GRANT'S

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Inflation cheering section

In February, the core CPI showed a year-over-year rise of 2.3%. It's a start, the vice chairman of the Federal Reserve Board suggested in March 7 remarks to the National Association for Business Economics: "[W]e may well at the present time be seeing the first stirrings in the inflation rate," said Stanley Fischer, Chair Yellen's intellectual soul mate—"something that we would like to happen."

It's settled pseudoscience (the phrase is Paul J. Isaac's) that a modern leveraged economy needs inflation as a baby needs a bottle. Pseudo- or otherwise, it's 21st-century doctrine. Few protest it, the central bankers least. They rather espouse it.

"An important concern about persistently low inflation," posited a colleague of Fischer's, Federal Reserve Governor Lael Brainard, also on March 7, "is that it can lead to a fall in longer-term inflation expectations, making it much more difficult to achieve our inflation target." It was, she said, "concerning," that more and more people appear to believe that the purchasing power of the dollar may actually hold its own.

When cyber-thieves spirited $101 million from an account at the New York Fed belonging to the Bangladesh Bank, the world stopped and stared. The biggest bank heist in history? Chicken feed, is the truth. A 2% annual rate of inflation would erase the purchasing power of $62 billion from the narrowly defined American money stock M-1. Don't get us started on M-2.

The very people you'd suppose would oppose the monetary equivalent of breaking and entering are the ones who are cheering it on. Exhibit A is the normalization of the once derisory idea that a central bank can institute spending by air-dropping bills or topping up people's bank accounts. "Helicopter money," Milton Friedman called his thought bubble.

Today, it's a policy-in-waiting. "It's a logical option for any country struggling with deflation and slow growth, as Japan has and perhaps other countries some day may," writes *The Wall Street Journal*'s Greg Ip in a March 21 blog post.

What do the scholars say? Ip quotes Richard Clarida, a distinguished Columbia University economist who happens to consult for Pimco, the great bond house: "We will see a variant of helicopter money (perhaps thinly disguised) in the next 10 years if not in the next five." And he quotes Peter Praet, chief economist at the European Central Bank: "All central banks can do it. The question is, if and when is it opportune."

Is nobody worried, or furtively indignant? Or has all the worry and indignation been squandered on the presidential candidates?

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"Honey, look! Inflation!"

Sell Big Food

In the physical world, some things are inherently safe, others inherently not. Daisies and dynamite, for example. There are fewer such clear distinctions to be drawn in the world of investing. Bonds are inherently senior to stock in a corporate capital structure, but "bonds," as an asset class, may or may not be riskier than "stocks," as an asset class. If risk is defined as the odds on the permanent impairment of capital, time and value decide.

Which brings us to Warren Buffett's favorite consumer packaged-foods company, to our former favorite canned-soup company and to "safety," as the Wall Street meme-makers define that elastic concept. In preview, *Grant's* is bearish on Kraft Heinz Co. (KHC on the Nasdaq), on Campbell Soup Co. (CPB on the New York Stock Exchange) and, yes, even on safety, as defined; mispriced investments are inherently risky, we are about to contend.

To judge by their assigned equity valuations, packaged-foods companies must be cycle-proof, even consumer-proof. Five years ago the dozen companies constituting the packaged-foods segment of the S&P 500 traded at an average of 15.6 times trailing net income. Today, they command an average of 24.8 times. There will always be Heinz ketchup, Campbell's soup and Kraft macaroni and cheese, the argument seems to run. The companies that make them may not deliver much topline growth, but, allegedly—Old

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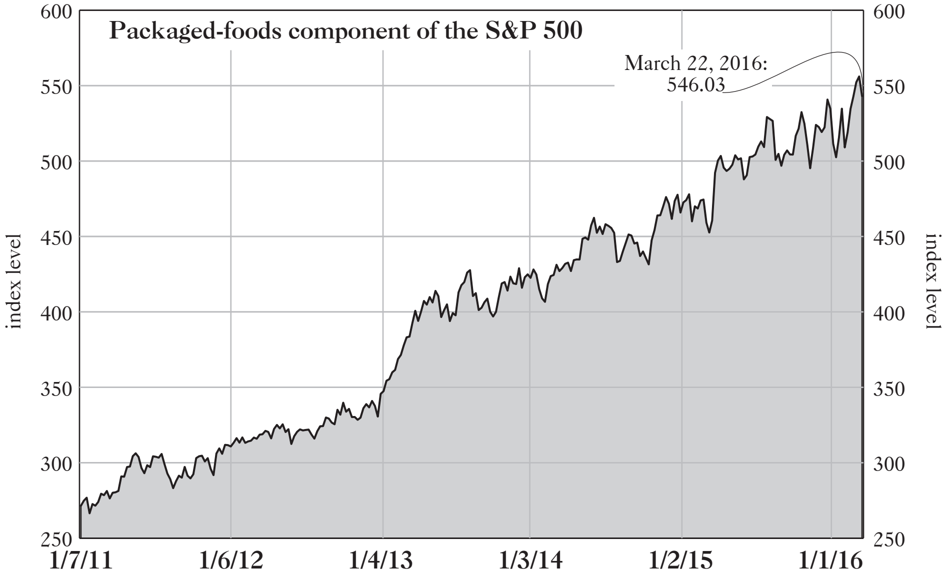
The new 'FANGs'?



source: The Bloomberg

Man River-fashion—they'll just keep rolling along.

You can be sure that the market isn't valuing the favored dozen on revenue growth. In the latest reported quarter, Hormel Foods Corp., producer of, inter alia, Spam and Skippy peanut butter, divulged a 4% drop in sales. Post Holdings, Inc. (Grape-Nuts, Honey Bunches of Oats) suffered a 4.2% decline in sales, excluding the benefits of acquisitions, and Kraft Heinz (Velveeta, Oscar Mayer) admitted to a 5% plunge in sales (pro forma the acquisition of Kraft Foods). "They are literally shrinking," Mathew T. Klody, managing partner of MCN Capital Management, Chicago, marvels to colleague Evan Lorenz, "and the market is paying 25 to 30 times earnings for them. If you look at these stocks, it looks like the FANG stocks [Facebook, Amazon, Netflix, Google] of six months ago. They've gone up parabolically."

Americans may be buying the stocks. They are not—as they have done in the past—buying the products. Health and wellness are today's on-trend watch words. They are not the first characteristics that spring to mind when contemplating the comfort foods of Kraft, Hormel, Heinz et al. Big Food still dominates the supermarket's center aisles. The trouble is that crowds are forming around the perimeter, where the kale is.

Newfangled foods—free-range, organic, gluten-free, farm-to-table, non-GMO and fresh, above all—are the drivers of sales growth today, John J. Baumgartner, the Wells Fargo Securities LLC analyst who covers packaged-foods companies, advises Lorenz. "I think the retailers are recognizing that the reason that they lost traffic in the couple of years following the recession to places like Trader Joe's and Whole Foods is because they didn't merchandise as much natural and organic," Baumgartner explains. "As they recognized that and are ramping up their merchandising of natural and organic in a traditional grocery environment, it is putting traditional food in a bit more of a bind."

