GRANT'S
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Phil Fisher meets Benjamin Graham

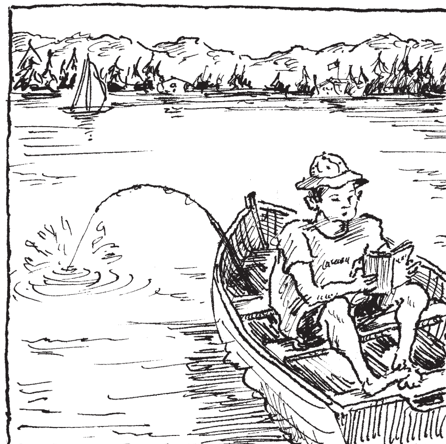
To the bond bulls, it matters not that the U.S. government is on the cusp of technical default, that the CPI has risen by 3.6% over the past 12 months or that—the elevated pace of inflation notwithstanding—the zero-percent funds rate is likely to persist "for an extended period." These facts are inconsequential. All you have to know, they say, is that Greece is on the verge of a more-than-technical default, that the euro is more precarious than the dollar, and that the so-called global reflation trade hangs by the thin thread of the People's Republic of China. Thus, the argument goes, the 10-year Treasury—quoted at all of 2.8% on Monday morning—is just as rich as it ought to be.

Now begins a comparison of the government bond yield with the Wal-Mart dividend yield, and more. We compare things that grow—e.g., the Wal-Mart dividend—with things that don't—e.g., the coupon attached to the U.S. 3 1/8s of May 15, 2021. We appraise the investment merit of Wal-Mart alongside the retailer's majority-owned Mexican subsidiary, and we size up both of those entities in relation to Costco, America's No. 2 retailer by market cap. In preview, we're partial to Wal-Mart.

Comparing the enterprise that Sam Walton founded with the enterprise that Sam Adams, John Adams and Thomas Jefferson founded isn't so farfetched as it might first appear. Though each is a wonder of the age and each is a cornucopia, each happens to be stuck in a growth slump. America is looking over her shoulder at the fast-rising Asian economies, Wal-Mart at Costco. Happily, however, there is nothing to compare in the matter of fiscal rectitude. The famously cash flow-negative U.S. government may command (for now) a triple-A credit rating, but the famously cash flow-positive retailer earns its double-A. At the three-year point on the yield curve, the Treasury is paying 0.67% to borrow, Wal-Mart 1 5/8%. Objectively, the Treasury is the weaker credit, but Wal-Mart has no Bernanke.

Chartered Financial Analysts may object that there can be no true comparison between the apple of a government bond and the orange of a common stock, and the two assets are, indeed, dissimilar. But all life is choice, and all investment is arbitrage. Professional asset managers may find themselves slotted in a one-asset career specialty, but, ultimately, even they must choose between one kind of claim and another. Will it be bonds or stocks, Secretary Timothy Geithner or CEO Mike Duke?

Wal-Mart was a $50 stock, more or less, when *Grant's* last addressed it in the issue dated Dec. 10. In truth, Wal-Mart has been a $50 stock for the past 10 years. Earnings have gone up but the multiple at which the earnings are capitalized has collapsed. Management has made its share of mistakes—including, recently, a failed attempt at rewriting the merchandising strategy—but the share price isn't its fault. Mr. Market has got it into his head that Wal-Mart can't and won't grow, that it will continue to lose market share and that—if share repurchases continue at the current torrid rate—the Walton family, returning to majority ownership, will somehow freeze out the public. On each point, we demur.



The story of Wal-Mart's lost decade in the stock market is easily told. In the fiscal year ended Jan. 31, 2001, earnings per share were $1.40 on sales of $42.67 per share, and there were 4.48 billion shares outstanding. Ten years later, in the fiscal year ended Jan. 31, 2011, earnings per share were $4.47 on sales per share of $114.95, and there were 3.67 billion shares outstanding. A decade ago, Wal-Mart commanded a trailing P/E multiple as high as 41.7 times; today it trades at 11.7 times. Granted, growth is all to the good; no value investor is against it. What are you willing to pay for it is, rather, the question before the house. And what *is* growth? Do you count the raw dollars of sales and earnings? Or the raw dollars divided by the share count? By the first method, Wal-Mart looks as if it were sleepwalking. By the second, it almost resembles Apple. Concerning the per-share WMT, Phil Fisher, the growth-stock guru, could find common ground with Benjamin Graham, the value guru.

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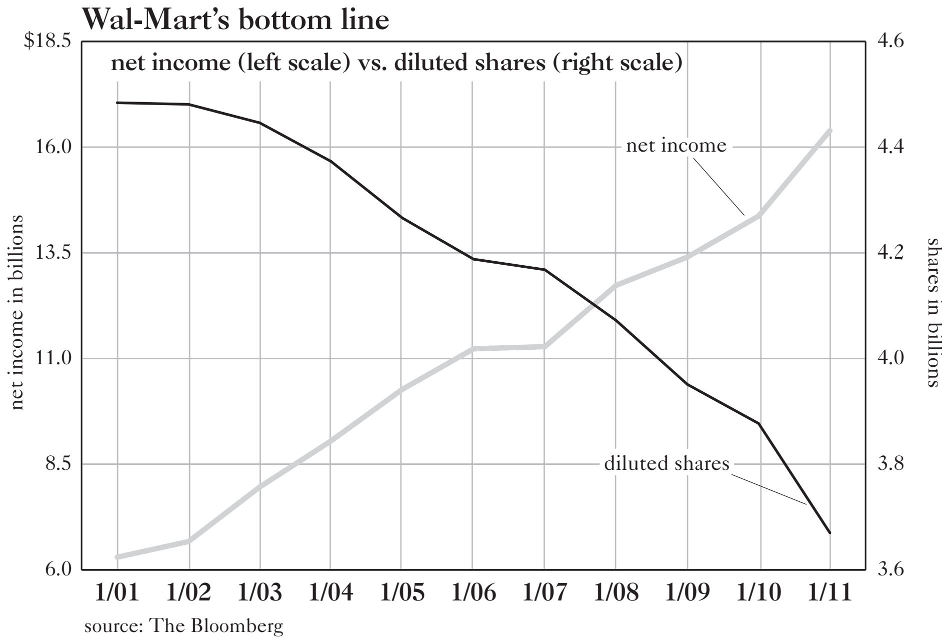


source: The Bloomberg

Tom Gayner, chief investment officer of Markel Corp. and a sizable holder of Wal-Mart, quips that during the 2007-09 bear market, the typical money manager went through three phases in his Wal-Mart experience. First, he invested in Wal-Mart, then he shopped at Wal-Mart and finally he worked for Wal-Mart. In 2011, however, it's the Wal-Mart customer base that's down on its luck.

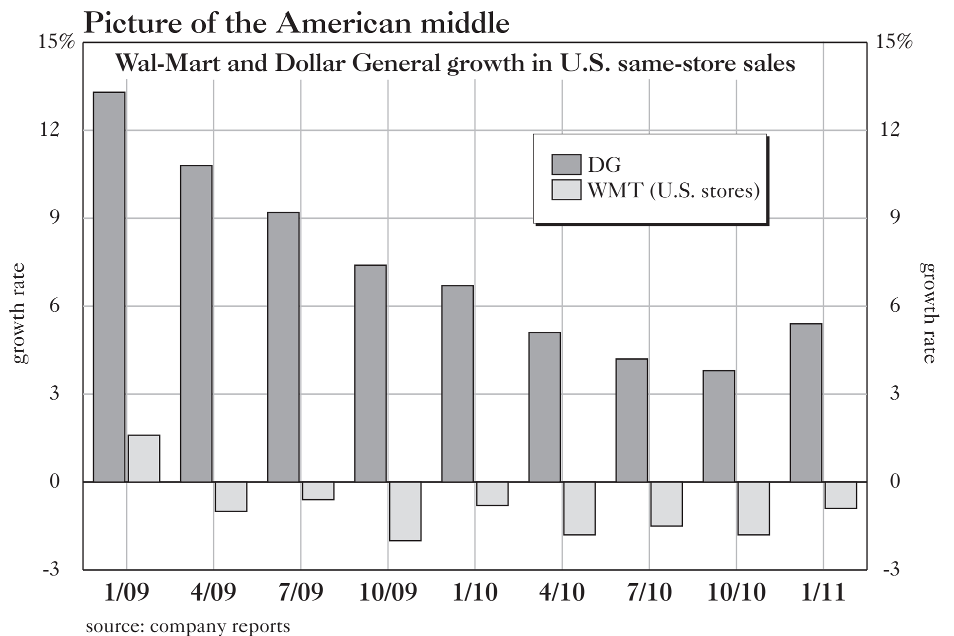
"American consumers are in the early stages of an unprecedented retrenchment," Stephen Roach, the Morgan Stanley economist turned Yale professor, wrote in the *Financial Times* a couple of weeks ago. "In the 13 quarters since the beginning of 2008, inflation-adjusted annualized growth in consumption has averaged just 0.5%. Never before in the post-war era have U.S. consumers been this weak for this long." Monday brought news of a second consecutive drop in inflation-adjusted personal consumption expenditures.

