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Panic of the headline writers

When two-year German government securities are priced to yield less than nothing and Martin Wolf, the cerebral *Financial Times* columnist, counsels panic (as he did only last Wednesday), an enlightened opportunist may begin to allow himself to think of the upside. Following is a survey of the emerging possibilities in European equities, distressed debt and real estate, with a sidelight on Athens.

We do mean "emerging." On Monday, Reuters reported that members of the Eurogroup have discussed contingency plans entailing capital controls and limits on withdrawals from automatic teller machines. No mystery, then, why real estate transactions are at a standstill outside of London and Paris or why frightened money huddles in bunds. Let it. The only real safety in this investing life, say we, is that to be found in good assets bought well. What kind of opportunities is the old continent serving up?

They will have to be good enough to beat the ones on offer in this blessed republic, where there is no European Union, no Angela Merkel and, best of all, no François Hollande. For instance, there is a portfolio of 97% leased, Class A suburban Indianapolis office buildings encompassing 433,972 square feet, situated 10 minutes from the Indianapolis International Airport and anchored by the U.S. General Services Administration on behalf of various units of the Department of Homeland Security. This all-American property, known as Intech I, II, III, changed hands late last year at an 8% cap rate. Indianapolis may be no Paris, but 8% is a fancy figure.

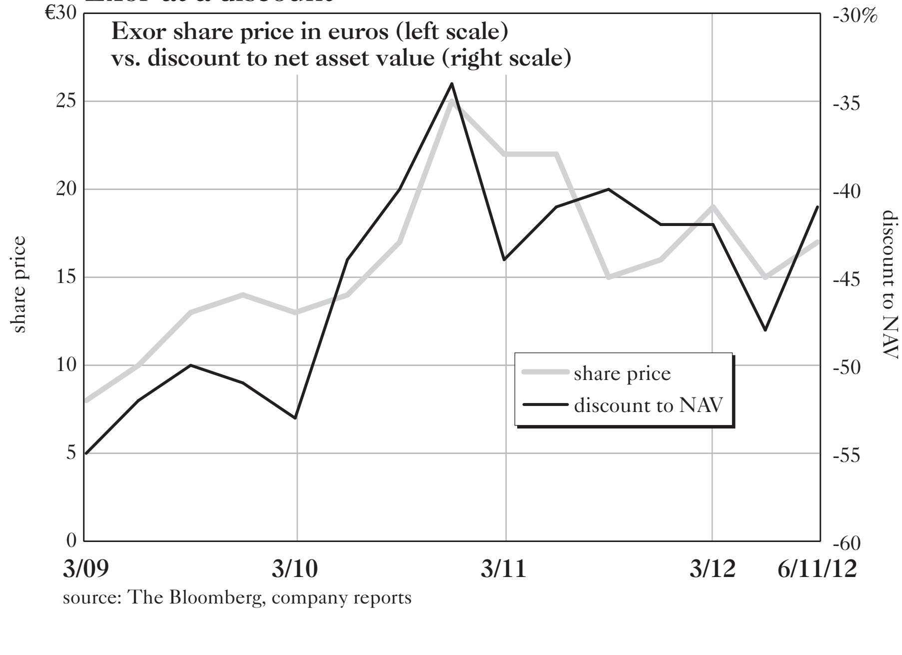
And a very high bar. In preview, you are not likely to clear it in European corporate debt or core European (or British) office buildings. European equities are cheaper than American ones, and a weakening euro will boost the Continent's export industries. However, for the kind of values that a young John Templeton was able to surface in European bourses during the darkest days of World War II, they are chiefly available in the green northern suburbs of Athens.

We begin our survey with the enthusiastic testimonial of an American distressed-debt investor. To our opening question: "Are there opportunities in Europe of the caliber to allow you to be almost indifferent to the outcome of the looming Greek elections?" he replied with a qualified "yes" (he asked to go nameless).

"Round numbers," he led off, framing the situation, "there's $1 trillion of high-yield bonds and loans in Europe, and there's about $2.5 trillion in the United States, just so you have some context. Of that $1 trillion in Europe, our sense would be that $200 billion to $300 billion is really distressed." Nor is this counting so-called fallen angels, one-time investment-grade credits that have tumbled into the high-yield bin. "There are more than enough numbers out there to satisfy the 20 to 25 existing European teams and another 20 to 40 new ones who [will] set up in the next few years," he said.