Untraditional is the millennial cohort's disdain for once revered brands. According to a recent survey by Mintel Group, almost half of Americans between the ages of 29 and 38 regard the Big Food companies with mistrust. Value is rather the young person's shopping mantra.

In 1986, *Grant's* published a profile of the independently thoughtful investor Bill Tehan. A one-time goldbug, Tehan had become a kind of food-bug. Disinflation was fattening the margins of the Hersheys and Heinzes and Kelloggs, and he was bullish on the group. How skinny were those margins, in comparison to today's, may bear a moment's reflection. In 1985, Campbell was earning 9.2% on sales, half of today's rate; Heinz was earning 12.1%, compared with 16.5% in 2015 and a projected 28.9% for 2017. (You can read the Tehan profile on the *Grant's* website.)

The low valuation of the food stocks in the wake of the Great Recession had little to do with business fundamentals. The affliction known in these pages as "2008-on-the-brain" was rather the source of knockdown P/E multiples. Anxious investors demanded government securities, not equities. The issue of *Grant's* dated Oct. 7, 2011 proposed a 10-year total-return contest between the common equity of Campbell Soup Co. and the then-current 10-year Treasury note. Our money was on CPB.

Here was a valuation story—ergo, by our definition, a safety story. Campbell traded at 12.9 times earnings and delivered a 3.6% dividend yield. The Treasury $2\frac{1}{8}$s of Aug. 15, 2021 traded at 102.66, a price to yield 1.83%. Suppose that Campbell's earnings and dividend stood still for the next 10 years, we proposed. At year 10, an investor would have earned a decade's worth of dividend payments, producing a 36% all-in return. Over the same period, a holder of the Treasury note would be just 18.3% to the good. It followed that, in order to achieve a break-even return with the 10-year note, the Campbell share price would have to decline. It would have to decline by 17%, or 1.9% a year for 10 years, in fact, to reduce it to parity with the government security.

So far, so good for the soup maker. In the past five years, Campbell has generated a 110% return, including dividends; the 10-year note has delivered 9.7%. Campbell's earnings per share has grown by 13.6%, and its revenues by 3.6%, while the share count has fallen by 3.4%. The quarterly dividend has been lifted to $0.312 from $0.29. Net debt has pushed higher, to $3.5 billion from $2.6 billion, as the debt rating has drifted lower, to triple-B-plus from single-A.

But nothing that Campbell did contributed more to the trajectory of its share price than what Mr. Market did for it. From 12.9 times earnings in 2011, the multiple leapt to 22 times today. That sprouting P/E ratio has served up the bulk of the return.

Maybe the time has come for P/E contraction. In the quarter ended Jan. 31, total company volumes (including the likes of V8 and Pepperidge Farm) showed a year-over-year decline of 2%, while dollar-denominated revenues, also measured year-over-year, were flat. (Sales of soup actually fell by 4% year-over-year.) The way forward is cost-cutting, management and Wall Street now concur. The upshot is a consensus projection for operating income of $1.5 billion in fiscal 2017 (ends July 31), up from $1.2 billion in fiscal 2014. To hear the analysts tell it, operating margins will spurt to 18.5% of sales in fiscal 2017 from 14.4% in fiscal 2014. Who needs growth in sales or market share when you have forecasts?

For ourselves, we elect to cut short our 10-year bet, crowning ourselves and Campbell the winner and Treasurys the loser. We note that the Campbell insiders have sold a net 289,010 shares over the past year for proceeds of $16.3 million. No soup for them; no soup for us.

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On, now, to Kraft Heinz, a grand specimen of the platform company, or roll-up, on which James H. Litinsky so profitably expounded at the *Grant's* fall conference (see the Oct. 30 issue). Certainly, 3G Capital, Inc. and Berkshire Hathaway, Inc. have been merrily rolling along. In 2013, they acquired HJ Heinz Co. for $27.4 billion in cash. Two years later, their acquisition vehicle bought Kraft Food Group, Inc. for $55.4 billion in cash and stock. Today, KHC is the largest American food manufacturer by market capitalization, at $93 billion. Mondelez International, Inc. is a distant second, at $63 billion.

For Litinsky, "platform" was a term of disparagement; not for KHC. "The Kraft Heinz Company," the investor-relations home page dilates, "a platform for performance. This historic transaction unites two powerful businesses and iconic brands, and provides a platform for leadership in the food industry, both domestically and internationally."

In the fiscal year ended Jan. 3, the combined entities of Kraft and Heinz produced $27.4 billion of sales to retailers worldwide. The United States and Canada contributed 79% of the total, Europe 9% and parts unknown 12%. You know the brands: Kraft, Oscar Mayer, Heinz, Planters, Velveeta, Philadelphia, Lunchables, Maxwell House, Capri Sun, Ore-Ida, Kool-Aid, Jell-O. Undisclosed is what each brand contributes to the corporate whole.

"Kraft Heinz's brands are ubiquitous," Lorenz observes. "On-trend, they are not. Yes, Oscar Mayer does produce a 'natural' line of lunch meats, but sugary drinks (Kool-Aid, Country Time), high-fat condiments (Cool Whip, Miracle Whip), sugary condiments (Heinz ketchup) and processed cheeses (Kraft, Velveeta) are the corporate workhorses. The price that you, the investor, pay for this conflation of chow is 34.9 times adjusted, pro forma 2015 earnings per share and 25.8 times the 2016 estimate. As for 2017, it's yours for just 20.2 times."

With revenues on the dwindle, management is promising $1.5 billion in cost reductions, or $1.23 for each of the company's 1.2 billion shares. According to Kraft Heinz, workforce reduction, overhead savings—3G's famous "zero-based budgeting"—and manufacturing and supply-chain efficiencies will deliver the savings by the end of 2017.

"As with Campbell Soup," Lorenz points out, "the Street has dutifully penciled in those projected savings and more into forward estimates. Operating income (of the pro forma kind) footed to $4.5 billion for the combined Kraft Heinz in 2015. Actual operating is expected to grow to $7.8 billion by 2017. This is despite an expected contraction in sales, to $27 billion from $27.4 billion over that span. Based on shrinking sales and expectations of growing profits, Street estimates imply that Kraft Heinz's operating margin will expand to 28.9% in 2017, from 16.5% (pro forma) in 2015."

"Of the dozen packaged-food companies in the S&P 500, only one, Mondelez, has an operating margin as high as the Street is betting that Kraft Heinz will achieve by 2017," Lorenz continues. "It's unlikely, though, that Kraft Heinz can follow Mondelez into the promised land of super-profitability. On Oct. 1, 2012, Mondelez (then Kraft Foods, Inc.) spun off its low-margin grocery businesses into a new company. This company, confusingly, bore the name Kraft Foods Group, Inc. In other words, Mondelez is a cherry-picked portfolio of higher growth and higher margin products. The operating margin for the other 11 packaged-goods companies in the S&P 500 averages 12.3% of trailing-12-month sales."

