GRANT'S
INTEREST RATE OBSERVER®

Vol. 33, No. 16c Two Wall Street, New York, New York 10005 • www.grantspub.com AUGUST 7, 2015

Global verbiage glut

From time to time, Ben S. Bernanke, central banker turned blogger and capital-introduction professional, vouchsafes his latest thoughts on a concept of his own devising, the "global savings glut." By the former chairman's telling, an excess of savings in emerging markets is the cause of ultra-low interest rates the world over (it isn't the Fed's doing). Could that be true? Yes—or perhaps no. As with the nonstop talk about secular stagnation or a commodity super cycle or the drawdown in international monetary reserves, you start to wonder what the words signify. "Not much," is the thesis of the essay now in progress.

Buying low and selling high is rather the point. So saying, we don't mean to deny that the emerging world is in a jam or that the difficulties are not traceable to macroeconomic causes. Our focus is rather on the investment opportunities that angry headlines usually surface. Five discrete investments—two pairs of unloved "emerging" stocks and a Brazilian corporate bond—are featured below.

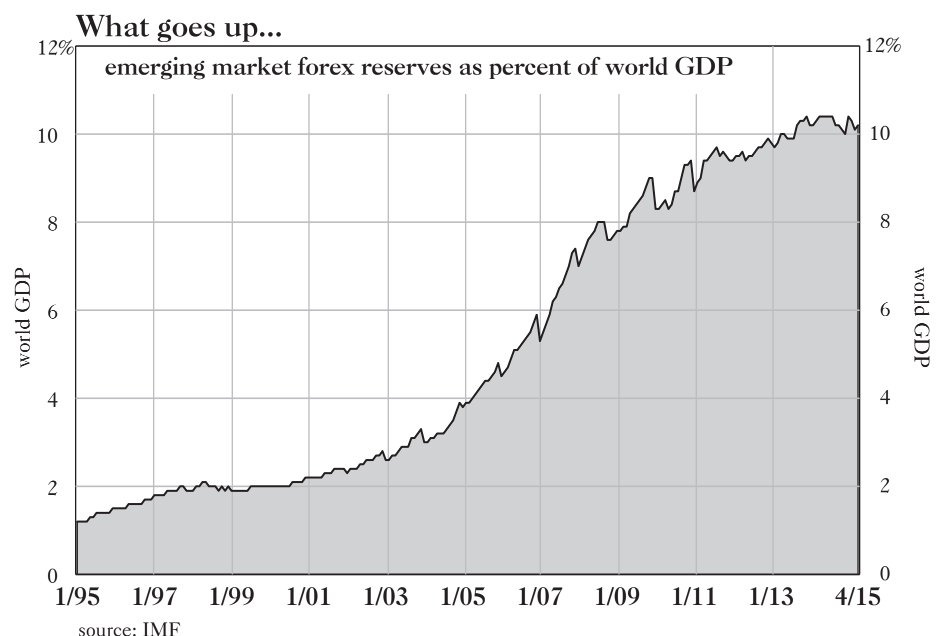
Each is cheap, each has merit—each had merit even before its price was sawed in half in sympathy with the goings-on in Turkey, Greece, Brazil, Russia, South Africa, Argentina, Colombia, China, etc. (India, one of the former so-called BRICs, is a bullish breed apart). The sawing suffices to show how macroeconomic problems can overwhelm business fundamentals. It turned out that in 2007-08, the only relevant American "fundamental" was the broad mispricing of credit. In 2014, the defining Russian fundamental was the looming bear market in oil (would that we had seen it coming; see, for instance, *Grant's*, Aug. 8, 2014). Perhaps, in 2015, it's the long-delayed consequences of the suppression of money-market interest rates that will set markets on their ear.

Still, cheap business value is a rare commodity. It warrants a certain tolerance for macroeconomic dislocation. If it weren't for the dislocation, the value wouldn't be there for the plucking in such profusion. In Monday's *Financial Times*, the CEO of a Brazilian truck manufacturer was quoted as saying, "In my professional life, I've already passed through 17 [economic] crises." He must have been grateful for so many buying opportunities—and for so many reciprocal selling opportunities—even if he didn't think to mention it.

