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Rumblings from the great white north

What are the chances of Warren Buffett being wrong? The chances of Buffett being wrong in the elevated company of 3G Capital, Bill Ackman and Mr. Market himself? High, we are about to contend.

Now unfolding is a bearish analysis of Restaurant Brands International, Inc. (QSR in New York and Toronto), the 3G-sponsored roll-up in which Buffett and Ackman are major investors and to which the excitable Mr. Market has assigned a record-high share price (and reciprocally low interest costs). Debt, interest rates, stagnation, valuation and the Ten Commandments are the points of focus.

3G got into the fast food business with its 2010 acquisition of Burger King Holdings, Inc. Burger King was a tired brand which the Brazilian cheapskates proceeded to revivify, and not through cost-cutting alone; they actually sprang for some new uniforms, rejiggered the packaging and toned up the menu—pre-acquisition, the bill of fare had been pejoratively described as "male-oriented."

Restaurant Brands International, as corporate Burger King rebranded itself, bought Tim Hortons, Inc. in 2014 and Popeyes Louisiana Kitchen, Inc. two months ago. 3G doesn't mind spending money when it comes to M&A. It paid 16.1 times earnings before interest, taxes, depreciation and amortization (EBITDA) for Hortons, the favorite destination of Canadian coffee-drinkers and donut-eaters, and 21.3 times EBITDA for Popeyes, the fried-chicken and biscuit purveyor. As a multiple of trailing revenues—6.7 times—the price that 3G paid for Popeyes is the richest for any $100 million-plus North American restaurant acquisition for all recorded time (*Grant's*, March 10).

In the words of colleague Evan Lorenz, the RBI business model is "capital-light and debt-heavy." Franchisees, not RBI, manage all but a handful of the Burger King, Hortons and Popeyes eateries. What the parent oversees are its leveraged balance sheet, its low, low Canadian tax rate (of which more below) and its fractured relations with Hortons franchisees. The three acquisitions have encumbered RBI with debts of $12 billion, net of cash, an amount equal to 6.1 times trailing pro-forma-adjusted EBITDA; in 2016, EBITDA covered cash interest expense and preferred dividends by 2.5:1.

The RBI brands are well-regarded and, in the context of a North American continent fairly overrun with restaurants, well-situated. Fast food, unlike casual dining (e.g., Applebee's, Chili's, Ruby Tuesday), is at least holding its own in the marketplace, according to John Hamburger, president of Franchise Times Corp. and publisher of the must-read *Restaurant Finance Monitor*. "Doing OK," says Hamburger, is about the highest accolade he can confer nowadays on any restaurant-industry segment.

Tim Hortons—"Timmy's" to its adoring Canadian fans—is the company powerhouse. In the 12 months ended March 31, Hortons outlets generated $6.5 billion in sales, 23% of the RBI total. They contributed $1.1 billion in adjusted pro forma EBITDA, or 55.5% of the corporate whole. Compare and contrast the contributions of Burger King, $799 million, and Popeyes, $85 million.

"Hortons stands apart," Lorenz observes. "It's not just that Canadian readers of *Grant's* prefer its coffee to Starbucks coffee by a factor of maybe 12-to-1 (I've asked), or that Hortons sells eight out of every 10 cups of coffee north of the border. No, what makes Tim Hortons singular is its unusual profitability for the franchisor."

How does the franchisor, RBI, make money? It earns a royalty, calculated as a percent of its franchisees' sales (3%–5%), as well as a lease fee, which is likewise determined as a percent of franchisee sales (as high as 10% for some Tim Hortons lessees). Not least—in the specific case of Timmy's—RBI earns a markup on the sales of paper products, food and other consumables that franchisees are contractually obligated to purchase from what amounts to the company store. This sourcing protocol accounts for a substantial part of Horton's unusually high profit contribution.

What drives RBI's earnings growth? Key are net store openings. No surprise, then, that RBI is pushing to propagate new franchisee-operated restaurants, mainly outside of North America. Thus, in mid-2010, there were 12,174 Burger King restaurants in the world; today, 15,768. At year-end 2014, there were 4,258 Tim

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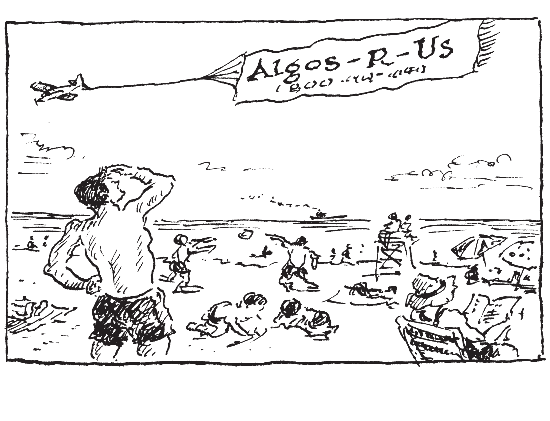


(Continued from page 1)

Star-studded price action

source: The Bloomberg

Hortons locations across the globe; today, 4,644. The hope for Popeyes—and the reason that RBI paid such a seemingly extravagant multiple for the chain originally called Chicken on the Run—is that it, too, will catch on in foreign parts; who doesn't like chicken?

And who doesn't like RBI? Among the analysts on the case, 10 rate the stock a buy, nine a hold and exactly none a sell. Maybe the sky-high price constrains the holdouts. The shares change hands at 37.9 times trailing adjusted earnings, or 42.9 times trailing GAAP earnings. Analysts have penciled in non-GAAP earnings-per-share growth of 16% in 2017, 32% in 2018 and—straining their eyes to see through the brick wall of futurity—14% in 2019. The 2018 figures reflect a boost from the expected refinancing of the $3.3 billion of 9% cumulative compounding perpetual voting preferred shares that Berkshire Hathaway owns (its contribution to the Tim Hortons acquisition); the stock becomes callable on Dec. 12.

The credit markets, too, bestow their blessings: 4¼% was the coupon attached to $1.5 billion of single-B-plus-rated secured first-lien bonds of 2024 in an upsized deal that came to market on May 3 at par. The interest cost was 1.25 percentage points below the BofA Merrill Lynch US High Yield 'B' Effective Yield Index, which is quoted at 5.52%; proceeds are earmarked to refinance Buffett's preferred.

Nor—unusually nowadays in corporate North America—is management unloading its shares. The single insider transaction in the past 12 months was a 5,000-share purchase. As for Ackman, RBI is the top holding of his Pershing Square Capital Management as of March 31; the fund held stock worth $2.4 billion, which, adjusted for the dilution of the voting preferred shares, controls 8.4% of RBI's corporate voting power.