Bulls pin their hopes on something called "trade spend optimization" (when the busy financiers say "spend," what they mean is "spending"). This will take a little explaining. The revenues that the likes of Heinz Kraft report are net sales. Gross sales can be 20% higher than net. Undisclosed marketing expense accounts for the difference.

Trade promotions have their origin in the 1971 Nixon price controls. In an attempt to get one step ahead of the government, packaged-food companies padded their selling prices. It was insulation they could use when the federal price-control ax fell. When that threat receded, the cannier food companies retained the gross-to-net spread as a kind of piggy bank. Ever since, they've used it to secure desirable shelf space or better placement in weekly advertising circulars.

It's an expensive stratagem. Compare and contrast a 1% reduction in

Pot boils over

source: The Bloomberg

trade promotions with a 1% increase in sales volumes. The former is much more efficient than the latter. By cutting trade promotions, you effectively increase prices; a dollar thus saved contributes a dollar to operating income. In contrast, a 1% increase in volumes boosts operating profit only by the assumed operating margin, say 29%. Wishing that trade promotions would go away, Wall Street's optimists are prone to assume that they will.

You can't assume away the debt. The roll-up of Kraft into Heinz left the food behemoth with $28.9 billion of net borrowings. Based on management's estimate of pro forma, adjusted EBITDA for the full year 2015, net debt to EBITDA totaled 4.3 times; the Street projects a 2016 decline to 3.9 times. In the fourth quarter, which included a full three months of the combined Kraft and Heinz results, operating income covered interest expense by 4.8 times.

Even if Kraft Heinz refinances a big slug of its 9% preferred stock in June, the shoe of leverage will continue to pinch (the company's triple-B-minus debt rating is just this side of junk). The clamoring bulls demand that management materialize $3.1 billion in free cash flow in 2016. The stockholders demand that 3G and Berkshire honor their pre-merger commitment to maintain (and, if possible, boost) the 55-cent-per-quarter dividend. So far, so faithful—the dividend now stands at 57½ cents a share—but that payout is costing the company $2.8 billion a year, or 91% of this year's estimated free cash flow.

Hopes for the 3G/Berkshire giant run high. Standard & Poor's all but promises a future ratings upgrade, and Goldman Sachs last week actually delivered one. Now KHC is a "conviction" buy, Goldman said, as distinct, presumably, from a "half-hearted, going-through-the-motions-just-for-a-shot-at-the-investment-banking-business" buy. "Investors, in our opinion," Goldman opines, "are underestimating KHC's earnings power that stems from improved pricing discipline, cost cuts, commodities and international-revenue synergies. We see a positive estimate-revision cycle ahead with further potential M&A offering incremental upside."

Goldman isn't alone in harping on mergers and acquisitions. Some speculate that General Mills, Inc. may be next on the Kraft Heinz menu. In any case, an anonymity-seeking bull tells Lorenz: "The addressable market or the addressable targets for Kraft is immense. We've sized it up to something around $1 trillion, in terms of enterprise value of potential targets they can go after and acquire. This is both public and private companies globally. It is $1 trillion and relative to Kraft's enterprise value of $122 billion; there is 10-X. There is an endless amount of pipeline for deals."

Bulls cast Kraft Heinz as a kind of armed missionary. The heathens can either convert voluntarily to zero-based budgeting and reduced trade promotions (thereby lifting both their margins and share prices), or they can undergo forced conversion at the not-so-gentle hands of 3G and Berkshire. To judge by the prevalence of 3G management jargon on recent Big Food conference calls—Campbell and ConAgra Foods, for instance, both spoke the new patois—the gospel of efficiency is making inroads.

Whether the converts stay converted is another matter, for the packaged-foods business was, and remains, dog-eat-dog. Kraft Heinz did try to economize on promotional spending in the UK recently. It stopped spending as it had customarily spent to push its branded soup. What it did not do, at the same time, was freshen the product or otherwise call new attention to it. It didn't take long for the competition to notice. A supermarket land grab ensued, at the expense of Kraft Heinz. Presumably, the humbled bully will be back again to reclaim its lost territory and market share. The point to mark is that the presumed counteroffensive will not come for free. Which leads us to conjecture that some portion of that allegedly certain $1.5 billion in promotional cost savings may not be saved after all. Businesses need sustenance, too.

"As the new health-and-wellness brands gain more distribution," Lorenz points out, "they likewise gain economies of scale that allow them to cut prices, and this they do over time (think Chobani, Kind Snacks and Naked Juice, among others). So, while existing packaged-food brands are trying to increase profits by cutting trade promotional dollars, the price gap is narrowing between established processed foods and on-trend, newer brands."

"My perspective, at least, is that what one company is talking about is usually what most of the other companies talk about," Rob Dickerson, the vice president and head of global packaged foods at Consumer Edge Research, an independent research boutique, remarks. "It changes every year. Right now it is trade optimization. Why weren't they talking about trade optimization three years ago? Three years ago they were trying to increase marketing and trade spend to increase volumes. That didn't work.

"Eventually you say," Dickerson proceeds, "'How do you generate higher profit margins to grow your profits?' You are just going down the line; what lever can we pull now? If these companies were growing volumes, would we be seeing as much discussion around trade promotions as we are? My theory is most likely we would not."

Investors have a lever to pull. It's the one marked "sell."

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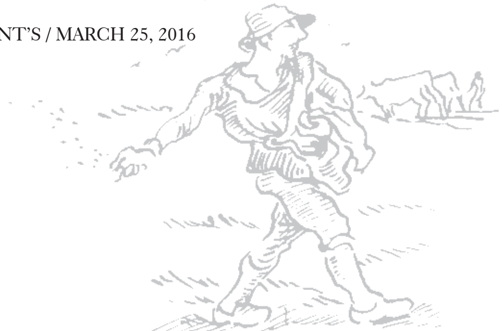
Taps for credit

A London correspondent writes:

Who'd be a European credit trader? A complicated job has been made more difficult by the latest confusing smoke-and-mirrors routine by the European Central Bank. Then, again, in some respects, it's become easier. Once you were paid to think. Now you're almost paid not to.

Signor Draghi, by promising to do "whatever it takes" to preserve the single currency, has, in a roundabout way, broken European credit markets. Not broken their ultimate functionality, perhaps (yet?); rather, the rhythm of the market has been stilled, most evidently in sovereign and covered securities. As the largest purchaser of these assets, the ECB has destroyed liquidity. Knowing that there is a buyer of last resort, would-be sellers may now take their own sweet time in transacting. In extending the ECB's mandate to corporate bonds, the disruption will spread still further down the credit spectrum.

