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Meet the Carrefour S.A. senior unsecured $1^3/_4$s of 2022

The central banks of the West, rattling their interest rates, are hinting at a big change. The European Central Bank, the Bank of England and the Federal Reserve are clearing their throats and making signs that—as Citigroup analysts put it the other day—"the Great Taper is coming" (we went to press the day before the Federal Open Market Committee tipped its hand on Wednesday). Whither bond prices?

"It depends on the bond," the careful analyst would say. Sovereign debt is different than corporate debt, and neither is identical to municipal debt. There are gradations in quality to consider, of course. And duration, too. There are bonds and bonds.

We write to observe how the monetary machinations of the past half decade have flattened yields and bulldozed distinctions. At a Sept. 7 press conference, Mario Draghi insisted that the price-insensitive purchases by the national central banks of the eurozone had produced no bond bubble. Well, then, the president of the ECB was pressed, does QE not come with any negative side effects? Draghi said he knew of none.

A bond bear market, if such is coming, will put those claims to the test. We expect that Draghi will wish that someone else had uttered them. An interest rate is a price. Prices convey information. Distorted prices convey misinformation. Build a new factory? Reckon the value of a future cash flow? Deduce financial risk from a credit spread? Manipulated rates give you the data you need to arrive at the wrong conclusion.

Like the flu, mispricing is communicable. Like a sneeze, arbitrage transmits the disorder from one place, and one asset class, to the next. Pygmy interest rates lead to tiny real-estate cap rates and towering equity P/E multiples.

"High-yield securities" is a universal misnomer these days. It's especially inapt on the Continent. Assets of the iShares € High Yield Corp Bond UCITS ETF (IHYG on the London Stock Exchange) deliver an average yield to maturity of 2.1% (with a relatively short 2.8-year average duration). At least, the yield-starved European masses may console themselves, it's a positive 2.1% yield. Still, a valuation so high makes transatlantic waves. It virtually commands a robust bid for dollar-denominated junk bonds priced to yield 5.1% (with an average 3.5 years of duration). Every price is relative and—following years of central bank meddling—many prices are cockeyed.

At first, the ECB confined its quantitative easing to government securities and bank debt. In March 2016, it expanded the list of eligible assets to include investment-grade corporates maturing in 30 years or less. As of Sept. 15, the half-dozen national central banks that do the buying on behalf of the ECB had accumulated €111 billion worth of corporate debt. In an August accounting, 20% of those securities had been plucked from the market at negative nominal yields. Since the start of the corporate-debt acquisition spree, risk spreads (defined as an

Like Germany, almost?

source: The Bloomberg

average of nonfinancial, investment-grade corporate yields minus the corresponding sovereign yields) have tightened to 95 basis points from 153 basis points. Bond investors nowadays do business in a hall of mirrors of the ECB's construction.

Striking enough in aggregate, the fruits of this spend-a-thon are more telling at the level of the individual security. First up in a cavalcade of financial distortion are the Carrefour S.A. 1¾s of July 15, 2022, quoted at 105¾ to yield 0.5% to maturity. That's 75 basis points richer than the German Bund 0s of 2022.