These are the bullish auguries. There are others. To start with, in the first quarter, RBI's same-store sales growth screeched to a halt, registering 10 or 20 basis points of contraction per segment vs. growth of 2% or thereabouts in the full 12 months of last year. On the April 26 earnings call, management blamed the dip on the year-ago incidence of Sadie Hawkins Day: It happens that 2016 was a leap year. (McDonald's Corp. showed 1.7% growth in first-quarter U.S. same-store sales, the Sadie Hawkins factor notwithstanding.)

"Something I find curious," Lorenz observes, "is that RBI has reduced the level of detail it provides. Through last year, management disclosed same-store sales growth, total sales growth and restaurant counts by geographic region. This is critical information for analyzing a company trading at a lofty multiple based on expectations of rapid international growth. In the place of these tables, RBI now only shows same-store sales in the most important region for each chain. So, for instance, we know that Tim Hortons' Canadian same-store sales fell by 0.2% in January–March and that, in the identical three months, same-store sales at American locations for Burger King and Popeyes dipped by 2.2% and 0.4%, respectively."

The bearish story on Restaurant Brands hinges on the franchisees: on their profits, or lack thereof, and on their complaints (especially the complaints of the Hortons franchisees). Some of the facts are front-and-center, others must be inferred and still others may be adjudicated.

You can infer something un-bullish from the public filings of Carrols Restaurant Group, Inc., the largest Burger King franchisee, with 788 stores, and a major RBI investee. Through convertible preferred shares, RBI owns 20.6% of Carrols (TAST on the Nasdaq), which, in turn, owns the right of first refusal on Burger King franchise transfers in 20 American states.

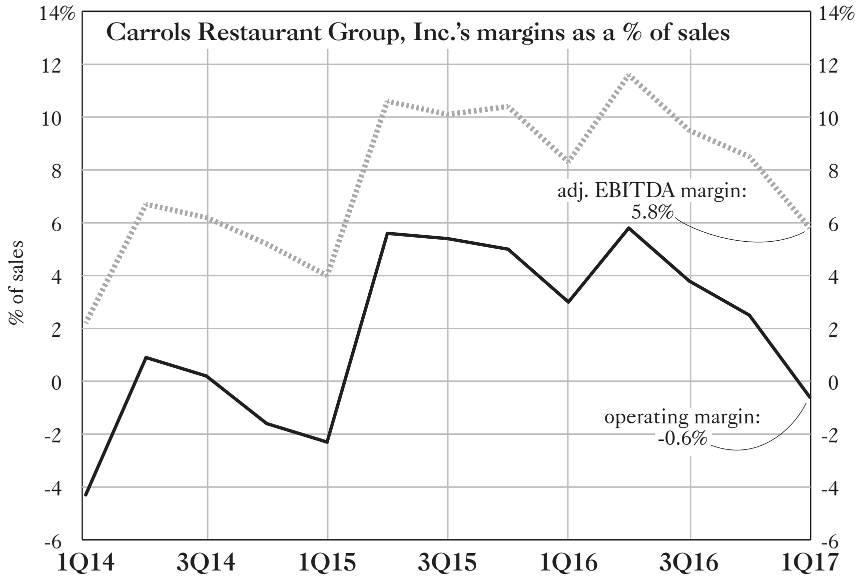
Carrols' operating margins are tumbling. They came in at negative 0.6% in the first quarter of 2017, from a peak of 5.6% in the second quarter of 2015. Over the same span, its "adjusted EBITDA" margin, a softer, more forgiving metric, was sawed in half, to 5.8%.

No mystery why, CFO Paul R. Flanders explained on the May 9 earnings call: "These decreases reflected a higher level of promotional activity since last year, continued pressure on labor costs and deleveraging of fixed costs due to the comparable sales decrease and seasonably lower average sales volumes."

The troubles at Tim Hortons go deeper than money and margins, though (at least for the investor) all is finally reducible to those vital elements. In a series of articles in the Toronto *Globe and Mail*, Marina Strauss details allegations against corporate management by disgruntled franchisees, as well as from a former Hortons CEO. Here are some of the complaints: The quality of products the franchisees must purchase from RBI—paper goods, food, condiments—has declined as their prices have increased; a switch to single suppliers for many such items has led to periodic supply interruptions, a.k.a. "stock-outs"; and corporate district managers have turned the famous 3G cost-control culture into an instrument of intimidation and brutality. Perhaps the most explosive allegation is that RBI has raided a franchisee marketing fund to pad the parent's bottom line. In each case, the franchisees charge, 3G is shifting costs from the corporate P&L to their own.

It bears repeating that Tim Hortons generates 55.5% of RBI's trailing pro-forma-adjusted EBITDA. If there is a

Pressure cooker



source: company reports

problem with Hortons, it is mathematically impossible for the Burger King and Popeyes divisions to grow fast enough to compensate for it.

Rebelliousness may not be Canada's foremost national character trait, but the formation, in March, of the Great White North (Hortons) Franchisee Association has something of the Spirit of 1776 about it. Separate and distinct from the company-sanctioned franchisee advisory group, the Great White North contingent is up in arms over RBI's management practices.

Defiance has already yielded some results. Thus, under heavy pressure, RBI agreed to delay the scheduled introduction of a digital app with which customers could order and pay in advance. On form, the franchisees contended, the front office would bungle the roll-out as it has dropped so many other operational balls.

"Every franchisee with whom I spoke confirmed that prices are up substantially on goods which they are required to purchase from the Hortons company store," Lorenz relates. "You can see it in the published financials. The Hortons division reports two revenue line items: a) 'sales,' meaning revenue earned both from customers and franchisees, and b) franchise and property revenues. What's clear is that, to RBI, 'sales' have become much more profitable: Between the first quarter of 2015, the first full quarter of ownership of Tim Hortons, and the first quarter of 2017, gross margins on sales increased to 23.7% from 13.3%. Between 2009 and 2013, the last five years of Tim Hortons as a standalone company, gross margins on sales ranged between 11.9% and 14%.

"Hortons has delivered strong earnings to the parent, as you might expect," Lorenz goes on. "Gross profits from franchise and property revenues increased by $17.8 million to $128.5 million between the first quarters of 2015 and 2017. Over the same period, gross profits on sales increased by $61.1 million to $124.9 million."

(You have to do some parsing to tease the fact of these rising prices from the RBI financials. The complicating factor is a category of restaurant classified as a variable-interest entity, a kind of halfway house between a company-owned establishment and a franchisee-owned establishment. After adjusting for VIEs, we affirm the conclusion that the front office has been jacking up prices to the franchisees.)

