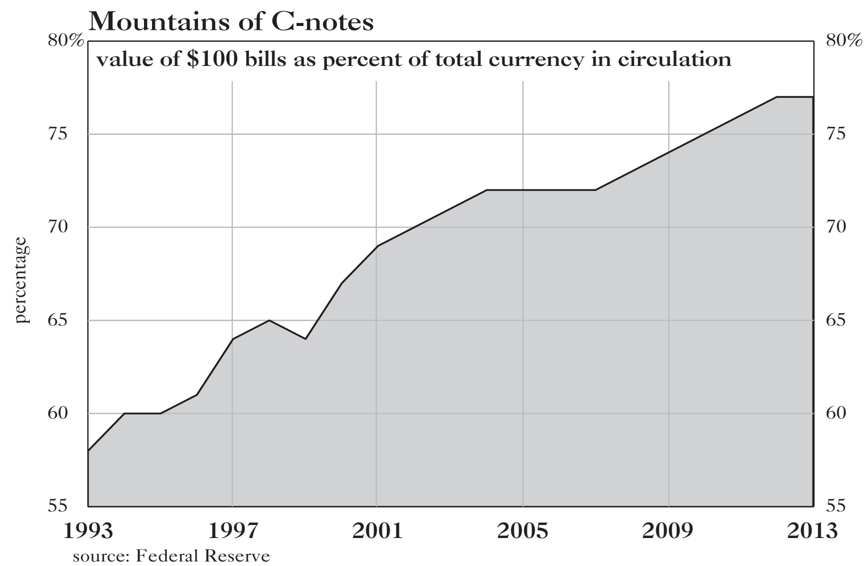
(July 25, 2014) The annual summertime monetary hoedown at Jackson Hole, Wyo., won't be the same this year, Bloomberg reports. The Kansas City Fed, host of the August fiat-fest, is cutting Wall Street dead. Economists from the TBTF banks, longtime schmoozers in Jackson Hole, are this year being invited to stay home.

Maybe that's a good thing—the crony financiers were especially thick on the ground at the 2006 proceedings, where they collectively seemed no more alert to the looming mortgage-cum-credit-crisis than the government employees did. Then, again, the Fed has a job of work on its hands. Its balance sheet is too big and its interest rates are too low. It may need some help in strategizing.

With money-supply growth ticking higher and the rate of producer-price inflation accelerating, "How to exit?" is one question. "Which rates are relevant in this zero-percent world?" is another.

Before QE, the funds rate was the central bank's one and only. "However," colleague Evan Lorenz observes, "with excess reserves measured in the trillions today vs. in the billions pre-crisis, the fed funds market has ceased to function." On to the next rate, then: The new reverse-repurchase rate, perhaps? Maybe or maybe not, the thinking goes, given the not-so-farfetched risk that the mere existence of the RRP facility might invite a bank run (*Grant's*, May 2), or maybe the interest rate on excess reserves, now fixed at 25 basis points? Or a new funds rate that encompasses more than the funds market?

Accompanying the technical debate is the continued growth of the monetary



aggregates. M-1 rose by $282 billion in the 12 months ended July 7, paced by an $87 billion increase in currency and a $196 billion jump in deposits. If $100

"Well I, for one, am going to miss QE."

bills represent 77% of the currency growth (as the Fed reports that they did in 2013), and if $20 bills account for the rest, the green emission would weigh 3.8 million pounds. More significant from a pure monetary perspective is the growth in deposits, which corroborates the surge in business lending—after all, loans create deposits.

Nearly four million pounds of paper money do create a sense of inflationary anticipation. Where's the thing itself? The Cleveland Fed, which calculates the CPI every which way (median, trimmed and otherwise), essentially comes up with 2%. Two percent is supposedly what the Fed is shooting for. Still, the Fed keeps on shooting. And as it fires, asset prices dance. Measured year-over-year, the S&P 500 is up by 17%, the Russell 2000 by 9.8%, the S&P/Case-Shiller Composite-20 Home Price Index by 10.8%.

Neither, for the 31st consecutive year, did *Grant's* cop a Jackson Hole invitation. Still, we contribute a question for the guests to bat around: "What is inflation, anyway?"

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Drug dealer

(March 7, 2014) Posterity, rubbing its eyes, will marvel at many things we now take for granted. Financial posterity may look back with particular amazement at Valeant Pharmaceuticals International (VRX on the New York and Toronto stock exchanges). The rise and—we now tip our analytical hand—fall of this razzle-dazzle deal-doer is the subject under discussion.

In Valeant, a financialized age has produced a financialized pharma company. You hear great entrepreneurs say that they didn't set out to achieve wealth or a towering share price—financial success simply followed commercial achievement. Valeant, under the leadership of CEO and Chairman J. Michael Pearson, gives pride of place to stock market capitalization in expressing its grand strategic vision. In the January "guidance" call, Pearson vowed to make Valeant "one of the top-five most valuable pharmaceutical companies as measured by market cap by the end of 2016. This equates to roughly $150 billion of market cap."

Grant's is bearish on Valeant. To declare an interest, Kynikos Associates, which employs your editor's elder daughter and whose founder and CEO, James S. Chanos, has subscribed to this publication for 30 years, is the source of the idea. Not that we blame Kynikos of any errors or misconceptions that might have crept into the following analysis. Here at *Grant's,* we make our own mistakes.

Anyway, we are confidently bearish, which, in view of the opacity of the corporate structure, is saying something. As you will presently see, Valeant grows by serial acquisition. Accounting for those acquisitions leaves all but the most determined analyst—in this shop, that would be Evan Lorenz—wondering which corporate end is up.

At a glance, nothing about Valeant seems too far out of the ordinary. It's an international (not, management emphasizes, "global") pharmaceutical company that focuses on dermatology, ophthalmology, branded generics and over-the-counter medicines. It sells over 1,500 products, directly or indirectly, in over 100 countries. In the fourth quarter, the United States, Canada and Australia together contributed 76% of revenue, emerging markets the balance. In 2013, Valeant generated revenue of $5.8 billion; it reported GAAP net income of minus $866 million and non-GAAP "cash" earnings of $2 billion. There are 333.1 million shares outstanding; it's an easy stock to borrow (though—as the track of the share price suggests—not an easy short to manage, or to sleep with).

The closer you look, the more you see what sets Valeant apart from its pharmaceutical peers. R&D spending is one of these eccentricities. Last year, Valeant invested just 2.7% of its sales into research and development compared to an average of 13.8% of sales for Johnson & Johnson, Pfizer Inc. and Merck & Co. Valeant does most of its compound-hunting in the stock market, not the laboratory; it acquired more than 25 companies in each of the past two years.

"Valeant is no ordinary pharma company," observed BMO Capital Markets analyst Alex Arfaei last year in his first report on the company. "The notion that a pharmaceutical company would essentially quit R&D and rely on acquisitions for growth is still discomforting, if not absurd for many reasons. Yet that is Valeant's expertise: the ability to identify inefficiencies in its target companies, pursue them aggressively while maintaining the discipline to not overpay, and successfully integrating the acquired companies in a more efficient, decentralized structure with a low tax rate. We argue this (now demonstrated) expertise is as valuable as a productive R&D engine because Valeant is applying the strategy in the right markets."

Certainly, the stock market's a believer. Since Pearson took the helm on Feb. 1, 2008, the share price has risen by 2,174%, an upsurge in which the CEO has himself amply participated. The former director and head of McKinsey & Co.'s global Pharmaceutical Practice, Pearson owns 3.4 million Valeant shares worth $486.5 million today. Depending on this year's price action, the boss stands to receive between 120,000 (if the price is $83 on certain measurement dates) and 480,000 (if the price is $224 on certain dates) performance-based, restricted stock units.

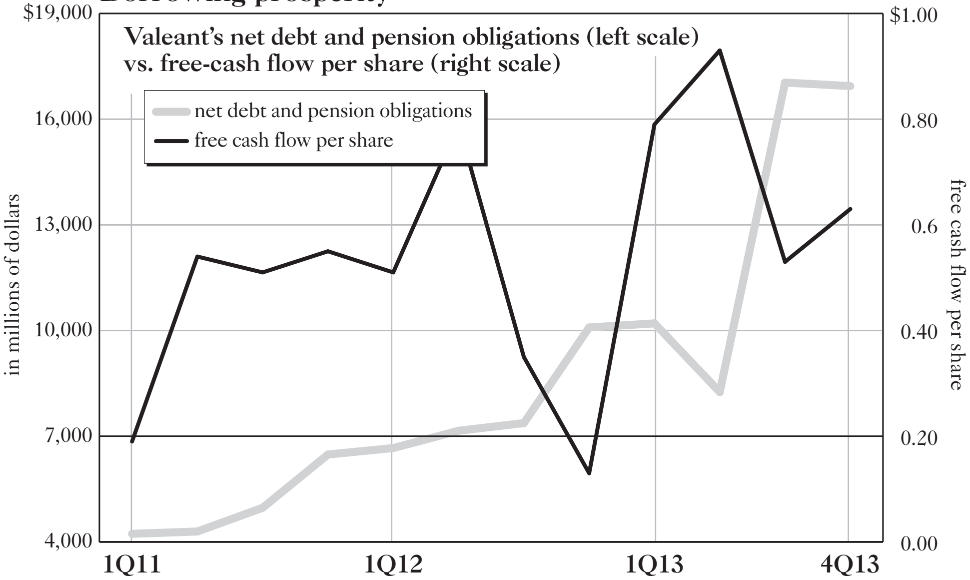
Enough said—for now—about the stock. What about the business? Managing the business gets half of management's time; M&A opportu-

Pick your 2013 corporate metric
Valeant's year-over-year growth rate

	including generics	excluding generics
From Valeant's press release:		
Developed markets, pro forma	-1%	6%
Developed markets, same-store sales	-5	9
Emerging markets, pro forma	12	12
Emerging markets, same-store sales	11	11
Total sales, pro forma	2	7
Total sales, same-store sales	0	10
From Valeant's 10-K report:		
Developed markets, same-store sales	-10	
Emerging markets, same-store sales	8	
Total sales, same-store sales	-5	
Total sales, pro forma	0	

source: company reports

Borrowing prosperity



source: company reports

nities absorb the rest, according to the chief financial officer, Howard Bradley Shiller. So much in thrall is the Street to Valeant's alleged deal-making prowess that one analyst, at least, goes to the remarkable length of penciling in "unannounced deal flow" as a major source of future Valeant earnings power.

So many deals, so much confusion. You begin to wonder if anyone outside the front office actually understands what the company's about or what it earns (about which more in a moment). Consider, says Lorenz, "the 2012 Valeant purchase of Medicis Pharmaceutical Corp. for $2.4 billion cash (Valeant always pays cash). Pre-acquisition, Medicis had recognized revenue not when it shipped its products to its distributor, McKesson Corp., but when McKesson sold those products to doctors. Post-acquisition, Valeant began booking sales as soon as the McKesson-destined products went out the door. In response to a query from the SEC, management defended the new practice. (Valeant's pricing policy, as distinct from Medicis, allowed greater certainty as to revenue was the essential response.) One is left to wonder what changes Valeant has chosen to effect in the numerous smaller acquisitions that never produced a similar regulatory paper trail."

Not even Valeant always knows exactly what it's getting. How could it when—for instance—Bausch & Lomb, a 2013 acquisition for which Valeant paid $8.7 billion, has not undergone an outside check on internal controls since 2007, when private-equity buyers took B&L private?

Implicit in the bull case for Valeant is that good things happen to the companies that Valeant buys. We don't see the data to support the contention. Thus, Lorenz observes, "Valeant talks about organic growth excluding drugs that lose patent protection—another variation on the old 'earnings-before-the-bad-stuff' method. Management also confusingly tabulates year-over-year organic growth in different ways. One way is as if Valeant controlled all acquisitions for both the current reporting period and the year-ago period. Another is on a kind of same-store-sales basis, which measures year-over-year performance without the impact of acquisitions. Indeed, in any given period the company may present five different growth rates: 'headline,' organic same-store sales including generics, organic same-store sales excluding generics, pro forma organic growth including generics, and pro forma organic growth excluding generics. Any questions?

"In 2013," Lorenz proceeds, "organic same-store sales growth, including generics, was a negative 5.1%, driven by a 10.4% decline in developed markets and an 8.5% gain in emerging markets. On a pro forma basis including the impact of generics, total sales declined by 0.5%. The fact that same-store sales are declining at a more rapid rate suggests that the longer a business is under the Valeant umbrella, the worse it performs."

It's not as if Valeant isn't pulling the levers to grow. It works hard to avoid tax, and it methodically raises prices on the products it acquires through M&A. The latter policy, especially, has prompted some analytical questioning: "We previously raised questions regarding adverse volume growth and the sustainability of large price increases for VRX's prescription derm brands. . . ," Bank of America/ Merrill Lynch analysts noted last summer. "[W]e believe it is notable that volume trends have deteriorated for many of the large branded drugs that VRX has acquired."