The tale is told in the very prosperity of Dollar General Corp. (DG on the Big Board), the 21st century's five-and-dime. Last year, Dollar General generated $13 billion in sales and same-store sales growth of 4.9% by selling a quarter of its merchandise for $1 or less. Compared to Dollar General, Wal-Mart fairly blots out the sun with 2.1 million employees and fiscal 2011 revenues of $421.8 billion. Net sales at the Bentonville, Ark., giant grew by 3.4% last year, but in the 50 states, same-store sales actually shrank by 0.6% (and have shrunk for eight consecutive quarters). Fiscal year 2009, with its 7.3% top-line growth and domestic same-store sales growth of 3.5%, seems, for the Wal-Mart shareholder, like a long lost golden era.

So Wal-Mart goes for growth outside the 50 states. With last month's $2.4 billion purchase of a 51% stake in South African-based Massmart Holdings, sub-Saharan Africa moved into the corporate sphere of influence. Of Wal-Mart's 9,198 stores, 4,774 are situated outside the United States, including 1,773 in Mexico. Wal-Mart de Mexico SAB de CV, the 65%-owned Mexican subsidiary (Bloomberg ticker: WALMEXV MM), shot the lights out in the 2000s, even in unprosperous 2009, when same-store sales climbed by 3% despite a 2.2% fall in nominal Mexican GDP. In the 10 years to 2010, Walmex sales and earnings per share sped along at compound annual rates of 16.7% and 19.1%, respectively. But Mexican growth, too, has decelerated. In the first five months of 2011, Walmex sales were ahead by 9.1%, comparable-store sales by 2.3%. In the first five months of 2010, by contrast, the company logged growth of 20.6% and 3.3%, respectively.

What has not subsided so far is the Walmex price-earnings ratio. At 26.6 times the current year's estimate, it is double the parent's multiple and only slightly higher than the lordly 24.1 times at which Costco trades. Is growth—measured in dollars or pesos without reference to the share count—so precious as that? Is Costco so superior to Wal-Mart in what is nowadays known as the customer experience? Let's find out.

Please note, observes colleague David Peligal, that Wal-Mart has delivered the goods that equity investors would seem most to prize. Thus, in the 10 years to Jan. 31, 2011, Wal-Mart's sales and earnings per share compounded by 10.4% and 12.3% per annum, respectively. "You look at the Costco stock chart," Peligal goes on, "and you assume that COST



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generated much faster growth, but not so. In the 10 years through 2010, Costco's sales and earnings per share compounded by 10% and 8% per annum, respectively. Costco does have its statistical advantages, even on a per-share basis; in 2010, its sales per share, at $175, were more than 50% higher than Wal-Mart's. But in the past 10 years, Wal-Mart has boosted its dividend by 18% a year. Costco, which initiated a payout in 2004, has boosted its dividend by 13% a year."

Costco is a magnificent merchandising machine, to be sure. But is it so much more magnificent than Wal-Mart? *Grant's* set out on a voyage of discovery to New Jersey's big-box country. We inspected a Wal-Mart in Secaucus at 11 a.m. and a Costco in Clifton at lunchtime. We talked to customers and gaped at the staggering mounds of golf clubs, automatic garage-door installation gear, engagement rings, hamburger meat and sunscreen (the piles being especially notable at Costco, which eschews the nicer forms of presentation). We talked to Wal-Mart fans and Costco fans, and satisfied ourselves of the essential truth of the proposition (sworn to by Eric Whitehead, your editor's right-hand man) that you really can't get out of Costco without spending at least $100. So it's Costco for sheer volume—you can find what you need in quantities three times larger than you need—but for the targeted purchase of the item you want in the size you can actually use, go to Wal-Mart.

Admittedly, Costco has the sizzle (and at lunchtime, the denser population of shoppers). To us, it seemed a little sad that Wal-Mart had to hire Will Smith, the comic actor, to be its paid friend and facilitator at the June 3 annual meeting. In fact, the actual star of that proceeding was the Wal-Mart board of directors, which authorized the repurchase of $15 billion of stock, renewing the prior year's authorization of $15 billion, of which all but $2 billion was spent.

The aforementioned Gayner reflected on the implication of these buybacks in which Wal-Mart has bought in 445 million shares over the past eight quarters. "Today," he observed, "the market cap is roughly $190 billion. So we're saying that the whole pie, steady state, is worth $190 billion. So my joking math is that, in

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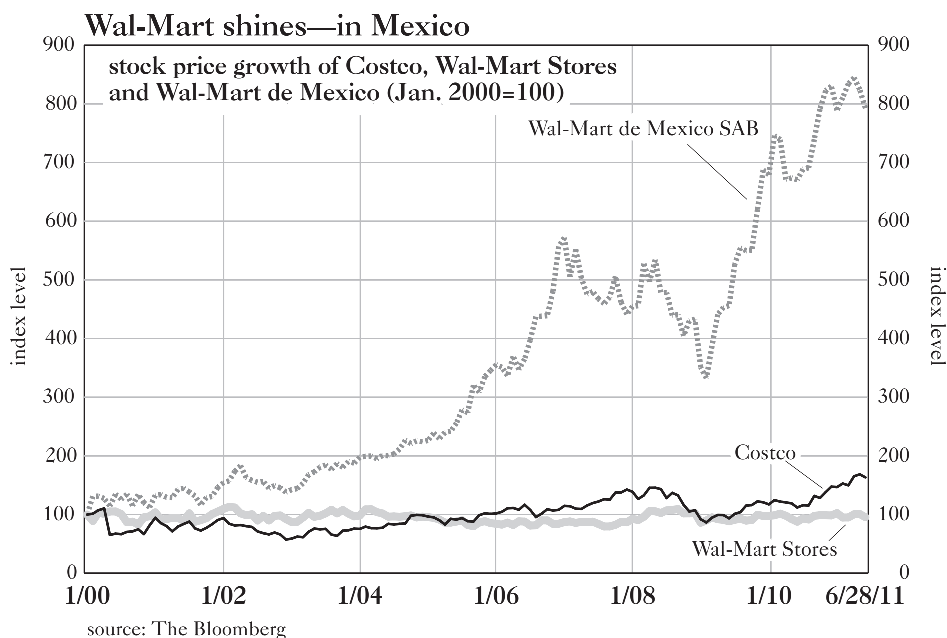

15 years at the current rate, the share count will be one. Instead of cutting that pie into roughly 3.5 billion shares outstanding, $190 billion will be cut into one slice. So that one slice will be worth $190 billion. If we're going to make 20% on our money between now and then, what is the net present value of $190 billion for 15 years? I think it's about $12 billion. I kept doing the math to make sure it was really right—to make sure the zeroes were right—and it is. It appears that the price chart is going to be 50, 50, 50, 50, etc., and then $12 billion—if the stock does nothing. I suspect that we will not reach that end point, but we don't really have to. You can cut it in half, cut it in half again, then cut it in half again—whatever margin of safety you want—but it sure seems like it's worth a lot more than $50 on that path."

As for the United States of America on the eve of the Fourth of July weekend, we love this country. As to its securities, however, someone else can have them.

•

Earth and sky

Concerning the elevated rate of inflation, two world thought leaders recently spoke as if from the same script. "[I]t is expected to subside," said Ben Bernanke at his June 22 press conference. It is "expected to drop steadily," averred Wen Jiabao in his June 24 *Financial Times* op-ed.