While no investment is cheap enough to armor an investor against an

Exor at a discount



source: The Bloomberg, company reports

unplanned Spanish default or a replay of the bankruptcy of Lehman Brothers, our informant continued, you can find—he and his organization have found and continue to find—senior debt of bankrupt or impaired German or British corporations trading at 50 cents or 60 cents on the dollar.

However, such plums don't yet litter the British or continental ground. Given the news backdrop, you might expect them to, even as you might expect the euro to trade cheaper than it does. The dollar has its problems, yet—at least—it is not widely tipped to be going out of business. But the banks that hold the debt can't afford to acknowledge that it's impaired. Rather, more specifically, the undercapitalized banks that hold the debt can't afford to acknowledge its real value. Nationalized, or partially nationalized, institutions have more flexibility.

"Just follow the government money," our informant advised colleague David Peligal. "The U.K. government put almost £50 billion of equity into RBS [Royal Bank of Scotland, which failed in October 2008] and a little less into Lloyd's Banking Group [which failed in March 2009]. These guys are selling, and they can afford to sell. The Irish banks are starting to sell non-Irish debt. The Germans, some of them, are selling non-German debt. The French and the Italians, which haven't taken government money, are not selling. They cannot really afford to sell because they are very levered, and sales at 50 to 60 cents of even defaulted or distressed debt would bankrupt them very quickly. By the way, in the U.S., we aren't that different. When you think about what we did with that $700 billion recap of some of the major banks, that was equity going in. It allowed a cleansing, so to speak, of some of the distressed debt which was stuck on these balance sheets. Private capital doesn't exist in sufficient enough size, so just follow the government money when it goes in, because that's going to win the cleansing."

Which suggests, Peligal prompted, that Spanish banks—should they receive the promised cash infusion—will undertake their own cleansing? "I think it will take three to six months," came the reply. "You'll see them sell non-Spanish assets first. It's just easier to sell. The Spanish banks have a lot of loans they've made to U.S. infrastructure projects, like the Indiana Toll Road."

Opportunity is coming, our informant continued. Indeed, it's already here. For instance, he said, consider a certain busted U.K. leveraged buyout (again, no names). The company is a globally competitive, yet poorly managed and heavily encumbered, maker of everyday consumer products. Precrisis, it generated what seemed unglamorously steady cash flows. During the blowout, however—from the 2006-07 peak to the 2008 trough—those cash flows, retrospectively viewed as plenty glamorous, were sawed in half. The senior debt trades at 45% of par, or at a ratio of enterprise value to earnings before interest, taxes, depreciation and amortization of 3.5:1.

"I've been doing this for 20 years," our source attested. "There are few times in life when you see an opportunity on this scale."

As for equities, are we the only ones who have anticipated more thunder and lightning? From their respective 2012 highs, the Greek and Spanish markets have fallen by 41% and 27%. But, in the year to date, the French, German and British markets are within a few percentage points of unchanged.

For one value seeker in European markets, the watchword is "assume the worst." Amit Wadhwaney, portfolio manager of the $1.9 billion Third Avenue International Value Fund, is that seeker. And what might the worst entail? Why, Wadhwaney tells colleague Evan Lorenz, a complete shutdown of the European capital markets in the context of one or more euro zone members readopting the currencies they forsook for the euro in 1999. Not just any stock passes the Third Avenue stress test.

Even so, Wadhwaney insists, there's something to do in Europe—if you don't mind complexity, off-putting appearances and a few warts. Take, for instance, Exor SpA (Exo on the Milan exchange), a ball of corporate yarn featuring ownership interests in Fiat, Fiat Industrial, SGS SA and Cushman & Wakefield, the collective stakes in which amount to €6.4 billion, or 79% of Exor's gross asset value. Smaller positions include 4.7% of The Economist Newspaper Ltd. and 64% of the Juventus Football Club. There are, besides, publicly traded bonds and equities. Altogether, Exor's assets foot to €8.2 billion. To find net asset value, subtract

Stocks here and there
equity indexes in the U.S. and Europe

name	country	P/B	P/E trailing	P/E forward	div. yield
S&P 500 Index	U.S.	209%	13.4 x	12.7x	2.1%
Dow Jones Industrial Average	U.S.	264	12.7	12.0	2.7
U.S. average		236	13.0	12.3	2.4
EURO STOXX 50	Europe	97	17.8	8.7	4.9
STOXX Europe 600	Europe	133	14.7	10.2	4.0
Europe average		115	16.3	9.4	4.4
FTSE 100 Index	U.K.	157	10.7	9.8	4.2
CAC 40 Index	France	99	10.0	9.1	4.6
German Stock Index DAX	Germany	116	13.3	9.3	4.3
Swiss Market Index	Switzerland	199	15.8	11.9	2.8
"Safe" country average		143	12.4	10.0	4.0
IBEX 35 Index	Spain	84	11.6	9.6	5.9
FTSE MIB Index	Italy	61	n/a	8.0	4.4
PSI General Index	Portugal	90	29.9	11.3	5.2
Irish Stock Exchange Index	Ireland	138	14.2	16.4	1.8
Athens Stock Index	Greece	51	n/a	10.0	4.2
"Risky" country average		85	18.5	11.1	4.3