Always, the conscientious shareholder will ask, "What do I own and what do I owe? And what do I earn?" As to the first point, in 2013, Valeant spent $5,323 million on acquisitions, up from $3,559 million in 2012. At year-end 2013, the balance sheet registered an $8.2 billion jump in goodwill plus intangibles to $22.6 billion. Net debt, including pension obligations, jumped to $16.9 billion from $10.1 billion. In the fourth quarter, GAAP operating income of $223 million fell short of $260 million in interest expense. Since 2010, revenues, the share price and net debt plus pension obligations have described similar fireball growth arcs, up at compound annual rates of 69.7%, 73.1% and 74.4%, respectively.

"What do I earn?" On a GAAP basis in 2013, Valeant showed a loss of $2.70 a share vs. a GAAP loss of $0.38 a share in 2012. Management asks that you avert your eyes from those unsightly data to focus instead on "cash EPS," a forgiving metric of its own creation. Cash EPS subtracts from income acquisition-related expenses, goodwill and intangible amortization costs; also, write-downs, legal settlements stemming from acquisitions and other "one-time" costs. On this bespoke basis, Valeant "earned" $6.21 in 2013 vs. $4.51 in 2012.

Valeant can say it "earned" $100 a share. If you buy growth in the stock market (and in the debt market), are the aforementioned attendant costs not real enough? In Valeant's case, especially, are they not recurring enough?

So, then, what does Valeant re-

ally earn? "Cutting through GAAP and non-GAAP earnings," Lorenz proposes, "let's settle on free cash flow—that is, cash flow from operations less capital expenditures. In 2013, free cash flow amounted to $927 million, or $2.89 per common share, up from $549 million, or $1.80 a share, in 2012. The 2013 reading would give Valeant a less-than-lordly free-cash flow yield of 2%. Unlike R&D expenses, which are debits in the free-cash-flow calculation, funds spent on acquisitions don't impact free-cash flow. As Valeant conducts its R&D via M&A, free-cash flow, if anything, flatters Valeant's ability to generate cash."

On the fourth-quarter earnings call last week, an analyst asked the Valeant CEO about a possible merger of equals between his company and a player to be named. "First of all," Pearson replied, "in terms of the number of opportunities out there, we would say, it's not five, 10 or 15, it's probably closer to 50 in terms of opportunities. . . . [W]e're in multiple discussions and we always have been and will continue to be. And when an opportunity is—when the opportunity comes—we'll move on it."

To that prospective merger partner, we would ask this simple question: Are you quite sure you know what you're getting yourself into?

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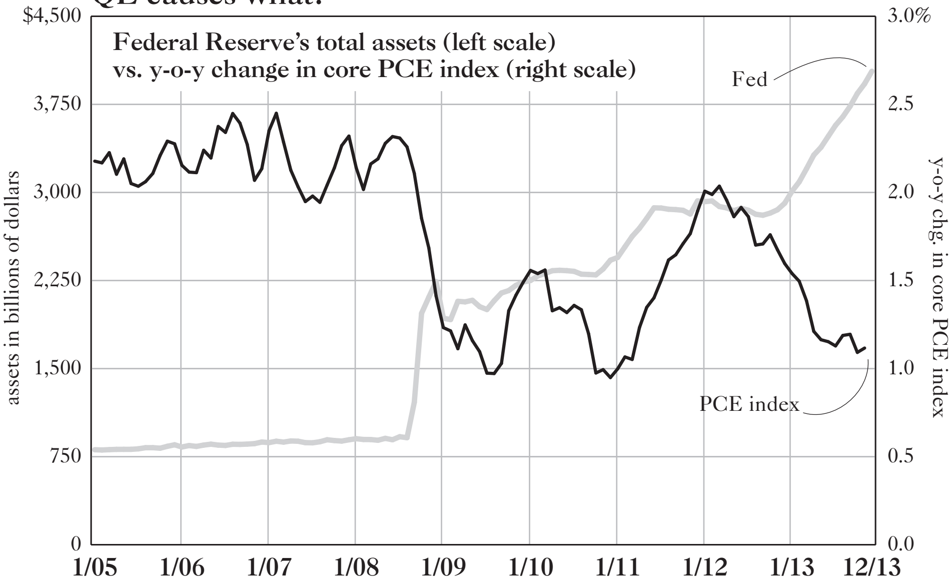
One last gasp for Treasurys?

QE causes what?



source: The Bloomberg

(January 10, 2014) In his valedictory to the nation's economists in Philadelphia last week, Ben Bernanke reiterated his commitment to a price level that never falls but always rises: a rate of 2% a year would be nice, the chairman affirmed. That sentiment, made familiar by years of repetition, scarcely raised an eyebrow, let alone a controversy. It's a deficit we undertake to correct. To put the conclusion ahead of the argument, the Fed will discover—we all will discover—that nothing's so unstable as a stabilized price level.

As we read the new year consensus of investment sentiment, people love stocks, hate bonds and feel sorry for gold. "In the many years I've been surveying experts for their predictions for the coming year," writes *New York Times*' columnist James B. Stewart, "I cannot recall another time when optimism about the stock market, the economy and corporate profits was so widespread. As is pessimism about the bond market."

Perhaps the trader's maxim applies: "If it's obvious, it's obviously wrong." If so, it may behoove us, aged and grizzled bond bears, to imagine a contrary scenario. We ground these imaginings in a longstanding *Grant's* theme, namely, there ought to be deflation.

There ought to be inflation, too, this publication has maintained at intervals since the dawn of QE. Let us rather now focus on the march of progress—and on the accretion of debt. As technology advances, prices should fall. As it costs less to make things, so it should cost less to buy them. In the case of TV sets, washing machines, refrigerators, cell phones, etc., prices have been falling for years. Not since 1996 has the durable goods' segment of the personal consumption expenditures price index registered a positive year-over-year change.

Debt, like progress, is a force for deflation. Encumbered firms produce to remain solvent. Heavily encumbered firms overproduce. Overproduction presses down prices. Easy access to debt prolongs the life of marginal firms. They don't go broke but, finding ready access to speculative-grade credit, carry on, thus adding to the physical volume of production and therefore to the overhead weight on prices. Debt is deflationary the more it drives production, or—in the case of governments and individuals—the more it constricts consumption.

Money printing is inflationary. It lifts some prices, but in the current cycle, not all of them. Banks have been impaired. Borrowers have been reluctant. The dollars that the Fed has conjured, most of them, take the shape of unmobilized bank reserves. They are inert.

The central bank is egging on inflation with one hand but suppressing it with the other. It materializes the dollars that drive some prices higher. It fosters the debt formation that presses certain other prices lower. What it refuses to do is let markets clear.

Since December 2007, the Fed, the People's Bank of China, the European Central Bank, the Bank of Japan and the Bank of England have collectively materialized the equivalent of $8.9 trillion. The five central banks have inflated their balance sheets to $15.1 trillion, or to 20.6% of global GDP, from $6.3 trillion, or 11.1% of world GDP in December 2007. Yet measured rates of inflation have dwindled. In neither the euro zone nor the United States will the rise in the chosen price indices in 2013 (stocks, bonds, commercial real estate, etc. not included) hit the central banks' 2% target.

"Anxieties are rising in the euro zone that deflation—the phenomenon of persistently falling prices across the economy that blighted the lives of millions in the 1930s—may be starting to take root again as it did in Japan in the mid-1990s," reported Monday's *Wall Street Journal*. The deflation bulletin shared page A2 with a dark ponderation on the threat of "secular stagnation," another homage to the 1930s.

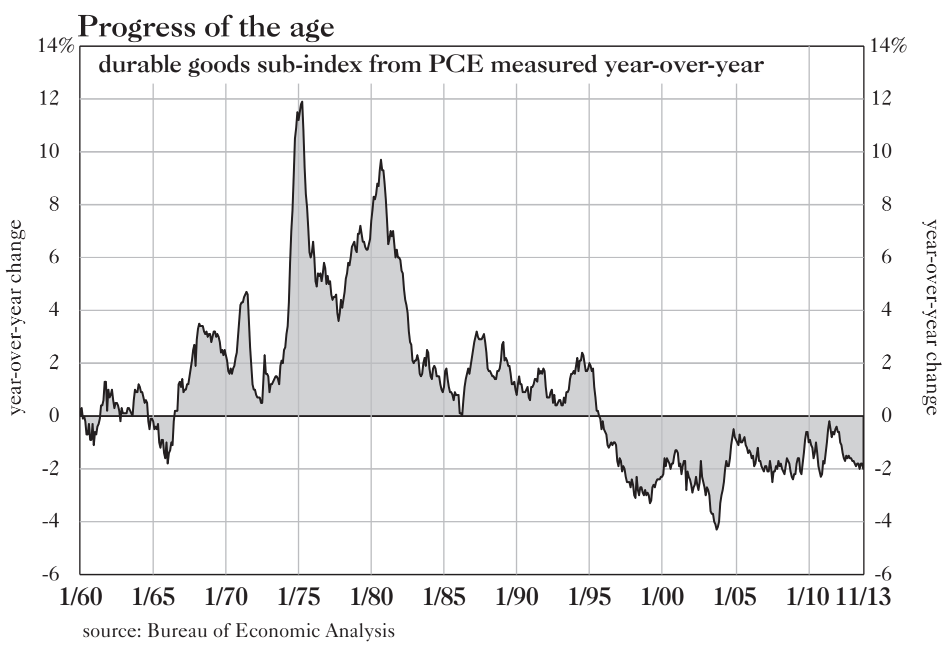
As for us, we find the 1920s more instructive. Between 1922 and 1927, wholesale commodity prices fell by 0.1 percent a year, while the cost of living rose by 0.7 percent a year. In that time of hurtling technological progress, one might have expected prices to fall, as they persistently fell in the final quarter of the 19th century. The Federal Reserve was happy to take credit for the fact that they didn't. The central bank seemed to germinate enough credit to resist the gravitational pull on prices of falling production costs and rising productivity. "Business and prices have both become more stable," asserted a Herbert Hoover-sponsored volume entitled, "Recent Economic Changes" in 1929. "There is evidence that our economic system is moving in this direction."

"Price stability" was the ideal, agreed Irving Fisher, professor of economics at Yale University, and Benjamin Strong, governor of the Federal Reserve Bank of New York. Fisher, hugely influential, contended that there was no such thing as a "business cycle"; price disturbances were rather to blame for booms and busts. Iron out the price level and you've conquered the "cycle," he—and many luminous others—contended.

There's more than an echo of Fisher in the words and deeds of our 21st-century mandarins. One notable difference is how the moderns define stability. For Fisher, "stable" meant just that, neither inflation nor deflation. For Bernanke and Yellen and the rest, "stable" means no deflation. To prevent what earlier ages took as a sign of progress—bargains are good, the primitives reasoned—the leaders of the Fed, like their forebears of the 1920s, have had to create enough credit to prop up the price level.

"The world is a cornucopia," this publication observed in the issue dated Jan. 14, 2005. "Thanks to the infernal machine of American debt finance, the Internet and the economic emergence of India and China, among other millennial economic forces, goods are superabundant. More and more services, too, are globally traded, therefore cheaper than they would be in the absence of international competition. Yet the measured rate of inflation in the United States is positive, not negative, as it was in so many prior eras of free trade and technological progress."

At the time we wrote, house prices were rising by 13% and the "core" personal consumption expenditures deflator was rising by 1.6% (both measured year-over-year). Household debt was expanding by 9.7%, personal disposable income by 2.1% (also measured year-over-year). The fed funds rate was quoted at 2.29%, up from 1.27% in November 2002, when the then-Governor Bernanke gave his famous speech about the bogeyman from the 1930s. "Deflation: Making Sure 'It' doesn't Happen Here," he entitled this effort.



Exactly how the former Princeton economist intended to lift average prices without distorting certain, very specific prices—house prices, for instance—he didn't say. Nor did he stop to define terms. That job fell to us, as follows: "Inflation is not 'too many dollars chasing too few goods.' Pure and simple, inflation is 'too many dollars.' What the redundant dollars chase is unpredictable. In recent months, they have chased stocks, commodities, euros, junk bonds, emerging-market debt and houses."

As for "deflation," what it isn't, we said, is falling prices. That is a symptom of the thing, not the thing itself. We defined deflation as too few dollars chasing too much debt: "Dollars extinguish debt; too few dollars in relation to the stock of debt is the precondition for what, these days, is euphemistically called a 'credit event.'"

In a debt crisis, people throw assets on the market to raise cash. The weight of this new supply, not offset by new demand, broadly sinks prices. *That*, to us, is deflation. If, on the contrary, prices fall because the world is becoming more efficient, we would call that circumstance "everyday low prices," or "progress." In no public utterance of which we're aware has any senior Fed official addressed this critical distinction. We had our hopes for the chairman's goodbye address, but the old professor let us down.

Whatever the source of deflation, the central banks of the world are pledged to resist it—by the means of creating more debt. They are not fighting fire with fire. They are fighting fire with gasoline.

