

# GRANTS'S

## INTEREST RATE OBSERVER®

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### Interest rates by the clock

Ultra-low interest rates work their black magic as the clock ticks. They pull consumption forward in time and push failure backward in time. They flatter the judgment of aggressive lenders and ease the burdens of encumbered borrowers. Now unfolding is a grand tour of credit with an emphasis on the temporal element.

In preview, the benefits of today's monetary experiments are mainly in the past; the costs of those benefits loom mainly in the future. A pair of real-life investment examples (a hard-charging regional bank, a capital-markets-dependent time-share vendor) will illustrate. Scene-setting precedes the security analysis.

As to the scenery: It's no front-page news that junk-bond defaults are rising or that corporate-bond downgrades are handily outpacing upgrades or that Mr. Market shows no mercy for a certain kind of demoted corporate credit. Not so obvious are the paradoxically bearish omens in bank credit.

Which is to say, they are so bullish, they are bearish. In the third quarter, for instance, nonperforming loans totaled 1.61% of total loans, according to the FDIC. It was the lowest reading since the fourth quarter of 2007, which happened to mark the start of the Great Recession. Even that cheerful fact understates how good is the going nowadays. Net charge-offs—i.e., losses on uncollectable loans net of recoveries on liquidating collateral—weighed in at just 0.40% of total loans in the third quarter, matching the level recorded in the third period of 2006, when house prices bubbled. (Quarterly charge-offs are expressed at annualized rates.)

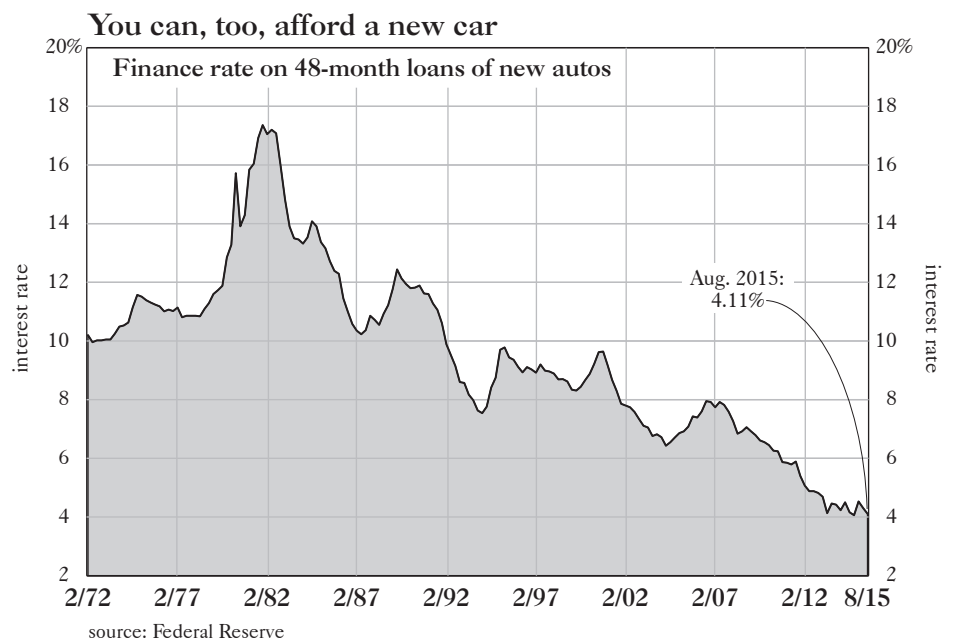
“Amazingly,” colleague Evan Lorenz relates, “in some loan portfolios, banks are admitting to what is essentially a perfect credit record—zero net charge-offs. Construction and development loans, of all things, showed net charge-offs of exactly zero as of Sept. 30—this on a lending base of \$266.1 billion. The Great Recession peak in net charge-offs on C&D loans—surefire candidates for trouble in a downturn—hit 8.02% in the fourth quarter of 2009.”

