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Cheaper and better

Evan Lorenz writes:

While private credit is all the rage, there are safer ways to shoot for—and sometimes even to get—double-digit yields. Pick-to-click Coface S.A. (COFA on the Paris Stock Exchange), for example, is priced to yield a 13.9% dividend and boasts an almost debt-free balance sheet. In preview, we remain bullish.

As you may recall, Coface insures the credit that businesses extend to one another (84% of trailing revenues) and performs such credit-related services as factoring, surety-bond underwriting and debt collection (16%). Guaranteeing corporate accounts receivable is a pleasingly consolidated industry, with Coface and peers Allianz S.E. and Grupo Catalana Occidente S.A. sharing 61% of global coverage; national or regional competitors, including China Export & Credit Insurance Corp., claim the balance.

Since we laid out the bull case for Coface in the issue of *Grant's* dated July 14, the stock has dropped 17.1% in dollar terms versus a 0.7% gain in the S&P 500. Lackluster results catalyzed the decline, as revenues fell by 0.3% year over year in the third quarter. An 8.1% rise in the noninsurance operations was not enough to offset a 1.7% contraction in the main business unit (all figures are adjusted for foreign currency movements).

"We are seeing a turn in the credit cycle," CEO Xavier Durand warned on the Nov. 14 earnings call. "We're seeing tighter financing conditions, which are starting to bite into the economy, reducing inflation [and] activity levels that are less than last year, both price and volume. We think the full impact on the economy is yet to come."

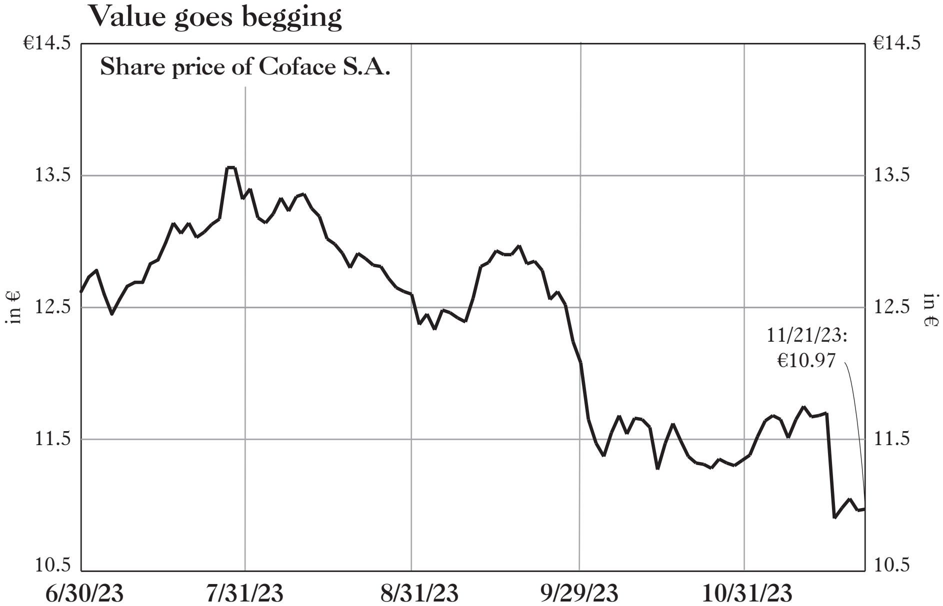
In another call later that day detailing the company's global outlook, Coface's Southern Europe economist, Marcos Carias, described the lagged impact of climbing rates. "Yes, [interest] rates for firms have been rising," he said about Italy in particular, "but, also…they have been able to pass through their prices to consumers. So the nominal revenues have been growing in tandem.

"Now," Carias continued, "we're probably going into a year where rates will remain higher, but inflation will continue moderating and, with it, of course, the nominal income of firms. So this creates a scenario in which there is increasing pressure on the cash flow that is coming to firms."

Nevertheless, Coface is still posting a strong underwriting performance. In the three months ended September, it reported a net loss ratio, i.e., costs to settle claims divided by insurance premiums, of 40%, a 300 basis-point decline from the year-ago period. Its combined ratio, i.e., the sum of claims-related losses and operating expenses divided by premiums earned, was a sterling 66.8%.

Economically sensitive companies are frequently valued off mid-cycle earnings. Assuming that recent results are, in fact, representative of what the company will average over a boom and a bust, the shares look commandingly

Value goes begging



source: The Bloomberg

cheap at 6.6 times trailing earnings and 83% of book value.

However, Durand cautioned, "there's no such thing as being in the middle of the cycle…when the tide rises, we rise with the tide. But, we can minimize the way or optimize the way we navigate those trends."

Financial conservatism is one such navigational tactic. The April 30 balance sheet showed €598.5 million in debt and operating leases against a cash balance of €538.7 million, yielding a ratio of net debt to capital of just 3%. In the first nine months, operating income covered interest expense by 11.2 times.

The €2.9 billion investment portfolio is conservatively managed. Bonds, of which 95% are rated investment-grade, make up 76% of the assets. The remainder consists of loans, deposits and other financial assets (15% of the total), real estate–related investments (6%) and equities (3%).

On Sept. 28, Moody's Investors Service upgraded Coface's insurance financial-strength rating to A1 from A2. The agency cited diversification into non-insurance businesses, the prudently managed investment portfolio and the strong balance sheet. Coface's Solvency II ratio, a regulatory measure of capitalization, was 192% as of last measurement on June 30 and has remained above 190% since 2020, despite growth in insurance in force. "Coface is becoming more strict on risk acceptance, and has already increased its number of actions to reduce or restrict growth in exposures to the most risky sectors or exposures," Moody's concluded.

Try as it might to minimize risk, Coface is hardly free from it. Year-to-date results included a €25.8 million writedown in the value of its real estate funds. In 2008, when it was still a division of investment bank Natixis S.A., Coface posted a peak loss ratio of 97.7%, which, if repeated, would wipe out earnings and, at least temporarily, put the dividend on hold. However, according to the company's own number-crunching, a repetition of the 2007–09 ordeal would still leave the business well-capitalized with a Solvency II ratio of 166%. In other words, the earnings power of the franchise should remain intact in a deep downturn.

Contrast this with private credit. By the lights of S&P Global Ratings, the typical non-traded loan backing a p.e.-sponsored buyout is leveraged 7.1 times and covers interest expense by 1.5 times (both as a function of Ebitda). In the face of a deep recession, credit impairments might erase the double-digit yields currently on offer.

At its current trajectory, Coface may disappear—from the public markets, at least. Arch Capital Group Ltd. holds a 29.9% stake in the credit insurer (for more on Arch, see the issue of *Grant's* dated Sept. 15). Given that Coface generated a 14.1% return on equity in the third quarter and trades at a 17% discount to book, Arch could eke out a 17% return buying the credit insurer at current prices without factoring in any cost savings from reducing duplicative overhead.

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