Bloomberg on Monday was out with the projection that debt as a percentage of the world's 34 largest economies (i.e., members of the OECD) will climb to 72.6% in 2014 from 70.9% last year, and from 39% in 2007. In addressing the economists in Philadelphia, Bernanke defended the radical policies of the past five years by alluding to the depression that wasn't and the recovery that is. He failed to mention that the means to the end of salvation was the near doubling of the world's debt burden. Nor did he choose to acknowledge the truism that debt and deflation go together like PB and J.

If the Food and Drug Administration were monitoring Bernanke's speeches, as maybe it should, the Federal Reserve's anti-deflation pledge would include some frank talk about side effects. "People who take QE or ZIRP may suffer from giddiness and a loss of financial perspective," the FDA-mandated disclaimer would say. "They may experience nausea, shortness of breath, hair loss, impotence, bankruptcy and heartburn."

The Fed's price stabilization program is no one-off policy. It's the very mission of the modern central bank. Committed to stabilizing some prices, the Fed is reciprocally (though tacitly) dedicated to distorting others. In the 1920s, an economist at the New York Fed devised a price index encompassing real estate prices and security values as well as rents, wages and wholesale prices. The Carl Snyder Index of the General Price Level rose by 2.7% a year between 1922 and 1929. An updated edition would certainly present a very different picture of today's "stability" than the indices that omit asset prices. Inflation is where the central bankers aren't looking for it.

It strikes us as not a little ironic that a central bank under the leadership of a supposed historian of the Great Depression lives in ignorance of the decade preceding the Great Depression. The best of the contemporary postmortems of the years 1929-33 harped on the unintended consequences of artificial price stability.

"Banking and the Business Cycle," produced in 1937 by the trio of C.A. Phillips, T.F. McManus and R.W. Nelson is the gold standard of the genre, to our mind. As the book is long out of print, we'll quote from it; the authors seem almost to be addressing the editor and the readers of *Grant's*. "The principal shortcoming of price level stabilization as a primary goal of monetary policy," Phillips et al. write, "is found in the fact that the 'freezing' of any one set of prices tends to establish resistances to the readjustments that need to be made continually within the price system if that system is to be kept in balance in the face of a highly dynamic economic setting: stabilization of *all* prices is, of course, quite impossible in any nation other than one having a completely 'frozen' economic structure. Nor is an unchanging price level any insurance against depression, as the events of recent monetary history have abundantly proved."

The authors go on to enunciate a law of unintended consequences. They don't use the word "bubble," but you can tell what they're driving at. "As long as economic progress is maintained," they continue, "resulting in increasing productivity and an expanding total output, there will be an ever-present force working for lower prices. Any amount of credit expansion which will offset that force will find outlets unevenly in sundry compartments of the economic structure; the new credit will have an effect upon the market rate of interest, upon the prices of capital goods, upon real estate, upon security prices, upon wages, or upon all of these, as happened during the late boom. A policy which seeks to direct credit influences on *any* single index, whether it be of prices, either wholesale or retail, or production, or incomes, in the interests of stabilization, will result in unexpected and unforeseen repercussions which may be expected to prove disastrous in the long run."

"Disastrous" grabs the reader by the collar; "long run" rather loosens the grip. How to apply the preceding ideas in the here and now?

By resisting deflation, today's central bankers will ultimately create one, we believe. But when? Before or after they instigate an unscripted 3% or 5% inflation rate? We don't know, nor do they.

At last report, November's, the PCE expenditure index registered a year-over-year rise of 0.9%. It's not so far-fetched to imagine monthly readings below the zero marker—there were seven of them in 2009. In five consecutive months between 1961 and 1962, there were year-over-year readings of less than 1%. In 12 consecutive months between 1954 and 1955, there were year-over-year readings in the CPI of less than zero. Nobody seemed to object very much in 1954-55 or in 1961-62. For that matter, the deflation of 2009 could be explained away by the financial crisis (that, actually, was deflation). But now? A more than passing slip into official deflation territory would send the Fed to general quarters. Then what?

Action, of course. The Bank of Yellen is as constitutionally incapable of inaction as were the Banks of Greenspan and Bernanke. The Fed would paw around in its tool kit. It would discover new, seemingly sharper-edged instruments—nominal GDP targeting, perhaps, or some literal application of the Bernanke helicopter-money metaphor.

How would the world interpret an admission of the failure of monetary policy to prevent this imagined lurch to deflation? We suspect it would buy Treasurys. Maybe the government securities market has another big rally in it, and maybe that hypothetical rally will reward this year's contrarians.

Where would all this lead? If we were writing the script, it would lead to a belated but well-reasoned loss of confidence in the institution of modern central banking. It would produce a flight from paper money into tangible things. That is, it would lead to inflation. We expect that it will. And we expect that come that historic moment, people will stop feeling sorry for gold.

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Yield to worst

(April 4, 2014) "The food is terrible," to quote the famously ambivalent restaurant review—"and the portions are so small." Much the same can be said of today's junk-bond market. The yields are terrible—and there's not enough new supply to satisfy the clamoring demand.

The subject at hand is the worldwide yield famine; the special point of focus is how to turn that distress to profit. You know that income-seeking Americans are scraping the bottom of the barrel. It's the same on the other side of the Atlantic. According to Friday's *Financial Times*, income-deprived Continental investors are bidding up speculative-grade debt from the European "periphery" to prices higher than comparably rated securities emanating from the European "core." Yield is the thing, even if you'll never get it. All in all, we conclude, the junk market—we are now back in North America—is ripe for the risky art of short selling.

Even in what the adepts call a "crowded" trade, the short seller's way is lonely. You, the man or woman inside the bear suit, conceive a point of view that usually does not comport with authorized institutional thinking. Let us say that you believe that stunted yields, receding credit quality and rising interest rates (or the threat thereof) have delivered an opportunity to sell short junk bonds or the mutual funds and exchange-traded funds that house them.

You take a walk around the block to interrogate yourself: Do you really want to do this thing? Normal people buy first and sell later. Short sellers reverse the order by selling borrowed securities first with the intention of buying later to close out the transaction (or, in the idealized short sale, never having to cover because the securities they shrewdly sold have become worthless). It's not always easy to get "the borrow." Nor is it usually expedient to remit to the securities lender the dividend or interest payment on one's borrowed stock or bonds. You, contemplating the advisability of becoming a short seller, take the measure of the known risks—rising markets, Federal Reserve "stimulus," peace and prosperity, etc. You add, as well, the high personal costs that short selling sometimes exacts—insomnia, heartburn, hair loss, paranoia. And having duly considered the pros and cons, you gamely exclaim, "Heck, yes!"

We write not mainly for these blithe, intrepid spirits—how many can there possibly be?—but for all who lend or borrow. As leverage is ubiquitous, so is credit topical. Besides, today's junk-bond market is a living laboratory in the consequences of radically easy monetary policy.

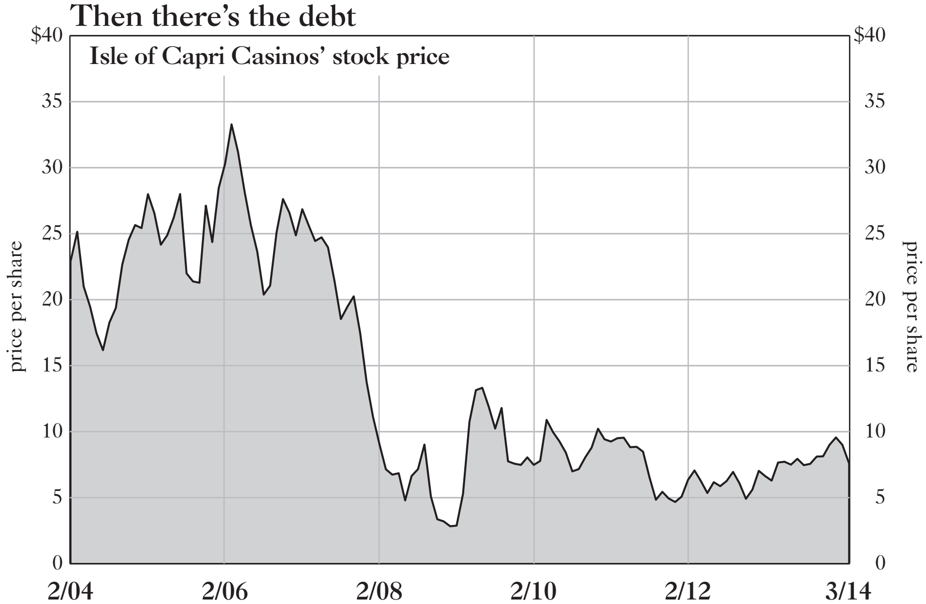
At the highs of junk-bond prices last May 9—this was on the eve of the 2013 tapering fright—the Bank of America Merrill Lynch U.S. High Yield Master II Index fetched 5.24%. The subsequent scare over the possible end of QE quickly pushed the average yield to 7.02%—178 basis points in only 33 trading days. Having sold the tapering rumor, the junk market proceeded to buy the news. So here we are at 5.63% on the same BofA Merrill Lynch index, a quarter point above the old lows in yield.

The contention here is that today's market is bereft of absolute value and low on the relative kind. The 2007 market was, we think, zanier on account of the higher incidence of leveraged buyout debt, but today's market is diligently closing the gap. "It's getting junkier," says Michael E. Lewitt, CIO of Eccles Street Asset Management LLC and editor of *The Credit Strategist*. "The ratings are slipping more. In terms of 'covenant lite,' [loans or bonds issued with a minimum of restrictions intended to enforce financial discipline on the borrower] a couple of years ago when covenant lite really started picking up, it really was just the strongest borrowers that the market would grant that kind of package to. That's no longer the case. Anybody can get a covenant lite package. The market is much less discriminating. The complacency has set in. Covenants are weakening in the loan market.

"In the bond market," Lewitt continues, "covenant packages are weaker and there has been some erosion in call protection. Historically, there has been five-year, non-call protection on bonds; we're seeing episodes of three years. In general, most deals that are coming to the market are not for newly minted LBOs. The bad news is they are often to pay dividends to equity sponsors to re-lever companies and that is never a good thing."

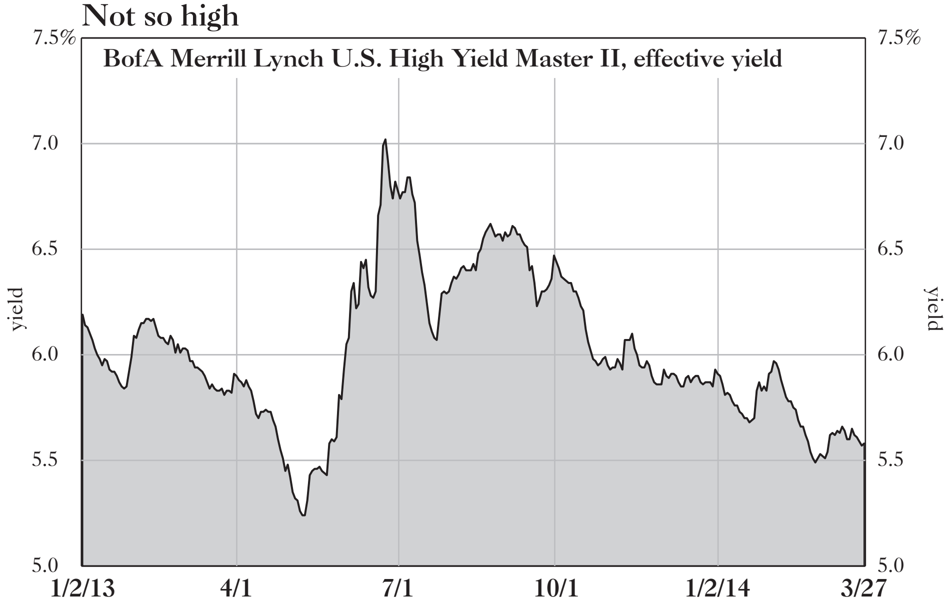
At current ground-scraping interest rates, "high" yield is an oxymoron. Many regret this state of affairs, though not the bears. A 15% coupon makes for a prohibitively expensive short sale (remember, the bearish speculator must pay the securities lender the interest he or she would

Then there's the debt



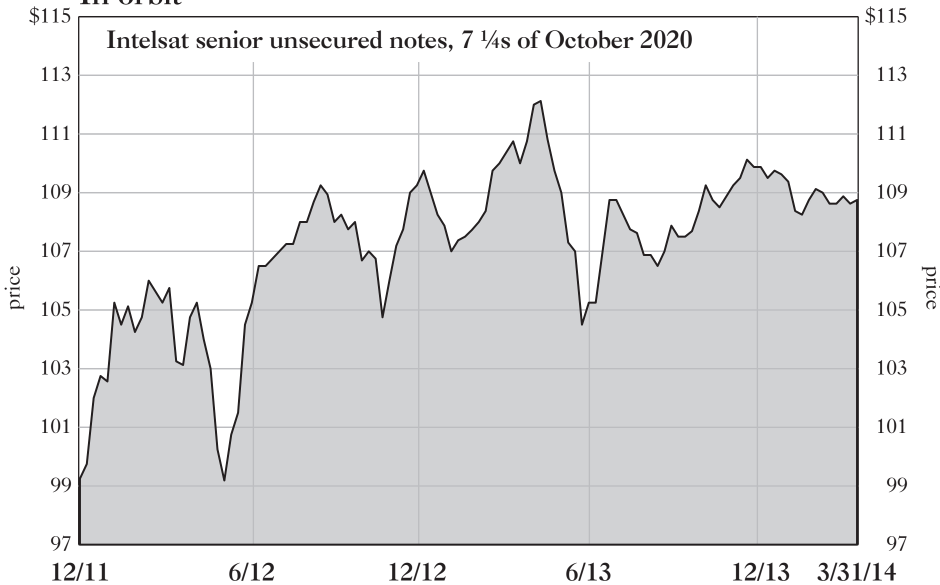
source: The Bloomberg

Not so high



source: Federal Reserve Bank of St. Louis

In orbit



source: The Bloomberg

have otherwise received through ordinary corporate channels). A 5% coupon alone won't make for a profitable short sale, but it gives the bears a fighting chance.