What pulled the rug out from under the emerging markets is still a topic of learned macroeconomic debate. Commodity prices have broken as the dollar has rallied. EM stocks and currencies have plunged. The burden of servicing dollar-denominated debt outside the 50 states is becoming more onerous. These are the symptoms of the problem. What is the cause?

Recalling that booms not only precede busts but also cause them, one turns to the People's Republic. On the upswing, China suppressed the renminbi-dollar exchange by buying dollars. It printed the renminbi with which to do the buying. In consequence, in China, money-supply growth accelerated, interest rates declined, official dollar holdings soared and factory chimneys smoked.

Now, the processes are reversing. Official dollar holdings are dwindling, economic growth is decelerating, capital is fleeing. Well, capital appears to be fleeing the People's Republic. To explain



the ambiguity on this point requires a short, instructive detour.

The IMF reports that foreign currency reserves held by emerging economies plunged by $533 billion to $7.5 trillion in the 10 months till April. Nothing like it has ever been seen before. It was far and away the steepest decline since the start of record keeping in 1995.

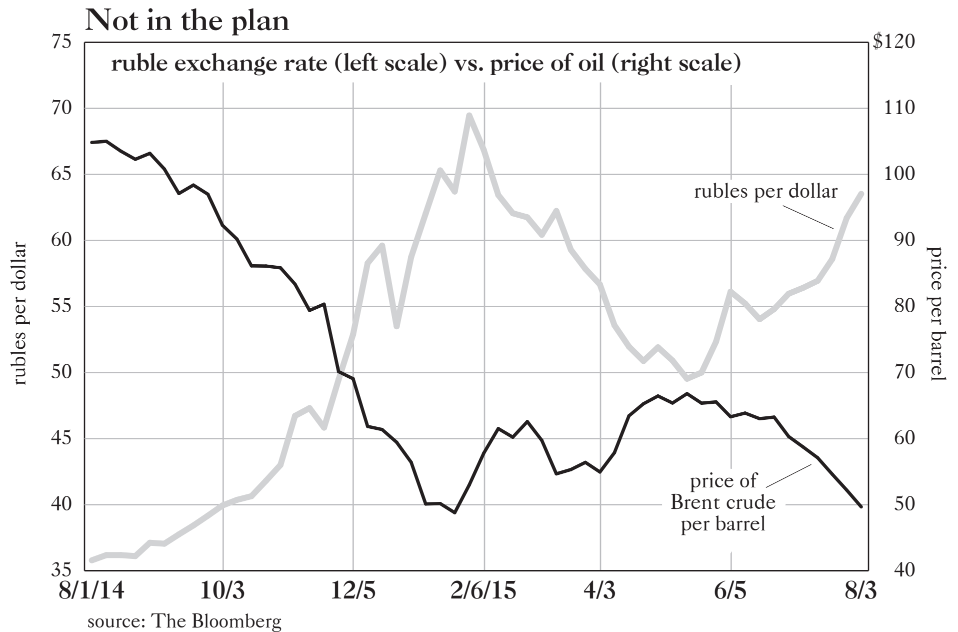
One is worried, of course. The data must signify something, they're so big. And they do signify something. What they signify is how little anyone really knows about the cross-border flows of hot money. That $533 billion is a raw, unprocessed datum. It requires adjustment for the changing value of the dollar, against which other currencies are valued, and it requires adjustment for variations in the composition of international reserves. It happens that the IMF has hard information on the makeup of only one-third of international currency reserves. The other two-thirds it must guess about.

The uncertainties reduce the careful analyst to expressing the size of reserve flows not as a single point but as a range of possibilities. In this case, the range may be expressed as between $533 billion on the high side and $44 billion on the low side. As you could drive a truck through the difference, you hesitate before saying much more than the not altogether informative, "emerging market currency reserves have declined."

Irresolution similarly set the tone of a report in Monday's *Financial Times* on supposed capital flight from China: "Analysts broadly agree that China has experienced capital outflows on an unprecedented scale. But they disagreed about their size, causes and risk to the economy." Note well: *other* than "size, causes and risk."