source: The Bloomberg

€1.3 billion in gross debt and €210 million in holding company costs (Exor's current operating costs capitalized for 10 years). The answer: €6.7 billion, or €27.05 per share, in NAV, compared to the current market cap of €4 billion, or €16.71 per share. By these lights, Exor is trading at 60% of calculated value, compared to 50% during the worldwide troubles of 2009. Over time the discount has tended to narrow, even as the net asset value has tended to increase. Between March 31, 2009, and the present, NAV has climbed from €3.7 billion to €6.7 billion.

If there's a unifying thread in the affairs of this miscellaneous collection of European businesses, it's the family of the controlling shareholders. Giovanni Agnelli created Istituto Finanziario Italiano, a.k.a. IFI, in 1927 to manage his investments in Fiat and Cinzano. The 2008 reorganization of IFI brought forth Exor, 59% of whose ordinary shares are still lodged in the Agnelli family. And at the head of Exor sits John Philip Jacob Elkann, age 36, the patriarch's grandson. It wasn't through merit alone that Elkann was named a director of Fiat at age 22, or chairman and CEO of Exor at 34. But merit Elkann has displayed. Under his leadership, the company has paid down debt, sold off marginal assets and simplified its rococo organizational table. "He's an incredible breath of fresh air," says Wadhwaney of the new generation. "He's quite extraordinary. He inherited an absolute, absolute mess. And what he proceeded to do with it was brutally rational but culturally atypical. Often people tend to cling to assets, all the pieces of the balance sheet. . . ." Elkann was able to let go.

On the May 29 conference call, a dialer-in asked Elkann about Exor's valuation. It's cheap even by the standards of European holding companies, the questioner observed. The young CEO replied that the discount would take care of itself if Exor could meet or top its goal of delivering growth in NAV faster than the rate of rise in the MSCI World Index. "If we're able to achieve that," said Elkann, "we think that, over time, the discount will diminish. In the meantime, that gives us a good opportunity when the moment is right to go forward with buybacks."

The nontrivial risk is that Elkann finds outlets other than share buybacks for the company's mobilizable cash. He's on record "to make one large investment" at a cost of as much as €850 million. As to what could possibly be a better investment than the shares of his own holding company, now under enlightened Gen Y management and valued in the market at an anomalous discount to NAV, Elkann didn't say.

"No value-investing forum would be complete without a sum-of-the-parts analysis of this or that discounted holding company," Lorenz observes. "This is especially true of closely held groups where the insiders' interests may just possibly diverge from those of the public shareholders. Such discounts to NAV tend to persist unless and until management realizes value through asset sales or large-scale share repurchases. To Elkann's credit, Exor repurchased €68.7 million worth of stock in 2011. It would be nice if he bought lots more in 2012 and beyond."

As for European stocks in the aggregate, you must judge for yourself whether the evident discounts from American valuations are adequate compensation for the overhead risks. The 50 big names in the Euro Stoxx index trade at 17.8 times trailing net income and 8.7 times the 2012 estimate. In contrast, the Dow changes hands at 12.7 and 12 times trailing and prospective earnings, respectively. Perhaps the European Central Bank's so-called long-term refinancing operations, a.k.a. LTRO, in the grand sum of €1.2 trillion, have emboldened the market or—just as likely—anesthetized or repressed it. The Continent's professional money managers can no more afford to miss a central bank-induced melt-up in stock prices than can their American cousins.

On forward expectations, stocks in the "risky" periphery of Europe are priced at 11.1 times earnings (9.7 times excluding Ireland), while "safe" Europe trades at 10 times the estimate. Such levels underscore that the panic in Europe is so far confined to the headlines. In a proper liquidation, companies trade at depressed multiples on depressed earnings.