We serve up four vignettes in support of this thesis. No. 1 concerns a transaction that captures the market's manic mood. No. 2 is about a liquid, overpriced, vulnerable bond that seems ripe for a short sale. No. 3 is a case study in what a Chartered Financial Analyst might call heavy competition overlaid on lousy fundamentals. No. 4 is an update on Intelsat, an over-leveraged borrower with an underachieving income statement.

The first evidentiary item concerns a February financing by BlueLine Rental for the purpose of enabling the promoters of a private-equity deal to take out 100% of their equity not two weeks after they'd put it in. According to Matthew Fuller of the LCD unit of Standard & Poor's, not since 2007—that fateful year—has any dividend recap deal followed so quickly on the heels of the closing of the acquisition as has BlueLine's.

BlueLine Rental, successor to the Volvo equipment rental business, rents backhoe loaders, skip loaders, track dozers, trenchers, skid steers, wheel loaders, boom trucks, knuckle lifts, electric man lifts, towable booms, welders, light towers, pumps, heaters and other capital items suitable for an expanding economy. The company does business at 132 rental locations; it serves 45,000 customers in 44 states, Puerto Rico and a pair of Canadian provinces.

BlueLine is a "rollup," the product of the consolidation of scores of equipment-rental franchisees into a centrally owned retail network. Platinum Equity, a Beverly Hills-based private equity shop, did the rolling. The price tag was $1.1 billion.

A senior bank line and $760 million of single-B-rated, 7% second-lien notes of February 2019, offered at par, financed the acquisition. That is, those borrowings financed the first phase of the acquisition. Demand for the 7s being unslaked, investors asked for another opportunity to participate in the leveraging up of a cyclical, macroeconomically sensitive business. BlueLine obliged with $252.5 million of triple-C-rated 9¾s of 2019 at 99.

Here was a double homage to booms gone by. Beyond the use of proceeds (a dividend for Platinum Equity) was the fact that the 9¾s are payment-in-kind, or PIK, notes; "toggle," too, is a part of the description. In certain circumstances, the borrower may choose to pay interest not in cash but in additional securities (in so choosing, it is said to toggle between one form of payment and another). Like the crocus or snowdrop, PIK securities are seasonal heralds of warmth and optimism. Their appearance in the capital markets is a sign that cyclical winter is past and that a new season of lending and borrowing is bursting forth.

The 9¾ notes pushed leverage for the borrowing entity to 5.9 times the favored, if not officially sanctioned, measure of cash flow called "pro forma, adjusted EBITDA." That was up from 4.6 times before the new PIK issue came into the world. (EBITDA, you know about: net income before net interest expense, taxes, depreciation and amortization; the "adjustments" applied to EBITDA include those related to other non-cash charges, brand license royalties and "estimated costs we expect to incur operating as a stand-alone entity," instead of, as before, a collection of franchised businesses.) This 5.9 times leverage compares to 3.2 times net leverage at double-B-rated United Rentals Inc. (URI on the NYSE), BlueLine's larger and publicly traded competitor, and to just under four times debt-to-EBITDA for the entire high-yield bond universe, according to a March 28 report by Morgan Stanley.

No mystery what's in this transaction for the private-equity investors. A more interesting question is what's in it for the bondholders? Under previous management, BlueLine's component businesses suffered operating losses in each of the prior three years. Then, too, according to the auditors, the process of integrating the dozens of acquisitions has revealed "material" weaknesses in the company's financial controls and information technology systems.

No doubt, Platinum Equity, with more than 150 acquisitions under its belt and 30 companies in its portfolio, means to fix the problems and return BlueLine to profitability. And if it succeeds, the creditors, too, would succeed, as success is modestly reckoned in the fixed-income world: They would get their money back, with interest.

As the BlueLine 9¾s are callable at 103 on Feb. 1, 2016, an investor's potential gains are hardly limitless. From today's price of 106.1, the securities would deliver a yield to call, or "worst," of 7.63%. To be sure, that would be a handsome gain for a fixed-income security. It would be less than overwhelming for an equity.

"The PIK toggle notes buyers are taking true equity risk, but their upside is capped," a paid-up subscriber who prefers to go unnamed tells colleague Evan Lorenz. "This is the inverse of a normal bondholder's position. You have all the downside risk, whether it is the economy slowing, rates moving higher, whether people start selling high yield because of the fear of all of the above." Looking back at the BlueLine $9\frac{3}{4}$s, our source suggests, the buyers will rue the day when they heard the words, "Sold to you."

"From what we see," our informant goes on, "it is probably the best time to be a long-short credit manager rather than just a long-only, buying new issues and hoping things go well." From the short seller's vantage point, the BlueLine PIK toggle notes have much to commend them. There are two problems, the coupon and—perhaps—the economy. Our source says that he does not intend to pull the trigger until business activity shows signs of decelerating.

On now to evidentiary sighting No. 2, which features our new best friend, Valeant Pharmaceuticals International (VRX on the Big Board). We won't repeat either our bearish analysis or our declaration of an interest (see the issue of *Grant's* dated March 7). Suffice it to say that Valeant is an acquisition machine, that the businesses it acquires tend not to prosper under Valeant management, that the Valeant front office is partial to non-GAAP measures of financial performance and that the company has generated positive GAAP net income in only three of the past eight quarters. Free cash flow in the fourth quarter amounted to \$216 million, which, as Lorenz notes, "is actually less than the \$241 million that Valeant generated in the second quarter of 2012—this despite a 152% jump in sales from the second quarter of '12 through the fourth quarter of '13."

A bear on Valeant might sell short the company's equity—or the opportunity to which we now turn, the company's single-B-rated, $6\frac{3}{8}$% senior unsecured notes of October 2020. There's much to be said for the latter approach.

Bulls and bears will go round and round on the nuances of purchase accounting as Valeant employs it, but there's no debating the debt; it ballooned to \$16.9 billion at year-end 2013 from \$6.5 billion at year-end 2011. Maybe Valeant's management can pull off the "merger of equals" it's been talking about. It would be a convenient way to de-lever the Valeant balance sheet. Or maybe Valeant's prospective merger partners will see the situation as we do. "While pharmaceutical executives have been happy to sell businesses and divisions to Valeant for cash," Lorenz points out, "my admittedly small sample of pharma contacts leads me to suspect that Valeant will have a hard time persuading a discerning appraiser of value to accept its stock. Then, too, creditors might begin to notice that Valeant's GAAP operating income in the fourth quarter failed to cover the company's \$260.2 million in interest expense."

Whatever you may think of Valeant, the company, the Valeant $6\frac{3}{8}$s seem to offer only a modicum of upside. The notes change hands at 108.4 to yield 4.86%; that is the yield to maturity. The yield to the Oct. 15, 2016, call, a price of 103.19, works out to just 3.92%. As far as we can see, the creditor stands to be a loser—or, at least, not much of a winner—no matter how Valeant may fare in the next $2\frac{1}{2}$ years. Who would commit capital on these terms?

Why, the junk-bond funds would; they have to. The SPDR Barclays High Yield Bond ETF (JNK on the NYSE Arca) and the iShares iBoxx \$ High Yield Corporate Bond ETF (HYG on the same exchange) count the Valeant note as their 17th and 21st largest holding, respectively. Junk funds need paper, especially the issues that weigh in at \$2 billion-plus, as Valeant's does. Over the past four weeks, observes Martin Fridson, CEO of FridsonVision LLC (*and* a featured speaker at the April 8 *Grant's* Conference—advt.), net inflows into high-yield mutual funds enlarged the assets of those funds by 1.2% (this figure excludes inflows into the high-yield ETFs), whereas in February, the latest period for which data are available, the universe of non-investment-grade bonds expanded by only 0.3%. "The big picture," says Fridson, "is that there is not enough supply."

As every gold bull can attest, ETFs buy in bull markets and sell in bear markets. In the case of gold, a mitigating feature of the 37% price decline between Sept. 5, 2011, and Dec. 19, 2013, was the persistent purchase of physical bullion by Chinese and Indians. It's not so clear who would take the other side of a junk-bond liquidation.

Big, liquid issues—the ones that

the ETFs like—"are the most vulnerable right now," Craig Kelleher, a partner in Boston-based Millstreet Capital Management, tells Lorenz. "We saw it in May last year. When those guys hit the 'sell' button, those large liquid names—they were *perceived* as liquid—can hit four- to five-point air pockets. ETFs now make up between 8% and 10% of the market and are predominantly in those large-cap names. Dealer inventories, as we know, are also at 10-year lows. Yet the high-yield market is multiples bigger than it was 10 years ago."

Though America's economy, too, has grown over the past decade, it has lost that characteristic American oomph. Notably lacking in dynamism is, for instance, the regional gambling business. According to the Mississippi Gaming Commission, casino-generated tax revenue dropped by 4.7% in December from the like month a year earlier, to $18.2 million from $19.1 million. That is 37.5% less than the haul produced in December 2007 at the start of the Great Recession.

When casino licenses were hard to come by, therefore precious, public gambling businesses commanded fancy valuations, as our previously quoted anonymous source recalls. "Well," he says, "that is quickly eroding as more and more states, in a desperate grab for tax revenue, are willing to sell themselves to the devil and open up casinos." Isle of Capri Casinos (ISLE on the Nasdaq) is an example of an established gaming business that must regret the lawmakers' surrender to sin. Pricing of the company's single-B-rated 5 7/8s of March 2021—they trade at 102 to yield 5.52% to maturity—seems not to reflect that the house is facing more difficult odds.

Isle of Capri owns and operates 15 small casinos in Colorado, Florida, Iowa, Louisiana, Mississippi, Missouri and Pennsylvania; only four of them generate more than $20 million in annual operating profit. The average Isle of Capri customer, not a member of the 1%, doesn't have much to gamble with, let alone to lose.

And now comes more competition. A new Golden Nugget casino is slated to open late this year near the Lake Charles, La., property that accounted for $7.9 million in Isle of Capri operating profit over the past 12 months, or 12.5% of the grand total. According to a new report by Susan Berliner of J.P. Morgan, the Golden Nugget opening will likely skim 25% from Isle of Capri's take at Lake Charles.

(The rising young investor Bernard M. Baruch once talked himself out of an opportunity to do business with the elder J.P. Morgan by using the word "gamble" in the great man's presence; how times change.)

Then, too, Lorenz relates, more competition is on the way in Iowa, home to three of Isle of Capri properties, which together chipped in $37.6 million, or 60%, of the company's trailing 12 months' operating profit. Operating profit generated by Isle's profitable casinos sums to more than 100% of total operating profit owing to losses from casinos in Pennsylvania, Missouri and Mississippi. A March 2 story in the *Quad-City Times* made reference to plans for a new casino in Linn County, Iowa, a 47-mile drive from the Isle of Capri's Waterloo location. Even without new construction, the newspaper report said—here it cited a pair of independent research studies—"a saturated market is already under threat from Illinois' rapidly expanding video poker in taverns, stores and restaurants."

Our informant is short the Isle of Capri debt, despite the not remote chance of a change in corporate control. Some 40% of the outstanding shares are held by the family of the founder, Bernard Goldstein, who died in 2009. Assume, our source begins, that the family does sell, would you, the hypothetical buyer, be inclined to refinance a coupon as low as 5 7/8%? No, you would not, our source answers his own question, "especially if you are potentially adding more leverage to it." Besides, an observant buyer could hardly fail to notice that, in the fiscal quarter ended Jan. 26, Isle of Capri's $17.9 million in GAAP operating income failed to cover the company's $21.9 million in interest expense.

We close out this bears' beauty contest with an update on Intelsat SA (I on the NYSE). For the full chapter and verse, see the issue of *Grant's* dated Jan. 24. You may recall that the company operates 51 fixed satellites, a hugely expensive and time-consuming line of work (to launch one of these birds can cost up to $400 million and take from design to launch, three years). You may also remember that the satellite business requires growing revenue to leverage the high cost of operation. It doesn't help matters that various governments are building a dozen new satellites and contemplating the launch of several dozen more.