Lorenz spoke to as many Hortons franchisees as would pick up the phone. Perhaps the ones who came forward were predisposed to complain—no organization is without the type. And maybe no change of corporate control between people-oriented founders and number-centric technocrats has ever pleased everybody.

With all that said, a dozen or so Hortons franchisees complained to Lorenz about managerial lapses at the franchisor level. Stock-outs, for instance: "The last time it was wrap [sandwiches], and [for] three or four days we had to run without wraps. That is a killer for us. How can you run a promotion, and run it on television, and it is couponed and everything else? We get people in the store, and when they get to the store it is not there. I don't have a good explanation. This never used to happen pre-3G."

The allegation that 3G is raiding the franchisee marketing fund is a point of especially bitter contention. Each store pays 3.5% of sales into the kitty, which finances local and national promotional drives; annual contributions run to $227 million. It isn't the parent's property.

Asked for comment, RBI did not entirely deny that it uses the fund for some non-marketing endeavors. It said that the spending—for whatever purpose it might be—complies with the letter of the contract governing the fund's activities. "We have a very specific set of policies with regard to what can be allocated to the ad fund, and those are all stipulated in formal documentation," said Markus Sturm, RBI's director of investor relations, in an interview.

Franchisees tell Lorenz that they have depositions from former RBI employees to support the contention that the company is misdirecting advertising funds. The Great White North group says that it has engaged John Sotos, founding partner of the eponymous Toronto law firm Sotos LLP, to represent them as they build a case against Restaurants Brands International. Sotos declined to speak to *Grant's*.

"So, no, we can't definitively prove the company has raided this fund," Lorenz writes. "However, it is noteworthy that general and administrative expenses for the Tim Hortons segment rose to $25.1 million (3.4% of division sales) in the first quarter of 2017, up from $16.2 million (2.5% of division sales) in the first quarter of 2016. The jump came after franchisees started raising issues with the advertising fund, and the rise in G&A expense was a shock to analysts covering the stock."

In mid-March, a former CEO of Hortons in pre-RBI days, Don Schroeder, let fly at the new owners: "The callousness with which RBI has treated hundreds of loyal and long-serving members of the [Tim Hortons] corporate team as well as countless suppliers who for years had been committed to providing the system with new and innovative products, leaves me with the inescapable conclusion that, in the absence of some collective action, our family of storeowners will share the same fate."

In *The Globe and Mail*, Strauss reports a sharp ratcheting up in the failure rate on headquarter-administered inspections. Prior to January, 15% of Hortons outlets flunked the company's Global Performance System exam; thereafter, 69% missed the mark. Following more adjustments, in March, 85% failed. Adding insult to injury, franchisees protest, the ever-so-cost-conscious 3G front office has fired most of the restaurant-support team who might have been able to help.

A franchisee tells Lorenz about the infractions for which the 3G inspectors dinged one of his stores in Alberta: "Some of the stuff that happened on our report was the temperature of the dishwasher—after five, six runs, [it] was one degree below where it should be—and we had a mouse trap pointing in the wrong direction at the back of the house," he told *Grant's*. "I had no idea—I am 62—that you had to point a mouse trap a certain way. Some of the stuff on the GPS report was [that] we didn't have knives with the Tim Hortons logo on them, we didn't have sugar sifters with the Tim Hortons logo on them. Just ridiculous stuff. That is why people are walking away. You can't pay people enough money for the abuse and reports we are forced to do to keep RBI happy."

Some speculate that RBI is cracking the whip to invoke the rule that debars a failed franchisee from acquiring additional stores. All this, the musing goes, is to prepare the ground for a future consolidation of Hortons outlets in the acquisitive style of the Burger King roll-up Carrols.

The GPS score is one criterion by which RBI grades franchisees; financial stability is another. The complaint comes back to Lorenz that, to the corporate front office, financial stability means reporting the correct kind of profit margins.

"Three franchisees tell me that RBI rejects profit-and-loss statements if profit margins are too low," Lorenz relates. "One-hundred twenty-nine Hortons franchisees responded to an anonymous online survey in Alberta. They reported an average 6.29% operating margin, roughly half the 13%–14% margin that the company claims that franchisees earn company-wide."

"What makes this even more disturbing," says a franchisee who asks to go unnamed, "is it created a culture where owners started to report inflated monthly profit numbers to keep RBI off their backs and qualify for expansion. As an advisory board member, this made my job even more difficult, as RBI was not responsive to questions regarding profitability. Their response was that they've collected P&L numbers from store owners and [that] profits are 'healthy.' I spoke up in an advisory board meeting, that false numbers were being reported and why, and I was quickly shot down by management." Franchisees to whom Lorenz spoke claim that RBI does not try to match up monthly P&Ls with audited financials.

Lorenz took these complaints to RBI: Is it company policy to reject franchisee-submitted P&Ls, and, if so, on what grounds do you find fault? "There may be occasions where the numbers don't make sense and they don't tie to the audited financials they provide," Sturm, the IR executive, replied. "It is a self-reported mechanism. Aside from some glitches that may arise that we need to get back to them [about], no, we are not managing numbers if that is your question."

Nothing you have so far read will provoke surprise that 3G pays the lowest tax rate it can find. Still less would it startle an experienced tax observer if 3G/RBI were found to have overreached in the search for the lowest rate in the most advantageous domicile. RBI reincorporated in Canada, from the United States, following the 2014 Hortons acquisition.

"In footnote 10 of RBI's 2016 10-K report," Lorenz observes, "the company states that it earned $1.1 billion in pretax profits in Canada and $150 million in pretax profits in the rest of the world. (It is impossible to square these figures with RBI's other segment disclosure.) In 2016, RBI accrued a $243.9 million tax at an 20.3% rate on its profit-and-loss statement. However, that tax accrual comprised $163.8 million in current taxes and $80.1 million in deferred taxes (i.e., the tax rate on current-period taxes is 13.7%, and $80.1 million in taxes were accrued as a balance-sheet liability). Of current-period taxes, $78.6 million was paid to Canada, $46.9 million to U.S. federal or state coffers and $38.3 million to parts unknown.

"In the risk-factors section of that 10-K report," Lorenz proceeds, "RBI warns: 'Future changes to U.S. and non-U.S. tax laws could materially affect the Company.' Noting, specifically, that 'the U.S. Treasury has recently issued final, temporary and proposed Treasury Regulations under sections 385 and 7874 of the Code and indicated that it is considering possible additional regulatory action in connection with intercompany transactions and so-called inversion transactions.' That is to say, it appears that RBI is aggressive in shifting profits to lower tax jurisdictions."