"In the prior issue of *Grant's*," Lorenz notes, "we mentioned BASF and Nestle as alternatives to the ground-hugging 10-year bunds (1.42%) and 10-year Swissies (0.52%). However, BASF, which trades at 9.4 times expected 2012 earnings and sports a 4.5% dividend yield, is not appreciably cheaper than America's industrial titans E.I. du Pont de Nemours (11.6 times expected P/E and 3.5% dividend yield) and Dow Chemical (12.6 times and 4%). No surprise there, perhaps—BASF, du Pont and Dow are citizens of the world. BASF derives only 53% of its revenue from Europe, with the balance from Asia Pacific (20%), North America (19%) and elsewhere (8%). Du Pont generated only 35% of turnover from the United States, with the remainder in Europe (26%), Asia Pacific (23%) and Canada and Latin America (15%). Dow's revenue is approximately evenly divided between Europe, the Middle East and Africa (35%), North America (32%) and the rest of the world (33%). As *New York Times* columnist Thomas Friedman almost said, the world is flat and so are valuations.

"Kraft, at 15.3 times expected 2012

What's 'core'?

commercial real estate investment activity by city (in millions of euros)

	turnover in 2011	% of 2011 European market
London	€ 15,722	13.32%
Paris	11,513	9.75
Stockholm	3,356	2.84
Moscow	3,310	2.80
Frankfurt	2,888	2.45
Munich	2,833	2.40
Manchester	2,323	1.97
Berlin	2,186	1.85
Hamburg	2,097	1.78
Oslo	1,837	1.56

source: CBRE

earnings and a 3% dividend yield, gives Nestle, 16.7 times and priced to yield 3.5%, a run for its money," Lorenz proceeds. "However, Nestle holds hidden assets on its balance sheet, chief of which is a 29.6% stake in French cosmetic and toiletries titan L'Oreal. That interest is worth today Chf 19.8 billion, but Nestle carries the investment at Chf 7.8 billion. The difference, Chf 12.1 billion, is worth Chf 3.66 per share, compared to the current share price of Chf 55.50. Adjusting for this holding, Nestle would be valued a 15.6 times 2012 earnings, or approximately in line with Kraft."

Then what about European bank loans and non-investment-grade bonds? Still less would Sir John Templeton, ever on alert to buy in a time of "maximum pessimism," be impressed by them. "It's strangely valueless given what's going on," Dan Smith, senior managing director of GSO Capital Partners, the big credit management firm, tells Peligal. "A lot of these assets are stuck. No one is trading them, at least not yet. Valuations on this stuff, compared to the U.S., are not great. They're trading at only a slight discount to the U.S. when, in our opinion, it should be significantly more based on the relative fundamentals and liquidity." The European banks are reluctant to sell, because a sale would very likely mean a loss—and there is only so much capital to allocate for loss recognition. "If they can sell it at or near par, they're happy to let go," Smith adds. "But if it requires them to take a loss, given that they weren't marked to market and probably not properly reserved, then they don't do it. They can't afford to." And thanks to LTRO, they have been able to pretend and extend, as we Americans put it.

Given the nontrivial risk of a Continent-wide economic breakdown, one would suppose that European commercial property would be cheap enough to tempt the adventurous value seeker. It's what crises are for. Early last month, Blackstone did pay a cap rate of just over 7% to acquire Devonshire Square, a five-acre office campus in the heart of the City of London. Does 7%-plus not seem generous in comparison with 10-year gilt yields of 1.69%? Well, not so very generous, because the building's main tenant is pulling up stakes and leaving. More representative of transactions in the so-called core markets of either London or Paris was the purchase late last month by a state-backed Chinese buyer of the London headquarters of Blackrock (not to be confused with the just-cited Blackstone). Here the cap rate was slightly under 5%.

In European real estate, Peligal's sources relate, core is the big idea. Better a 5% cap rate in London, Paris or Frankfurt than an 8% cap rate at the periphery. "We have many of our large institutional clients who wish to put money into London today and buy property," one of these informants says. "Consider their alternatives—buy a 30-year U.S. Treasury at 2.5%, a German bund at negative interest rates or own euros. . . . Against these, buying property on a 5% yield, in a good country, where property cash flows and hence property values should go up over time, seems like a pretty good alternative."

Or you could go house hunting in the Kolonaki Square section of Athens, close by the presidential palace, where prices have plunged by 40% or 50% or more. "The prices now are very low," an Athens real estate developer and a friend of a friend who well knows the market, said by phone from Athens on Tuesday. Some people are selling because they can't make their mortgage payments, others are selling to avoid a property-tax levy (the government is belatedly trying to collect taxes), while still others are selling just to get euros while euros are still the coin of the realm.

"If you see a property that usually—let's say a villa in a very nice place that used to sell for €4 million—and it was sold for €850,000," our source says, "a discount of this level is ridiculous."

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