Fourth-quarter results, released on Feb. 20, featured operating income for 2013 in the sum of $1.2 billion, good enough to cover full-year interest expense by 1.08 times. For the year, revenue was $2.6 billion, a slight decrease from 2012. On the conference call, CEO and Chairman David McGlade said that, owing to reduced spending by the U.S. government and excess capacity in Africa, 2014 revenue is expected to total between $2.45 and $2.5 billion, a 4.9% year-over-year decline at the midpoint from 2013 results. Not to worry, the chief counseled dialers-in: "We remind our investors of our commitment to a two-phase investment model. The first several years of this plan is not dependent upon revenue growth but instead on the use of increasing cash flows to reduce our debt. We are sharply focused on de-levering to create equity value."

As of Dec. 31, there was $15.3 billion in total debt outstanding. On the call, the company announced plans to repay $400 million of that balance this year. Investors must bet that McGlade can do more with less revenue—in 2013, free cash flow amounted to $116.1 million and there is only $247.8 million of cash on the balance sheet.

To judge by the yields on Intelsat debt, bond investors have every confidence in McGlade—and in Janet Yellen, Jack Lew, Barack Obama and Vladimir Putin, besides. Thus, the single-B-plus-rated 7 1/4s of 2020 ($2.2 billion in par outstanding) change hands at 108.75, a yield to maturity of 5.63%. Inasmuch as the 7 1/4s are callable at 103.625 on October 2015, the yield that an optimistic holder may receive is likely to be closer to the yield to call, or "worst." That would be just 3.64%.

The best of times—the worst of times.

•

Fuel least popular

(November 29, 2013) The Environmental Protection Agency makes war on it, people of any shade of green despise it, and the advent of cheap natural gas threatens to marginalize it. Coal—and a flourishing, $217 million market-cap coal miner—are the topics under discussion.

With the Nov. 14 news that the Tennessee Valley Authority will shutter eight coal-fired electricity-generating plants, the suspicion deepens that if anything could disprove the cheerful adage that all P.R. is good P.R., that something just might be coal. Even so, the official mineral of the state of Kentucky continues to generate 40% of America's electricity. Clean-burning natural gas accounts for just 27%.

Nor is coal likely to relinquish its lead in what is sometimes optimistically referred to as the "foreseeable" future. It will, by 2040, continue to claim as much as 35% of the electricity-generation market, compared to 30% for natural gas, projects the U.S. Energy Information Administration. That is, coal won't soon be going the way of the dinosaurs, from whence it came.

For connoisseurs of contrary opinion, Hallador Energy Co. (HNRG on the Nasdaq) ticks not one box, but two. Not only does it mine coal, but also its coal is the high-sulfur type that's linked to acid rain. To the question: "Why on earth would any utility choose to burn it—or be allowed to burn it?" There is this answer: Federal regulations long ago required utilities, at heavy expense, to neutralize those pollutants. "Counter-intuitively," Lucas Pipes, analyst with Brean Capital, advises colleague Evan Lorenz, "the increasing environmental standards have forced utilities over the tipping point to where it makes sense for them to burn higher-sulfur coal after they have installed higher-emission-standard technology."

So it is that high-sulfur coal is enjoying a renaissance. It's found in abundance in the so-called Illinois Basin, which encompasses the Land of Lincoln and parts of Indiana and Kentucky. Reserves in this locale are relatively accessible and extraction costs are relatively low—on the order of $30 a ton, about half the cost of the low-sulfur coal buried in the immense Central Appalachian Basin, a region stretching as far north as the Canadian border and as far south as Alabama.

Coal is in a steep bear market; the price of central Appalachian coal traded on the Nymex has declined to $54.93 per ton, down from $143.25 on July 1, 2008. But even at $44.50 a ton, the average price for all regions in 2013, mines like Hallador's operate in the black. Not so their Central Appalachian counterparts. Since 2005, according to Pipes, annual production in the Illinois Basin has expanded to 135 million from 93 million tons, while that in the central Appalachian zone has contracted to 75 million tons from 216 million tons.

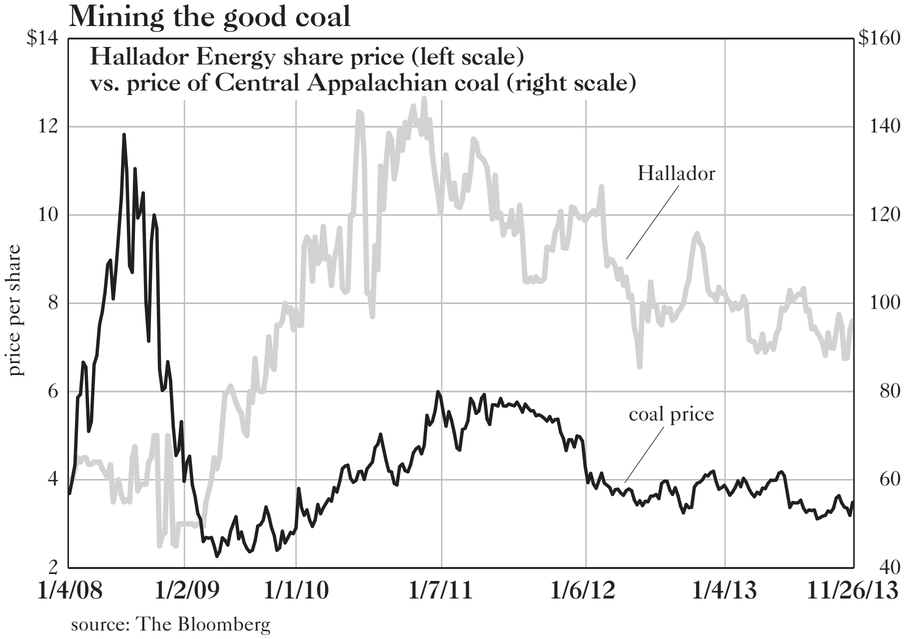
"Within the coal industry," Lorenz points out, "there are lots of losers—and one or two winners. Conspicuous among the former are the companies that leveraged to expand at the top of the 2007-08 energy cycle. Arch Coal, Peabody Energy Corp. and Consol Energy are among these encumbered unfortunates. James River Coal Co., which had a market cap of $704 million at year-end 2010, is quoted today at $54 million. Patriot Coal Corp., which had a market cap of $1.8 billion at year-end 2010, filed for bankruptcy protection in July 2012."

A very different proposition is Hallador, a lightly leveraged, low-cost, pure play on the Illinois Basin. Wholly owned Sunrise Coal is Hallador's principal business unit; it's responsible for all but $4.2 million of the company's $25.2 million in trailing 12-month operating income. Savoy Energy LP, a private oil and gas exploration company in Michigan, and Sunrise Energy LLC, a private oil and gas exploration company in Indiana—Hallador owns 45% of the first and 50% of the second—round out the corporate stable. As of Sept. 30, the parent's balance sheet showed $11.4 million of debt against $13.7 million of cash.

Hallador, via Sunrise, extracts coal at a cost of less than $30 a ton, the lowest cost of any public miner (only closely held Foresight Energy LLC, controlled by the farsighted Chris Cline, posts a lower cost per ton). The great bulk of the company's coal comes from the Carlisle mine, situated near the Indiana town of the same name. The Carlisle is a high-sulfur, underground deposit from which "continuous" mining machinery can surface as many as six tons of coal per minute. Carlisle has a capacity of 3.3 million tons a year and identified reserves of 43.5 million tons.

While Hallador's Ace-in-the-Hole mine, 42 miles northeast of Carlisle, a low-sulfur surface project, chips in a half-million tons in annual productive capacity and 3.1 million tons of reserves, and while management is developing a pair of much larger deposits on the Indiana-Illinois border (the so-called Bulldog and Russellville Mines), the fact is that, for now, Hallador is a one-mine company, with all the risks that concentration entails. For instance, in

Mining the good coal



source: The Bloomberg

Hallador Energy Co.
(in millions of dollars, except per-share data)

	12 mo. 9/30/2013	2012	2011	2010	2009	2008	2007
Coal sales	$136.2	$138.0	$129.0	$117.4	$70.3	$27.2	$0.0
Other revenue	3.4	2.3	(0.8)	0.5	0.4	0.5	0.0
Coal operating expenses	118.6	105.8	99.3	90.7	78.3	51.2	28.4
Coal operating income	21.0	34.6	28.9	27.3	(7.6)	(23.4)	(28.4)
Equity income (Savory)	3.5	2.0	5.5	1.0	(1.7)	(2.3)	0.0
Equity income (Sunrise Energy)	0.6	0.2	0.9	0.0	0.0	0.0	0.0
Total operating income	25.2	36.8	35.3	28.3	(9.3)	(25.7)	(28.4)
Interest expense	1.5	1.1	1.3	1.9	2.0	4.0	4.1
Profit before tax	31.1	34.5	56.7	36.6	36.0	13.6	(2.8)
Net income	23.5	23.8	35.8	22.4	20.2	8.9	(2.4)
Diluted shares (in millions)	28.8	28.8	28.7	28.6	24.4	19.3	13.3
EPS	$0.82	$0.83	$1.25	$0.78	$0.83	$0.46	($0.18)
Cash	$13.7	$21.9	$37.5	$10.3	$15.2	$21.0	$7.0
Debt	11.4	11.4	17.5	27.5	37.5	40.0	35.4
Net debt	(2.3)	(10.5)	(20.0)	17.2	22.3	19.0	28.4
Oper. income/int. expense	17.1	33.5	27.4	14.7	(4.5)	(6.4)	(6.9)
Cash flow	27.8	37.0	60.1	45.5	45.2	18.8	(1.5)
Capital expenditures	(40.5)	(26.2)	(33.0)	(35.6)	(43.5)	(21.9)	(17.2)
Free cash flow	(12.7)	10.8	27.1	9.9	1.7	(3.1)	(18.8)

source: company reports

the first three quarters of this year, the cost of production at Carlisle jumped to $28.37 a ton from $26.53 in the 12 months of 2012. It was the discovery of a pocket of high gas (the same heat and pressure that transforms organic material into coal also produces highly flammable methane) that caused the bump up in cost; mining operations had to be moved to less productive parts of the mine while ventilation shafts were sunk to address the gas problem. The result: Cash flow in the 12 months to Sept. 30 declined to $27.8 million from $37 million in calendar 2012.

Another thing for the would-be investor to consider is the inescapably capital-intensive nature of the mining business. Capital expenditures, which totaled $40.5 million over the last 12 months, up from $26.2 million in 2012, have been inflated by $9 million for the purchase of Ace-in-the-Hole, $4 million for land around Carlisle and Bulldog and costs to permit the two new mines. To bring either into production at Carlisle's three-million-ton-per-annum rate would require an additional $150 million. Management estimates that maintenance capital expenditures will run between $3.50 and $4 per ton of capacity, or approximately $12-$13 million for the Carlisle mine.

"We don't operate on a factory floor where it is the same every day," Brent K. Bilsland, president of Sunrise Coal, reminds Lorenz. "Mining is about following the geology. From time to time, we have all four of our mining units in great conditions, and from time to time, we have three out of four in bad conditions."

There's no confusing Hallador with Exxon in the stock-market liquidity department; management, the board and affiliates own two-thirds of the 28.6 million HNRG shares outstanding. One-half of this chunk of inside holdings is persistently shrinking. Yorktown Energy Partners LLC, owner of 9.7 million shares, or 34% of the outstanding, has been distributing blocks of 750,000 shares to its limited partners every quarter or so. Many of the recipients turn right around and sell their Hallador in the open market.

Yorktown tells Lorenz that its exit from Hallador is no reflection on the company or its management. The fact is, rather, that the investment funds holding Hallador shares are nearing the end of their respective lives. "We wouldn't distribute a stock we thought either had issues or we thought was highly overvalued," Yorktown partner, Peter Leidel, says. "We want to distribute stocks we think people can hold and do well with. We think the stock ought to be higher than it is, but coal is out of favor."

Perhaps this overhead supply weighs on the share price. Certainly, the coal bear market does the stock price no good. In any case, the shares trade at 10.2 times trailing net income and yield 2.1%; they're quoted at a multiple of enterprise value to EBITDA of five times.

Whether you consider Hallador cheap at the price will depend, in part, on your view of natural gas. On this score, it's notable that gas prices weighed in at an average of $2.73 per million Btus in 2012 but have averaged $3.58 per million Btus so far in 2013 and are tipped to rally to $3.81 in 2014 (so, at least, tips the gas futures market). It's not inconceivable that coal, in relation to gas, is as cheap as it's going to get for a while. "When the ratio of natural gas prices to coal prices is approximately 1.5 or lower [per million Btu], a typical gas-fired combined-cycle plant has lower generating costs than a typical coal-fired plant," the EIA noted in its Annual Energy Outlook 2013. Coal, according to the agency, is expected to command $2.20 and $2.29 per million Btu in 2013 and 2014, making the black mineral cheaper to burn than natural gas.