Last month at the Berkshire Hathaway annual meeting, Warren Buffett defended the 3G model with some observations on the imperative need for productivity growth. To which Charles Munger added, "We don't see any moral fault with 3G."

Of course, it is better to live in a country in which Exxon Mobil Corp. generates $197.5 billion in revenues with 71,100 employees than in a country in which China Petroleum & Chemical

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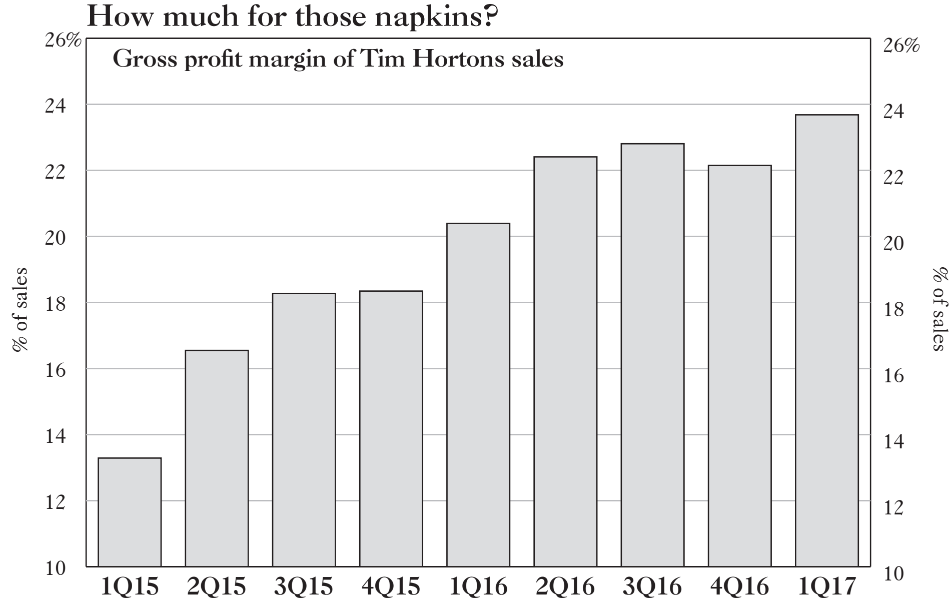
How much for those napkins?



source: company reports

CREDIT CREATION

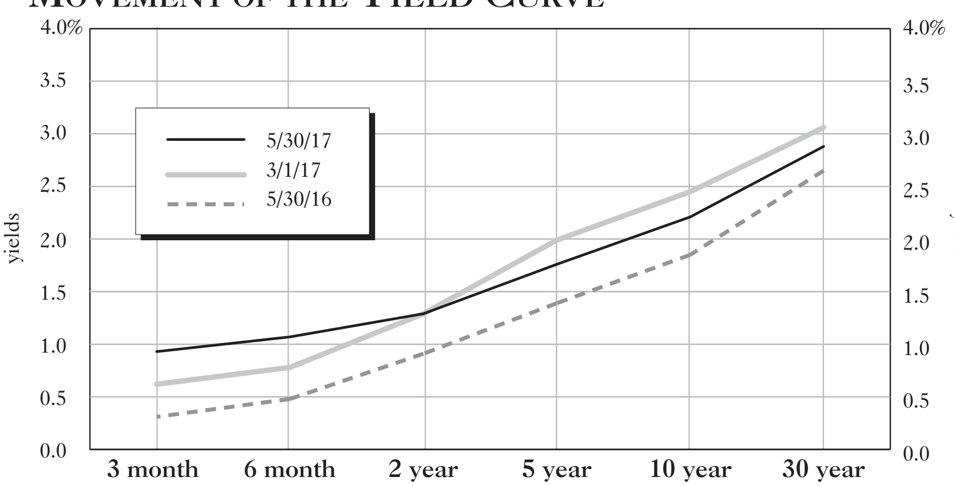
FEDERAL RESERVE BALANCE SHEET
(in millions of dollars)

	May 24, 2017	May 17, 2017	May 25, 2016
The Fed buys and sells securities…			
Securities held outright	$4,256,760	$4,254,590	$4,238,016
Held under repurchase agreements	0	0	0
and lends…			
Borrowings—net	50	65	84
and expands or contracts its other assets…			
Maiden Lane, float and other assets	177,815	184,461	193,099
The grand total of all its assets is:			
Federal Reserve Bank credit	4,434,634	4,439,125	4,431,286
Foreign central banks also buy, or monetize, governments:			
Foreign central-bank holdings of Treasurys and agencies	$3,244,210	$3,234,198	$3,218,126

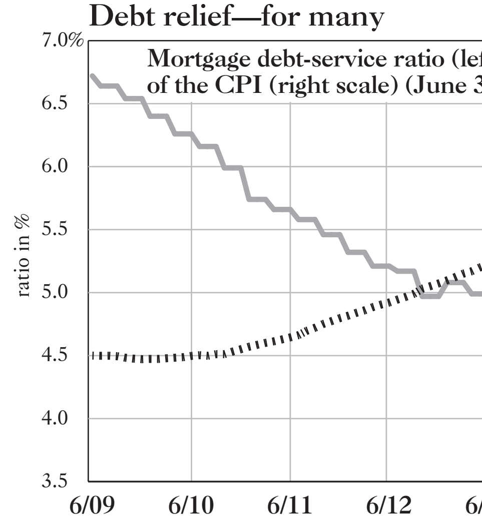
BANK OF JAPAN BALANCE SHEET
(in billions of yen)

	May 20, 2017	April 20, 2017	May 20, 2016
The BoJ buys Japanese gov't bonds… Bonds purchased	¥425,008	¥420,564	¥361,924
and lends… Loans and discounts	44,405	44,394	32,170
and expands or contracts its other assets… Other assets	28,745	26,104	21,107
Its assets total:	¥498,158	¥491,061	¥415,201

MOVEMENT OF THE YIELD CURVE



source: The Bloomberg



sources: Federal Reserve, Bureau of Labor Stati

To forgive

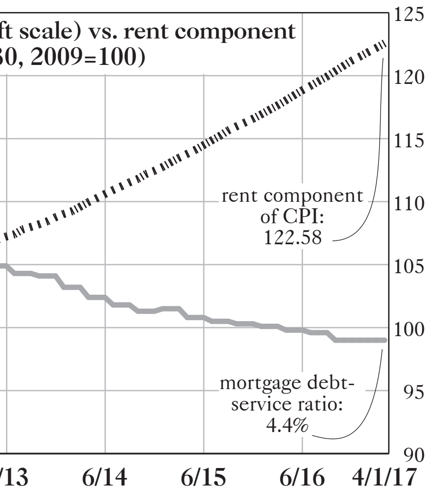
Evan Lorenz writes:

The average U.S. FICO score rose to 700 in April, the highest level since at least 2005 and up from 686 in October 2009, according to Fair Isaac Corp. Scores should continue to climb, *The Wall Street Journal* reported on Monday, as the six-million-plus adults who sought court protection during the financial crisis are having their bankruptcy records purged from credit reports. Depending on the bankruptcy-code chapter, this merciful forgetfulness takes 7 to 10 years.

