GRANT'S

INTEREST RATE OBSERVER®

Vol. 37, No.12b | 233 Broadway, New York, New York 10279 • www.grantspub.com | JUNE 14, 2019

Long-shot nation

Peace and prosperity are well and good, but trouble is the seedbed of value. If it's low price-earnings ratios, high real interest rates and fat credit spreads you're looking for, search the countries where you wouldn't necessarily want to apply for citizenship. Now in progress is a Cook's tour of the long-running inflation-devaluation-corruption-default-recession-statism champion of the Western Hemisphere, the Argentine Republic.

To anticipate, we serve up a gamble on the birthplace of the tango and Eva Perón. Peso-denominated, inflation-linked bonds are priced for disaster perhaps even more grandiose than the kind for which Argentina is justly famous. Cement-producer Loma Negra Companía Industrial Argentina S.A. and state-controlled oil company YPF S.A. (LOMA and YPF, respectively, on the New York Stock Exchange) appear to offer an adequate margin of safety. But it's a sign of these asset-inflated times that clear and compelling absolute value is sparse even in a country that may or may not return the calamitous former president Cristina Fernández de Kirchner to national office later this year.

The Argentine value proposition turns on the re-election of President Mauricio Macri. A former mayor of Buenos Aires, Macri won office in 2015 on a platform to undo Kirchner's damage. Beginning strong, he attacked currency controls, import restrictions, utility subsidies, agricultural-export restrictions. But the baleful Kirchner legacy has proven harder to uproot than a tree stump.

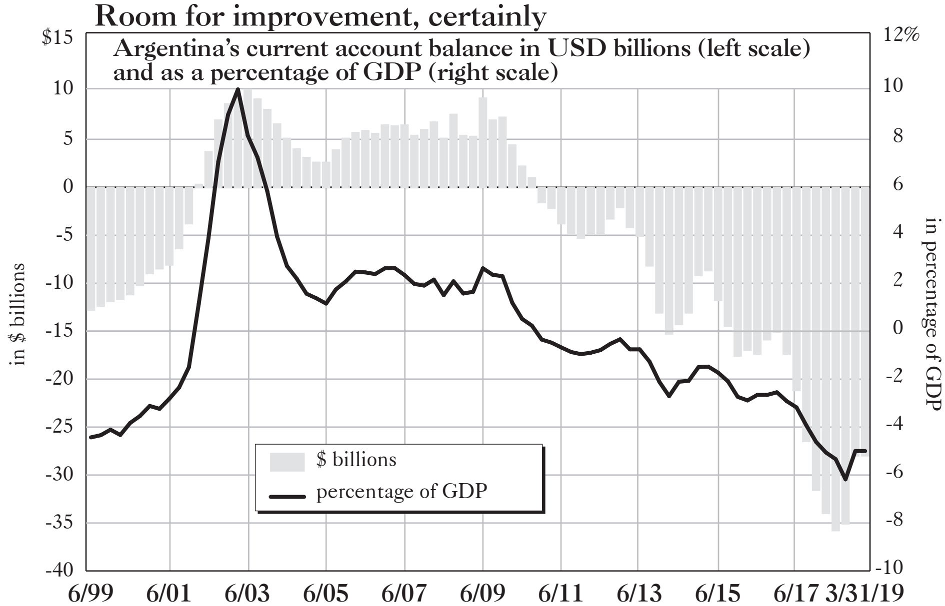
Tugging on that stump, Macri watched inflation hit 47.6% last year, the highest rate since 1991. (Perhaps Jerome Powell and Mario Draghi, who complain that they can't get a decent inflation started, should ask Guido Sandleris, president of the Argentine central bank, for pointers.) Drought wreaked havoc with the 2017–18 harvest, the peso-dollar exchange rate was sawed in half, the current-account deficit bulged and the fiscal deficit exploded. Desperate, Macri secured a $56.3 billion credit line from the International Monetary Fund, an organization as reviled in Argentina as it is in Greece. But the quid for the IMF's quo has been an immensely unpopular fiscal belt-tightening. To mitigate the effects of austerity, Macri has taken a page from the dog-eared Peronist book by restoring certain vote-buying subsidies and, in April, by slapping price controls on 60 basic consumer items.