They could be right, and they could be wrong. Certainly, there is reason to wonder. Smothering debts coexist today with high-speed money printing. The first produce deflation, the second promotes inflation. Our central bankers have managed to serve up both scourges at once.

Let us say that inflationary forces will triumph (a working assumption, not a high-confidence forecast). Brick-and-mortar REITs are one coping asset, gold-mining equities another. In the past year or so, REITs have been favored, gold-mining stocks disfavored. We like the miners. Mr. Market likes the REITs.

Valued on the basis of forward earnings, REITs stand at a 25-year high in relation to the S&P 500. In no small part, their popularity derives from stunted interest rates. Low rates are doubly helpful for the owners and operators of income-producing properties. Cheap leverage is one blessing they confer; advantageous cap rates are another. To borrow from Mike Kirby, co-founder of the REIT-centered investment firm, Green Street Advisors, REIT equities resemble bonds almost as much as they do stocks. They "march to the fixed-income drummer," says Kirby. "That gets us a little more comfortable that we aren't in bubble territory, unless, of course, bonds are in a bubble."

Gold-mining stocks are sensitive to interest rates, too, of course (what investment asset isn't?). But they are sensitive in a slightly different way than REITs are. Over the long term, the miners derive their value from gold, while gold, in a paper-money world, derives its value from the missteps of central bankers. Particularly bullish for gold is the misstep that pushes money-market interest rates below the measured rate of inflation. At last report, for May, the CPI registered a year-over-year rise of 3.6%, while the funds rate clung to zero. To address Kirby's question, bonds may or may not be in a bubble, but they are certainly on cloud nine. Long gone are most of the cynical survivors of the 1946-81 bear bond market, who vowed they would never again be flummoxed into accepting negative real yields. Thirty years into the successor bond bull market that began on Oct. 1, 1981, when the long bond was quoted at nearly 15%, the typical fixed-income investor has learned that there are many things worse for his or her career than accepting negative real yields. Being out of the market during a ferocious rally, for instance, is much worse. Having rewarded the faith and hope of a generation of investors, the bond market, therefore, can seemingly do no wrong. In any case, at this writing there are negative real yields out to the 10-year point on the Treasury curve. The longer the creditors submit to having their pockets picked in this fashion, the better it will be for the miners and REITs alike.

Gold-mining equities may be married to the gold price, but the spouses are not infrequently estranged. Since Bernanke's famous preview of QE2 at Jackson Hole, Wyo., last Aug. 27, for instance, the gold price has jumped by 21%, while the Philadelphia Stock Exchange Gold and Silver Index has risen by only 6%. Over the same 10 months, the MSCI U.S. REIT index has gained 18%.

We take this divergence to be an opportunity more than an indictment, and so it seems to the gold-mining authority, John Doody. The theory of mining company value is crystal clear, as the editor of the *Gold Stock Analyst* reminds our colleague, Evan Lorenz. "[G]old stocks offer leverage. Leverage coming from a dollar increase in the gold price adds to profits today by

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one dollar per every ounce you're going to produce. But it also makes all the ounces you've yet to mine, [ounces] still in the ground in the form of reserves, it makes each of these ounces worth a dollar more. Since companies tend to have anywhere from 10 to 15 years of mining in the ground, that's what gives you the leverage."

Lately, there's been leverage to the downside, as costs have risen almost as fast as the gold price. "Power is about 25% of the cost of running a mine," says Doody, "and power prices are generally dependent on oil. So oil going up from the early 2000s, when it was $15 to $20 a barrel, to being $100 a barrel or thereabouts [today], has had a big impact on profits. The host nations have done things to get more of the gold price for themselves in terms of higher royalties or higher taxes. And, of course, employees want more money. So there are plenty of cost pressures that have been pushing on the profit margins."

Then, too, notes Bill Fleckenstein, a longtime precious metals investor and a director of Pan American Silver, mining is a tough and unpredictable business, exactly unsuited to the kind of stock market that puts a premium on beating the quarterly earnings forecast. Maybe some ore didn't ship or maybe a host government has its hand in the till. Or maybe the ore grade you are mining turns out to be lower than you had expected. "You know," says Fleckenstein, "rising costs are going to be part of the problem, but these things are starting to make a ton of money. The other thing you forget is depreciation—you depreciate your mine over whatever you think the useful life is, and the useful life ends up longer. Look at the cash flow on some of these companies. These companies are all swimming in cash flow and that's going to continue to roll up."

Investors seem not to believe it. To calculate the fair value of a mining equity, Doody's publication divides market cap by the number of ounces of production and by the number of ounces in the ground. "Right now," the editor relates, "the average ounce in the ground is capitalized at a little over $300, while the average ounce in production is calculated at around $6,500. For each of these independently, we regress that over the gold price to see where the current market cap falls relative to where it's been in the past for this bull market, beginning in 2001. And then we take those numbers and effectively average them vs. the gold price to get what we call a predicted value line. And you can see, looking at the chart in the current *Gold Stock Analyst*, that over the last 10 years the actual value has run above the predicted value as high as 20-something percent, and it's run below the predicted value. In the crash of '08—I'm looking at it now—it got down to 36% under the predicted value. Whenever the actual value is plus or minus 10% away from the predicted value, we have the potential for either an oversold market or an undervalued market. And right now, with the last data we ran, which was the middle of June, it was almost 19% under the predicted value. And every time we've been a double-digit amount under the predicted value, we've always had big run-ups in gold stocks."

Fetching as gold stocks may be in the aggregate, there's nothing like a pick to click. Doody, however, turned away a request for the name of the gold stock most likely to succeed. It's the wrong approach, the compiler of the *Gold Stock Analyst*'s Top 10 list replied; you can't own just one or two. "I never know in the next year, or in the next six months, which one of these undervalued stocks Mr. Market is going to look on with favor," Doody went on. "If I knew that, there'd be only a Top One, and we'd be doing this by satellite communication because I'd be so smart and rich I'd be on my 200-foot yacht in the Mediterranean."

As it was, Doody was speaking from Fort Lauderdale, Fla., but he did kindly vouchsafe a pair of ideas. The first is Yamana (AUY on the Big Board), which is headquartered in Toronto but has properties in Brazil, Argentina and Mexico. "Yamana," pronounced Doody, "[is] an incredibly undervalued situation, in my opinion, based upon its huge cash flow and the market not yet giving it credit for growth from existing mines. The company is doing about one million ounces a year at a cash cost of about $100 an ounce because of by-product credits, and in 2014 there will be 1.7 million ounces a year. . . with a cash cost still around $200 an ounce because of by-product credits. These are mines they already have. They're building them, they're in the production process. Their margin is $1,400 an ounce at current prices, and they're producing over a million ounces, so that's a cash flow of $1.5 billion this year, paying out a dividend of 18 cents. Stock is around $12, so that's a 1.5%, 1.6% yield, which is pretty high for a gold stock."

And the P/E multiple, at 11.4 times, is pretty low for a gold stock. Analysts

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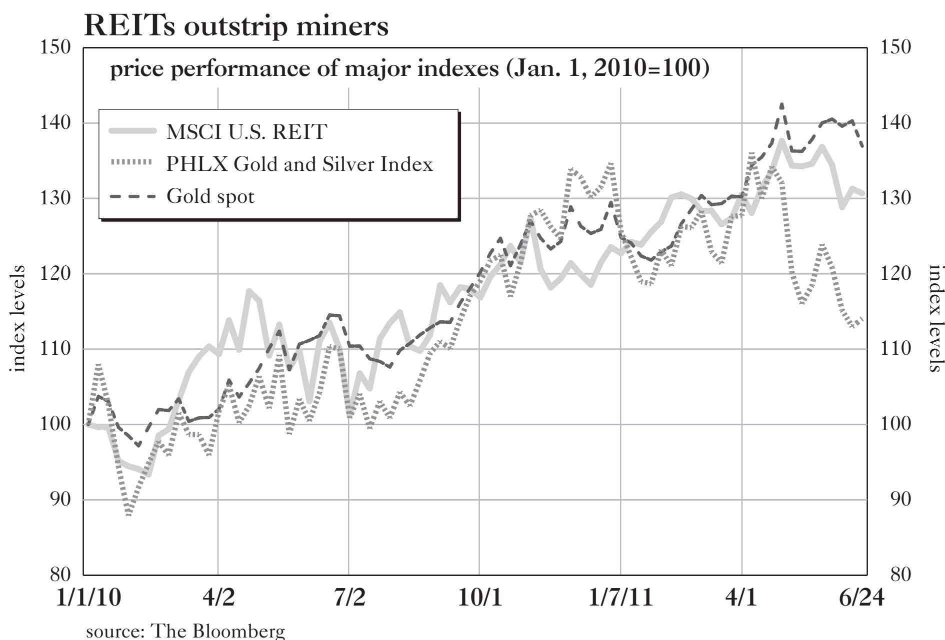