(Borrowers-to-be are set to receive another boost on July 1. Out of fear of the Consumer Financial Protection Bureau, the three major credit bureaus will expunge tax liens and civil judgments that lack a complete list of a borrower's data, which most filings lack. This may help 11 million prospective consumers, even though borrowers with liens and judgments are twice as likely to default.)

In April, the unemployment rate fell to 4.4%—the lowest level since May 2001—from 4.5% in March and 5% a year ago. With more jobs, consumers should find it easier to service obligations. This is, at least, what the Federal Reserve's debt-service-ratio (DSR) data, which compares interest payments to disposable income, finds. The DSR fell to 10% in the first quarter of 2017 from a high of 13.2% in the fourth quarter of 2007.

• CAUSE & EFFECT



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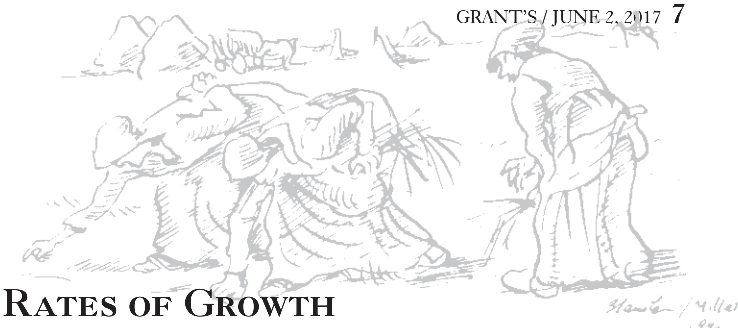
e is divine

Nevertheless, problem consumer loans are ticking up across the country and especially from subprime and near-prime borrowers. Delinquencies increased on subprime lender Santander Consumer USA Holdings, Inc.'s securitized auto loans to 13% of the total in April from 11.9% a year ago. Credit-card issuers Synchrony Financial and Discover Financial Services boosted their provisions for loan losses by 44.6% and 38.2% year over year in the first quarter due to slow-paying borrowers.

How to square a strong jobs market and balance-sheet sightings with a rise in bad credit? Fixed costs have been rising for the bottom third of borrowers. The price of apartment buildings has soared as cap rates dropped due to years of EZ monetary policy. Medical costs have jumped under Obamacare. Since June 2009, the end of the Great Recession, the rent and medical components of the CPI have risen by 22.6% and 26%, respectively, almost double the 13.7% increase in the general index.

While more well-to-do households have also been hit by rising medical costs, they've had an offset courtesy of the Federal Reserve. The decline in the DSR was almost entirely driven by the mortgage component, which fell to 4.4% of disposable income in the fourth quarter of 2016 from 7.2% in the fourth quarter of 2007.

It pays to be rich. •



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

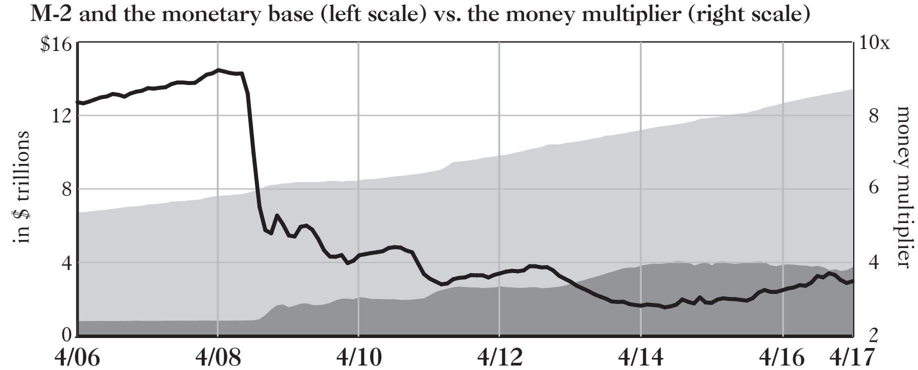
	3 months	6 months	12 months
Federal Reserve Bank credit	1.4%	0.8%	-0.1%
Foreign central-bank holdings of gov'ts	7.5	6.8	0.0
Bank of Japan	12.0	14.0	20.0
Commercial and industrial loans (April)	-1.3	-0.3	2.6
Commercial bank credit (April)	1.4	1.5	4.5
Asset-backed commercial paper	18.5	-3.9	-2.2
Currency	11.6	8.2	6.6
M-1	10.0	8.2	6.9
M-2	5.7	5.7	5.9
Money zero maturity	6.1	5.1	5.1

REFLATION/DEFLATION WATCH

	Latest week	Prior week	Year ago
FTSE Xinhua 600 Banks Index	13,584.61	12,878.70	12,352.64
Moody's Industrial Metals Index	1,748.98	1,768.42	1,434.50
Silver	$17.32	$16.80	$16.34
Oil	$49.80	$50.33	$49.48
Soybeans	$9.27	$9.53	$10.80
Rogers Int'l Commodity Index	2,215.13	2,237.74	2,204.26
Gold (London p.m. fix)	$1,265.05	$1,252.00	$1,223.85
CRB raw industrial spot index	506.11	504.38	448.26
ECRI Future Inflation Gauge	(Apr.) 113.2	(Mar.) 113.2	(Apr.) 107.9
Factory capacity utilization rate	(Apr.) 76.7	(Mar.) 76.1	(Apr.) 75.4
CUSIP requests	(Apr.) 1,662	(Mar.) 2,050	(Apr.) 1,482
Fed's reverse repo facility (billions)	168.0	182.3	40.5
Index of central bank stocks in gold terms*	44.32	45.25	34.57

*Index=100 as of 12/31/2007

EFFECTIVENESS OF THE MONETARY POLICY
M-2 and the monetary base (left scale) vs. the money multiplier (right scale)



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Corp. (a.k.a. Sinopec) produces $283.1 billion in revenue with 451,611 employees. It would also be better to own a business in which the venality of the owners was in the service of preserving and improving the brand rather than—inadvertently, through short-sighted fixation on the bottom line—debasing it.