No sense, then, on too great insistence on quantitative macroeconomic diagnosis. Some policy errors have created a deflationary undertow, others an inflationary over lift. The dollar surges, EM currencies buckle. Country-specific, heterogeneous problems have yielded uniform, homogeneous outcomes of one particular kind: Bear markets dot the EM landscape. Records are beginning to fall. Thus, for instance, the Malaysian ringgit and Indonesian rupee have fallen by 16.9% and 12.7% against the dollar in the past year to levels not seen since the end of the Asian financial crisis in 1998.

Turbulence mixes badly with leverage. It is not farfetched to expect some thunderclap of a bankruptcy in the EM world. With regard to China, a Hong Kong-based



friend of this publication, asking not to be named, advises colleague Evan Lorenz that China's fast-growing, $30.5 trillion asset banking system is at risk. "Deposit growth is very weak right now," our source relates. "Maintaining that growth requires you to take more liability risk."

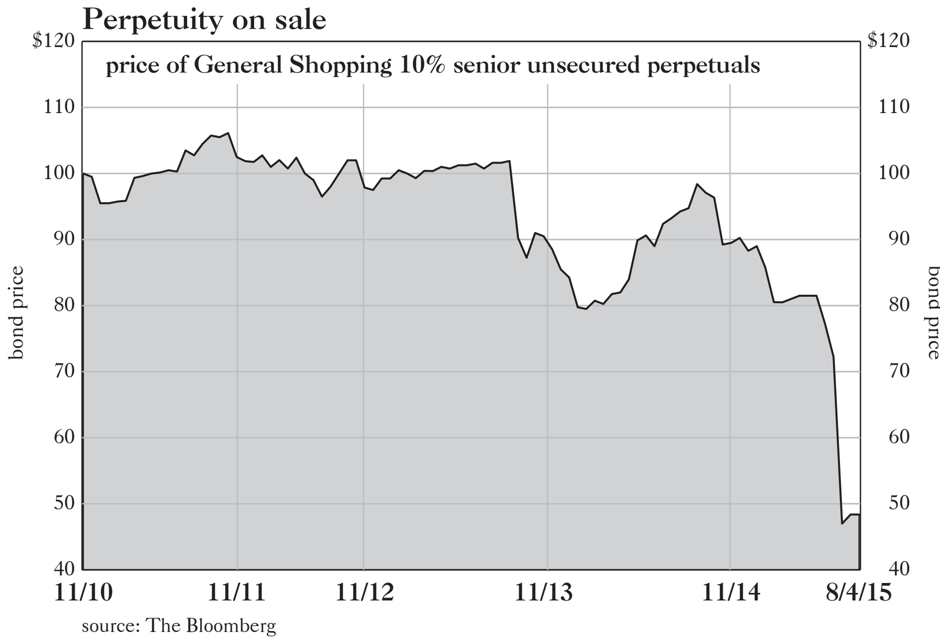
On form, muses Russell Napier, an independent strategist and co-founder of Electronic Research Exchange, downturns in emerging markets tend not to stop until there's a major default. Observe, says Napier, how very much like Mahathir Mohamad, prime minister of Malaysia during the Asian financial crisis, the president of Turkey, Recep Tayyip Erdogan, is beginning to sound with his railing against the "interest rate lobby" and his accusations of "treason against this nation."

"If Turkey imposed exchange controls, that is a de facto default," Napier says. "Turkey is one of the biggest components of the emerging markets debt index. I think it would be tantamount to the BNP Paribas closing those three mortgage-backed securities funds in 2007. People would realize the lack of liquidity and the higher credit risk and things would come to a halt very quickly. We've lent money to emerging markets before, but we've never lent it to them in this form of bonds, which are theoretically liquid through open-ended funds. It is the holding of them through open-ended funds which is dangerous if someone does impose capital controls or if someone defaults."