If, on the one hand, the embattled former civil engineer wins a second term this fall, widows and orphans may kick themselves for not having taken a flutter on Argentine credit-default swaps (quoted at a level implying a 51% chance of nonpayment in the next five years) or the dollar-denominated Argentine government 8¾s of 2024, quoted at 70 cents on the dollar to yield 16.7% to maturity.

If, on the other hand, the socialist opposition returns to power, even 16.7% could appear skimpy.

Economists have long puzzled over the "Argentina paradox." Why did a

Room for improvement, certainly



source: The Bloomberg

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

country that ranked 10th in the world in per capita wealth on the eve of World War I spend the next century sliding backward? Decades of military government, Peronism, import substitution and inflation couldn't have helped. However, the infamous 2001 default on $100 billion of sovereign debt, then the top default, in nominal dollars, in history, recalls the flaw that may have been present even in the belle époque of the early 20th century. In 1890, Barings Bank, London, almost came a cropper on account of its overexposure to Argentine securities. Maybe there is no Argentina paradox but simply bearish destiny.

Be that as it may, the immediate concern is that Argentine valuations may still not be cheap enough to compensate for the considerable risks. At 6.4 times forward earnings, the 20-stock Merval index is richer than the 5.7 and 4.8 times quoted on Russia's RTS index and Turkey's BIST-100. Nor will the Buenos Aires exchange's size and liquidity be to everyone's taste. The market cap of the 56 listed stocks comes to a grand total of $41.2 billion, of which just $16 million change hands on an average day; most U.S. investors will find that their participation is limited to American depositary receipts. (For context, in New York, more than $10 billion of Amazon.com, Inc. trades on a given day.)

The holding company of Grupo Financiero Galicia S.A., one of Argentina's best-run banks, is valued at nearly three times book value. It's a reflection of both the 30%–40% returns on equity that the bank has been earning and the prevailing 70% Argentine money-market interest rates that make possible such a gaudy ROE.

"There is a lot of pessimism, and it's very difficult to predict what will happen," says a successful, publicity-shy Argentine fund manager who got on the phone with colleague Fabiano Santin. "Yes, we've hit rock bottom, but Argentina's debt situation, in a scenario of a government without credibility, becomes chaotic. There is not enough pessimism for the case that [if Kirchner's ticket] wins, the chance of a default is very high, because our dollar-denominated debt is way too high. Is it 50/50, the election odds? If so, then I don't think there

Discounting Mrs. Kirchner

source: The Bloomberg

is enough pessimism in the assets. I'd describe prices as 'fair.' Even if Macri wins, the scenario is not easy."

And while the Merval index did rise by 13.5% in dollar terms in May, most of the rally is attributable to MSCI's decision, effective the first of that month, to add Argentine equities to its emerging-markets indexes and delete them from its frontier-markets indexes. Argentine credit, which received no index-induced promotion, staged no parallel advance.

The essential bull case is reducible to Macri's re-election. That such an outcome is even possible is itself a point for optimism—strictly by the economic numbers, you wouldn't give the incumbent a chance. But the domestic economy seems to be mending, the current account improving and inflation moderating. Certainly, the farm economy, which contributes 10% to GDP, is growing again. And the real, effective peso-dollar exchange rate is near the lowest in almost eight years—18% cheaper, in fact, than when the newly elected Macri lifted exchange controls in December 2015.

"People are pricing that we're going back to populism, that the country will default again on its debt next year, that there will be a new balance of payments crisis," Andy Cummins, founder and CIO of Explorador Panam Horizon Fund, L.P., which holds 28.1% of its $250 million portfolio in Argentine securities, tells Santin. "And our view is that none of this is going to happen, and that the bet on Argentina is very asymmetric."