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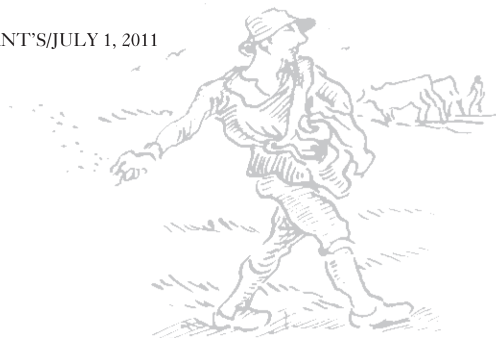


CREDIT CREATION

FEDERAL RESERVE BALANCE SHEET
(in millions of dollars)

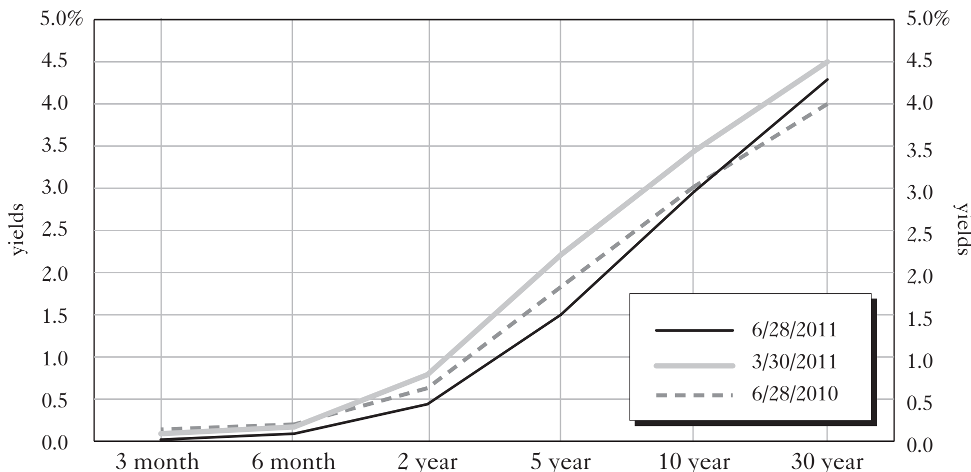
	June 22, 2011	June 15, 2011	June 23, 2010
The Fed buys and sells securities…			
Securities held outright	$2,621,959	$2,605,229	$2,071,086
Held under repurchase agreements	0	0	0
and lends…			
Borrowings—net	13,159	13,282	69,425
and expands or contracts its other assets…			
Maiden Lane, float and other assets	191,502	191,235	187,638
The grand total of all its assets is:			
FEDERAL RESERVE BANK CREDIT	$2,826,620	$2,809,746	$2,328,149
Foreign central banks also buy, or monetize, governments:			
Foreign central bank holdings of Treasurys and agencies	3,459,586	3,446,649	3,089,929

EUROPEAN CENTRAL BANK BALANCE SHEET*
(in millions of euros)

	June 2011	May 2011	June 2010
Gold	€350,670	€350,669	€286,691
Cash and securities	813,238	818,539	743,362
Loans	445,945	438,184	844,913
Other assets	304,685	249,774	253,620
Total	€1,914,538	€1,857,166	€2,128,586

*totals may not add due to rounding

MOVEMENT OF THE YIELD CURVE



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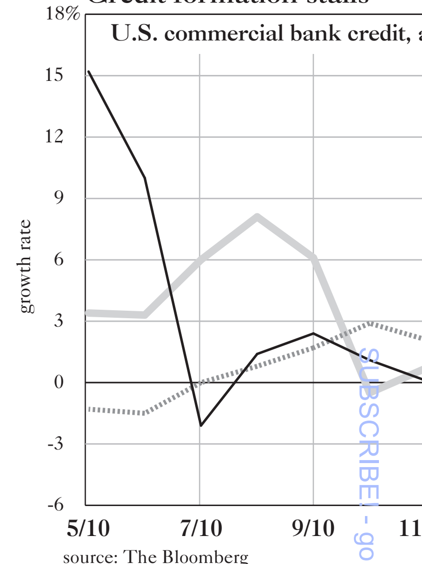

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Chili in

Lending to businesses is accelerating to judge by the data in the upper right-hand corner of these pages. However, overall bank credit—the grand total of loans and securities—is stagnating. QE2 is ending and QE3 hasn't begun. Who will lend in the interim?

It's easier to say who won't be lending. Readers of David Baris' June 16 op-ed essay in the *American Banker*, we think, will be newly disposed to risk aversion. "Recent Federal Deposit Insurance Corp. lawsuits against directors of failed banks," writes Baris, "assert that they are personally liable for voting to approve individual loans that went bad if the loans had deficiencies at the time of approval."

Listening to the regulators, you could have sworn they wanted banks to lend. Just about one year ago, Ben Bernanke himself, in an address entitled, "Restoring the Flow of Credit to Small Businesses," tried to nudge them. But the bankers, especially the community bankers, seem unnudgeable.

The trade press is a chronicle of the small bankers' woes. Regulatory expenses are way up, overdraft fees way down. And now comes the FDIC with its "professional liability" suits against the officers and directors of failed banks who approved loans they shouldn't have. Seven such actions have already been filed, including the $900 million case against the

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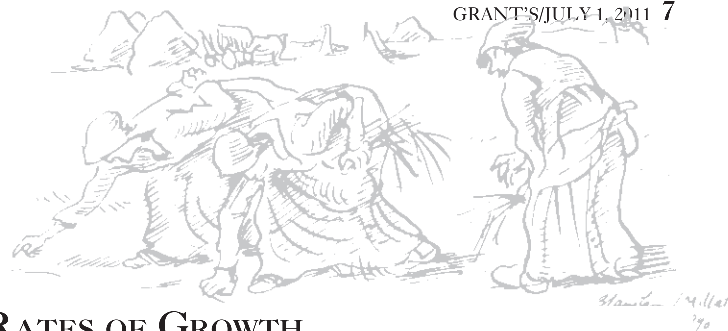
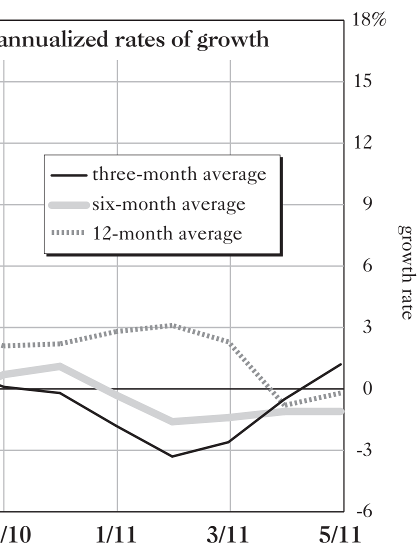


• CAUSE & EFFECT



the air

leading lights (and their wives) of Washington Mutual.

Concerning outside directors of community banks who lent their judgment to the approval of soured credits, the legal ground is murky. Loan approval is no formal part of a bank director's job. But should a director, presumably not without business judgment, keep mum when he thinks he has something to contribute to a credit decision? It would be better, of course, if the directors approved only good loans, but they sometimes err. And when that happens and things go pear-shaped and the FDIC sues? The agency whose face has been that of Sheila Bair is taking the new position that banks may not pay for a director's defense against FDIC legal action. Nor, the agency maintains, may a director make copies of bank documents with which to mount a legal defense.