So there's no guarantee that what's cheap may not become cheaper. If the point needed proving, the gold-mining stocks would nail it down. They have wasted away to the point that we at *Grant's*, their close and loyal friends, hardly recognize them by sight on our brokerage house statement (note for the file: Buy more at the bottom). Then, too, American equity values remain Uberized. A sell-off in New York would likely not be seen as a bull market catalyst in Bogota, Sao Paulo or Moscow.

Herewith our picks to click (or, in the case of the Russians, to re-click) *at some indeterminate date*: Avianca Holdings SA, the Colombian airline (AVH is the ticker for the New York-listed American Depository Receipt); Grupo Nutresa SA, a top Colombia-based food distributor, processor and marketer (the peso-denominated common shares are listed in Bogota); the senior debt of General Shopping Brasil S.A., a financially leveraged owner and operator of Brazilian shopping malls; and a pair of Russian equities that may be familiar—perhaps all too familiar—to constant readers. They are Sberbank (SBER on the Moscow and London exchange; SBRCY is the American Depository Receipt); and Moscow Exchange (MOEX, listed on itself).

One year ago, these pages prophesied that "as tensions subside, so will Russian equities come in for what the comrades used to call 'rehabilitation.'" Tensions have not subsided, the oil price has not rallied and the ruble has not recovered. In the past 12 months, Sberbank, Russia's largest bank, has declined by 41% in dollar terms (it is up 2% in rubles); Moscow Exchange has fallen by 31% in dollar



terms (it has rallied by 21% in rubles). Each company remains profitable. Each remains value-laden, and each remains a kind of call option on normalcy. We remain bullish (to declare an interest, your editor owns Sberbank).

In picking Russia, this publication failed to pick a winner. Real Russian GDP is on track to sink by 3.4% this year as the rate of inflation tops 15%, according to a forecast by the IMF. Sberbank is a mirror to those circumstances: It has reported sharply lower net income (down 58% in the first quarter; second-quarter results are due on Aug. 27), higher loan-loss provisioning, rising non-performers (now 3.9% of total loans, up from 3.2% a year ago) and contracting net interest margins in consequence of a central bank rate that jumped to 17% in December from 8% four months earlier; 11% is the current rate. Still and all, the bank remains profitable. In the first quarter, it earned 12.5% on equity, down from the 20%-plus returns generated in 2013 and 2012 but more than respectable in the comparative light of, for instance, J.P. Morgan Chase & Co., which earned 10.2% on equity in the first quarter.

Sberbank common is priced at 75% of book value and 6.2 times trailing earnings; the (shrunken) dividend delivers a yield of 0.6%. Sberbank preferred, which confers no voting rights but holds an identical economic interest to that of the common, is priced at 53% of book value and 4.5 times earnings. It yields 0.9%.

"Throughout its post-Soviet history," observes Boris Zhilin, co-founder and principal of Armor Capital, "Sberbank has weathered at least two severe storms—in 1998 when Russia defaulted on its sovereign debt following the Asian crisis, and in 2009 as a result of the Great Recession. Despite that, its book value per share in U.S. dollar terms posted a compound annual growth rate of 17% from 1997 through the end of 2014 (the ruble lost about 90% of its value vs. the U.S. dollar throughout this period). In other words, painful upheavals notwithstanding, those who held shares of Sberbank did very well, provided a sufficiently long-term investment horizon." For the grandson, then.

Even faster than the ruble exchange rate has fallen, the earnings of Moscow Exchange have risen. They leapt by 124% in the first quarter (second-quarter results are due on Aug. 5, the day after we go to press). On the first-quarter call, MOEX's management laid out a five-year plan to boost growth through initiatives in commodities trading, over-the-counter derivatives clearing, risk management and collateral management.

Moscow Exchange is priced at 9.8 times trailing net income; the 3.87 ruble-per-share payout delivers a 5.5% dividend yield. J.P. Morgan analyst Alex Kantarovich is projecting a boost in the payout to 6.10 rubles per share in fiscal 2016.

Dilma Rousseff's Brazil is perhaps a more inviting place than Vladimir Putin's Russia, but that speaks chiefly to the weather. With respect to inflation, the immediate economic outlook and currency depreciation, the two countries are very nearly peas in a pod. Which brings us to the perpetual, 10%, dollar-denominated debt of General Shopping. Quoted at 48 cents on the dollar, the securities yield 20%; at par value, $250 million are outstanding.