"It's noteworthy," Santin observes, "that Macri's popularity has held up as well as it has, given what Argentina has gone through. Alberto Fernández, Kirchner's former chief of staff, leads the opposition ticket for the national election slated for Oct. 27; Kirchner last month announced that she would be playing second fiddle this time. Polls conducted from May 30 to June 2 show Macri and Fernández-Kirchner within five or so percentage points of each other. One poll actually has Macri ahead.

"Perhaps," Santin goes on, "another Fed rate-cutting cycle could reverse the dollar's strength and help the peso—and contain inflation. As Francisco Velasco, head of research and strategy at Banco Mariva, has noted, currency outflows should tail off since investors have already pulled out $25 billion (more than 80%) of the cumulative stock and bond inflow that followed Macri into office."

"It turns out that of the 10 best oil shale fields in the world, as we do the analysis, seven are in the United States," Leigh Goehring, co-founder and co-manager of the Goehring & Rozencwajg Resources Fund, advises Santin by email. "According to our modeling, there are only three oil shale fields in the world than can match the qualities of those found in the United States: the Bazhenov

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

shale in Russia, the La Luna shale in Colombia and the Vaca Muerta shale in Argentina"—in which YPF, the aforementioned, Big Board-listed Yacimientos Petrolíferos Fiscales, Argentina's top oil producer, holds rights to about 30% of the acreage.

Full development of Vaca Muerta lies in the future. For the present, YPF produces 515,000 barrels of oil equivalents a day, owns three refineries with half of the country's capacity, 1,600 gas stations representing a 35% market share and a petrochemicals business that produces 2.2 million tons of fertilizers, methanol and other chemicals annually. Except for 2016, YPF has shown a net profit every year since it listed in New York in 1993.

YPF commands a $6.3 billion market cap. Its enterprise value (equity plus net debt) trades at 3.0 times estimated, adjusted 2020 earnings before interest, taxes, depreciation and amortization, a 40% discount to its global peers. Debt is a manageable 1.7 times trailing adjusted Ebitda. "YPF's proven and probable reserves at current prices, plus the company's refineries, gas stations and petrochemicals businesses valued at 5.0 times adjusted Ebitda, together exceed YPF's enterprise value," attests Explorador, which owns the shares. "This implies [that] investors receive YPF's electricity assets, gas pipelines and incremental upside from Vaca Muerta's development for free."

Oil bears have other options. Loma Negra, founded more than 90 years ago, is the largest cement producer in Argentina. It claims a 44% market share at home and a 46% share in neighboring Paraguay. It's vertically integrated and boasts its own logistics network, including a 1,900-mile railway concession.

"Cement prices in U.S. dollars are at historical lows in Argentina, and there are projections for big efficiency gains next year," a Brazilian fund manager tells Santin. "Argentina's cement industry is well-organized, there are only four players, no more than two operating in each region of the country. In other words, there is no competition. Argentina's per capita cement consumption is at historical lows. It has already been hit very hard. Even if [Kirchner's] coalition wins, she is going to have to pull forward investments, and construction is set to rise. Loma Negra has the capacity to absorb all growth that comes if Macri is re-elected and there is another growth cycle."

Loma Negra's vital signs include these: market cap, $1.2 billion; net debt to adjusted Ebitda, 0.6 times. At the current peso-dollar exchange rate, the consensus forecast calls for adjusted Ebitda to grow by 30%, to about $270 million in 2020, not unreasonable in a time of 55% inflation. Such a scenario would imply a valuation of 5.0 times forward adjusted Ebitda. For reference, North American, European and Asian peers trade at forward adjusted Ebitda multiples of 10.0, 6.6 and 8.8 times, respectively, all with lower prospects for growth.

As with YPF, the investor is paying for the prospective higher earnings that a Macri victory could serve up. It's not so farfetched a hope if the free-market version of the incumbent president (as opposed to his recent tack to price controls) could subdue inflation and institute a growth agenda by reattracting the foreign capital that fled in 2017–18.