"Hallador gets credit for what it is," Lorenz observes—"that is, a low-cost producer in a geologically fertile region. But it gets little, if any, credit for its two oil and gas development businesses, or for what its coal-mining operations might become. What management hopes to become is much bigger—and could be. To bring either Bulldog or Russellville into production would take nine months and the previously cited $150 million. 'Either one of those projects doubles our company,' Bilsland tells me. 'We are trying to get into a position where five years from now, we can bring three or four more new projects and triple the size of our company. That's our goal.' The financing would appear to be available: Hallador has in place a revolving credit facility of $165 million, of which $153.6 million remains untapped. Hallador's covenants limit the company's borrowings to 2.75 times EBITDA. Management takes a dim view on diluting ownership via an equity raise and would prefer to fund growth via cash flow and its credit facility, even if that means it takes longer to ramp up a new mine."

"What I like about this management team is that they are rational deployers of capital," Mat Klody, managing partner of the Chicago-based hedge fund, MCN Capital Management, and a Hallador shareholder, tells Lorenz. "They didn't do a lot of stupid things at the peak of the cycle and now they are seeing a lot of potential M&A opportunities pop up. They've been cautious to date about deploying capital, in particular with the great organic opportunities in place. They are definitely opportunistic."

"Opportunistic"—in capitalist circles, it's the highest praise.

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The art of inflation

(April 18, 2014) A seven-foot shiny steel rendering of Popeye the sailor man by the sculptor Jeff Koons is tipped as the *piece de resistance* of next month's evening auction of postwar and contemporary art at Sotheby's in New York. It's expected to fetch $25 million. The cycles and vagaries of taste and value are the topics at hand. We approach them by way of 21st century London and 17th century Seville.

Connoisseurs of pictures and collectors of securities may profitably reflect on the respective fortunes of the painters Oscar Murillo (b. 1986) and Esteban Murillo (1617-1682). The current Murillo, Oscar, is the creator of the work shown at the bottom left, "Untitled (Burrito)." It brought £194,500, or $322,870, commission included, in February at Christie's in London. The price was 10 times the low end of the pre-auction estimate.

The 17th century Murillo painted the picture at the lower right. "Ecce Homo" depicts the scourged figure of Christ in the moments before his crucifixion. "Mater Dolorosa," a rendering of Christ's anguished mother, which accompanies it, is not shown. The two pictures were offered together for sale by Sotheby's in December. Failing to attract a bid suitably close to $320,000, the low end of the pre-sale estimate (which happened almost exactly to anticipate the inclusive "Burrito" price), the works were withdrawn.

Oscar Murillo, *Untitled (Burrito*

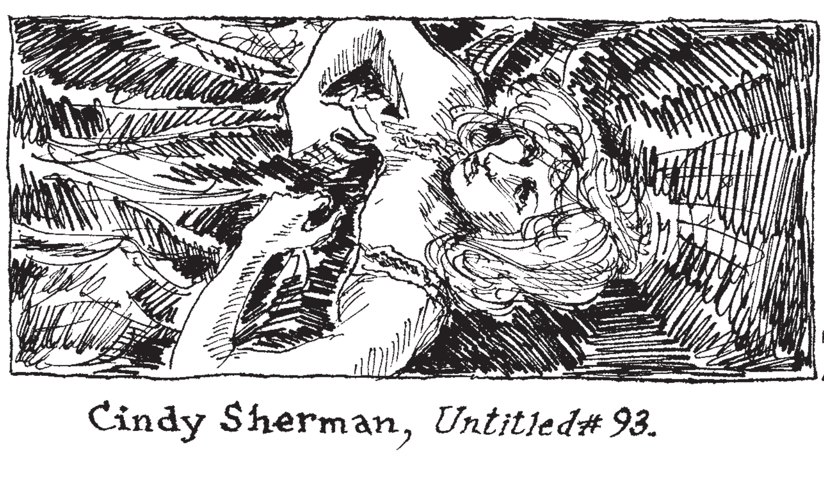
Oscar Murillo, 28-year-old former office cleaner, is one of the hottest of the so-called emerging artists. Esteban Murillo, a shining light of Counter-Reformation Spain, is one of the colder of the submerging Old Masters (there is no claimed family connection between the two). At the Christie's Old Masters auction in New York in January, 109 paintings—all the works on offer—fetched a combined $19.1 million, or not quite four-fifths of the expected value of one Popeye, observes colleague Charley Grant. In the language of Wall Street, Oscar Murillo is a kind of momentum stock. Esteban Murillo is a kind of value stock.

Before listening to Cliff Asness hold forth at last week's *Grant's* Conference, we might have glibly proposed a conceptual pair trade: shorting Oscar while going long Esteban. Asness, a Ph.D. in finance from the University of Chicago, advised the *Grant's* audience not to disparage momentum investing. Scholarly studies, including his own, show that one can profit by being long what has been going up and being short what has been going down. It's not that value investing doesn't work, Asness said, only that momentum deserves a place in the professional canon, too.

Well and good. Oscar—let us say—is trading above his personal 200-day moving average. He is going up and has been going up. Perhaps his bull market is only beginning. Maybe one of his canvasses will make a new record at the May auctions. Possibly, one of Esteban's devotional paintings will make a new low.

This publication is in receipt of a selection of pointers for any who would compete in the red-hot, momentum department of the contemporary art market. The fundamental concept, advises our well-connected informant, is to heed the buzz. Buy with your "ears," she advises, as opposed to your eyes. Hear what the insiders are saying—curators, dealers, artists and collectors.

Here, according to Carol Vogel, writing in *The New York Times* last month, is what one noted collector has said. Mera Rubell and her husband had arrived at 9 A.M. at the Independent Art Fair in New York to meet Murillo. This was in March 2012. "[H]e looked disheveled, exhausted, like a homeless person," Rubell is quoted as saying. "He'd stayed up for 36 hours straight and made seven or eight paintings, so he had something to show us. They blew us away. We ended up spending four hours talking to him. . . the last time I saw that kind of energy was Keith Haring or Jean-Michel. It was so intense. I don't even think he was on drugs."



Cindy Sherman, *Untitled# 93.*

Esteban Murillo, *Ecce Homo*

Maybe the central bankers are on drugs. Maybe modern money sets the prices on modern art. We shall now climb down, slightly, from that approach to the valuation question. We have been reading Gerald Reitlinger's "The Economics of Taste: The Rise and Fall of Picture Prices, 1760-1960" (the first volume of what turned out to be a three-volume work was published in London in 1961). It's a history of cycles.

In the early Victorian era, Esteban Murillo was a hot artist. To be sure, he was long dead, but the taste-makers of the day, including a Bonaparte prince and the Czar of Russia, appraised him a genius. In 1852, Murillo's "Immaculate Conception" fetched £24,600 in a private sale, the highest price that any picture would command until the mid-1880s. In today's gold value, the painting brought £3.9 million or $6.6 million. Nine feet high, it shows the Virgin "surrounded with a tumbling torrent of corpulent cherubs," as Reitlinger puts it. Victorian taste "died hard," the author relates, but die it did, and Esteban Murillo's work entered a long bear market. In 1950, a very good Murillo, "Christ Healing the Paralytic," cost Britain's National Gallery 8,000 fiat pounds sterling—a deep discount from the gold pounds fetched by "Immaculate Conception."

Nearby you see a rendering of "Untitled #93.," a photograph by Cindy Sherman, which sold for $96,000 at Christie's in 1998 and is expected to bring between $2 million and $3 million when auctioned next month at the Sotheby's contemporary art extravaganza in New York.

"No. 93.," as far as we know, was created to be viewed. To describe a type of work whose evident purpose is to be sold, *The New York Times* correspondent Scott Reyburn has coined the term "Flip Art." Murillo, among others, he writes, "make abstract painting that are a clever play on the act of painting. These abstracts often employ novel—not to mention cheap—painting techniques, such as using a fire extinguisher. . . or home improvement products. . . . They're often big, and have significant wall power."

Time will tell about their staying power. Fifty years ago, on April 21, 1964, Andy Warhol unveiled "Brillo Boxes." It did not seem obvious to the established art world that those ever-so-familiar-looking packages were art or that the artist who produced them would become a cult figure.

Claude Gellée (1600-1682), known simply as Claude, "the most perfect landscape painter the world ever saw," according to John Constable, was a cult figure in the early 19th century. He was among the highest-priced painters on the market until the cultists found other immortals to venerate. In 1808, one Claude landscape had fetched £12,600; in 1895, another made just £472.

Now Claude is rediscovered. At a Christie's sale in New York in January, the artist's "A Wooded Landscape," a drawing of an unidentified vista in the Roman countryside, brought $6.1 million, more than seven times the estimate. If it can happen to Claude, why can't it happen to Murillo—Esteban, that is? And if could happen to Esteban, why couldn't it happen, in reverse, to Oscar?

Tastes change, money cheapens—and cycles turn.

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Introducing the Grant's Story Stock Index

(November 15, 2013) No bull stock market is complete before the debut of the kind of equity that's valued on the quality of its narrative. It's the anticipation of earnings, not their actual arrival, that sets the speculative heart fluttering in the late stages of a proper levitation. "The road is better than the inn," wrote the immortal Cervantes centuries before the Twitter IPO.

Now unfolding is a review of the new crop of story stocks. We write for the not-so-far-receptive members of the Federal Open Market Committee, as well as for the sainted paid-up subscribers. Nothing flatters distantly projected earnings more than an ultra-low discount rate, as Evan Lorenz, our own in-house Chartered Financial Analyst, points out. Here, then, is a story of interest rates as much as of stocks.

"One hundred dollars of earnings 10 years in the future are worth $38.55 today if discounted at 10%," CFA Lorenz reminds us. "At a 5% discount rate, they are worth $61.39. But at a zero-percent rate, they are worth $100—and would be worth that much from here to eternity." So while each of the 15 component companies in the *Grant's* Story Stock Index has its own story to tell, the unifying theme is ZIRP.

Not just any "shooter," to reclaim a term from the "great garbage market" of the 1960s, qualified for the *Grant's* index. Lorenz screened for stocks that are expensive on multiples of earnings, EBITDA (i.e., earnings before interest, taxes, depreciation and amortization), or that show no earnings but trade at high multiples of revenues. When possible, our candidates exhibit other characteristics of a good short-sale specimen, including insider selling and an adequate supply of shares to borrow (the exceptions on this latter score are Zillow and ChannelAdvisor). All but one of the names is a member of the Russell 2000, the exception being Sprouts Farmers Market, which we deal with elsewhere in this issue. Let's have a look at what the bull dragged in.

Tile Shop Holdings (TTS on the Nasdaq), our first exhibit, ticks the most critical story-stock box: It's valued not on what has happened but what may come to pass in the far reaches of the future. Founded in 1985 by the incumbent CEO, Robert A. Rucker, Tile Shop went public only in 2012. The company operates 83 stores that average more than 22,000 square feet. It operates them in 28 states, mainly in the Midwest and Mid-Atlantic regions, in which it sells tiles, both stone and ceramic, as well as setting and maintenance products. It buys straight from manufacturers; 58% of its tile comes from Asia.

Chinese quality control not being all that it might be, the heavy reliance on Asia raises concerns about product integrity. Indeed, Rucker conceded on the Oct. 30 earnings call, that some of the company's merchandise "may contain trace amounts of inorganic metals." He said that, to nip a potential problem in the bud, URS Corp. has been retained to investigate the company's supply chain.

Quoted at 48 times the 2013 earnings estimate, Tile Shop would like the world to know that it means to grow to 140 to 150 stores in the "near term" and to more than 400 stores in the "long term."

And the world's a believer, to judge by the track of the share price. Home Depot and Lowe's Cos., which also carry tile products, change hands at an average of 21.8 times their 2013 estimates. Has Mr. Market, under the influence of Mr. Bernanke, perhaps gotten a little ahead of himself? As it is, Tile Shop trades at a $1.1 billion equity market cap. Let us assume that it achieves its near-term goal of 145 or so stores. And let us further assume that, having built them, the company watches its earnings multiple contract to match the more mature valuations of Home Depot and Lowe's (the road is better than the inn, after all). In that case, if one applied Tile Shop's current tax rate and margins, a $1.1 billion equity market cap would be in order. In other words, you could argue, Tile Shop is already valued as if it has done what its CEO has only promised it will do.

If Tile Shop commands a much higher valuation than its mega-box, do-it-yourself comps, a bull might interject, it's because Tile Shop earns so much higher margins than they do. In fact, the would-be national tile superstore chain reported a 27.7% EBITDA margin in 2012, more than double those of Home Depot and Lowe's.

One might suppose that the cost of being a public company would whittle Tile Shop's EBITDA margin, say by two or three percentage points; the law of diminishing returns may prove another source of margin compression. The store count grew to 53 from 42 in the three years through 2011. It jumped 28%, to 68, in 2012, and it's expected to rise by an additional 29%, to 88, in 2013.