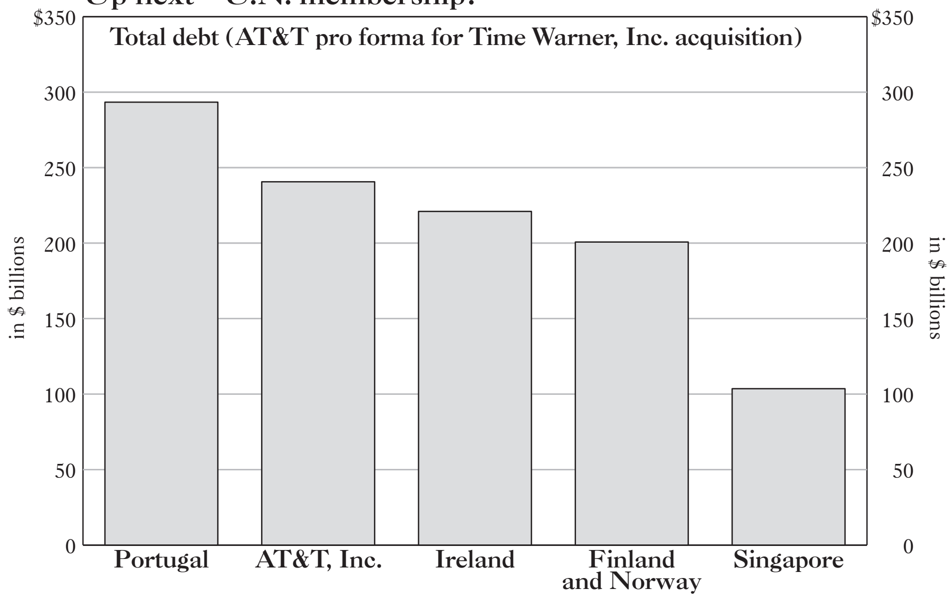
Triple-B-plus-rated Carrefour operates 12,000 retail food stores, from convenience marts to hypermarkets, in 30 countries. It's the world's second largest food retailer, after Wal-Mart. France accounts for 46% of its sales, the rest of Europe 27%, Latin America 19% and Asia 8%. Europe, France included, produces 74% of EBIT, meaning earnings before interest and taxes.

If the analysts polled by Bloomberg know their business, Carrefour's EBITDA, i.e., earnings before interest, taxes, depreciation and amortization, will weigh in at €3.64 billion in 2017, down from €3.88 billion in 2016. In the first six months of this year, EBIT did actually fall by 21.5%, to €621 million, from the year-earlier period. On Aug. 30, the world learned that bearish fact, Carrefour's shares slumped by 13%.

The competition may claim credit. In January, E.Leclerc Group overtook Carrefour to become the top French grocer both in terms of store fronts and market share (21.1% to 20.9%, according to an April estimate by Statista). Then there's the man named Bezos. On Sept. 1, *The Wall Street Journal* reported that Amazon.com, Inc. already counts France as its third-largest European retail market and that, in March, the Everything Store began to offer one-hour Prime delivery of groceries and beverages, household and baby items. Likewise offering 60-minute deliveries is Grupo Casino S.A., another French retailing up-and-comer. *The Journal* quotes Bruno Monteyne, analyst at Bernstein Research, as saying that Carrefour's online operations are "woefully small."

On the June 30 balance sheet date, Carrefour showed net debt of €7.7 billion, vs. an average of €6.9 billion for the previous five years at the same mid-year point. In the first half of 2017, cash from operations minus working-capital movements fell by 10%, to €976 million, from €1,088 million in the like period in 2016. Based on operating results and historical cash-flow figures, not to mention the long shadow of Jeff Bezos, we judge that Carrefour must stretch to deliver on its promise to return 2017 cash flow to the level of 2016.

Up next—U.N. membership?



sources: The Bloomberg, MoffettNathanson estimates

Priced as they are, and featuring the credit risk that they do, the Carrefour 1¾s are bonds that only a central bank could love. Or not love, precisely, for the ECB and its minions buy programmatically and cold-bloodedly, like index funds and ETFs. Price and value figure not in the monetary algos.

The bullish case for the Carrefour 1¾s is that the Bank of France will eventually buy some (it doesn't own any yet). The ECB and its national subsidiaries continue to buy €60 billion of fixed-income securities each and every month—they need bonds as a slurry pipeline needs coal, copper or phosphates. What price might the Bank of France pay? The limit is a price equivalent to the ECB deposit rate, currently minus 40 basis points. As the Carrefour bonds change hands at plus 50 basis points, the maximum Bank of France bid would furnish 90 basis points of upside running room. The prospective 90 basis-point rally multiplied by the duration of the security, i.e., 4.4 years, gives you 396 basis points of potential price appreciation.

Downside risk looms larger. To start with, Draghi could succeed in substantially depreciating the euro. Alternatively, or additively, Bezos or Casino or E.Leclerc Group could succeed in substantially degrading Carrefour. Either way, a 50 basis point yield to maturity seems meager pay in the world in which we live (or just about any other world).