"Although no tangible evidence yet exists that the spooking of bank directors has caused a decline in available credit," observes colleague Charley Grant, "it is difficult to imagine otherwise. The role of a bank director is not particularly lucrative. The American Association of Bank Directors says a board member of a community bank with between $500 million and $1 billion in footings can expect to earn all of $24,518 a year—minus FDIC-related legal expenses, as it now seems." •

ANNUALIZED RATES OF GROWTH
(latest data, weekly or monthly, in percent)

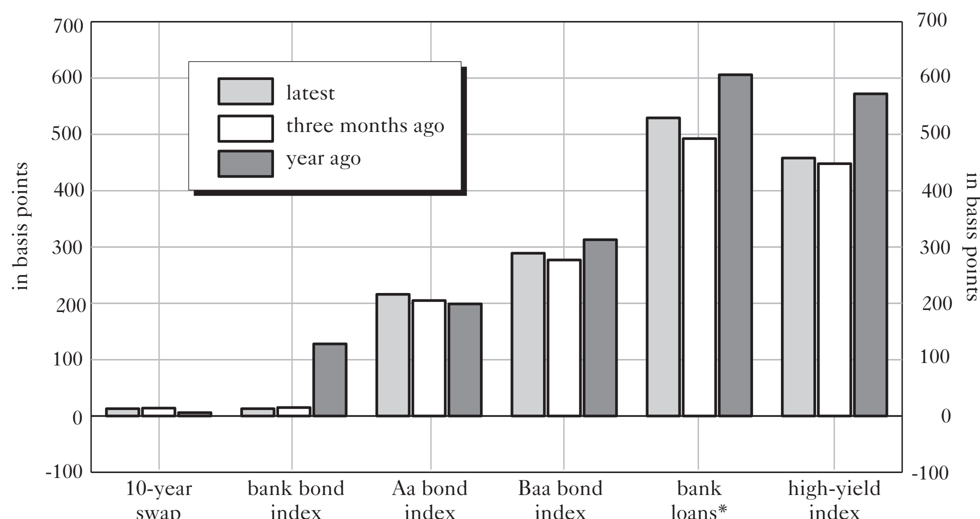
	3 months	6 months	12 months
Federal Reserve Bank credit	44.0%	40.8%	20.6%
Foreign central bank holdings of gov'ts.	5.9	6.2	11.8
European Central Bank	-8.8	-3.3	-9.6
Commercial and industrial loans (May)	12.5	8.9	3.4
Commercial bank credit (May)	1.1	-1.1	-0.2
Primary dealer repurchase agreements	8.2	-1.2	4.3
Asset-backed commercial paper	67.1	26.6	-5.1
Currency	9.7	9.4	8.7
M-1	14.6	13.8	13.6
M-2	5.3	5.0	4.9
Money zero maturity	9.8	6.5	6.8

REFLATION/DEFLATION WATCH

	Latest week	Prior week	Year ago
FTSE Xinhua 600 Banks Index	9,071.97	8,659.78	9,289.28
Moody's Industrial Metals Index	2,260.36	2,208.69	1,758.90
Silver	$34.64	$35.75	$18.74
Oil	$91.16	$93.01	$76.51
Soybeans	$13.20	$13.33	$9.56
Rogers Int'l Commodity Index	3,859	3,977	2,975
Gold (London p.m. fix)	$1,514.75	$1,537.50	$1,236.25
CRB raw industrial spot index	595.56	601.87	481
ECRI Future Inflation Gauge	(May) 101.0	(April) 102.9	(May) 99.7
Factory capacity utilization rate	(May) 76.7%	(April) 76.7%	(May) 74.3%
CUSIP requests	(June) 1,452*	(May) 1,667	(June) 1,716

*as of June 24, 2011

CREDIT SPREADS



*spread over three-month Libor
sources: The Bloomberg, Standard & Poor's LCD

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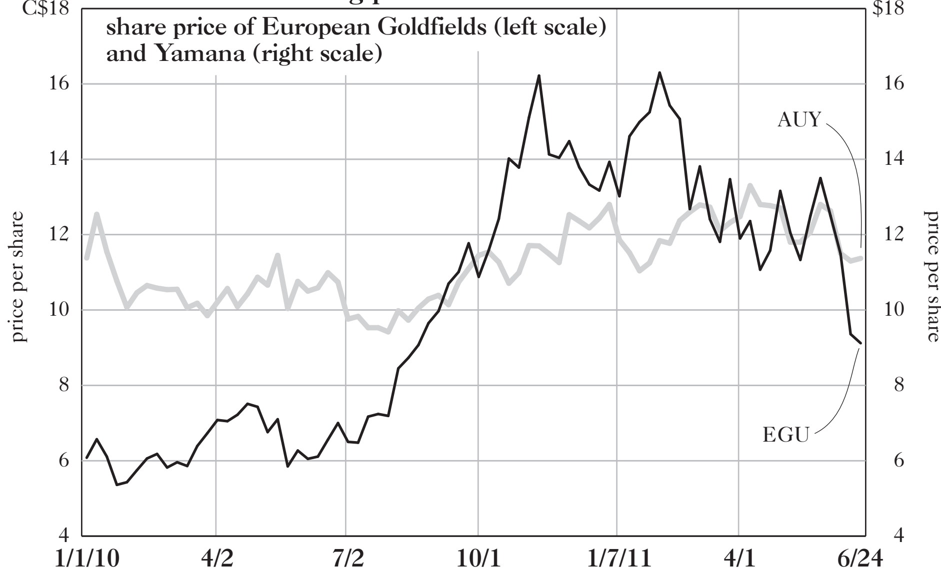
(Continued from page 5)

like the company—Bloomberg counts 17 buy recommendations against two holds and not a single sell—but investors are cool. Maybe they recall a string of underwhelming acquisitions in 2006-08, or perhaps they are still pondering the suitability of the 2009 acquisition by Aura Minerals of three of Yamana's mines while the chairman of Aura also happened to be serving as the lead director of Yamana. However, for Doody as well as for us, the future looms brighter than the past. On June 22, Yamana announced a 25% increase in the 2011 exploration budget, to $105 million, as a result of the "significant cash flow being generated."

European Goldfields (EGU on the Toronto Stock Exchange), Doody pick No. 2, has two properties in Greece, another in Romania. The Greek deposits are jewels so rich that the project-financing banks in London oversubscribed the $300 million development loan. The mines are fully permitted, according to Doody. All that's required to start digging is the go-ahead from the Greek government in the person of the newly installed minister of the Environment, Climate Control and Power, George Papaconstantinou. Papaconstantinou's predecessor, Tina Birbili, had agreed to deliver a decision by July 6, but the ministerial shift will probably mean a new delay. Since, in any case, there's no confusing the Hellenic Republic with the state of Nevada, the EGU share price has tumbled by a third in six months. You'd suppose, says Doody, that Greece would like nothing more than the 1,500 to 2,000 on-site jobs that the first of the two mines is expected to entail (along with a hypothetical 7,500 to 10,000 off-site jobs). Then, too, according to Doody, the head of the Greek subsidiary that owns the European Goldfields properties on behalf of the parent is a former head of the largest construction company in Greece. "So," says Doody, "you've got tremendous connections."

European Goldfields' current market cap—C$1.7 billion—can be thought to represent the present value of the projects that Papaconstantinou may or may not approve (excluding the one in Romania that is outside his jurisdiction). The market is understandably, but perhaps excessively, wary. If all three sites become operational, the company is thought to be capable of producing $528 million to $703 million a year in cash flow, assuming an average gold price of $1,500 and average production of 460,000 ounces a year. "At $600 million," Lorenz points out, "European Goldfields would be valued at 2.9 times prospective cash flow. If the company were able to execute on all three mines by 2015, it could produce 460,000 ounces a year. With by-product credits, the cost per ounce is effectively negative, but let's call it zero for the sake of simplicity. Assume earnings before interest, taxes, depreciation, and amortization of $690 million with a gold price of $1,500. Depreciation may foot to about $63 million a year. The aforementioned project loans—$435 million including the credit for Romania—would cost $30 million a year at a 7% interest rate. At a corporate tax rate of 25%, one could imagine net income on the order of $448 million, or $2.44 a share. At the prevailing C$8.90 share price, EGU would therefore be trading at less than 3.9 times the not impossibly hypothetical number for net income four long years out."

