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Bees to honey

"Go west, young man," counseled Horace Greeley in 1865. "Go east, young man or young woman, if you happen to be the chief financial officer of an American corporation that could use a jolt of ultra-cheap euro-denominated debt," would be timelier, if less punchy, advice for 2017. Go east to Europe and borrow for next to nothing (not counting the currency hedge).

Debt and distortion are the topics at hand. The risk-reward propositions inherent in a trio of euro-pay corporate bonds furnish the illustrative highlights. You haven't been reading *Grant's* for long if you can't anticipate the conclusion. In short, you, the investor, are being taken for a ride. Reciprocally, you, the opportunistic CFO, are perhaps being taken on a different kind of ride. Who knows how it will end? The world has never been in this interesting monetary and interest-rate position before.

"Financial repression is alive and well in Europe," Keith Ney, fixed-income portfolio manager at Carmignac Gestion S.A., tells colleague Fabiano Santin. "It's been 3½ years since interest rates went negative. Yet the market's pricing in almost another three years before the interest rates or the ECB discount rate get back to zero. European savers are desperate."

Let's see what desperation looks like at the microeconomic, or bond, level. First up are the single-B-rated 6% subordinated notes due 2025 of Loxam S.A.S., a closely held French equipment-rental company. The securities, of which €250 million are outstanding, change hands at 109½ for a 4.52% yield to maturity, or a 449 basis-point spread to the 2025 bund (priced to deliver a lush 3 basis points to maturity, before tax).

According to S&P, the lowly single-B rating of the Loxam notes reflects the securities' "subordinated and unguaranteed position in the capital structure." It further reflects, in case of default, a likely recovery rate of between nothing and 10% of one's principal.

Loxam had a 2016 top line of €927 million, of which 80% was sourced from the home country. The company rents backhoes and loaders, booms and scissors, forklifts and tele-handles, compactors and rollers, concrete mixers and saws. On a Loxam lot, you can likewise find power drills, chainsaws, modular shelters, large compressors, generators, suspended platforms and scaffolding.

Bullish on construction, Loxam is making acquisitions in Europe, the Middle East and Brazil. For the quarter ended Sept. 30, debt jumped to €2.2 billion from €1.1 billion in 2015; most of it was incurred to pay for the purchase of the U.K.-based Lavendon Group plc, in March. Would Loxam have been able to raise this money with coupons varying from 3.5% to 6% except for the open-handed president of the ECB? S&P, seeming to doubt it, responded to the "unexpected . . . and relatively aggressive" acquisition by placing Loxam's debt under surveillance for possible downgrade. By the close of this year, the agency projects, Loxam will be carrying debt in the range of near 4.3 to 4.5 times EBITDA.

"Trailing 12-months EBITDA did jump to €414 million in the Sept. 30 quarter, from €304.8 million in 2016, mostly owing to acquisitions," Santin observes. "Yet free cash flow, defined by cash from operations minus capital expenditures, was negative in the trailing 12 months to Sept. 30; it weighed in at minus €131.8 million. Better were the 12 months till Sept. 30, 2016, when free cash flow fell just €10.7 million short of breaking even. Then, too, notwithstanding acquisitions and higher leverage, Loxam spent €95 million in December 2016 on minority interests in its own privately held shares, which corresponded to 10% of the total equity. Interest coverage defined by operating income divided by interest expense stands at 2.2 times for the first nine months of

Three specimens
Issuer financial metrics*

Issuer	Current rating	Operating margin	Total debt/ EBITDA	Fixed-charge coverage
Loxam S.A.S.	double-B-minus**	15.6%	6.2	2.3
Marks & Spencer plc	triple-B-minus	6.5	3.3	3.5
Novomatic A.G.	triple-B	9.4	3.1	5.3

sources: Capital IQ, Fitch
*Using trailing 12-months data.
**Loxam's subordinated notes due 2025 carry a single-B rating.

the year. You wonder what will happen when Europe stops booming."

Specimen No. 2 are some triple-B-minus-rated notes of Marks & Spencer plc, the 4¾s of 2025. The notes, which are ranked senior unsecured and of which £400 million are outstanding, trade at 111¾ pence on the pound to provide a 3% yield to maturity, or a 200 basis-point spread over the 2024 gilt. The 133-year-old U.K.-based retailer sells food in more than 940 locations and clothing in over 340 department stores and outlets and on its website.

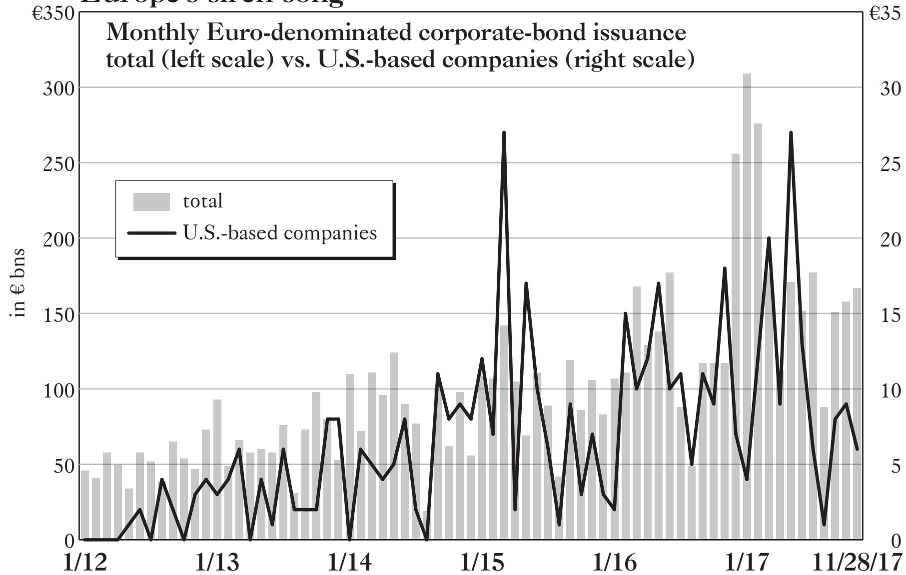
M&S's revenues were £10.7 billion for the trailing 12 months ended Sept. 30, vs. £10.6 billion in the like 12 months of 2016. Food-store openings delivered the lift. All but £1.2 billion of the top line was made in Britain, with home-country sales split between food (£5.7 billion) and clothing and home (£3.7 billion).