Following the ECB's continuation of QE last week, Portuguese covered bonds have rallied to the point at which they trade flat to Australian bank covered bonds (the latter securities, for now, existing beyond the direct manipulative reach of the Bank of Draghi). There's a similar effect in corporates: Five-year bonds of split-rated Ener-



CREDIT CREATION

FEDERAL RESERVE BALANCE SHEET
(in millions of dollars)

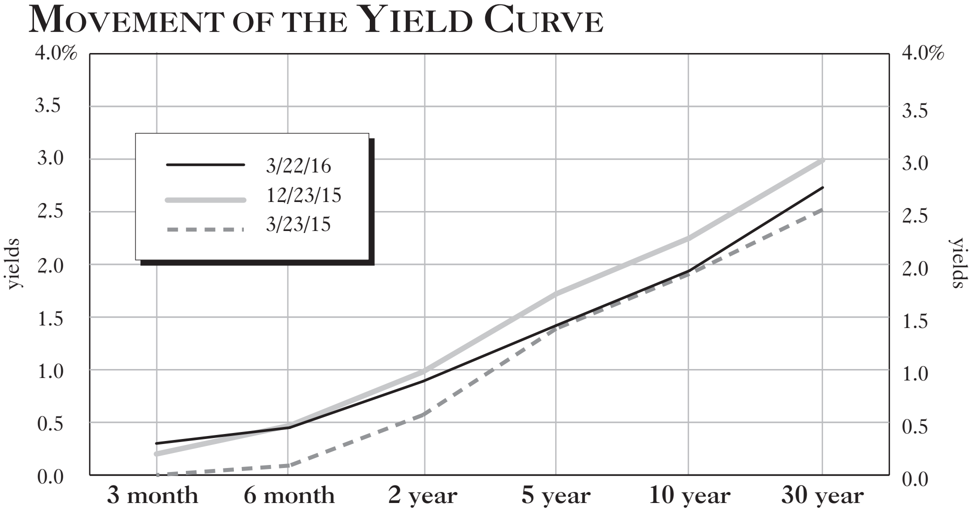
	March 16, 2016	March 9, 2016	March 18, 2015
The Fed buys and sells securities…			
Securities held outright	$4,247,349	$4,244,328	$4,245,736
Held under repurchase agreements	0	0	0
and lends…			
Borrowings—net	15	12	15
and expands or contracts its other assets…			
Maiden Lane, float and other assets	198,876	197,018	215,377
The grand total of all its assets is:			
Federal Reserve Bank credit	$4,446,240	$4,441,358	$4,461,128
Foreign central banks also buy, or monetize, governments:			
Foreign central-bank holdings of Treasurys and agencies	$3,251,866	$3,254,451	$3,223,453

EUROPEAN CENTRAL BANK BALANCE SHEET*
(in millions of euros)

	Mar. 18, 2016	Feb. 19, 2016	Mar. 20, 2015
Gold	€338,713	€338,713	€343,839
Cash and securities	1,815,461	1,758,689	1,125,084
Loans	516,443	526,731	465,609
Other assets	215,581	213,442	223,309
Total	€2,886,198	€2,837,575	€2,157,841

* *Totals may not add due to rounding.*

MOVEMENT OF THE YIELD CURVE



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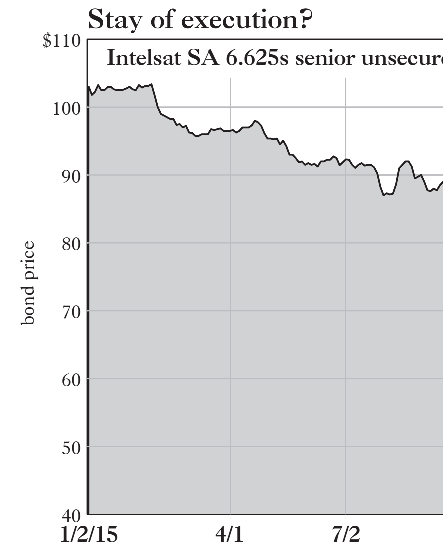

source: The Bloomberg

Credit ri

At the Feb. 22 sounding, the narrowly defined money supply M-1 was shrinking. Measured over a three-month interval, it was shrinking at an annual rate of 0.7%. No more. Observed two weeks later, it had returned to growth (see table to the right). Twenty-odd billion came out of demand deposits, then eighteen-odd billion flew back.

Volatile, these monetary movements may be, but they're nothing like Mr. Market's mood. Since falling to 1829.08 (10.5% below its Dec. 31 close) on Feb. 11, the S&P 500 has rallied to 2049.8 (up 0.3% for the year). Junk-bond yields, as measured by the BofA Merrill Lynch High Yield Index, have plunged to 8.12% today from 10.07% on Feb. 11. Yields rated triple-C and lower—the sub-basement of speculative grade—have dropped to 18.4% today from 21.68% on Feb. 11. It may or may not be coincidental that the price of West Texas Intermediate likewise carved out a bottom on Feb. 11, at $26.21 per barrel. Since that fateful date, the price of crude has surged by 57%, to $41.22.

"To see just how far the sentiment has swung," colleague Evan Lorenz relates, "consider the winter-to-spring saga of triple-C-rated Intelsat SA, the world's largest satellite-services company (*Grant's*, Jan. 24, 2014). Intelsat's Feb. 22 earnings call featured news that management had retained Guggenheim Securities LLC to assist with 'balance-sheet initiatives.' Whatever that phrase might have meant,

• CAUSE & EFFECT

isk: "On"

it didn't sound bullish, with Intelsat on the hook for $14.5 billion."

Could management, or the monetary gods, or someone, effect a refinancing? Creditors seemed to doubt it. On Feb. 23, the Intelsat 7¾ senior unsecured bonds of 2021 fell to 24.25 from 28.25 to yield 48.8%, while the B-2 term loan due 2019 dipped to 87.125 from 91.313.

That was then. On Monday, the company sold $1.25 billion's worth of first-lien senior secured notes, the 8s of Feb. 15, 2024. The deal, so LCD Capital IQ reported, was upsized by $250 million and priced at the tighter end of "early market whispers." Not bad at all, the Standard & Poor's unit observed, for "a debt-laden issuer whose unsecured notes, such as the 6.625% series due 2022, trade in the mid-50s, offering about 18.5%. . . . " Maybe it *was* the monetary gods.

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Correction: Retail money-fund assets did not soar by $104.2 billion between Nov. 23 and Feb. 22, as we reported in this space two weeks ago, using data from the Federal Reserve Bank of St. Louis. In fact, growth was more along the lines of $10 billion. The mistake stemmed from new money-fund reporting requirements. Confusion as to classification between institutional and retail money funds seemed even to confound the regulators, Peter Crane, president and publisher of *Money Fund Intelligence*, observes.