"On the recruiting site Glassdoor.com," Lorenz winds up, "the 31 reviews from RBI employees give the company 1.8 stars out of a possible five—you expect as much, given RBI's focus on lean, people-free operations. What you might not expect are the kind of allegations that should at least raise eyebrows for current RBI shareholders and creditors. 'RBI has cut costs to the bone by getting rid of all the professionals in the organization and hiring kids out of school through their MBA program,' says a comment dated March 24. 'Turnover rate is at nearly 50%. They preach process and meritocracy but at the end of the day there is no meritocracy and process goes out the window. Decisions are made by a couple of key decision makers usually based solely on cost not what's best. Then when the poor decisions by these key decision makers result in poor results the blame is pushed back to you. They have destroyed not only the corporation but many small franchisees, their business and livelihood in the Burger King brand and are doing the same thing at Tim Hortons. Popeyes is next.' "

The criticism seems not to accord with the fancy RBI price/earnings multiple.

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Ever higher

On Monday, shares of the world's most encumbered and possibly most astounding property developer leapt by 23% in Hong Kong trading, bringing the year's gain to 215% and leaving envious bitcoin bulls to wonder why they chose to back such a losing laggard as the invisible digital currency.

China Evergrande Group is just about the most of everything, including the world's most painful short within the universe of companies commanding a market value of $1 billion or more and boasting a short interest of at least 10% (so relates Bloomberg, citing Markit). Some 20.7% of the Evergrande free float is sold short.

For the sellers, it's been a nightmare. The stock costs an arm and a leg to borrow, and then you wish you hadn't borrowed it—had never even heard the name—because the price only goes up. Then, again, many a lucrative bearish journey begins in exasperation.

We call the attention of the readers of *Grant's* to this situation because, in the first place, everything about Evergrande is incredible (the board of directors in 2016 earned $46.5 million, J.P. Morgan reports), and, secondly, because we suspect that the company name will one day become proverbial, like "Bank of United States" or "Hindenburg."

Corporate performance, as conventionally measured, can't easily explain the levitation: In fiscal 2017, Evergrande is expected to earn 11.2 billion renminbi on revenue of RMB 268 billion. Nor does valuation seem the obvious catalyst: At 36 times trailing net income, the shares are twice as expensive as those of a pair of comps, which themselves are fast-rising, Country Garden Holdings Co. and Sunac China Holdings Ltd.

The most persuasive explanations for the ferocious updraft in Hong Kong ticker No. 3333 have little to do with securities analysis. They include aggressive, debt-financed share repurchases, a timely "overweight" recommendation from Morgan Stanley and the hope of a relisting of the Evergrande property subsidiary in Shenzhen. The switch in trading venue will catalyze a one-time price surge to close the prevailing gap between the (relatively low) Hong Kong price and the (prospectively high) Shenzhen one, or so the thinking goes. A titanic short squeeze has likewise powered the surge, though that commonplace observation leaves unanswered the question: What possessed the bears to sell the shares in the first place? And a more fundamental question: What does this company do for a living?

Evergrande buys land and builds apartments—800,000 units are under development. Its specialty is sprawling, elaborate residential communities on the outskirts of Chinese cities, though if "communities" connotes inhabitants, it is not quite the right word.

Evergrande does more than build mini-cities. It owns a soccer club and a plastic-surgery hospital. It holds interests in bottled water, vegetable oil, life insurance, grain, health, financial services, entertainment, media, milk and such.

Evergrande wheels and deals. It pays its suppliers (some of them, some of the time) in its own stock. It creates and distributes "wealth-management products," by which the yield-starved Chinese saver speculates. "A typical [WMP]," says Anne Stevenson-Yang, co-founder of J Capital Research and the guest on the current *Grant's* podcast (just visit our website —*advt.*), "would be Evergrande Real Estate Superior Debt No. 1 Dedicated Trust Plan Phase 8, issued by Industrial Bank, issued to Inner Mongolia Luqiao Real Estate (an Evergrande affiliate) and secured by land holdings of that company. The 'private equity funds' are even more liberal and exciting names like Shandong Highway Xinye City Development Share Investment Management Co. Ltd. Jinan Evergrande Dedicated Fund. There is a whole lot of debt in China that calls itself equity."

For a harrowing look inside Evergrande, please treat yourself to the new J Capital report (visit www.GrantsPub.

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Fundamentals explain only so much

source: The Bloomberg

com/EvergrandeReport; still another *advt.*). Stevenson-Yang, by whose courtesy we post the analysis, gets right down to business. "Evergrande," she writes, "is . . . arguably the biggest pyramid scheme the world has yet seen. Servicing the company's mountainous debt requires constant new borrowings, and those loans in turn require that the growth continue."

Evergrande, Stevenson-Yang contends, is built on a simple misconception: the idea that apartments build and preserve wealth, no matter what (if anything) they may yield. It is not a uniquely Chinese fallacy. On a flying inspection of the Texas real estate bubble in the late 1980s in the company of Frederick E. "Shad" Rowe, your editor heard it from the developers themselves. "Real estate," they would say, "isn't a cash-flow business, it's an asset-appreciation business." It's an asset-appreciation business until you can't service the debt.

"Evergrande's debt," Stevenson-Yang proceeds, "ultimately relies upon the belief that its physical plant has value. No company has more masterfully maintained the illusion that these properties are reliable stores for the people's savings. Few of the properties fill up, and many have already visibly deteriorated, but nominally rising prices even where there is no secondary market uphold the scaffolding of the dream."

In Stevenson-Yang's telling, the chairman of Evergrande, Hui Ka Yan, resembles Jeff Bezos and a pair of Elon Musks. He doesn't just build half-empty apartment towers, but rather half-empty "grand constellations of towers, villas, exhibition centers, stores, hotels and restaurants that can accommodate 65,000 at a single site."

As for the finances: "The company has had negative free cash flow since 2006. In addition to massive on-balance-sheet debt, the company has partnerships, third-party guarantees, ballooning presales, forced loans from construction companies to which it owes money and myriad other hidden means of obtaining the ever-widening flows of cash needed to meet maturities of current debt. It is a company that would send most financial managers running for their blood pressure pills."

