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You only get par

Take a plunging VIX and a resurgent S&P. Add tight credit spreads, rock-bottom sovereign yields and a worldwide income famine. Voila: today's not-so high-yield bond market.

Asymmetric investment opportunity is the subject at hand. You, the trusting buyer of corporate debt at 100 cents on the dollar, stand to receive your principal upon call or maturity and interest along the way. You can hear the voice in the back of your head reminding you of the nature of the security you have purchased. It won't—it can't—make you rich. Interest rates can move against you, the company that borrowed your money may borrow itself into the poor house, and the currency in which you have lent may depreciate. Indeed, the central banks of the world have pledged themselves to depreciate the money they manage by 2% a year. If the Yellens and the Draghis succeed in this mission, the holder of a 10-year security will be given a sum of principal worth only 80% of the amount that he or she originally handed over. Never mind the political rage of the middle class. We wonder why the creditors haven't risen up.

Netflix, Inc., the streaming media company, DVD shop and movie studio hybrid is case study No. 1 in investment asymmetry. Netflix common (NFLX on the NASDAQ) may or may not be a good investment. It *has* proved a superb investment. Whether it can tack on another eight-fold rise in price over the next five years will depend in large part on management's demarche into original content. Success could deliver immense rewards to the stockholders.

Holders of the Netflix 4 3/8s of November 2026 would hardly share in the hypothetical bonanza. Interest and principal are what they signed up for, after all. The downside—always looming, especially in a business as fast-changing as digital technology—is another matter. In the risk of business failure, the lenders partake only a little less fully than do the stockholders.

Rated B1/B-plus, the Netflix notes change hands to deliver a yield to maturity of 4.54%. They are quoted at a spread of 203 basis points to the split-rated U.S. Treasury 10-year note. In 2016, the company generated operating income sufficient to cover interest expense by 2.5 times.

That was, to repeat, last year; the noteholders must wait until 2026 for their principal. They may be biting their nails. Free cash flow weighed in at negative $127 million in 2014, at negative $921 million in 2015 and at negative $1.66 billion in 2016.

It 2014, Netflix paid $3.8 billion for programming—"streaming content assets." It laid out $5.8 billion for that purpose in 2015 and $8.7 billion in 2016. Dividing those figures by the average number of users paying for this service underscores the rising cost of do-it-yourself movies and television shows—$76.55 per user in 2014, to $108.21 per user in 2016.

Netflix, which will celebrate its 20th birthday this summer, has adapted to changing tastes and technology before. Maybe it will again—or maybe it won't. If not, the stockholders may lose everything, and the noteholders, too, would likely take a haircut. Default-induced losses might reach 35% of par value, according to S&P, or 68% of par according to Moody's (both estimates date from October). Comparing the risk-reward proposition at which the noteholders are staring, we recall the candid remark of a late private-equity giant. Referring to the insurance-company bond departments who financed the leveraged acquisitions of a generation ago, the titan shook his head. What chumps, he said.

Next up is the speculative-grade bank debt of Restaurant Brands International, Inc. (QSR on the New York Stock Exchange), the Canadian fast-food behemoth in which 3G Capital, the Buffett-partnering private-equity operation, holds a 43% voting interest. On Feb. 21, QSR—an amalgam of Burger King and Tim Hortons—committed to raise $1.3 billion in senior debt. Proceeds were earmarked for the acquisition of Popeyes Louisiana Kitchen, Inc. (PLKI on the NASDAQ) at a price of $1.8 billion. In paying that fancy consideration, Restaurant Brands rang a bell. The multiple of price to trailing 12-months sales, 6.7 times, was the highest on record for a $100 million-plus North American restaurant acquisition, according to the Gadfly department of Bloomberg. The loan, which carries a spread of 225 basis points over Libor with a floor of 1%, is rated B-plus by S&P and matures in 2024.

Restaurant Brands was already leveraged. At year-end, net debt footed to $7.1 billion, which figure rises to $10.6 billion if capital leases and a series of 9% preferred shares issued to Berkshire Hathaway subsidiary National Indemnity Company are included. (Though these preferreds are perpetual, they are also cumulative—unpaid dividends must be made up; they are puttable, too, at a liquidation value of $3.3 billion on Dec. 12, 2024.) Adding capital leases and the preferreds, net debt is equal to 5.8 times trailing earnings before interest, taxes, depreciation and amortization (EBITDA). Accounting for the acquisition of Popeyes, net debt will rise to 6.4 times trailing EBITDA, giving no effect to realized cost savings or, conversely, deal expenses.