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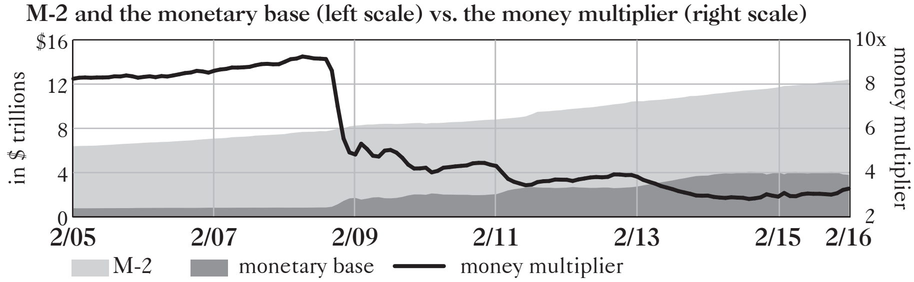
ANNUALIZED RATES OF GROWTH
(latest data, weekly or monthly, in percent)

	3 months	6 months	12 months
Federal Reserve Bank credit	-0.3%	0.1%	-0.3%
Foreign central-bank holdings of gov'ts	-7.7	-5.0	0.2
European Central Bank	21.8	23.6	33.5
Commercial and industrial loans (Feb.)	10.2	10.3	10.5
Commercial bank credit (Feb.)	8.8	7.6	7.3
Asset-backed commercial paper	33.5	40.1	21.4
Currency	6.6	7.6	5.9
M-1	4.0	4.1	4.0
M-2	7.8	5.8	5.5
Money zero maturity	3.7	4.2	5.4

REFLATION/DEFLATION WATCH

	Latest week	Prior week	Year ago
FTSE Xinhua 600 Banks Index	12,381.12	12,160.47	13,043.19
Moody's Industrial Metals Index	1,475.71	1,434.94	1,685.78
Silver	$15.81	$15.61	$16.11
Oil	$39.44	$38.50	$43.96
Soybeans	$8.98	$8.96	$9.62
Rogers Int'l Commodity Index	2,079.49	2,031.46	2,540.36
Gold (London p.m. fix)	$1,252.10	$1,264.75	$1,166.00
CRB raw industrial spot index	438.71	437.09	468.48
ECRI Future Inflation Gauge	(Feb.) 105.1	(Jan.) 103.4	(Feb.) 101.8
Factory capacity utilization rate	(Feb.) 76.7	(Jan.) 77.1	(Feb.) 78.9
CUSIP requests	(Feb.) 1,320	(Jan.) 1,133	(Feb.) 1,595
Fed's reverse repo facility (billions)	67.6	39.7	91.2
Grant's Story Stock Index*	85.86	84.62	113.29
*Index=100 as of 7/31/2013			
Grant's Never-Never Index*	141.37	141.83	186.96
**Index=100 as of 1/4/2013			

EFFECTIVENESS OF THE MONETARY POLICY
M-2 and the monetary base (left scale) vs. the money multiplier (right scale)



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gias de Portugal (EDP) trade just 80 basis points wider than the five-year debt of investment-grade RWE of Germany. Three years ago, the differential was 280 basis points, and as recently as February, it was 200 basis points. Or consider the message imparted by credit default swaps. In 2011 and 2012, the five-year CDS of the two issuers, Portuguese and German, traded at a differential of more than 800 basis points. Today? A mere 50.

Liquidity is another pain point. Around €30 billion of European corporate investment-grade bonds change hands in an average month; the central bank may swallow as much as a third of that amount. Hardly a boon for the beleaguered trading desks of European investment banks! As it is, sovereign and covered debt yields nothing, more or less. Now that investment-grade corporate debt has been launched down the same barren slope, one may spare some pity for those investors in search of absolute returns. Good luck to them!

While Draghi's latest trick may be notched up as another resounding success by the technocrats of Brussels and Frankfurt, one wonders if Mario should be quite so eager to please the markets. After all, at some point this debt will need to be refinanced. Will the ECB still be expanding its balance sheet in 2020, to help peripheral issuers fund at near the same interest cost as their German counterparts? And if so, will the same accommodation be tendered for the next maturity and for the one after that? Even the universe, we are told, cannot expand forever. Similarly, there is cause to doubt that the ECB can ultimately achieve "escape velocity" for the eurozone economy. And if it did? A prudent investor would start preparing for a rough re-entry.

"ECB policy spurs corporate bond sales," the *Financial Times* reported on Tuesday as "Europe's long-dormant junk bond has stirred into life with half the year's total volume sold in a week." What will they do when junk yields hit zero? Don't worry. These days, remember, you're paid not to think.

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Investment value—"on"

Examining the arc of its share price, or for that matter of its bond prices, you might be led to assume that Seacor Holdings, Inc. (CKH on the New York Stock Exchange) either drills for oil or manages a fleet of profitless Greek freighters. What Seacor does is buy low and sell high. A bullish reappraisal (see the issue of *Grant's* dated Feb. 22, 2011) follows.

What precipitates the analysis is a message from an interested party in response to the piece in the previous issue of *Grant's*. Atwood Oceanics, Inc. (ATW) and Transocean Ltd. (RIG) were the subjects; each has been laid low by debt. When, oh when, we lamented, would some bright light figure out a way to buy assets during a bear market rather than having to sell them (or, still worse, having to file for bankruptcy protection)? In reply, our informant observed that such a bright light does, in fact, live, and that his name is Charles Fabrikant, Seacor's executive chairman, chief executive and chief capital allocator.

"My observation about the capital markets these days," Fabrikant told *Grant's* over the phone on Monday, "is they tend to paint with a broad brush." It's either "risk-on" or "risk-off," he said. It's buy this ETF or sell that ETF.

Seacor occupies a kind of parallel, Benjamin Graham universe. "We are investors, not just operators," the company characterized itself one month ago at the Stifel Transportation and Logistics Conference. "We are opportunists, not blinkered. We are agnostic about source of profit, but religious about returns."

Seacor's miscellaneous income-producing assets mainly sit on the water. You might think of the company as a seagoing Berkshire Hathaway or a freshwater Leucadia National. The stock trades at a 29% discount to its Dec. 31 book value.

The discount didn't come from nowhere, admittedly. Last year marked the first annual loss in Seacor's 24-year history as a public company. Then, too, Seacor's largest business segment, offshore marine services, is an oil-and-gas-and-wind-power derivative; what its 173-vessel fleet services is the offshore energy-production business. Of the recent performance of this particular segment, Fabrikant—as usual, unescorted by a P.R. minder—comments, "It stinks."

Nor do Seacor's other business lines ring the current bells of Wall Street fashion. They comprise inland river services, meaning towboats, hopper barges and terminals of various kinds (grain, liquid, river); and shipping services, including harbor tugs, tankers, a Great Lakes bulk carrier and bunker barges. The two segments each delivered 22% of revenues, as well as, respectively, 22% and 29% of segment assets. Majority-owned Illinois Corn Processing and lines of business marked "other" account for an additional 22% of revenue and 10% of segment assets.

Fabrikant, age 70, is the principal architect of this amalgamation of assets. The owner of 1.05 million shares of Seacor common, with a market value of $55 million, he has more than amassed the *Money* magazine-recommended minimum for living a life of carefree retirement. Happy as a clam in his work, says the CEO, he has no plans to retire, though (he continues), if he were either to step down or fall down, a cadre of talented young executives would be perfectly able to carry on in his place. To declare an interest, Fabrikant is a paid-up subscriber to *Grant's*. To declare a further interest, your editor happens to own his stock.