The on-balance-sheet liabilities of RMB 1.16 trillion may or may not be the least of it, but it is the least interesting part of it: "Off balance sheet, there are hundreds of billions more. Dozens of banks, trusts and private equities aggregate funds for Evergrande at rates as high as 15% and terms as short as three months."

Not just anything puts bitcoin in the shade.

•

The Fed taketh away

"President Donald Trump won't inherit the same windfall that the Federal Reserve handed the Obama administration each year, and his budget shows he knows it," Bloomberg reported the other day.

The combination of a rising funds rate and a shrinking balance sheet (or the expectation of same) points to lower income at the Bank of Yellen, and therefore smaller remittances to the Dept. of the Debt, or rather, of the Treasury.

"The double whammy," Bloomberg relates, "is reflected in the president's proposed budget and projections, [which show] Fed remittances falling from $116 billion in fiscal year 2016 to a low of $50 billion in 2020 before rebounding. Given the administration's proposals, the budget also projects that net interest outlays will climb from $240 billion last fiscal year to $428 billion by 2020 as rates increase."

Experienced in writing prophetic copy, we would rather phrase it, "if" rates increase.

•

Crisis without value

After falling out of bed on May 18, the Brazilian stock market climbed right back in under the covers. Proximate cause of the 16.1% (in U.S. dollar terms) plunge was the tape-recorded suggestion that incumbent Brazilian president Michel Temer is, or was, politically speaking, for sale. Evident source of the rebound was the infusion of $724 million into Brazilian-themed index exchange-traded funds. Whether the snapback says more about Brazilian finance or American investors is the question before the house.

This publication supports bargain-hunting wherever there are bargains to be hunted. Nor do we object if the bargain-laden markets are places in which you might rather not spend the night (e.g., our bullish analysis of Russia's Sberbank, in the issue of *Grant's* dated May 16, 2014; or our friendly appraisal of Turkey, from this year's Jan. 13 issue). As we survey crisis-wracked Brazil from our lower Manhattan aerie, there's one telltale problem: We can't find the bargains.

You'd suppose that the politics of the Great Green country alone would propagate investment opportunity. Operation Car Wash, the Brazilian authorities' investigation into high-level political corruption, has been under way for three years. If Temer departs, he would be the second president to do so in 12 months, joining his predecessor, Dilma Rousseff.

And if politics can't make rich securities cheap, what about a 13.7% jobless rate? Or a string of 11 consecutive quarters of year-over-year declines in real GDP? You may say that recessions always end, and this one may be on its last legs (the Brazilian finance minister the other day was forecasting "very strong" growth in the first quarter, perhaps as much as 0.7%). Maybe the macroeconomic signs are improving. If the fiscal signs are likewise mending, it's from a base very near rock bottom.

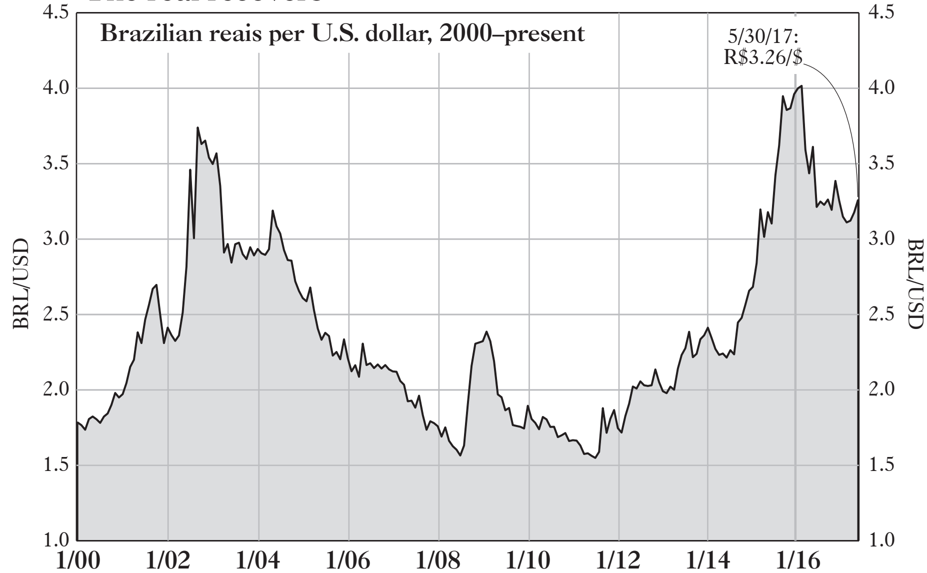
Thus, after a budget deficit of 9.0% of GDP in 2016, S&P forecasts this year's shortfall to be 8.8%. On May 22, the agency placed Brazilian sovereign debt under surveillance for a ratings demotion from the already speculative-grade level of double-B: "The risks are now tilted toward even lower growth amid heightened political uncertainties of the spillover effects associated with the corruption investigations and reversal of the improvement in private-sector sentiment."

"The corruption here in the past few years have been rampant, like nowhere else in the world I can think of," Marcelo López, partner and fund manager at L2 Capital Partners in the southeastern Brazilian city of Nova Lima, tells colleague Alex Hess. "It's actually a funny thing. Now that corruption is exposed, there are very [many] businesses in Brazil that, because they are not receiving their 'fair share,' are unwilling to approve projects. The country's at a standstill, believe it or not, because the corruption is diminishing."

Knowing only this much, a value investor from Mars might be rubbing his or her spidery hands together in anticipation of the kind of opportunity that used to materialize in the days before the central banks conquered planet Earth. If so, our visitor is in for disappointment.

Brazil's dollar-pay 6s due April 2026 are quoted at $108.66 to yield 4.79% to maturity. While outyielding the 10-year U.S. Treasury by 258 basis points, the Brazilian securities are payable in a currency which Banco Central do Brasil, unlike the Federal Reserve, may not lawfully print. Are those 258 basis points adequate compensation for the risks attached to this country's long-range fiscal situation? Before he was so rudely interrupted by his own recorded voice, President Temer was trying to lead a reform of Brazil's social security system. As it is, many or most workers may retire in their mid-50s with almost full benefits. The precariously employed president has been pushing for an additional decade on the job. According to a May 3 Thomson Reuters dispatch, "about 71%" of Brazilians want no part of that idea.

The real recovers



source: The Bloomberg

Local-currency-denominated public debt does not, to us, scream "bargain" any more than the dollar bonds do. The real-pay 10s due 2027 yield 10.8% to maturity, or 600 basis points more than Brazil's 2026 debt priced in dollars. It's a premium that's less inviting the more you study the implied prospects for currency depreciation.