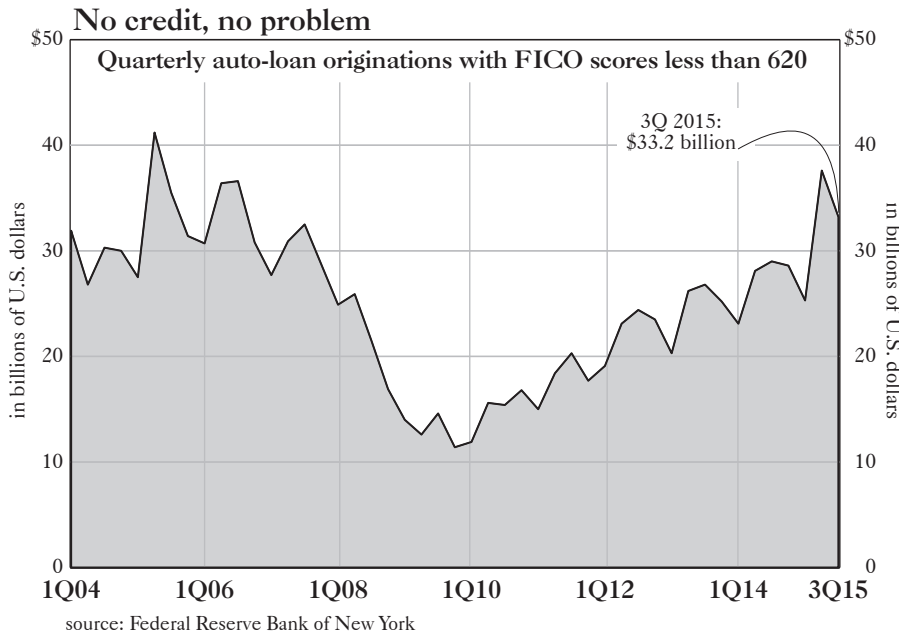
What do they say about something that's too good to be true? The Kroll Bond Rating Agency, in the persons of Christopher Whalen and Joe Scott, reply: “Credit does have a cost, so when a financial institution is publishing data that suggest otherwise, we believe that investors need to beware. . . . Simply

stated, the credit results measured by metrics such as charge-offs and recoveries are simply too good to be believed—or sustained.”

“When you look at recovery rates,” Whalen goes on, “people are buying collateral post-default and banks are not taking a loss. [The sale price] is enough to clear the debt and then some, and then someone else owns the building. This is a sign that you have a pretty frothy market in terms of asset prices.”

Ultra-low interest rates pull and push. They pull forward in time the consumption of cars and trucks, among other financeable goods. They push backward in time the consequences of the loans which a banker wishes that he or she had never said “yes” to—a misconceived syndicated loan, for instance.





Cars and trucks, first. In November, Americans bought 18.05 million units at an annualized selling rate, second highest (just behind October) since 2005. To whom or what might the city of Detroit give thanks? To the improving American labor market and to the slightly better than recessionary pace of American business activity, of course. There is something else. A new vehicle has never been easier to finance.

Thus, according to Experian Plc, the average term of a car loan is 67 months, a record, and lease transactions, as opposed to sales, constitute 31.1% of new vehicle dispositions, just shy of a record set earlier this year. According to the Federal Reserve, the cost of borrowing on old-fashioned, 48-month terms, stands at 4.11% (or it did in August), five basis points higher than the Nov. 2014 low.

Then, too, the salesman's mantra "no credit, no problem!" has made its cyclical reappearance. The New York Fed relates that auto loans with FICO scores of 620 and lower (the average score is 695) totaled \$33 billion in the third quarter, near a 10-year high. Last month, an asset-backed bond fashioned from subprime auto loans came to market. Consumers representing fully one-third of the collateral had a FICO score below 500 or else no FICO score at all. Rent-A-Center, which sells consumer durables on the rental installment plan, blamed a third-quarter earnings miss on "higher levels of subprime consumer debt and subprime auto debt, both of which are impacting

[the customer's] ability to stay current on their payments."