In years past, says the front office, a new store would generate sales of $1.9 million in Year 1, whereas recent openings produced revenues of $1.8 million in the first 12 months of operation. Not that that fact is cause for concern, CFO Timothy C. Clayton assured dialers-in on the third-quarter earnings call. "[T]he performance of our stores in subsequent years is growing at a faster rate than previously discussed," said Clayton. "We now find that, on average, our new stores grow at a 22% to 23% rate the second year, 12% to 14% the third year, at 7% to 9% in the fourth year." How Clayton can be so sure of years three and four, we don't know; Tile Shop's recent growth spurt only started two years ago.

That it's no easy thing to manage an expansion like the one Tile Shop envisions is obvious on its face. But for any who doubt it, consider management's about-face on advertising outlays. A note in the 2012 10-K report boasts: "Unlike many of our competitors, we do not rely on significant traditional advertising expenditures to drive our net sales. We establish and maintain our credibility primarily through the strength of our products. . . ."

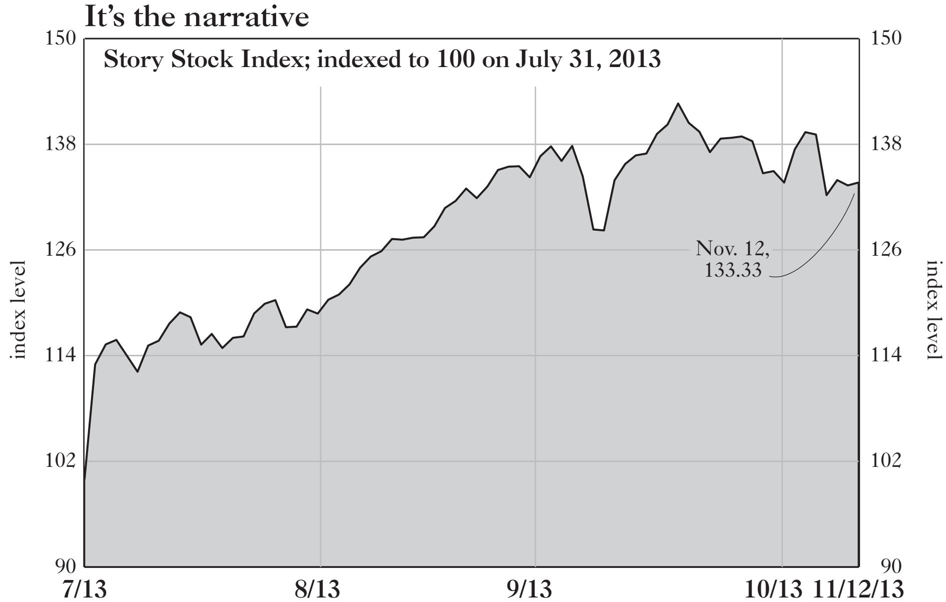
Compare and contrast Rucker's remarks on the Oct. 30 call: "Right now, we're testing television advertising in a few select markets to replicate a national advertising budget." All in all, we are going to venture that not since the great mosaics of the churches of Constantinople has anything having to do with tile been so richly valued as Tile Shop is in the zero-percent Bernanke stock market.

Health is the narrative of our second Story Stock Index component company. Boulder Brands (BDBD on the Nasdaq) is the top maker of gluten-free foods in North America and a leading maker of buttery-like spreads without trans fat. Udi's and Glutino and Earth Balance and Smart Balance are among its brands. Its customers may be vegan, or gluten-intolerant, or trans-fat averse, or just fashionable. Whoever they are, management is betting there'll be more of them, and the stock market seems to agree. The shares are valued at 50 times forecast 2013 earnings.

"The bull case for Boulder is that the gluten-free diet is going mainstream," Lorenz relates. "A certain number of Americans suffer from celiac disease, a disorder in which eating gluten—found in wheat, barley and rye—triggers an immune reaction. The National Foundation for Celiac Awareness puts the figure at three million, and it reckons that another 18 million may be gluten-sensitive. Boulder Brands estimates the combined ranks of celiacs and the gluten-sensitive at 43 million. It does Boulder no harm that the No. 2-ranked male tennis player, Novak Djokovic, ascribes his professional surge to a gluten-free diet.

"I have a number of relatives who are gluten-sensitive," Lorenz continues. "While gluten-free is rapidly expanding from a low base, there are many reasons to doubt it will catch on with the mainstream like the Atkins diet in the 2000s, the low-fat diet in the 1990s, or even bran muffins in the 1980s. Reason No. 1, gluten-free bread lacks the

It's the narrative



source: The Bloomberg

Story Stock Index
(in $ millions)

name	ticker	mkt. cap.	short int. float	price to est. 2013 earn.	EV/est. 2013 sales	EV/est. 2013 EBITDA
Demandware	DWRE	$1,888	5.2%	—x	17.6x	—x
ChannelAdvisor	ECOM	841	6.7	—	13.9	—
Tile Shop Holdings	TTS	1,072	15.0	47.7	4.9	19.8
Opko Health	OPK	4,081	16.2	—	42.4	—
Boulder Brands	BDBD	917	13.4	49.8	2.5	15.4
Sprouts Farmers Market	SFM	7,058	3.4	101.8	3.1	39.2
Infoblox*	BLOX	2,274	3.9	80.5	8.0	50.9
8x8 Inc.*	EGHT	720	5.7	49.2	5.2	37.3
Constant Contact	CTCT	858	8.7	38.6	2.6	16.4
Mobile Mini Inc	MINI	1,785	4.1	33.6	5.8	15.2
Cornerstone OnDemand	CSOD	2,449	5.7	—	13.1	2125.3
Shutterstock	SSTK	2,569	11.9	87.8	10.5	49.1
Textura*	TXTR	709	18.7	—	18.4	—
Yelp	YELP	4,578	12.1	350.2	19.5	155.1
Zillow	Z	3,056	22.1	5188.0	14.8	121.4

*non-financial years
source: The Bloomberg

taste and texture of bread made from wheat—if you have to eat it, be sure to toast it and slather it with cheese. No. 2, gluten-free recipes are typically higher in calories than ordinary ones. No. 3, gluten-free is more expensive."

As for Boulder, you wonder about the quality of its revenue growth. In the third quarter, it achieved a 17% bump in sales with a 40.4% leap in accounts receivable. It was the ninth consecutive quarter in which growth in receivables outpaced growth in revenues.

One wonders, too, about the Smart Balance division. In the third quarter, it chipped in 35% of sales and 46% of earnings, and it did so on the back of declining revenues—down by 4.4% after adjusting for discontinued product lines. Nor will competition likely be less intense after the scheduled April 7, 2015, expiration of the patents that protect the Smart Balance approach to heart-healthy spread manufacture.

Boulder Brands grew out of Smart Balance, but that core business alone could never have landed the company in the kicky *Grant's* Story Stock Index. Failed attempts to "leverage" the Smart Balance brand, in fact, led to a $130 million write-down in 2010. Source of the current corporate sparkle is rather the gluten-free business. It contributes the lion's share of the 65% of revenue and 54% of profit that Smart Balance brands did not provide in the three months to Sept. 30.

How does the gluten-free business look from outside the corporate walls of Boulder Brands? To the CEO of Annie's Inc., John M. Foraker, who spoke at the Barclays Back to School Consumer Conference on Sept. 4, it seems to look a little faddish.

"Those [gluten-free] items are doing exceptionally well," said Foraker. "They've been growing much faster than the total business for quite some time, but we are also cognizant that some consumers are in gluten-free maybe for diet reasons and other things, which may be not as sustainable. So we want to make sure that we have products that taste great. So that's limited what we've done there in terms of SKU proliferation."

Net of cash, Boulder Brands shows debt of $242.1 million, or 3.9 times trailing 12-month EBITDA. Over the past 12 months, operating income covered interest expense by 2.4:1. Debt is a fad, too.

A "storied story stock"—that's Lorenz talking—is our specimen No. 3, Opko Health (OPK on the Big Board). Founded in 1991 as Cytoclonal Pharmaceuticals and known at other times as eXegenics, Opko has apparently never generated net income. It has tried but failed to produce cures for cancer, infectious diseases and macular degeneration. Still at it, the company is today trying to diagnose prostate cancer, to produce a long-lasting human growth hormone and to cure nausea related to chemotherapy. It owns a portfolio of miscellaneous businesses distributing and/or manufacturing veterinary and pharmaceutical products in Mexico, Spain and Israel.

Bulls are rooting hard for the success of an Opko test for prostate cancer; a clinical trial of the device, called 4Kscore, is slated for the first quarter of next year. A lingering cloud over the test is a critical editorial that appeared in the May 2010 edition of "Clinical Oncology." "In this report," said the editors of an article detailing the performance of the Opko product, "24% of all cancers and 14% of high-grade cancers would be missed . . . it seems that a change in screening practices that misses any high-grade cancer cannot be considered an improvement over standard screening." In other words, it would seem, here is a cancer test that misses cancer.

What remedial action, if any, Opko has subsequently taken to address the concerns of its critics, we don't know. Some, the bulls must expect. An estimate by Jefferies & Co. ascribes $4 out of the $10 share price to the value of the 4Kscore test. On a hopeful note, the company launched the product in the U.K.; it did so in October 2012. On a somewhat less hopeful note, no trace of any 4Kscore-derived revenue is to be found in the company's subsequent financial filings.

To be clear, we do not insist that Opko will not succeed in one or more of its myriad undertakings; a new growth hormone is said to look promising. All we are saying is that this particular lottery ticket, valued at 42 times estimated 2013 revenues, says as much about the stock market as it does about the present value of any reasonably likely future cash flows that Opko might one day actually generate.

Reviewing the flyaway stock market of 1968-69—that "great garbage market"—the author John Brooks, in his history, "The Go-Go Years," had this to say about stocks like the ones in the new *Grant's* index:

"[W]hat a promoter needed to launch a new stock, apart from a persuasive tongue and a resourceful accountant, was to have a 'story'—an easily grasped concept, preferably related to some current national fad or preoccupation, that *sounded* as if it would lead to profits."

Tiles may not yet be a national preoccupation, and the top of this particular stock market may not yet be in sight. So be it. At *Grant's,* the watchword is vigilance.

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Paycheck to paycheck

(January 24, 2014) A slight emendation: Amazon isn't the most highly valued company by any and every reckoning of value. By the standard of enterprise value to sales, Conn's Inc. (CONN on Nasdaq) ties the Everything Store, 2.60 times to 2.60 times. Now unfolding is a bearish analysis of a stock that only seems to want to go up.

This may not be news you think you can use. We understand that precious few investors, even *Grant's* readers, will sell anything short. Federal Reserve policy actively discourages the practice. The normal human desire for a good night's sleep likewise militates against selling an asset you don't actually own but must go out and borrow. We are offering up more short ideas because we can't find enough suitable long ideas (reciprocally, in 2009 through 2012, we featured many more longs than shorts). We make no representation that the stock market has peaked. We only judge that, based on our idea of what constitutes value, the evident rewards of being long increasingly pale before the evident risks. Journalistically and analytically, we are tilting to the bear side of the boat.

Back to Conn's. Based in The Woodlands, Texas, the company operates more than 70 clean, well-lit and well-stocked stores in Texas, Louisiana, Arizona, Oklahoma and New Mexico. Conn's sells Samsung washers and dryers, Serta mattresses, Sony televisions and HP laptops, among myriad other products and brands. Many others do, too, of course. But not every retailer "provides financing solutions to a large, underserved population of credit-constrained consumers who typically are unbanked and have credit scores between 550 and 650," to quote from our subject's SEC filings. Conn's is a subprime retailer, and credit—so we say—is its Achilles heel.

"Conn's," observes colleague David Peligal, "essentially allows these customers to make an aspirational purchase. The lucky aspirants just have to be prepared to pay an 18% interest rate for the privilege. Depending on whether you've been long or short," Peligal adds, "Conn's has either been one of your best investments or one of your worst investments."

Conn's is an outlier in many respects. Its growth is supersonic, its sponsorship is first class (Stephens Inc., the closely held Little Rock investment bank, is among the major investors), its margins are otherworldly—and Amazon has so far failed to lay a glove on it. Best Buy, Sears Holdings Corp., Aaron's, hhgregg and Select Comfort Corp. are among the predominantly brick-and-mortar retailers that laid holiday eggs. Conn's, whose fiscal year closes on Jan. 31, has disclosed no results beyond November's, which—as usual—have the look of typographical errors: Overall retail sales jumped by 49% and same-store sales by 32%.