Let us concede that this is not a mainstream approach to institutional money management. Fiduciaries in the market for inflation protection tend not to tarry long on the European Goldfields of the world but, rather, to home in on the Newmonts (if gold-mining shares are what they're after)



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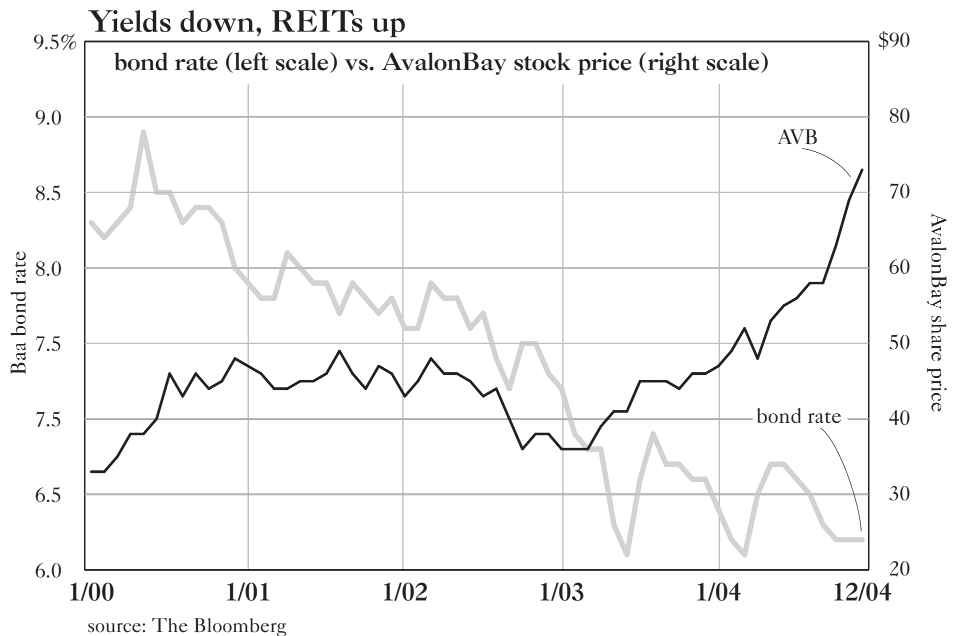
or, perhaps more likely, on real estate investment trusts.

In an inflationary environment, the theory goes, REITs are the beneficiaries of rising rent rolls and of appreciating property values. To which, however, must be appended a caveat: If interest rates, too, are on the upswing, bullish bets are off. Recall, please, the bond-like characteristics of a real estate investment. As with a bond, so with a building: yields and price move in opposite directions. In real estate, the critical valuation term is the cap rate. To find a building's cap rate, divide net operating income by market value. Falling cap rates imply rising asset values, rising cap rates the opposite. In turn, falling interest rates tend to produce falling cap rates, rising interest rates the opposite. Why? The value of a building depends importantly on the interest cost of financing it. In real estate, low interest rates are manna.

Subpar economic growth is not without its compensations, the afore-quoted Mike Kirby observes. Ground-hugging interest rates are one. Minimal new construction is another. "If the economy grows, even at a plodding pace, eventually the space is going to fill," he says. "In the meantime, at a plodding pace, rates will stay low, which props up commercial real estate values—cap rates will stay low. That's great, and if I am going to make the bull case for REITs, it's five years of that. A downturn is bad news, but it's probably not horrible news, because I'll take low cap rates over higher net operating income all day long. In a downturn, so long as it is not a severe one, I presume interest rates are no higher than they are today, maybe lower. The cash flow emanating from the properties probably wouldn't get hit very hard. So it's not the worst thing in the world."

The worst thing in the world, in fact, is the slow destruction of real estate value attending a long deflation. A case in point (see *Grant's*, April 24, 1992) is the decline and fall of 120 Broadway, a famed lower-Manhattan office tower, during the Great Depression. In 1929, the building, conservatively capitalized as a freestanding corporation, was full of prime tenants that had signed long-term leases at bull-market rates. But, as those top-dollar leases rolled off, Depression-era rents rolled on, and once-prime tenants turned subprime. And though rents fell, operating costs and taxes kept rising. The Equitable Building, as 120 Broadway is known, sailed through the early and mid-1930s, but there was no escaping its deflationary fate. The owners filed for bankruptcy protection in 1941, eight months before Pearl Harbor.



AvalonBay Communities (AVB on the New York Stock Exchange), the nation's No. 2 apartment REIT, does business in the here and now, not in the 1930s. The owner of upscale properties on the East and West coasts, it's basking in the slow-growth, low-interest rate, faintly inflationary and faintly deflationary world that Kirby describes. On a price-earnings basis, REITs always look rich—over the past five years, the MSCI REIT index was quoted an average of 49 times—but today they look like something that belongs in a glass case at Bergdorf's. AvalonBay trades at 100 times earnings and yields only 2.8%, while the MSCI REIT average is quoted at 83 times earnings and yields 3.5%.

Adepts know not to talk about price-earnings ratios within earshot of knowledgeable REIT investors. The preferred REIT valuation metric is, rather, FFO, or funds from operations, which is defined as net income plus depreciation and amortization minus asset sales. But neither are the REITs cheap in terms of FFO. Since 2004, a period that includes a real estate boom, a real estate bust and now a second, more selective real estate boom, AVB has been quoted at an average of 57 times earnings and at 22.2 times FFO. Today, it changes hands at 31 times trailing FFO.

On the face of it, AvalonBay doesn't look cheap, and it isn't. But management forecasts a growth spurt. It says it expects FFO to grow by 19% in 2011, while analysts are projecting an additional 16% gain for 2012. On the basis of such forecasts, the shares are trading at 26.8 and 23.1 times estimated FFO for 2011 and 2012, respectively.

The portion of the REIT bull story having to do with a dearth of new construction doesn't apply to AvalonBay. The company kept right on growing during the Great Recession, and its faith in the future of the rental apartment is starting to bear fruit. One of Avalon's recession-era projects, a $300 million, 600-unit tower in the Fort Greene section of Brooklyn, which opened in the fourth quarter of 2009, has "stabilized," to quote John Christie, AvalonBay's senior director of investor relations. "Whereas in the downturn, we were cutting rents to sell it," says Christie, "we've been able to renew those rents at double-digit rent increases with a fairly strong retention rate."

But, the bulls point out, strong operating fundamentals aren't the only way to make money in REITs. Falling interest rates—falling cap rates—also ring the cash register. After the 2001 recession, Christie recalls, a

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plague of locusts beset the apartment business. As jobs were hard to find, so were tenants. House prices were lifting as mortgage rates were falling. It was no good trying to raise rental rates when just about any sentient being could buy a house (the national homeownership rate zoomed to 69.2% in 2004 from 67.5% in 2000). At AvalonBay, funds from operations plunged by 19% from 2001 to 2003. But then came a kind of deliverance. The 1% funds rate—in place for 12 months until June 2004—not only lifted the residential real estate market but also the stock market, and the AvalonBay share price mounted a partial recovery.

For now in the REIT world, it's back to the future in interest rates. On the fourth-quarter 2008 conference call, the president of AvalonBay, Timothy J. Naughton, fielded a question on cap rates. He said that because there were essentially no transactions, there were essentially no cap rates. Three months later, Naughton reckoned that cap rates had "moved into kind of the mid-6% to 7½% range." As for the present, Christie advises Lorenz, "I would say right now cap rates range from somewhere in the mid to high 4s on the West Coast and New York, to maybe the mid 5s in some of the other East Coast markets and suburban New York." As a plunge in cap rates to 4½% from 7% implies a more than 50% gain in price, one may observe that no small amount of good news is already baked into the REIT market.

In short, a reversal in interest rates would smile on few financial assets. REITs, being so highly valued, are especially vulnerable to a monetary tightening. Gold stocks, being relatively cheap, are relatively better protected against it. It would be hard on gold and the gold miners if the Fed imposed a funds rate meaningfully higher than the inflation rate. As we see no sign of any such policy—QE3, we think, is a better bet than stringency—we like the miners.

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Sale of the century

Bloomberg reports that Bank of America is poised to sell its remaining 25.6 billion shares in China's No. 2 bank, China Construction Bank, worth—on a mark—163.3 billion Hong Kong dollars or 21 billion of the American kind. It would be a brilliant sale, greater even than the 1966 disposition of Trans World Airlines, or the 2000 disposition of AOL—or the 2008 sale of Countrywide Credit to none other than Bank of America. However, we believe, with respect both to China and its Communist Party-directed credit apparatus, the clock is ticking. Will BAC get out in time?