We come by the General Shopping story through our value-seeking friends at Explorador Horizon Fund L.P., which manages $300 million and is based in Sao Paulo. General Shopping owns and operates 16 shopping malls in southeast Brazil, mostly in the state of Sao Paulo; the founding family, the Veronezis, own 60% of the stock. The rest trades on the Brazilian public market.

General Shopping is an example of a good business chained to a bad currency. Taking in *reals*, it must pay out a certain number of dollars. The local currency's plunge in depreciation stresses the balance sheet and introduces the apprehension that partly explains the bargain price of the bonds (sky high Brazilian interest rates explain the rest). "General Shopping's B1 senior unsecured debt and corporate family ratings reflect the good quality of its portfolio with solid margins and high occupancy rate as well as the management team's experience and successful track record in development," judges Moody's in a June bulletin. The other side of the ratings coin concerns that sinking currency and the interest-rate problems that go with it.

The bull story on the General Shopping 10s harps first on operations, second on asset coverage. At year-end 2014, CBRE appraised the value of the assets at $880 million. "If we take all liabilities," Daniel Delabio, Explorador portfolio manager, tells *Grant's*, "we're talking about total debt of $570 million. So still you have $200 million-plus of value in excess of liabilities. The market value of the debt is less than half the value of the total properties. It's good value even in a distressed scenario. That is point one. Point two is that we don't think it is going to restructure or needs to go that route. They are not against the wall to do anything, because cash liquidity is very high. Today, their cash position is 1.5 times earnings before interest, taxes, depreciation and amortization. And that should be enough to pay interest. Even if they don't get any new funding, or any new bank loans for the next two years, they should be able to pay principal and interest.

"We're talking about the senior debt," Delabio goes on. "But they also have subordinated bonds, where they can pay coupons in kind. So we're talking about a company that has enough EBITDA today

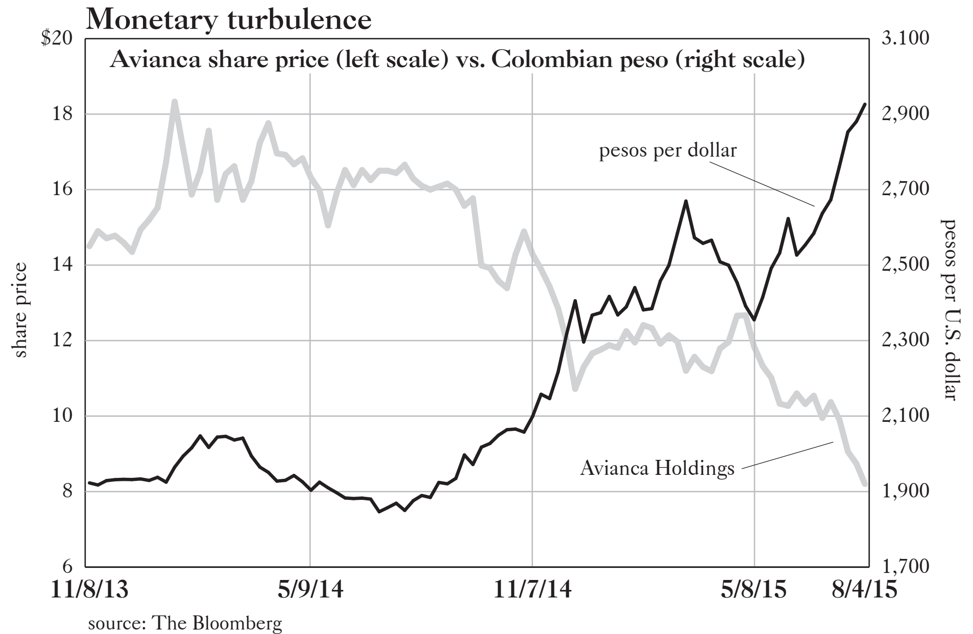
to pay its cash interest payments but also has the optionality to defer coupons on the subordinated debt, which would be in favor of the senior bonds. So a bond at 48 cents with those dynamics, there is asset coverage, there is liquidity, there is seniority to the subordinated bonds, and you should be able to collect your coupons. With time, this should re-rate, and the bond should move up in price."