If Argentine equity seems overvalued in relation to Argentine debt, the relative abundance of the latter—Argentine sovereign obligations in the sum of $277 billion are outstanding—may help to explain the disparity. Rated middling junk, i.e., B2/B, Argentina is the third-largest sub-investment-grade sovereign-debt issuer in the world behind Brazil and Greece. It is surely among the most persistent defaulters, having broken good faith with its creditors on eight occasions since it declared independence from Spain in 1816.

Make no mistake: The investor in Argentine debt is playing the ponies. The bet is on an election that will likely be decided in the historically Peronist suburbs of Buenos Aires, whose residents may not soon forget whom to thank for the reductions in subsidies on bus fare, water and electricity that the incumbent set in motion. In 2015, Macri carried key precincts in and around the capital. As for his 2019 prospects, our lookout in lower Manhattan affords no unique view.

By the lights of Moody's Investors Service, the government of Argentina is a "stable" credit but a precarious one. Who could disagree (except, perhaps, with the perceived stability)? Some 76% of the country's external sovereign debt is denominated in foreign currencies, chiefly the dollar. Government debt, as a proportion to government revenue, has vaulted to an estimated 482% this year from 202% in 2013; the ratio of external debt to current-account receipts has leapt to an estimated 516% this year from 164% in 2013. If, indeed, inflation is moderating, growth returning and the peso stabilizing, those Argentine green shoots haven't sprouted a day too soon.

How to speculate on a bullish outcome? One could buy the U.S. dollar-denominated 7½s of 2026 (of which $6.5 billion are outstanding, ISIN: US040115GX20) that afford the protections of New York law. They trade at 79, near their all-time low, for a 12.0% yield to maturity.

Or one could forego such protection as New York law may provide, reasoning that the 15-year legal battle that raged after the 2001 default is an experience that no sane bond speculator would care to relive. "Besides," observes Santin, "the downside in the short run, in case of default, may not be very different across the sovereign capital structure. Better, then, the dollar-pay 8¾s of 2024 (of which $12.6 billion are outstanding, ISIN: ARARGE03H413) that were drafted under a local law indenture.

"Changing hands at 70 cents, the lowest since coming to market in 2014, the 8¾s of 2024 trade at a discount to the 2026 New York law notes and yield 16.7%," Santin continues. "A sinking fund affords an investor the chance to take some money off the table in a muddle-through scenario; on May 7 next year, and for each of the following three years, the sinker is directed to retire 16.66% of the issue's principal value at par. If Macri wins and the bonds rally to the same 10% yield at which they traded in February, they would, by December, return the holder a capital gain of more than 20% in addition to coupon income."

To those accustomed to the 0.7% *pre-tax* real yield on offer in U.S. 30-year TIPS, the values assigned to Argentine inflation-linked securities may look like a jumble of typographical errors. For instance, the peso-denominated, inflation-linked 5.83s of 2033 (of which $423 million equiv-

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

alent are outstanding, ISIN: ARARGE03E121) pay a 13.8% yield after inflation, a rate unseen since 2012–13 and even in the Lehman maelstrom of 2008–09.

The yield, needless to say, doesn't come for free. The first risk is the peso. The second risk is the inflation index. The government calculates it, either Macri's government or some other. Kirchner's government suppressed the official inflation rate and criminalized the collection of alternative, privately calculated price data.

If, in the kind of bullish outcome of which daydreams are made, the bonds repriced to the same 8% real yield at which they traded earlier in the year, their price would jump by 43%. If inflation came down significantly and GDP growth returned with fiscal accounts in the green, the linkers could eventually trade at a 4% yield, or 90% above the current price.

Your broker or banker would buy the bonds through Euroclear. A phone call to Gamblers Anonymous might prudently precede the laying down of an outsize bet.

•

Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc.
PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else.
Copyright ©2019 Grant's Financial Publishing Inc. All rights reserved.

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.