When, in 2005, Bank of America took its initial $3 billion stake in China Construction Bank, it did so almost noblesse oblige. More than capital, the *Los Angeles Times* reported, the Americans would be contributing the "technical and management support that could help China Construction Bank transform into a sophisticated institution competing with international rivals."

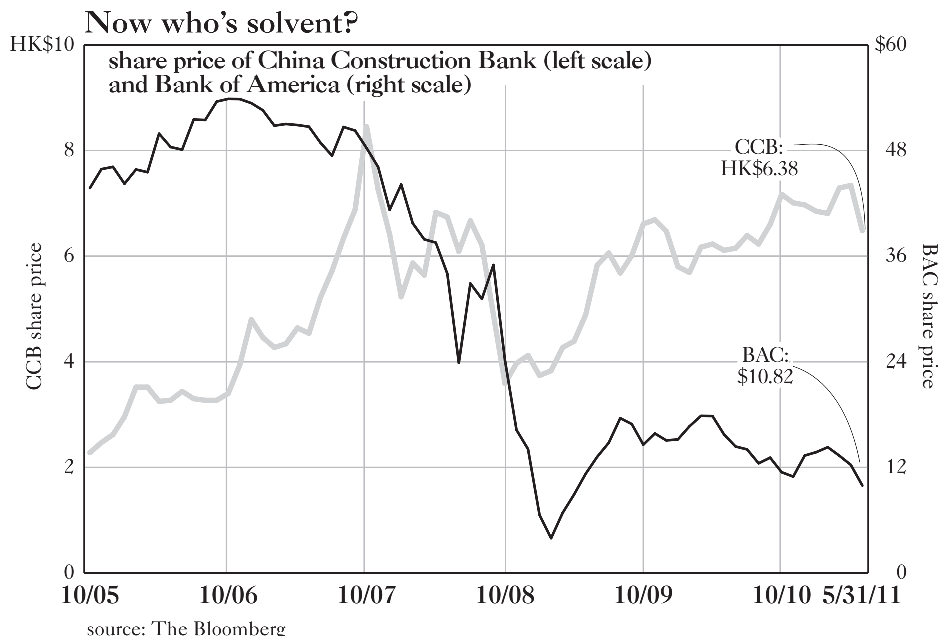
In 2005, seemingly, the Chinese had everything to learn, the Americans everything to teach. Though BAC was pushing the envelope of leverage—its ratio of tangible equity to tangible assets was only 4.3%—it was evidently solvent. Moreover, it was keeping its officers' names out of the crime blotters. As for CCB, its former chairman, Zhang Enzhao, was arrested on bribery charges in June 2005 (and was subsequently convicted), the very month in which BAC made its maiden investment. What could the folks at the BAC home office in Charlotte, N.C., have thought of that?

And what tricks of the trade were the American emissaries teaching their Chinese protégés? Mortgage underwriting? It wasn't long before the prestige of the teachers slipped in the formerly admiring eyes of the students.

After the fall of Lehman Brothers, Bank of America fell into the arms of the U.S. government. It accepted a $45 billion TARP infusion as it watched its share price plunge from a pre-crisis high of $54.90 to a panic low of $3.14 (though it's not so clear that the panic was entirely unreasonable).

Not that government support per se would have shocked the Chinese. The banking system of the People's Republic, as *Grant's* has lately contended, is an arm of the state, or, more specifically, of the Communist Party. The banks are not so much banks as they are public utilities, lending not for the sake of the shareholders but of the national agenda (or, more cynically, of the job security of the people who write the national agenda). In any case, BAC's virtual annexation by the U.S. government must have seemed, to the Chinese, altogether unremarkable.

Stumble the Americans might have done in mortgage lending and risk management, but they did make a superlative acquisition. "After reeling from credit losses and from issues relating to such acquisitions as LaSalle, Countrywide and Merrill Lynch,"



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colleague Evan Lorenz points out, "Bank of America sold its initial CCB investment for a $7.3 billion pretax gain in May 2009." Now comes—the fates allowing—the disposition of the remaining $21 billions' worth. "Note," Lorenz points out, "in full circle, it is now the Chinese who are recapitalizing the Americans."

If, that is, the sale can be consummated. At a glance of the CCB financials, you wouldn't necessarily doubt that it can be. At the end of the March quarter, China Construction Bank showed total regulatory capital to risk-weighted assets of 12.45% and core capital to risk-weighted assets of 10.33%. Tangible equity amounted to 6.4% of tangible assets, while nonperforming loans totaled just 1.09% of loans. Allowances covered those acknowledged bad debts by 229%, while returns on equity registered a quite spectacular 26.2%. And all the while—it says so right on the page—nonperformers have steadily fallen, even through the harrowing years of 2008-09, after peaking at 3.29% of loans in 2006. However, as with Bank of America at the peak of its visible prosperity, appearances can be deceiving. In a credit bubble—and China is certainly in one—no leveraged financial institution is presumptively solvent. The prudent investor, rather, assumes the opposite.

In 2008, as the world economy reeled, the Chinese authorities ordered the banks to lend. CCB did its bit in 2009 by pushing out 1 trillion renminbi, thereby enlarging its balance sheet by 27.4% (China's banks collectively lent the equivalent of 28% of GDP). "Our business grew at a reasonable pace in 2009," Chairman Guo Shuqing blandly informed the shareholders in his annual message. But there is nothing reasonable about such a titanic wave of credit formation. On May 31, Reuters reported that the Chinese regulators suspect that as many as one-third of the 2009-vintage loans are problematic. Applying that proportion to CCB would mean the impairment of Rmb337 billion, or 45% of equity.

If banks are inherently blind pools, Chinese banks are blind pools with the extra added mystery of large off-balance-sheet exposures. At year-end 2010, CCB admitted to Rmb2 trillion in off-balance-sheet derivatives, commitments and contingent liabilities. "Not enumerated, however," Lorenz observes, "are the so-called trust loans, a 'product' that may sound disagreeably familiar to American students of structured credit. Trust companies package bank loans and sell interests to yield-hungry savers—the 3.25% one-year deposit rate set by the People's Bank is well below even the officially acknowledged inflation rate of 5½%. Like structured investment vehicles in 2007-09, these off-balance-sheet items may entail substantial on-balance-sheet risk. 'In the past,' Charlene Chu and Chunling Wen found in a Dec. 17, 2009, Fitch report, 'banks often guaranteed the principal on the wealth management products, or pledged to unconditionally repurchase the products at maturity. Guarantees have since been banned, but in some cases, third-party guarantees of the underlying loans remain present.'"

One thing that CCB did seem to learn from the ambassadors from BAC is the fine art of public relations. Thus, writing in the 2010 annual report, President Zhang Jianguo declares this year, 2011, to be the "Year of Off-Balance Sheet Activities" and the "Year of Risk Management for Overseas Operations." More likely, to us, is that 2011 is the "Year in which Bank of America Barely Makes Its Escape with Its Immense Capital Gain Intact—or Not."

Lorenz adds up the possible damage. "Against CCB's Rmb749.1 billion in first-quarter equity," he relates, "we see Rmb263 billion in year-end nonperformers and special-mention loans. Assuming a 50% recovery rate, this implies losses of Rmb131 billion, which nearly wipes out the Rmb147.7 billion in first-quarter provisions. Rmb402.9 billion in real estate loans are more problematic still; we pencil in a 30% recovery rate that would imply a Rmb282 billion loss, completely eliminating the remaining provisions and leaving equity at Rmb483 billion. Adding up our expected Rmb418 billion of losses on CCB's debt security portfolio by marking the low-yielding portfolio to market—Rmb10 billion in known losses (as related in a recent issue of the English language journal *Caixin*) and Rmb336.6 billion in estimated losses from the 2009-vintage lending binge—equity dwindles to minus Rmb281.4 billion. Without even knowing how much CCB has lent to local governments, how much CCB has lent to developers through shell corporations or what 'debt securities classified as receivables' (a line item consisting of the detritus from the NPL clean-up in the previous decade) are truly worth, CCB's net asset value is pretty clearly negative."

As for those 25.6 billion shares of CCB that Bank of America intends to dispose of, why wait? Indeed, why should anyone wait?