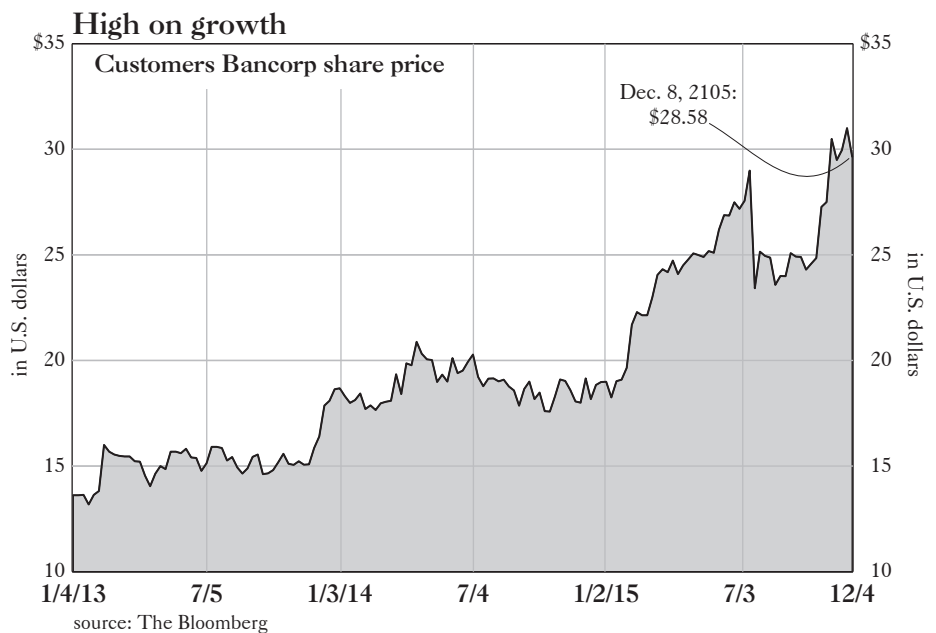
So Detroit may thank Janet Yellen for this year's car sales. It may reciprocally blame her for some credit-induced reversal next year. And Wall Street, though not best known for gratitude, may thank Yellen for this magnificent season of deal-making. It didn't come from nowhere. Thanks to low interest rates and EZ money, it, too (at least a part of it), was plucked from the future.

It was a sign of the times when the share price of NXP Semiconductors NV rallied, not declined, after the announcement by NXP in March that it intended

to acquire Freescale Semiconductor Ltd. As a rule, an acquirer's share price declines on such news. That NXP didn't fall but rallied was a marker of the debt-drenched times.

Now there are signs of a return to M&A normalcy. Consider a pair of transactions in the chemicals business, each featuring a European suitor and an American bride. Thus, since the announcement in July by Solvay SA, of its intention to buy Cytec Industries, Inc., of New Jersey, shares of the Belgian acquirer have plunged to €93 from €120. And since the announcement last month by Air Liquide SA, of its intention to buy Airgas, Inc., of Pennsylvania, shares of the French acquirer have fallen to €105.80 from €123. Buying high (at proposed multiples of price to EBITDA of 20.7 times and 13.6 times, respectively) is questionable even when money is yours for the asking. The buy-high strategy becomes problematical when bond yields are on the upswing.

Like their own humble depositors, banks must scratch for interest income. They find it, among other places, in syndicated loans, or, as the regulators call them, "shared national credits." Loans to encumbered businesses, i.e., "leveraged loans," constitute a sizable share of the syndicated category. It's a kind of credit that Federal Reserve examiners, in a Nov. 5 report, excoriated. Fully one-third of the past year's leveraged loans betrayed "ineffective or no covenants, liberal repayment terms and incremental debt provisions that allow for increased debt above starting levels and



the dilution of senior secured creditor provisions,” or so said the report.

Isn't it just like the Fed (or maybe just like the human animal) to castigate the conduct for which it is responsible? Someone or something pressed interest rates lower. The Fed played its part in the decline. Now the central bank condemns its charges, the banks, for climbing speculative stepladders to reach for the yields that are no longer available at eye level.

“You're at the point in the credit cycle where problem loans are so low that a few credits going down isn't a big deal, but, on the margin, it's a headwind,” Christopher McGratty, analyst at Keefe, Bruyette & Woods, tells Lorenz. “To me, it illustrates that the banking industry in general has been over-earning massively on credit.”

People will say, observes McGratty, that low interest rates are crushing net-interest margins, and so they do. What only the cognoscenti observe is that low credit losses fatten what might be called “credit-adjusted” net-interest margins. Pushing failure into the temporal background, ZIRP and QE provide cover for the careless banker. They make him seem prudent.