Acronym is the lingua franca of the EM world. First came the BRICs. They were succeeded in 2013 by the Fragile Five. And now, through the offices of BNP Paribas, come the "PICTS," signifying Peru, Indonesia, Colombia, Turkey and South Africa. As BNP sees the situation, they are a kind of United Nations of financial risk.

The intrepid team at Explorador dissents from that top-down fatwa. As of June, 18.5% of their fund was apportioned to Peru, 13.8% to Colombia. As for the latter, much of what could go wrong already has. Before its price collapsed, oil generated more than half of Colombian export sales. In the past 12 months, the Colombian peso has depreciated by 36%, the third worst performance among the 150 currencies that Bloomberg tracks (Ukraine and Russia edged out Colombia in the monetary race to the bottom). The Colombian stock market has fallen by 59% in dollar terms from its November 2010 peak. Five years ago, the MSCI Latin American index traded at 15 times the average of 10 years trailing net income. It trades at 9.6 times that 10-year trailing average today.

Avianca Holdings S.A., the foremost Colombian airline, owns regional airlines in South and Central America. It has subsidiaries in Ecuador, El Salvador, Costa Rica, Peru, Nicaragua and Honduras. Its on-time performance stacks up well against U.S. carriers, indifferently against neighboring ones. Standard & Poor's rates its debt B-plus for higher-quality junk; in the 12 months to March 31, operating income covered interest expense by a slim 1.5 times. The shares are quoted at 4.5 times earnings.

Avianca is a sum-of-the-parts story, too. On July 13 came word that management had sold 30% of its LifeMiles B.V. subsidiary, a six million member consumer loyalty program, for $343.7 million to Advent International, a private-equity investor.



The purchase price valued the whole at more than $1 billion. "So," says Delabio, referencing Avianca's overall $1 billion equity market cap, "you're almost getting the stand-alone airline for free." Yes, he adds, the oil price implosion has damaged Colombian GDP. It has simultaneously raised up Avianca.

"One-third of Avianca's costs are tied to oil," Delabio goes on. "And lower [consumer] demand will be offset by lower oil-related expenses. So we see margins actually extending from 6% last year to 7.5% this year, and this is below company guidance. The company is guiding to 8% to 10% margins for the year, so we're being conservative."

Grupo Nutresa SA, our final EM submission, is a prosperous, conservatively financed, $4.1 billion market-cap food distributor and processor. "The Nestle of Colombia," a bull might call it. It is an exotic stock: to buy it, an American high net worth individual must execute a local share swap with his or her broker. Read on anyway. Nutresa crystallizes the problem of the good business yoked to a bad currency (and to a problematical macroeconomy).

Nutresa processes and distributes cold cuts, biscuits, chocolate, coffee, tea, juice, ice cream and pasta. It is Starbucks' Colombian coffee vendor. It operates ice cream parlors and hamburger casual restaurants. It employs 39,000. As Explorador does the arithmetic, Nutresa's food business changes hands at 17.6 times next year's likely earnings and at 1.5 times book. John Haskell, Explorador's head of research, reckons that Nutresa trades at a 37% discount to comparable worldwide food companies.

Says Haskell: "They have a 61% market share in Colombia. Their market share comes about because they have been advertising for decades in Colombia. Their brand equity provides an intangible asset that provides a barrier to entry. They also have an incredibly dense distribution network. They have 100,000 individual partners with over one million points of sale. They're not only in Colombia; they're also across Latin America. . . . If I were Nestle and looking to enter Colombia or expand my market share, I would think seriously about what it would take to replicate what Nutresa has built up over decades."

On Tuesday, Dennis Lockhart, president of the Federal Reserve Bank of Atlanta, rattled the world when he uttered the not altogether novel words that the Fed may raise the funds rate. When the monetary dust finally does settle, Nutresa and its ilk will still be standing—they might be even cheaper.

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