Deformity exhibit No. 2 are the euro-denominated AT&T, Inc. 1.8s of September 4, 2026, which trade at 101½ to yield 1.6%, or 131 basis points more than the corresponding German Bund. AT&T, familiarly known by its stock ticker, T, is already the largest telecommunications company in the world. On completion of its acquisition of Time Warner, Inc., it stands to become the world's biggest non-banking corporate debtor. Combine the projected obligations—funded debt, operating leases, unfunded pension obligations, post-retirement benefit obligations—and you come up with a quarter trillion dollars, calculates Craig Moffett, founder and one-half of the eponym of MoffettNathanson Research. Pro forma the acquisition, Moffett tells *Grant's*, triple-B-plus-rated AT&T will show a ratio of net debt to EBITDA of 3.7 times, up from 3.1 times before the transaction.

"It's the largest balance sheet of any nonfinancial company in history," Moffett marvels. "To put it in perspective, it's more than the country of Ireland,

and just a little bit less than Portugal. It's more than Norway and Finland combined. It's more than the country of Singapore. It's an insanely large amount of debt for one company to hold. And the simple credit metrics don't sound remotely like investment-grade credit metrics."

Indeed, as the average triple-B-rated issuer presents a 2.7 ratio of debt to EBITDA, Moody's has placed T under surveillance for a possible downgrade. Anyway, as Moffett and we agree, the dynamics of the wireless communications business seem calculated to keep a creditor awake at night.

Once upon a time, carriers competed in three dimensions: handset selection, network quality and price (*Grant's*, Dec. 23, 2016). Now that vendors offer equivalent handsets, the competitive criteria are reduced to two. And—by the way, who needs "quality," at an extra cost of $20 or $30 a month?—maybe to one.

Underscoring the intensity of the competition, Sprint Corp. and T-Mobile U.S., Inc. last year added almost nine million subscribers, compared to 2.3 million for AT&T and Verizon Communications, Inc. Now T-Mobile is offering two lines of unlimited talk, text and data plus a freebie Netflix subscription for $80 a month. Sprint and Verizon have their own promotions. AT&T recently floated plans to give away HBO subscriptions with a wireless plan for $60 a month.

Such enticements accentuate the deflationary tendencies already in evidence before the coming of today's "everything unlimited" telephony bazaar. Not for nothing did Janet Yellen single out cellphone pricing as a source of weak inflation data this spring (Would the chair prefer that Americans pay more? She so implied.) Between 2008 and year-end 2015, the wireless service component of the CPI fell by 2% annually—and tumbled by 13% from August 2016 to July 2017 as T-Mobile's "unlimited" plan ricocheted through the industry.

AT&T may or may not prove a sturdier credit than, say, the government of Portugal. The company's 1.8s are priced, almost, as if T were as sturdy as Germany. For the sake of the creditors, it had better be, as the pricing leaves little room for adverse surprises. Let euro-denominated interest rates rise by one percentage point, and the creditors would be out eight points in price (given the bond's eight-year modified duration). They would surrender more than four years of interest through an uptick in borrowing costs that the ECB is actually striving (though not just yet) to bring about. It's a strange investment when getting out whole constitutes the upside.