Comes now the first of our illustrative investment cases. Customers Bancorp, Inc. (CUBI on the Big Board), of the southeastern Pennsylvania town of Wyomissing, is a \$7.6 billion-asset bank that as recently as 2008 was a \$274 million bank. Under the baton of Jay Sidhu, CEO and chairman, Customers spends

little, grows fast and borrows much. The shares, of which 26.9 million are outstanding, are valued at 1.6 times book and 12.5 times 2016 forecast earnings.

Customers, a fat-free institution, shows a ratio of expense to revenue (i.e., an “efficiency ratio”) of 54%, as opposed to a 61.8% average for banks in its \$1 billion to \$10 billion weight class. Branches and sales offices number just 21. Staff expenses as a percentage of assets stand at only 0.81% vs. an average 1.32% for peers and 1.75% for the industry as a whole.

Since year-end 2009, Customers' assets have grown at the compound annual rate of 71%. Were that pace to continue for another 10 years and one fiscal quarter, the Wyomissing midget would surpass in size today's \$1.8 trillion Citigroup. (Probably, that won't happen; Customers is pointing toward a mere \$9 billion in assets by the end of 2016.)

“We target high-quality borrowers,” says Robert E. Wahlman, Customers' CFO, in reply to Lorenz's request for a managerial overview. “We pay a little more for deposits. We charge a little bit less for loans. That leaves us with a little bit tighter net-interest margin than most banks—our NIM ranges from 2.73% to 2.90% this year on a quarter-to-quarter basis. But we make it up because of the high quality. We don't have as much provision expense and also we focus on technology as much as we can to deliver a low-cost product.”

With a loan-to-deposit ratio of 112%, Customers is clearly in the borrowing business. It funds itself with deposits,

with brokered deposits (20% of total deposits) and with advances from the Federal Home Loan Banks System. Excluding a warehouse facility for mortgage lenders, Wahlman says he wishes to emphasize that Customers' loan-to-deposit ratio would come in at less than 100%. Be that as it may, Sidhu's bank is beholden to the capital markets.

You may remember Sidhu as the CEO who ran up the assets of Sovereign Bancorp, Philadelphia, to \$90 billion in 2006 from a half-billion in 1986, who engaged in a noisy corporate-governance dispute with Relational Investors (“They have a pre-Enron mentality on their board in a post-Enron environment,” charged Sidhu's antagonist of Sidhu) and who, from his headquarters in the Northeast, launched a memorably undisciplined (and memorably disastrous) auto-lending blitz in the Southwest.

Has the tiger changed his stripes? In 2013, Customers invested \$23 million in a New Delhi financial-services company that was supposed to be on the verge of procuring an Indian banking license. No license so far. “When it plunked down the \$23 million,” observes Lorenz, “Customers was a \$3.8 billion institution. There were supposed to have been synergies with this Indian non-bank. You scratch your head.

“You wonder, too, about a \$9 million bad loan—recognized this year—that was supposed to have been covered by a letter of credit from ‘a top-20 bank,’ a letter that, according to Sidhu, ‘was verified by our relationship manager with the issuing bank.’ The loan defaulted, and the letter turned out to be fraudulent.

“So I wonder about Customers' underwriting process and whether its supremely taut expense-control regime has left enough credit-monitoring resources to oversee the balance sheet.”

Blinding growth and low interest rates are the lipstick and mascara on the face of credit. So no particular significance attaches to the fact that Customers' nonperformers register a scarcely visible percentage of overall loans (just 0.27% on Sept. 30). Time removes the makeup.

Diamond Resorts International, Inc. (DRII on the NYSE), a seller and manager of timeshare vacation properties, is investment specimen No. 2. You might suppose that managing 108 vacation properties—not owning but managing—would be the ideal business in this time of not-so-terrible business activity, low gasoline prices