Let it be said that M&S has pledged to try to retain its (weak) investment-grade rating and, as an earnest of that determination, paid down £200 million of debt in the 12 months till Sept. 30. Net borrowings thereby dropped to £2 billion. Fitch estimates that 2017 leverage (total debt plus operating leases) will end up at 3.2 times earnings before interest, tax, depreciation, amortization and rent (EBITDAR). Interest coverage, as defined by EBITDAR over interest expense and rent on store leases, should be near 3.4 times, the rating agency projects.

In May, M&S announced the appointment of Archie Norman, a retail turnaround veteran, as its new chairman. "We've got a lot of work to do," Norman told *The Guardian*. Indeed: For the first half of 2017, food revenue fell by 0.1%, clothing and home by 0.7%, each on the basis of same-store sales. Inflationary forces have put pressure on M&S, and gross margins slipped to 31.3% from 32.6% last year. Adjusted operating income in the U.K. has declined by 17.8% year over year.

M&S says it means to slow down the food-store expansion and, to cut costs, focus on closing underperforming department stores. The new CEO, Steve Rowe, says he would like to see the company generate one-third of sales from the online channel by 2022, while conceding that this will take some doing (including heavier infrastructure investments). Even casual perusers of the news understand the high degree of difficulty involved in righting a struggling retailer. It is no good omen for M&S that Next plc surprised the market on Nov. 1 by reporting a 7.7% drop in same-store sales for the three months ended Oct. 29. Next's stock plummeted by more than 9% on the day of the announcement, with M&S relinquishing half that amount in sympathy.

Europe's siren song



source: The Bloomberg

As for that 3% yield on the M&S notes, inflation in the U.K. is currently running at a rate of 2.8%. The 20 basis points of daylight between yield and debasement are a gift to the creditors, before relevant tax.

Our third and final specimen, Austria-based Novomatic A.G., is in the gambling business. It makes slot machines and video-lottery gadgets and operates 1,700 betting parlors, or casinos. As for investors, they can gamble on the Novomatic triple-B-rated 1⅝% senior unsecured notes due 2023, of which €500 million are outstanding. You can have them at 104½, for a 0.8% yield to maturity and a 106 basis-point premium to the 2023 bund.

Revenue comes in at about €2.5 billion a year, most of it sourced in Austria, Germany, the U.K., Spain and Italy. Though sales have pushed higher (thanks to a mix of organic growth and acquired assets), operating results have lagged.

Thus, in the first half of this year, operating income fell to €104.2 million from €141.4 million in the year-earlier period, a 26% droop. Nor is free cash flow—a key metric in such a capital-intensive business as this—much to write home about, falling to €25.5 million in the first six months from €32.8 million a year earlier.

"Novomatic," Santin points out, "carries a total of €1.6 billion in debt and €652 million in cash, which cash management has been using for acquisitions, including the purchase of a 53% stake in publicly listed Australia-based Ainsworth Game Technology Ltd. for A$473.3 million (€306 million). The transaction is expected to close by the end of 2017. With the June 2016 purchase of Talarius Group of the U.K. for £102.5 million, Novomatic crowned itself 'the largest operator of gaming facilities in the sector of so-called Adult Gaming Centers in the U.K.' To sustain the buying spree, the firm secured a €1 billion credit line on a five-year term with a syndicate of banks for general financing purposes, including acquisitions, last March."

In June, S&P assigned Novomatic a rating outlook of "negative," citing an expectation of higher leverage and greater regulatory risk. The regulation in question is the "Interstate Treaty on Games of Chance," enacted by the German government in 2012 to limit the number of gambling slots, starting in 2017. The treaty could force operators to shut down up to 50% of machines in Germany (the country represents 29% of Novomatic's revenues) in the next two years, according to S&P estimates.

Earlier this year, Novomatic scrapped plans for an IPO, also on the grounds of regulatory danger. Though prospective shareholders have been denied the opportunity to roll the dice on Novomatic, bondholders are free to take a whirl. The pot of gold is that aforementioned 0.8% yield.

According to Bloomberg data, American companies (or, more exactly, companies whose primary country of risk is the United States) issued an average of €5 billion per month of euro-denominated debt from 2012 to mid-2016. Since mid-2016, average monthly issuance has nearly doubled, to €9.5 billion. The siren song of sensibly free money is tickling corporate eardrums all the way across the Atlantic. No doubt, the relevant CFOs will remember that the debt is repayable.

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