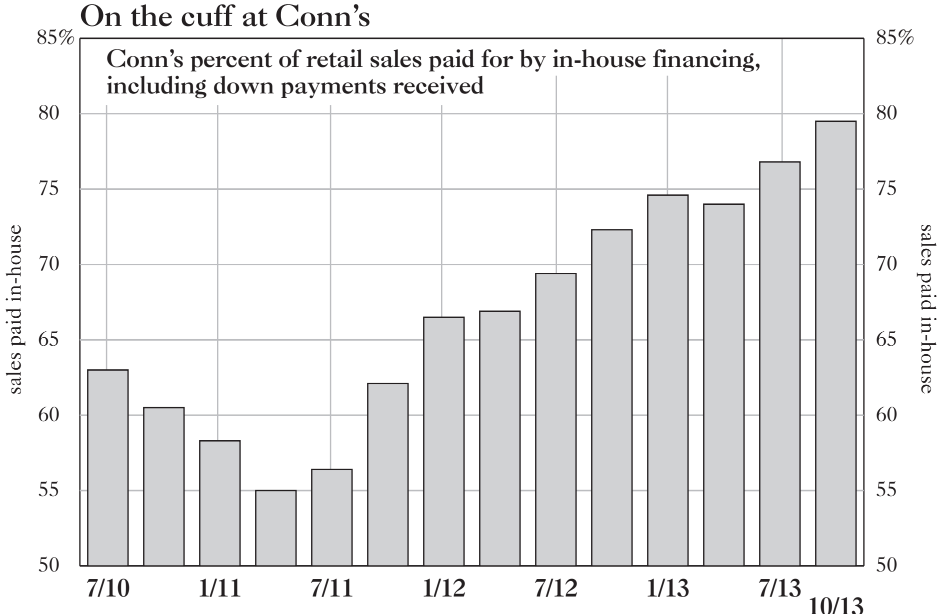
"The bull case for Conn's is pretty simple," Peligal observes. "One, it's pretty hard to find retailers comping at 30%. With management guiding same-store sales up 22% to 25% in fiscal 2014 and up 7% to 12% in fiscal 2015, the figures are clearly outpacing the competition. For perspective, Best Buy's shares plunged by almost 30% on Jan. 16, when the electronics retailer disclosed a 0.9% drop in domestic same-store sales comparisons in the nine weeks to Jan. 4. For a second thing, Conn's sees long-term potential for more than 300 stores in the United States; it says its target market comprises 30% of the American population. Many bulls are no doubt saying, 'Gee, there's growth and a big runway for these guys!' More thoughtful optimists may simply reflect, 'Look, we know this is going to end badly, but they're comping 30%. Too many people are short it. Numbers are going up. We're just going to ride this thing and squeeze the shorts.'"

Not the least of Conn's' quirks is that, of the 25.1 million-share float, no fewer than 4.5 million shares are sold short. The stock pays no dividend, and it's easy to borrow. The bear story is to us—though not yet to Mr. Market—more than persuasive.

"Very simplistically," Peligal relates, "two things happen at a Conn's store: Merchandise walks out of the building and dollar bills walk in. The rate of change in merchandise walking out is what counts in the comp stores' data. It's the metric that was up by the amazing, aforementioned 32% in November—and by 23.7% in the first nine months.

"Short-sellers focus more on the rate of growth of dollar bills walking in," Peligal goes on. "The essential bear story is that the rate at which these dollars are walking into Conn's locations this year is largely unchanged, surging comps and new-store openings notwithstanding. So something is wrong with this picture. Essentially, Conn's is giving people merchandise and telling them they don't have to pay for it just yet, or they can pay for it slowly, or the company can restructure their loans, etc. With same-store comps rising by double-digits and with 10% to 15% more locations this year than last, cash revenues are essen-

On the cuff at Conn's



source: company filings

tially flat. What's financed the scorching growth is customer receivables."

Catering as it does to people who (many of them) live from paycheck to paycheck, Conn's has stepped up the rate of its in-house lending. In fiscal 2012, it financed 60.4% of retail sales, in fiscal 2013, 70.9% of retail sales. In the third quarter ended Oct. 31, it financed 79.5% of retail sales, including down payments, evidently a quarterly record. Like many another retailer, Conn's has engaged an outside financing partner—in this case, GE Capital—to manage part of the lending operation. But unlike much of the retailing world, Conn's has elected to do the bulk of its financing business itself (GE deals with only the better credits). At a Dec. 11 conference hosted by J.P. Morgan, the chairman and CEO of Conn's, Theodore Wright, addressed his company's financial strategy. "Sometimes people look at our credit operation and they think of us as a credit company," said Wright. "We are not. We are a retailer that has a credit product it uses. We do one thing and one thing only in credit. It's a secured installment amortizing credit product to finance products we sell. That's it. We've done it for 45 years."

The bear story turns on this point. Is it business as usual at Conn's? Or will unscripted credit losses do the damage that (to date) Amazon has failed to inflict? We opt for the latter train of thought, management for the former. The front office has advised analysts to expect a drop in credit problems in the fiscal year ended Jan. 31, 2015. As a percentage of the average portfolio balance, Conn's projects, bad debts will decline to 8% or 9% from the 9.4% or 9.7% expected in the current fiscal year.

"Now here is an odd thing," Peligal observes, "loans past due by 60 days or more, expressed as a percentage of the average portfolio balance, jumped to 8.5% in the latest quarter from 7% in the like year-ago period. The delinquency data commend themselves to the analyst because they are unmassaged, less so the bad-debt data. Suppose that a Conn's customer owes an unpaid credit balance. It is 209 days overdue. By the book, 209 days is the bright shining line, cross it and a good debt becomes bad. Imagine this scenario: A Conn's credit representative calls the reluctant debtor, saying, 'Look, you owe us $1,000. Just pay us $100 and I'll restructure your account and make you current.' After having received a string of phone calls from Conn's, the debtor may relent and pay the $100. If he pays, Conn's may reclassify his balance from 'late-stage delinquent' to 're-aged receivable.'"

On Oct. 31, the Conn's balance sheet showed $422.2 million of long-term debt and $3.7 million of cash and equivalents. On Nov. 25, management completed negotiations with a syndicate of banks to expand and extend the company's asset-based, floating-rate loan facility. The amended terms feature a lengthening of the maturity date to November 2017 from September 2016, and a bumping up of the borrowing limit to $850 million from $585 million. Here's a sign of the times in credit: The banks agreed to cut the borrowing cost by 25 basis points per annum. They must be bullish on Conn's, too—or, if not that, confident in Janet Yellen. We surmise that it isn't getting any easier for Conn's to collect what its customers owe. Thus, in the October quarter, operating margin in the credit department fell to 19.6% from 29.9% a year before.

Elsewhere at Conn's—specifically in the beating heart of the retail business—gross margins are up, up and away. In the October period, home-appliance margins registered a year-over-year jump to 32.9% from 28.2%; those in furniture and mattresses, to 50.3% from 45.3%; and those in consumer electronics, to 29.4% from 24.5%. All of this came amid a broad-based rise in average selling prices. Or, in the words of the latest 10-Q report: "continued margin improvement across all major product categories due primarily to the continued focus on higher price-point, higher-margin products and realization of sourcing opportunities."

Too good to be true? One wonders, especially in consumer electronics, where, for retailers not named Conn's, gross margins cluster in the low 20s. Best Buy—no market darling lately—stands out for touching 24%. Then, too, gains in gross margins typically come in dribs and drabs, not by leaps and bounds. "I mean, Best Buy, if they do everything right and everything goes their way, they'll have gross margins up 50 basis points," one bearish portfolio manager—he declines to be identified by name—tells Peligal. "I've never seen a consumer electronics retailer with anywhere near that level of improvement. It's an absurd level of improvement. . . . There's literally nothing you can do as a retailer of these high-ticket, competitive-priced products to do that. So it's a mystery to us."

We're not the only curious ones. On the Dec. 5 earnings call, Michael Poppe, the Conn's chief operating officer, fielded a question about the 490 basis-point spurt in consumer electronics margins. Better sales of pricier items, like 65- and 75-inch television sets, and fewer sales of low-margin products, are the reasons, he replied. Our anonymous source has his own pet theory. He conjectures that Conn's is somehow lumping the present value of future interest payments into the sales price it recognizes at the time the merchandise walks out the door." Asked to comment, Brian Taylor, the CFO, e-mailed a denial: "We recognize interest income as earned over the term of the retail installment contract—not at the time of sale," he said.

What do the consumers say? Not what the company says in general, according to Peligal's survey of a number of consumer-review sites. To investors last month, Conn's represented that, based on company survey data, "sales customer satisfaction" stood at 94% in each of the first three quarters of this fiscal year. And at the previously mentioned J.P. Morgan conference, Wright remarked, "And because of the value we provide to the consumer, we have a high rate of repeat purchase—71% of our credit balances today are to customers who have bought from us more than once. On average over a five-year period, a customer that buys with us will buy twice more again, so we have strong customer retention because of the value that we provide."

Maybe the consumers who unburden themselves online are constitutionally cranky, but let's hear them out. "On the Consumer Affairs Web Site, out of 196 ratings describing overall satisfaction, Conn's received a 1-star rating 166 times," Peligal reports. "It received twenty 2-star ratings, five 3-star ratings, two 4-star ratings, and three 5-star ratings. On Jan. 20, a verified reviewer named "Christopher of Austin, TX" describes his experience purchasing multiple items from the north Austin Conn's store and why he gives the store a 1-star overall satisfaction rating. 'I feel like by purchasing furniture through Conn's, I've given up my ability to purchase things on credit in the future. I have a credit-monitoring program through my bank that alerts me at least once a week that Conn's has reported me for delinquency, despite repeated reassurance that my account, provided I honored my end of the arrangement, which I did, would be both current and removed from collections. I'm tired of 8:00 a.m. phone calls asking me for money I've already paid.'

"Moving to the Yelp Web site," Peligal proceeds, "an individual named 'P.B. of McDade, TX' also gave a Round Rock [TX]-located Conn's store a 1-star (out of five) review on Nov. 29, 2013. Wrote P.B: 'There is a moral to this rant. Every single person I dealt with at Conn's—EVERYONE—lacked ANY kind of training on how to deal with ANY kind of customer-service issues. There was not one isolated instance, it was everyone. So bad that I swear I was on Candid Camera. I'm retired from 35 years in the grocery business, the last 20 or so running a store for 2 different large grocery retailers. You will die without good customer service. Conn's does not even have a clue. Bold prediction. Conn's will fail. This was my first and last shopping experience with Conn's.'"

One review, posted on the Glassdoor Web site, especially stands out. Signed "Cut throat," the critic identifies himself as a Conn's store manager in Fort Worth, Texas. His advice to Conn's senior management? "Save what u get, exit to another industry." Or maybe just sell your stock.

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Vacation delectation

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Fiat-fest 2014

(July 25, 2014) The annual summertime monetary hoedown at Jackson Hole, Wyo., won't be the same this year, Bloomberg reports. The Kansas City Fed, host of the August fiat-fest, is cutting Wall Street dead. Economists from the TBTF banks, longtime schmoozers in Jackson Hole, are this year being invited to stay home.

Maybe that's a good thing—the crony financiers were especially thick on the ground at the 2006 proceedings, where they collectively seemed no more alert to the looming mortgage-cum-credit-crisis than the government employees did. Then, again, the Fed has a job of work on its hands. Its balance sheet is too big and its interest rates are too low. It may need some help in strategizing.

With money-supply growth ticking higher and the rate of producer-price inflation accelerating, "How to exit?" is one question. "Which rates are relevant in this zero-percent world?" is another.

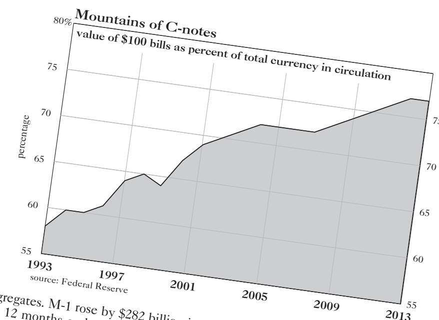
Before QE, the funds rate was the central bank's one and only. "However," colleague Evan Lorenz observes, "with excess reserves measured in the trillions today vs. in the billions pre-crisis, the fed funds market has ceased to function." On to the next rate, then: The new reverse-repurchase rate, perhaps? Maybe or maybe not, the thinking goes, given the not-so-farfetched risk that the mere existence of the RRP facility might invite a bank run (*Grant's*, May 2), or maybe the interest rate on excess reserves, now fixed at 25 basis points? Or a new funds rate that encompasses more than the funds market?

Accompanying the technical debate is the continued growth of the monetary aggregates. M-1 rose by $282 billion in the 12 months ended July 7, paced by an $87 billion increase in currency and a $196 billion jump in deposits. If $100 bills represent 77% of the currency growth (as the Fed reports that they did in 2013), and if $20 bills account for the rest, the green emission would weigh 3.8 million pounds. More significant from a pure monetary perspective is the growth in deposits, which corroborates the surge in business lending—after all, loans create deposits.

Nearly four million pounds of paper money do create a sense of inflationary anticipation. Where's the thing itself? The Cleveland Fed, which calculates the CPI every which way (median, trimmed and otherwise), essentially comes up with 2%. Two percent is supposedly what the Fed is shooting for. Still, the Fed keeps on shooting. And as it fires, asset prices dance. Measured year-over-year, the S&P 500 is up by 17%, the Russell 2000 by 9.8%, the S&P/Case-Shiller Composite-20 Home Price Index by 10.8%.

Mountains of C-notes

value of $100 bills as percent of total currency in circulation



source: Federal Reserve

"Well I, for one, am going to miss QE."

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