Profiling the captain of the good ship Seacor for her 2012 book *Dynasties of the Sea*, journalist and CNBC producer Lori Ann LaRocco writes: "[His] approach is to invest as if every dollar were his last." As a result of this approach, LaRocco adds of Seacor, "It is an intricate puzzle that uses cross-fertilization of information to track opportunity in disparate markets and industries. Sister business units compete for allocation of capital and, in some instances, for customers."

Seacor and Wall Street are ships in the night. As Fabrikant can't parse "risk-on/risk-off," neither can the Street figure out—or, at least, can't model—Seacor. Fabrikant hosts no conference calls, and he seldom makes public appearances (the Stifel presentation was a rarity). "Visibility remains shrouded," observed one sell-side analyst in the wake of fourth-quarter 2015 GAAP earnings, which, with considerable forbearance, he described as "lumpy." Instead of the expected 82 cents a share, Seacor served up a loss of $3.36 a share. In the circumstances, it's not so surprising that the corps of sell-side Seacor-watchers numbers approximately two, or that they rate the shares no higher than "hold" and "neutral." You could excuse them for screaming "sell" out of sheer exasperation.

Still and all, over past two dozen years, Fabricant et al. have generated growth in book value per share on the order of 12% per annum (as adjusted to include two special cash dividends and the spin-off of the helicopter operator Era Group). For perspective, over the same span, Berkshire Hathaway has delivered roughly 14%.

With so much of his portfolio in the cyclical ditch, do you wonder how Fabrikant is allocating capital? Cash—sterile, zero-percent-yielding dollar bills—is one favorite bolt-hole. ("Diversification and liquidity," reads Seacor's handout at the Stifel event. "We are prepared for opportunity.") Seacor shares is another. Fabrikant et al. have repurchased nearly $275 million's worth of stock in the past two years, reducing the number of shares outstanding by 16% and leaving the insiders with a collective ownership position of 9.5%. Not that the chief capital allocator has stopped investing in the business. Dollars apportioned to capex reached $295 million in 2015 and $360 million in 2014, up from an average of $238 million in the five years through 2013. In addition is a substantial boat- and ship-building program—$455 million was so earmarked in 2015, up from $143 million two years earlier.

Seacor, which is just as happy to sell as it is to buy, recently disclosed plans to offload 27 barges and 13 towboats to tank-barge operator Kirby Corp. for a consideration of $88 million. Tax advantages attach to the sale of certain types of vessels—these vessels, for instance; you can deposit the proceeds in a construction reserve fund and thereby defer taxable gains, provided the proceeds are reinvested in new boats or ships within three years.

"Seacor's calculated portfolio approach applies not just to vessels and investments," a new member of this staff, Alex Hess, points out, "but to entire operating segments. Since the maiden *Grant's* essay on Seacor appeared in the issue dated Sept. 17, 2010, Fabrikant has often reinvented the company. In early 2012, a sizeable portion of the environmental-services segment—which accounted for 33% of revenues in 2010, due in part to its cleanup work for BP in the Gulf of Mexico—was hived off to a private-equity buyer. The previously referenced Era Group, which accounted for 17% of revenues in 2012, was shed in January 2013. A future divestiture might include the offshore marine-services segment, which, in December, issued $175 million in 3.75% seven-year convertible notes to the Carlyle Group. The notes are putable in just under two years—*if*, by then, the division has not been divested."

Though liquidity is a Fabrikant watchword, and though the CEO has demonstrated remarkable talents in the art of asset conversion (cash to boats and back again), Seacor and the credit-rating agencies are likewise ill-matched. "The downgrade," comments Moody's of its demoting Seacor this month to B3 from Baa3, "reflects the company's high financial leverage metrics, caused primarily by the deteriorating earnings in its offshore marine-services segment. ... The downgrade also incorporates the company's structural complexity, with debt issued at multiple subsidiaries."

Granted, borrowing has been on the upswing in recent years. At last count, $1.15 billion of debt at par value was issued and outstanding. Besides the aforementioned 3.75% converts issued to Carlyle, obligations include a pair of convertible issues with a combined par value of $515 million. A series of 7.375% notes accounts for another $196 million on the balance sheet, and a credit facility for Seacor's 51%-owned SEA-Vista subsidiary adds $210 million more.

However, not all debt is equally urgent. Assuming the Carlyle converts

Value, ahoy!

source: The Bloomberg

are not put back to Seacor in 2017, just $78 million in debt is due before 2019. That year, the $196 million in 7.375% senior notes mature. In 2020 the SEA-Vista line of credit expires. The two additional (non-Carlyle) convertible bonds do not fall due until 2027 and 2028. What are the odds that both shipping and oil are still in fathomless bear markets by the time even the first of these instruments matures?

Fabrikant-led management seems not to live in dread of some looming maturity wall but rather has been buying and retiring debt years in advance. Last year, for instance, it purchased and retired $37.6 million of the 7.375% notes due in October 2019, as well as $65.5 million of convertible. With regard to the 7.375% notes, they change hands (as it were, by appointment) at $87.25, according to FINRA, offering an 11.93% yield to maturity.

Admittedly, net interest expense of $23 million is none too manageable when operating income totals $21 million, which was the case in 2015. Then, again, operating income totaled $165 million in 2014 and $100 million in 2013. Besides, Seacor is perennially buying this and selling that, usually at a profit (2015, the annus horribilis, dealt a $2.4 million loss). In the period from 1997 through 2014, the company recorded gains on the sale of assets every year, and at an average of over $38 million. There appears to be liquidity for assets that float, at least for Seacor; over the past 10 years, it's averaged $220 million in fixed-asset sales per year. Even in 2015, perhaps the hardest year on record for numerous consolidated subsidiaries, Seacor off-loaded $95.5 million in fixed assets.

"With wheeling and dealing serving as such a critical part of the company's operating model," Hess points out, "one can look to the balance sheet as a further source of cash. Property and equipment totaled $2.1 billion at historical cost, and $1.1 billion net of accumulated depreciation. Construction in progress, as mentioned, adds another $455 million. Equity investments are carried at a value of $331 million. Best yet, cash and near-cash assets total (an untaxed) $923 million."

Put it all together and what have you got? Why, more than a ship that swims. You've got a bargain.

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Business is hard

Our old flame Horsehead Holding Corp. (trading in the over-the-counter markets as ZINCQ) became a bankrupt last month; the "Q" in the ticker denotes "insolvent." Its road into Chapter 11 and its prospective road out again are the topics under discussion. Financial leverage, economic cycles, commodity prices, human foible (ours, among other's), bad luck and—just to emphasize—financial leverage are the featured sub-topics. You start to wonder why they invented debt in the first place.