Even as the lenders signed the checks, the vital signs of the fast-food industry were weakening. Comparable sales at Burger King restaurants (that is, currency-adjusted sales at both franchised and company-owned restaurants open for at least 13 months) rose by 2.3% year over year in 2016 vs. 5.4% in 2015. Comparable sales at Tim Hortons grew by 2.5%, down from 5.6% in 2015. At Popeyes, comparable sales growth similarly slowed to 1.7% from 5.9% in 2015. At Carrols Restaurant Group, Inc. (NASDAQ: TAST), the world's largest Burger King franchisee, comparable sales did increase by 3.2% year over year in the most recent quarter, but operating profit fell by 47%.

It would take an especially flinty credit analyst to ignore the stardust at 3G and (not so far in the background) Berkshire Hathaway. Still, neither Jorge Paulo Lemann nor Warren Buffett got where they are in life by ignoring the analytical unity of risk and reward. As for this transaction, a default at Restaurant Brands could cost the senior creditors 34% or 40% of their principal, Moody's and S&P respectively estimated in February.

TransDigm Group, Inc. (NYSE: TDG) and its senior subordinated debt constitute asymmetric exhibit No. 3. The B-rated aircraft-parts supplier borrowed $300 million the other day at a 6.26% yield to a 2025 maturity.

Investment opinion on TransDigm equity is cleaved. The bearish indictment (thank you, Citron Research) holds that the TransDigm M.O. is to borrow money, buy companies, fire employees and hike prices. Higher margins are the first-order effect of this stratagem. Commercial and regulatory vulnerability follow. Some 12.7% of the TDG float is sold short.

Certainly, TransDigm is leveraged, with net debt equal to 7.1 times trailing EBITDA at year-end. Net of refinancing costs (a recurring item at TransDigm), operating income in the most recent 12 months amounted to 38% of sales. That fat margin allowed the company to cover net interest expense 2.4 times over. If the bears are wrong, the bondholders will earn their 6.33% yield to a 2020 call. If it's the bulls who miscalculate, the creditors may suffer equity-like losses. In a bankruptcy, the lenders would probably secure recoveries no higher than 30% of par, according to the range of ratings-agency estimates (S&P calculated in May 2015 a recovery of zero, but allowed for a range of up to 10%).

In the tax code, debt is the advantaged corporate asset class (pending a Trumpian overhaul, interest expense is deductible from corporate income while dividend payments are not). The code of real life is different. There, equity comes first. A singularity indeed is the CEO whose compensation is tied to his company's debt ratings. No whining is allowed on this score, as everyone knows the rules. Still, you wonder what sad thoughts went through the creditors' minds at the news that TransDigm would pay a $24-per-share special dividend—in the grand total of $1.4 billion—late last year.

As interest rates are tiny on both sides of the Atlantic, so is income scarce. You find it by standing on the top rung of a rickety stepladder and reaching as high as you can. Ardagh Group, a maker of glass and metal packaging incorporated in Luxembourg, recently raised €750 million ($792.7 million) through a series of double-B-minus-rated senior secured notes. The 2¾s of 2024 yield 3.18% to a 2020 call at 101.375. They deliver 2.75% to a 2022 call at par and 2.75% to maturity in 2024.

Ardagh shows a ratio of debt to EBITDA of 6.7:1. Its operating income, €590 million, covered net finance expenses, €471 million, by a ratio of 1.25 times in 2016 (based on pro forma figures, which include the acquisition of certain beverage-can manufacturing assets of Ball Corp. and Rexam plc; see *Grant's*, Oct. 28, 2016).

"There isn't much leeway there, and the loss of a few key Ardagh customers could make for even less," colleague Alex Hess observes. "In the two principal business units, metal and glass packaging, the top 10 customers delivered 44% and 42%, respectively, of 2016 revenue. Maybe management will finally bring off the IPO of the company at which it has so long been hinting, and perhaps S&P is correct in its Feb. 24 estimate that the loss to the holders of the 2¾s in bankruptcy would be negligible. It would be good if those things were so. For a 2.75% yield to maturity on a speculative-grade credit, everything ought to go according to plan."

"Since the chief emphasis must be placed on the avoidance of loss," propounded Benjamin Graham and David L. Dodd in *Security Analysis*, first published in 1934, "bond selection is primarily a negative art. It is a process of exclusion and rejection, rather than of search and acceptance. In this respect the contrast with common-stock selection is fundamental in character."

It's a good bet that the father of value investing never saw the likes of SoftBank Group Corp. (9984 on the Tokyo Stock Exchange) or, we should say, the interaction of the world's fixed-income investors with SoftBank. A series of SoftBank euro-denominated 4s of 2022 are priced to yield 1.68% to their call date of April 2022 and 1.78% to maturity three months later.

"And what does one get for a sub-2% yield over five years?" Hess asks, and he answers: "An opaque, Ba1/double-B-plus-rated telecommunications-cum-Internet-cum-ecommerce-cum-media-cum-hedge-fund conglomerate with net debt of 4.3 times adjusted EBITDA that, under its charismatic founder, Masayoshi Son, has committed to investing $25 billion in a company-sponsored venture-capital fund."