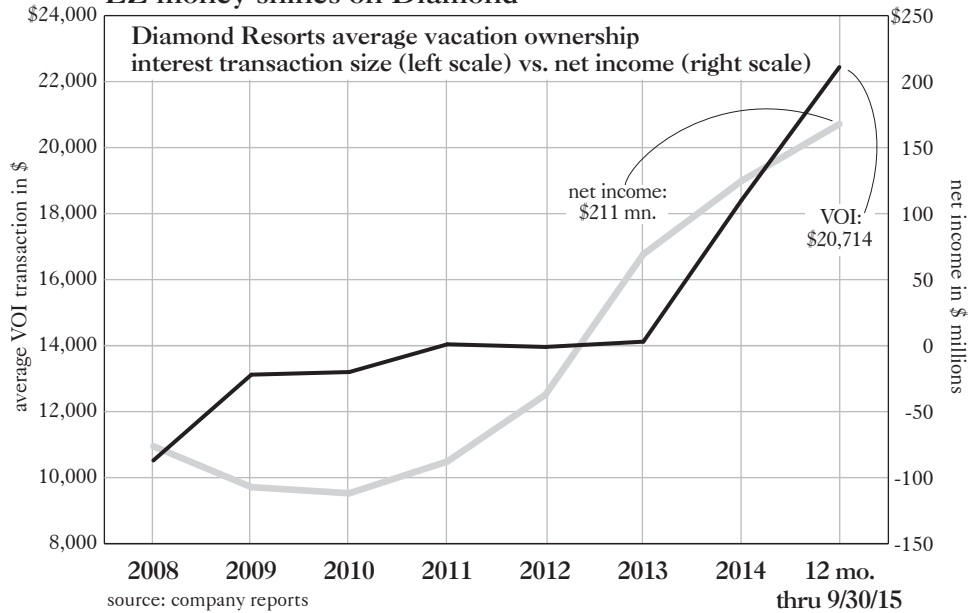
and lower-than-low interest rates. Let us see about that.

Diamond levies an annual fee for managing the properties under its care. In 2014, it charged an average of \$1,627 per member. And if a member defaults, Diamond adds that deficiency to the charges it makes on non-defaulting members. No less than 33% of income before corporate expenses was secured in this fashion during the third quarter.

This isn't your father's timeshare world. No more do you buy the rights to a certain week at a particular house, room or cabana. Diamond rather sells you a kind of intra-company scrip. You can spend this currency to reserve a spot at a Diamond property at the time of your choosing. Diamond calls this currency VOI, for "vacation ownership interest." For a week in the sun, you would need more than \$27,000 of VOI, not to mention that annual fee. If you happen not to have \$27,000 in the checking account, Diamond will lend you the money, for 10 years at 15%. Selling and financing vacation-ownership interests accounted for 67% of third-quarter earnings.

Diamond is no small potatoes. Fully 530,000 families own vacation rights to Diamond-managed real estate. The typical Diamond family earns \$90,000 a year, almost \$30,000 more than the median American family brings home. Comparing even that elevated income with the cost of a week in the Diamond-hosted sun, you are not surprised to discover that some timeshare members are borrowing money. More to the point of the bearish thesis, you are not surprised to find that some of these borrowers are in over their heads. In the third quarter, net charge-offs on VOI loans jumped to 7.7% from 6.5% in the second quarter.

### EZ money shines on Diamond



You can't blame the Federal Reserve for Expedia.com. The discounted room rates that the travel site displays may taunt an observant timeshare-owner into regretting that he or she had ever signed on to such an expensive annual commitment as Diamond Resorts. We may so speculate because of the deceleration in the growth in new timeshare members; to expand, the company must sell more time to existing members. And some of these existing members are showing signs of financial fatigue.

Evidence of strain is available, for instance, in a 2014-vintage Diamond-issued security, called DROT 2014-1, in the face amount of \$260 million. It's an asset-backed security whose collateral consists of loans to finance VOI purchases. Some of these loans have defaulted, analysts from the Kroll Bond Ratings Agency pointed out last month.

Had Diamond management not exercised its right to substitute performing loans for defaulted ones, the bonds would have shown a gross, cumulative loss on the order of 5.62%, or 1.14% above the loss that had been expected after the securities had been in the market for 12 months.

Timeshares are sold, not bought, the saying goes. So, we may add that, at the margin, timeshares are financed, not purchased for cash on the barrel-head. When credit was scarce between 2008 and 2011, Diamond financed only 35% of VOI sales. The result was an 8% plunge in revenue and a succession of deep bottom-line losses.

Diamond today finances upwards of 75% of VOI sales. The company's future is no more certain than that of the institution of very easy money.

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