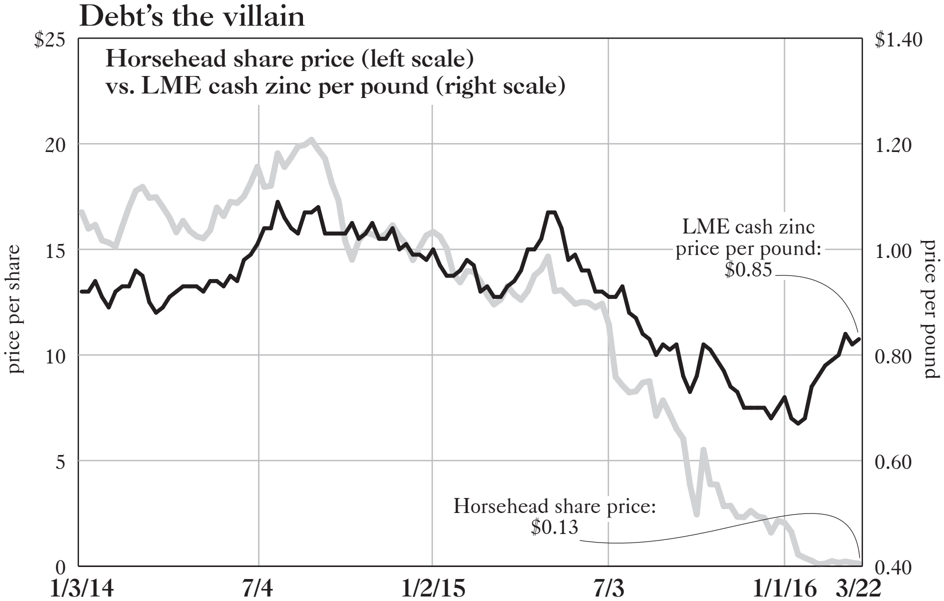
Pittsburgh-based Horsehead, corporate descendant of businesses organized more than 150 years ago, creates 21st-century zinc from recycled poisonous dust; the dust is the residue of steel-making in electric arc furnaces. Subsidiaries produce zinc oxide and recycle nickel-bearing wastes. There are 57.9 million shares outstanding, each today quoted at around 13 cents. Towering over the resulting anthill of stock-market capitalization is, as of early February, $420.7 million of debt. Debtor-in-possession financing (the senior-most claim on a bankrupt's estate) is expected to push the grand total of IOUs, counted at face value, closer to $500 million.

Horsehead and we go back together almost five years. In December 2011 (see the issue of *Grant's* dated Dec. 16), the share price was $8.62, the earnings prospects were dazzling and management was on the top of its game. The company had forehandedly hedged zinc prices going into the Great Recession. It had effected a series of well-crafted acquisitions. It would certainly not repeat the bankruptcy in 2002, brought about by the fatal intersection of debt and falling metals prices.

Plans for a new, state-of-the-art zinc plant in Mooresboro, N.C. was the bullish buzz of 2011. It was going to be a very beautiful, great and transformational zinc plant. It would boost the company's annual EBITDA-generating capacity to $150 million from $50 million. All management had to do was build and operate the factory. All the price of zinc had to do was go up. All China had to do was not combust. *Grant's* was bullish.

We were still bullish more than a year later (see the issue dated March 8, 2013), the ever-present threat of the People's Republic of China notwithstanding. "[I]t would not be bullish for Horsehead if China went the way of all credit-debauched economies," it said here, "but we are willing to subordinate China in this case to a bigger, more immediate consideration." This consideration being, of course, the new zinc plant. To finance it, the company paid a 10½% coupon to borrow $175 million; Moody's rated the debt B2, for speculative. No bearish inferences should be drawn from those difficult terms, we quoted the chief financial officer as saying. Horsehead was only paying the price for its diminutive size:

Debt's the villain



source: The Bloomberg

"We're investing in a project that approximates our current market cap," the CFO said. On Dec. 31, 2012, the balance sheet showed cash and equivalents of $244.1 million against long-term debt of $263.3 million; there was more than enough breathing room, we bulls agreed.

The Mooresboro plant has never come close to realizing its rated productive capacity of 155,000 tons of zinc per annum. After the May 2014 grand opening, it came to light that management had had to rip out and replace some brand-new anodes, pumps and filters. It was an evil omen.

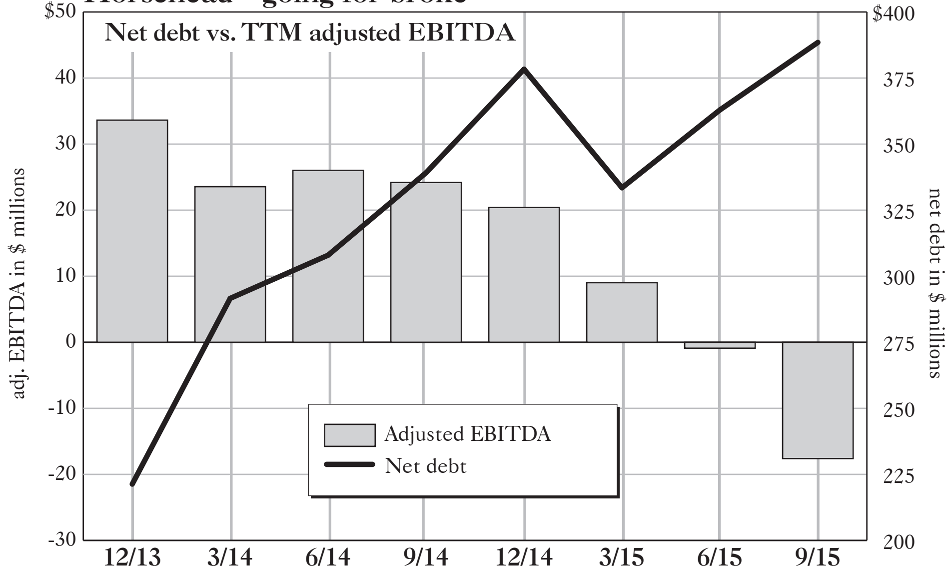
Or so it appears in retrospect. It did not seem so at the time; perfection plays no part in any known shakedown cruise, we recall thinking. By and by the share price hit $20.

"Mr. Market," we observed in the Labor Day 2014 issue of *Grant's*, "has chosen not to fret over the final price tag of $525 million, some 40% higher than the first estimate. He has rather chosen to focus on a rising zinc price, now over $1 a pound." And we quoted the CEO, James Hensler, as saying that investors had not truly grasped the size of the opportunity, even at the $20 share price: "I do not think," said he, "that the market is fully pricing in the potentially much higher zinc prices that some analysts are forecasting in 2015 and beyond or the potential return on the additional return on the additional free cash flow that the business will generate once Mooresboro is fully ramped up and we begin investing the cash and/or paying down debt."

Or not. "In other words," we said, striking, now, a new dissenting note, "the transformational event has happened and the market has noticed—has, in fact, jumped to its feet to applaud. Not a bad time to slip away from the crowd to prospect for something new, we judge." For zinc, for Mooresboro, and for the price of a share of ZINC, those were the good old days. It was essentially downhill from there.