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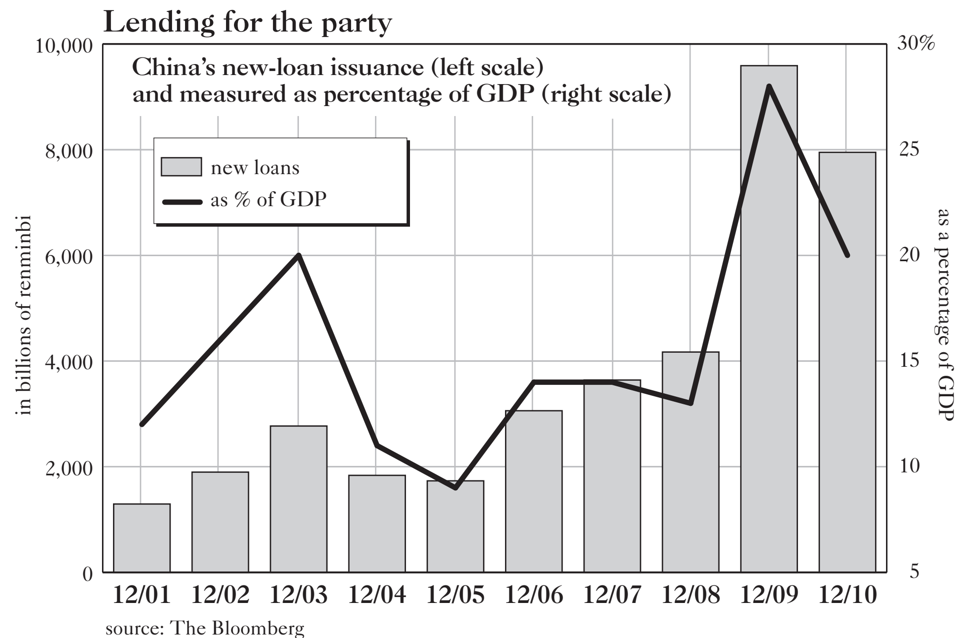

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We said it. Did you read it?

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Thrifts on the cheap

A pair of attractively valued thrifts has washed up in the great mutual-to-stock conversion wave (*Grant's*, Oct. 29).

Plano (Texas)-headquartered ViewPointFinancial Group is a well-capitalized bank in a healthy housing market in a wealthy and growing American community—it ought to be in the Smithsonian. ViewPoint (VPFG) has 23 branches, half in thriving Collin County, and tangible equity equal to 13.2% of tangible assets (compared to 8.2% tangible equity-to-tangible-assets for all publicly traded banks). Assets foot to slightly less than $3 billion, of which 30% consists of cash and government securities; loans make up just 57% of assets. Of loans classified as held to maturity, 35% are residential real estate, 44% commercial real estate, 10% home equity, 7% other consumer, 3% commercial and 1% construction. Nonperforming assets constitute 0.7% of the total. In the September quarter, which could mark the trough of the credit cycle, net charge-offs, expressed at an annualized rate, came in at 0.21% of the portfolio.

"Their nonperforming asset ratio is less than what the charge-offs are at any other peer banks," raves a fan and stockholder, Johnny Guerry, a partner of a Dallas-based hedge fund, Clover Partners, which counts ViewPoint as its biggest position. "They didn't participate in any of the securitizations, they didn't do any of the option ARMs, and most of the loans they make they hold on balance sheet and most are made at loan-to-value ratios of 50% to 60%.

"If you look back at the past decade, you really had a movement of banks going into the Sun Belt," Guerry goes on. Now the credit clouds have rolled in—except in the Lone Star State. "Texas, if you look at peak to trough, what happened to home prices, especially what happened in Dallas, it's only down about 5%. It is the last man standing for really attractive areas to grow a banking franchise."

Pathie E. McKee, ViewPoint's chief financial officer, concurs: "Here, locally, we're seeing that housing inventory that is on the market is remaining very stable; it's not getting worse, it's not getting better. We never really had any problems in Dallas and the Collin County area."

The run-of-the-mill bank spent the past three rugged years withdrawing. ViewPoint was on the offensive. Especially was it alert to the opportunities created when some competitors yanked warehouse lines of credit from correspondent lenders, and when others abandoned the commercial real estate market. "In early 2008, when the capital markets really collapsed and the competition from the life companies really declined," Mark E. Hord, ViewPoint's executive vice president and general counsel, fondly remembers, "there were still deals going, still people who needed refinancing. We were out there lending. We had a great year...."

Read the full story at: www.grantspub.com/thrifts

— *Grant's Interest Rate Observer*, **November 12, 2010**

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We have broken out the centerfold story for your reading comfort.
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Chill in the air

Lending to businesses is accelerating to judge by the data in the upper right-hand corner of these pages. However, overall bank credit—the grand total of loans and securities—is stagnating. QE2 is ending and QE3 hasn't begun. Who will lend in the interim?

It's easier to say who won't be lending. Readers of David Baris' June 16 op-ed essay in the *American Banker*, we think, will be newly disposed to risk aversion. "Recent Federal Deposit Insurance Corp. lawsuits against directors of failed banks," writes Baris, "assert that they are personally liable for voting to approve individual loans that went bad if the loans had deficiencies at the time of approval."

Listening to the regulators, you could have sworn they wanted banks to lend. Just about one year ago, Ben Bernanke himself, in an address entitled, "Restoring the Flow of Credit to Small Businesses," tried to nudge them. But the bankers, especially the community bankers, seem unnudgeable.

The trade press is a chronicle of the small bankers' woes. Regulatory expenses are way up, overdraft fees way down. And now comes the FDIC with its "professional liability" suits against the officers and directors of failed banks who approved loans they shouldn't have. Seven such actions have already been filed, including the $900 million case against the leading lights (and their wives) of Washington Mutual.

Concerning outside directors of community banks who lent their judgment to the approval of soured credits, the legal ground is murky. Loan approval is no formal part of a bank director's job. But should a director, presumably not without business judgment, keep mum when he thinks he has something to contribute to a credit decision? It would be better, of course, if the directors approved only good loans, but they sometimes err. And when that happens and things go pear-shaped and the FDIC sues? The agency whose face has been that of Sheila Bair is taking the new position that banks may not pay for a director's defense against FDIC legal action. Nor, the agency maintains, may a director make copies of bank documents with which to mount a legal defense.

"Although no tangible evidence yet exists that the spooking of bank directors has caused a decline in available credit," observes colleague Charley Grant, "it is difficult to imagine otherwise. The role of a bank director is not particularly lucrative. The American Association of Bank Directors says a board member of a community bank with between $500 million and $1 billion in footings can expect to earn all of $24,518 a year—minus FDIC-related legal expenses, as it now seems."

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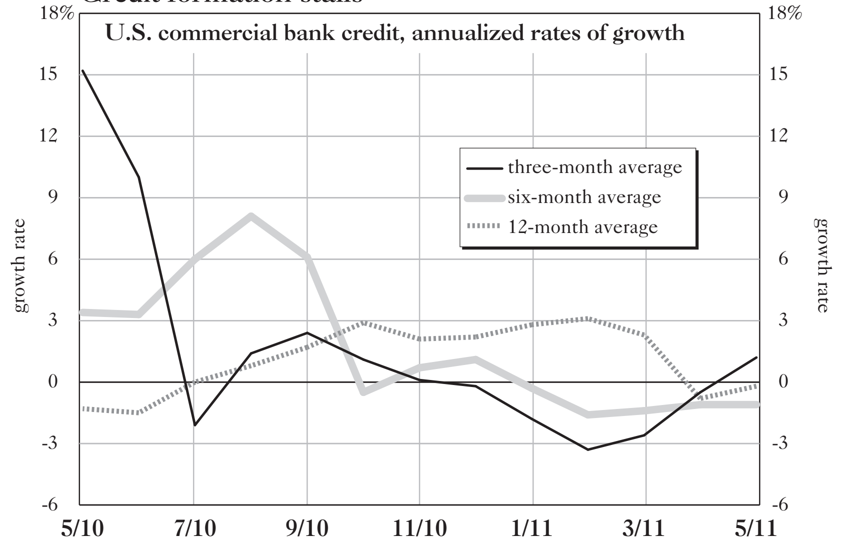

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