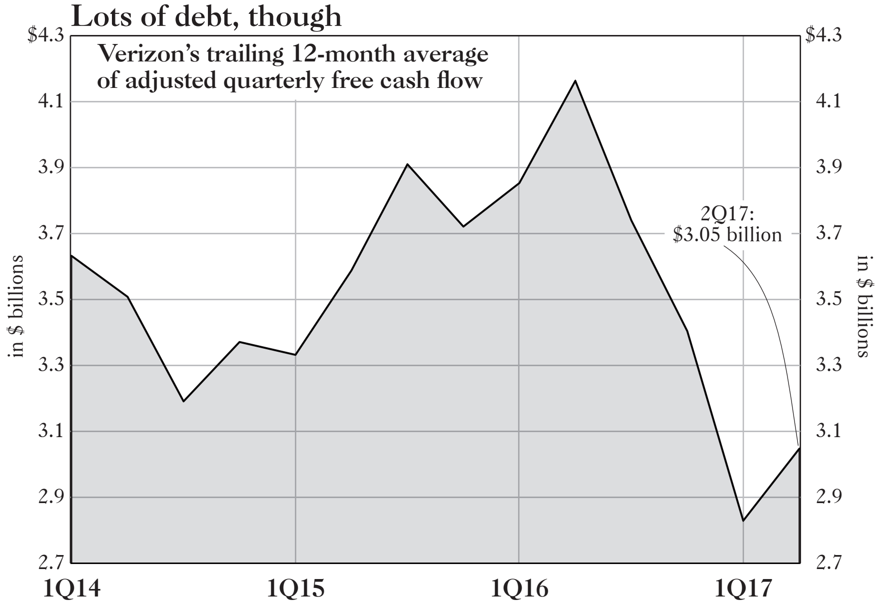
Or—in the central-bank-warped credit markets of 2017—not so strange. Examples abound of bonds that fail the mother-in-law test: "Knowing what I know, could I face the dear lady if the overpriced bonds in which I was about to place her dropped by 10 quick points because the Fed decided to 'taper'?" We think, in this context, for instance, of the single-B-minus-rated Restaurant Brands International, Inc. 5s of October 15, 2025, quoted at 101½ to yield 4.7% to maturity. We incorporate by reference the *Grant's* bill of particulars against the 3G Capital-sponsored issuer, sometimes known by its ticker, QSR (see, for instance, the issue of *Grant's* dated June 2). For brevity's sake, compare the above-named security with the iShares i Boxx $ High Yield Corporate Bond ETF (HYG on the New York Stock Exchange Arca). More than 85% of the ETF's exposure is to companies rated single-B and higher. The assets deliver a 5.2% yield to maturity at a 350 basis point spread to Treasurys; the duration of the portfolio is 3.5 years. The QSR bonds trade at a 250 basis-point premium to Treasurys with a duration of 5.7 years.

Or—the final example from the land of Mario Draghi—consider the euro-denominated, triple-B-plus-rated Verizon senior unsecured 1⅝s of March 1, 2024, trading at 103.9 to deliver a yield to worst of 1%. Verizon, a.k.a. VZ, may well be, as J.D. Power says, the best wireless network in America, but the accolade has come at the cost of a sprawling balance sheet. Since 2012, Verizon has more than doubled its debt, to $117 billion, much of it earmarked to pay Vodafone for the 45% interest in Verizon Wireless that VZ didn't already own (that was in 2013). Squinting to spot the prevailing tiny interest rates, VZ duly availed itself of the opportunity to borrow on the cheap.

All would be well if this accumulated debt were the means to the end of improved financial performance. It has not delivered the goods so far. Thus, in 2014 Verizon generated $13.1 billion of free cash flow (defined as cash from operations minus capital expenditure and wireless licenses). In 2016, it served up $5.1 billion in free cash flow. Accounting distortions only partly explain the collapse in that metric, as the company produced a quarterly average of $3 billion in free cash flow over the past 12 months vs. an average of $4.1 billion in the 12 months ended June 2016, Moffett calculates.

Leverage, at least, is on the upswing. In the latest quarter, VZ's ratio of net debt to EBITDA reached 2.6 times, up from 1.4 times in 2012. Add in $22 billion in underfunded pension liabilities

Lots of debt, though



source: MoffettNathanson Research

(and adjust for operating leases and asset-backed securities) and leverage climbs to 3.4 times EBITDA.

In the second quarter, Verizon showed a 6.7% year-over-year decline in wireless service revenues—the tenth such consecutive drop—and a 5.3% year-over-year fall in so-called wireless adjusted EBITDA (the wireless segment delivers 85.7% of EBITDA). "Verizon reignited its growth engine in the quarter," CEO Lowell McAdam quoted himself as crowing in the earnings release. The subsequent paragraph revealed a change in corporate mood: "On a comparable basis excluding divestitures and acquisitions (non-GAAP), consolidated revenues declined 2.0%."

Before buying the stake from Vodafone, VZ was an A-minus credit. As noted, it's now a triple-B-plus credit. "We no longer expect to be able to achieve an upgrade to our pre-Vodafone credit rating in that [2018-2019] time frame," Verizon admitted in a May 8-K filing. The bond market shrugged it off. The ECB was buying, and VZ rallied with the rest of the investment-grade market. Odd that Draghi refused to acknowledge even the pleasant side effects of radical QE.

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