As it was for North Atlantic Drilling Ltd. (NADL), a specialist in the frostbitten work of boring holes in the freezing seabed in the service of lifting oil. It happens that we devoted a portion of that Sept. 5, 2014 article on Horsehead to a review of our earlier, bullish analysis of North Atlantic Drilling. What we didn't say is that we should have said, to wit, in view of the developing epic bear market in oil, the NADL share price was a goner. "Hold," was rather the call. From $11.39 a share, the stock scraped bottom at 23 cents in December 2015. Seadrill Partners, a member of the greater NADL family through the latter's majority owner, Seadrill Ltd., is today a speculative-grade credit. Its Caa-2 rating fully comports with the current share price of NADL. That price is $3.32—following, mind you, a 1-for-10 reverse split at year end. So much for editorial clairvoyance.

Horsehead—going for broke



source: The Bloomberg

Back, now, to Horsehead. The creditors are on their way to becoming the new stockholders. A half-dozen-member Ad Hoc Secured Noteholder Committee is presenting a united bondholder phalanx to the United States Bankruptcy Court for the District of Delaware (the six own, at par value, $221 million of debt instruments and, according to court documents, are furnishing the super-priority DIP financing).

Aggrieved others—notably, shareholders smarting from the provoking juxtaposition of a purely nominal share price with $400 million of book equity—have failed to secure a seat at the bankruptcy table. Seated or standing, they are unlikely to realize much, if any, value from their investment. Horsehead's convertible bonds are quoted at just under nine cents on the dollar, the aforementioned 10.5% notes at 56 cents on the dollar. The the bank debt, of which there was $62 million outstanding when the company declared insolvency, appears to be money-good, something that can't be said for the bank debt in some recent energy-related bankruptcies.

In a Chapter 11 proceeding, GAAP accounting metrics don't count. Cash is rather the coin of the realm, and Horsehead was running out of it even before it filed; on Sept. 30, the ratio of cash and equivalents to current liabilities weighed in at just 0.30.

Possibly, the assets will again prove valuable in some future zinc bull market. For now, Mooresboro is cold iron (the plant was idled on Jan. 22, less than two weeks before the bankruptcy filing). Nor does management seem to know how long it will take to fix what's broken at Mooresboro. As Chiza Vitta, director of upstream metals and mining at Standard & Poor's Ratings Services, tells *Grant's*: "They are kind of plugging holes as they come up."

It's a cinch that Hensler et al. did not actually try to become overleveraged. They borrowed as Mooresboro disappointed and as cash flow dwindled. On Sept. 30, net debt reached $380 million, up from $233 million two years earlier. Looking back at Horsehead—and, indeed, at North Atlantic Drilling—we are reminded that each was a speculation on the volatile price of a single commodity. Each was, at respective removes, a derivative bet on China. Whatever the lesson of these narratives might be, we certainly intend to heed it. Maybe it's only this: It's hard to run a successful business.

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We have broken out the centerfold story for your reading comfort.
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Credit risk: "On"

At the Feb. 22 sounding, the narrowly defined money supply M-1 was shrinking. Measured over a three-month interval, it was shrinking at an annual rate of 0.7%. No more. Observed two weeks later, it had returned to growth (see table to the right). Twenty-odd billion came out of demand deposits, then eighteen-odd billion flew back.

Volatile, these monetary movements may be, but they're nothing like Mr. Market's mood. Since falling to 1829.08 (10.5% below its Dec. 31 close) on Feb. 11, the S&P 500 has rallied to 2049.8 (up 0.3% for the year). Junk-bond yields, as measured by the BofA Merrill Lynch High Yield Index, have plunged to 8.12% today from 10.07% on Feb. 11. Yields rated triple-C and lower—the sub-basement of speculative grade—have dropped to 18.4% today from 21.68% on Feb. 11. It may or may not be coincidental that the price of West Texas Intermediate likewise carved out a bottom on Feb. 11, at $26.21 per barrel. Since that fateful date, the price of crude has surged by 57%, to $41.22.

"To see just how far the sentiment has swung," colleague Evan Lorenz relates, "consider the winter-to-spring saga of triple-C-rated Intelsat SA, the world's largest satellite-services company (*Grant's*, Jan. 24, 2014). Intelsat's Feb. 22 earnings call featured news that management had retained Guggenheim Securities LLC to assist with 'balance-sheet initiatives.' Whatever that phrase might have meant, it didn't sound bullish, with Intelsat on the hook for $14.5 billion."

Could management, or the monetary gods, or someone, effect a refinancing? Creditors seemed to doubt it. On Feb. 23, the Intelsat 7¾ senior unsecured bonds of 2021 fell to 24.25 from 28.25 to yield 48.8%, while the B-2 term loan due 2019 dipped to 87.125 from 91.313.

That was then. On Monday, the company sold $1.25 billion's worth of first-lien senior secured notes, the 8s of Feb. 15, 2024. The deal, so LCD Capital IQ reported, was upsized by $250 million and priced at the tighter end of "early market whispers." Not bad at all, the Standard & Poor's unit observed, for "a debt-laden issuer whose unsecured notes, such as the 6.625% series due 2022, trade in the mid-50s, offering about 18.5%. . . . " Maybe it *was* the monetary gods.

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Correction: Retail money-fund assets did not soar by $104.2 billion between Nov. 23 and Feb. 22, as we reported in this space two weeks ago, using data from the Federal Reserve Bank of St. Louis. In fact, growth was more along the lines of $10 billion. The mistake stemmed from new money-fund reporting requirements. Confusion as to classification between institutional and retail money funds seemed even to confound the regulators, Peter Crane, president and publisher of *Money Fund Intelligence*, observes.

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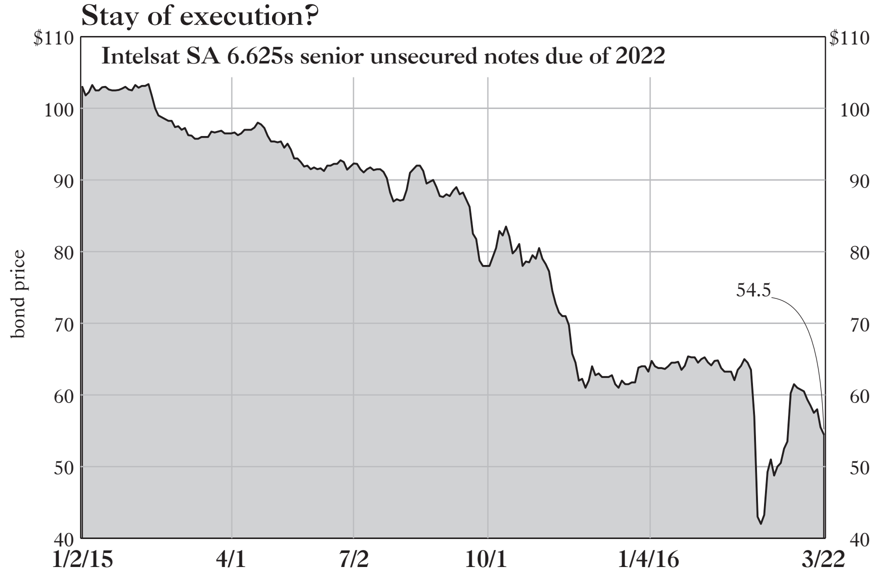
Stay of execution?



source: The Bloomberg