In the nine months through December, B2/B-rated Sprint Corp. (NYSE: S) generated 40% of SoftBank's EBITDA. At the end of last year, Sprint, on whose capital structure *Grant's* maintains an analytical fatwa (see the issue dated Dec. 23, 2016), accounted for 30% of the parent's outstanding debt. The briskly acquisitive SoftBank recently announced its intention to acquire Fortress Investment Group LLC (NYSE: FIG; *Grant's*, Feb. 24) for $3.3 billion as well as to merge its own OneWeb Ltd. satellite venture with Intelsat SA (NYSE: I) in a deal that would involve SoftBank's investing $1.7 billion in cash into the newly merged company.

"Perhaps," Hess reflects, "SoftBank creditors take comfort in the fact that, not adjusting for recent transactions, operating income covered interest expense 2.8 times in the nine months through December. They should recall that the complexity of SoftBank, combined with leverage, has triggered unexpected blow-ups in the past. Shares fell by 79% from their early 2007 peaks to their 2008 lows during the financial crisis. In early 2009, five-year credit default swaps in SoftBank topped out at 2,450 basis points (for perspective, at the height of concerns surrounding Petrobras's solvency, the Brazilian oil company's five-year CDS traded at 1,212 basis points). Also in 2009, SoftBank posted a loss of ¥75 billion on a series of collateralized debt obligations used to redeem publicly traded bonds. This faux pas reduced SoftBank's profit by more than half in the fiscal year ended in early 2009.

"Or perhaps," Hess proceeds, "creditors draw courage from the belief that

Sprint's debt is non-recourse to them. While Sprint said as much in their most recent bond prospectus, filed over two years ago, one might wonder if the Japanese conglomerate would be allowed to walk away from a defaulting Sprint. Perhaps, as the fourth largest mobile network in the United States, Sprint is the iPhone-era version of 'too big to fail'? Sprint's standalone creditworthiness already depends on SoftBank's support (*Grant's*, Dec. 23, 2016)."

And the creditworthiness of the French government—on what does it rest? For one thing, surely, on the government's commitment to pay in the same currency in which it borrowed. Or, perhaps in a stronger currency. Presidential aspirant Marine Le Pen avowedly prefers a weaker one. She warns that, if elected in May, she intends to redenominate most of the national debt. Of the grand total of €2.1 trillion, 80% was issued under French law. It is this mass of sovereign securities that Le Pen and her National Front would begin to service not in euros but in a not-now-existing French franc.

David Rachline, Le Pen's head of strategy, was quoted as telling the *Financial Times* on Feb. 10 that the National Front, if elected, would pursue a "competitive devaluation." Such a monetary switcheroo would constitute a sovereign default almost 10 times larger than the €200 billion Greek debt restructuring of 2012, "threatening chaos to the world financial system on top of the collapse of the single currency."

The ratings agencies concur with that judgment. "There is no ambiguity here," a representative of S&P was quoted as telling the newspaper. "If an issuer does not adhere to the contractual obligations to its creditors, including payment in the currency stipulated, [we] would call it a default."

To which Mikael Sala, head of a think tank friendly to Le Pen, demurred with a shrug: "We will be elected by the French people—it is not our job to please S&P. They do not have much credibility after the financial crisis, anyway."

Around the time of these free and frank expressions of opinion, the French 10-year note was quoted at a yield of as much as 1.14%. It has subsequently rallied to a price that corresponds to a yield of 0.96%. In the now seemingly distant days of September 2016, it was quoted at a yield as little as 16 basis points.

How to price an existential risk? The European debt markets are attuned to French political polls (which show Le Pen badly lagging in a two-person race against the independent centrist Emmanuel Macron); to the supposed gold standard of European sovereign debt, the German schatz; to the Swiss and Danish and Czech currency pegs; and to the ever-present bond bid of the European Central Bank. A Continental fixed-income investor relates that "a QE-driven rigor mortis" has set in. "Fluid, free-market discounting of an ever-changing probability distribution has given way to fragile equilibriums until the jump risk finally materializes," our source says.

For our part, we recall the wise words of Graham and Dodd on the essentially negative art of bond selection. We remember (as if it were yesterday) the failures of political polling on the eve of Brexit and of the American presidential election. And we recall the dictum of Comte de Mirabeau (1749–91) on the topic of sovereign risk. "I would rather have a mortgage on a garden than on a kingdom," said he.

The word "mortgage" puts us in mind of the risk-reward proposition inherent in the mortgage-backed securities market early in 2007. If all went according to plan, an investor could depend on the return of his or her principal at par, along with modest coupon payments en route. If, however, house prices took an unscripted pratfall, there would be many fewer coupon payments and a substantial loss of principal.

In so many kinds of bonds, how very like 2007 is the year 2017.

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