"The going rate for committing to a non-deliverable exchange of U.S. dollars for reais 10 years into the future is R$5.91 for each dollar, versus R$3.26 today," Hess observes. "This means that the forward market expects the real to depreciate at a compound rate of 6.1% per year against the dollar—more than you would pick up in additional yield by buying Brazil's real-denominated debt instead of its dollar bonds. By contrast, forward quotes and extrapolations from Bloomberg indicate per annum depreciation rates versus the dollar of 2.4% for the Chinese renminbi, 3.5% for the Indian rupee and 4.4% for the Russian ruble."

Maybe the Brazilian bond bulls judge that the forward market gives insufficient credit to a central bank that has held its policy interest rate in the double digits to drive down year-over-year growth in the consumer price index to 4.1% (as it was in April). The currency market, at least, does give credit, with the real quoted at R$3.26 against the dollar, up from R$4.18 in September 2015.

And maybe the Brazilian stock bulls look at cyclically low margins—6.4% over the past 12 months, down from

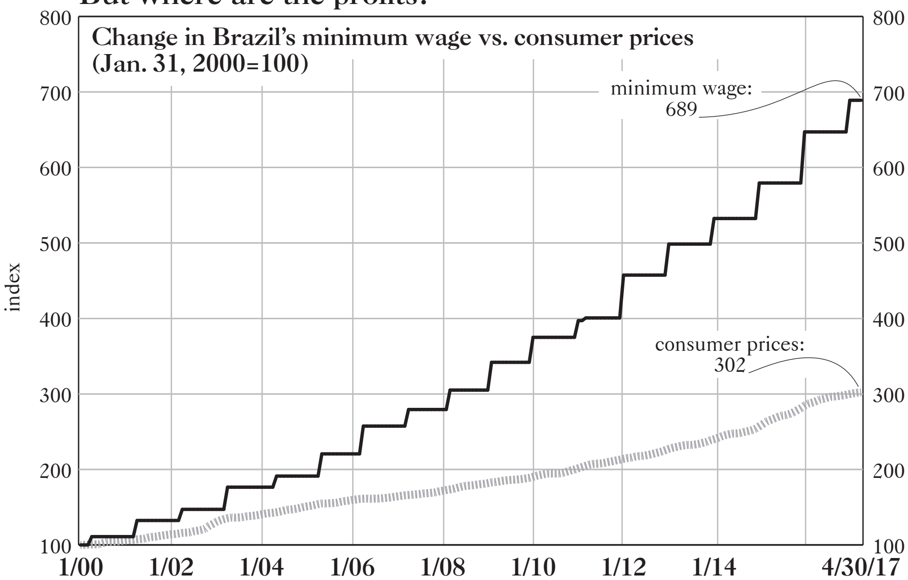
Fundamentals and valuations in four emerging markets*

	10-year local currency bond yield	10-year dollar-pay bond yield	10-year implied depreciation vs. USD	P/E ratio	Moody's rating	S&P rating
Brazil	10.8%	4.8%	6.1%	17.3x	Ba2	BB
Russia	7.6	4.0	4.4	7.1	Ba1	BB+
India	6.7	n/a	3.5	22.5	Baa3	BBB-
China	3.7	3.2	2.4	16.7	A1	AA-

*Implied depreciation is based on forward prices; price/earnings ratios are for large-cap stock indices.

sources: The Bloomberg, S&P Global Ratings, Moody's Investors Service

But where are the profits?



source: The Bloomberg

12.4% in 2010—and cyclically low earnings to conclude that better times lie directly ahead. And perhaps they anticipate lower interest rates. "We are seeing value in almost every sector in Brazil simply because the market is depressed in all directions," Mark Mobius, executive chairman of Templeton Emerging Markets Group, tells Bloomberg.

The question is how you get from the depressed, not optically cheap present to the prosperous future. Brazil indexes its minimum wage to increase by the sum of the rate of inflation in the prior year plus the rate of real GDP growth the year before that. In consequence, wage gains continue to outstrip the employers' capacity to pay them. While consumer prices have risen by 46% since corporate earnings peaked in 2011, the minimum wage has climbed by 72%.

We would expect a shipwreck like Brazil to be valued like a shipwreck. As it is, the Bovespa large-cap index commands a P/E multiple of 17.3. The market has jumped by 71% from its January 2016 lows, by 112% in dollar terms, to become the world's best-performing major stock index (and remains so after the May 18 spill). In this central-bank-managed world, when do things ever get absolutely cheap?

Consider AmBev S.A. (ABEV3 in Brazil, with depositary shares listed on the New York Stock Exchange under ABEV), the third largest company in the Brazilian index and a separately listed subsidiary of Anheuser-Busch InBev S.A./N.V. (ABI on the Euronext Brussels exchange). AmBev, with pointers on frugality from 3G Capital, brews beer under the brands Skol and Brahma and owns the exclusive Brazilian right to sell Pepsi. Last year, Brazil accounted for 66.9% of AmBev's sales, which have fallen by 3.5% per annum over the past two years. AmBev trades at 12-month trailing multiples of 24.7 times earnings and 6.5 times sales.

It's not that there are no statistically cheap stocks in Brazil. It's just that—as often as not—an inquiring analyst discovers that such seeming bargains deserve their low valuations. JBS S.A. (ticker JBSS3 in Brazil), the giant meat processor, is a case in point. In the 12 months through March, JBS reported sales of R$164 billion, or $50.3 billion. Swift and Pilgrim's Pride are among its brands. A globally competitive business trading at 5.7 times earnings, for a market cap of R$20 billion, JBS would seem the very essence of value.

And the company might answer that definition except for a heavily encumbered balance sheet (operating income covered financing costs by a mere 1.4 times in the 12 months through March 31) and a criminally burdened front office. Over the weekend, the billionaire chairman of JBS, Joesley Batista, resigned; it was his recorded voice, in colloquy with Temer, coolly discussing the market in Brazilian politicians, that caused the stock market tumble. For his part, Temer accuses Batistia of doctoring the tape and positioning himself in the currency-futures market to profit on the uproar over the (fake) news of Temer's complicity in the sprawling Brazilian bribery industry. On a more clinical, business note, you wonder how much of the success of JBS is owing to capable management and how much to political favors bought and paid for.

The afore-quoted López has this to say about the market in which he is expert: "It's one of the few countries in the world where I don't see a bubble." The cleanest dirty shirt Brazil might be (we are not so sure about that). If true, what does that say about the rest of the shirts in the laundry?

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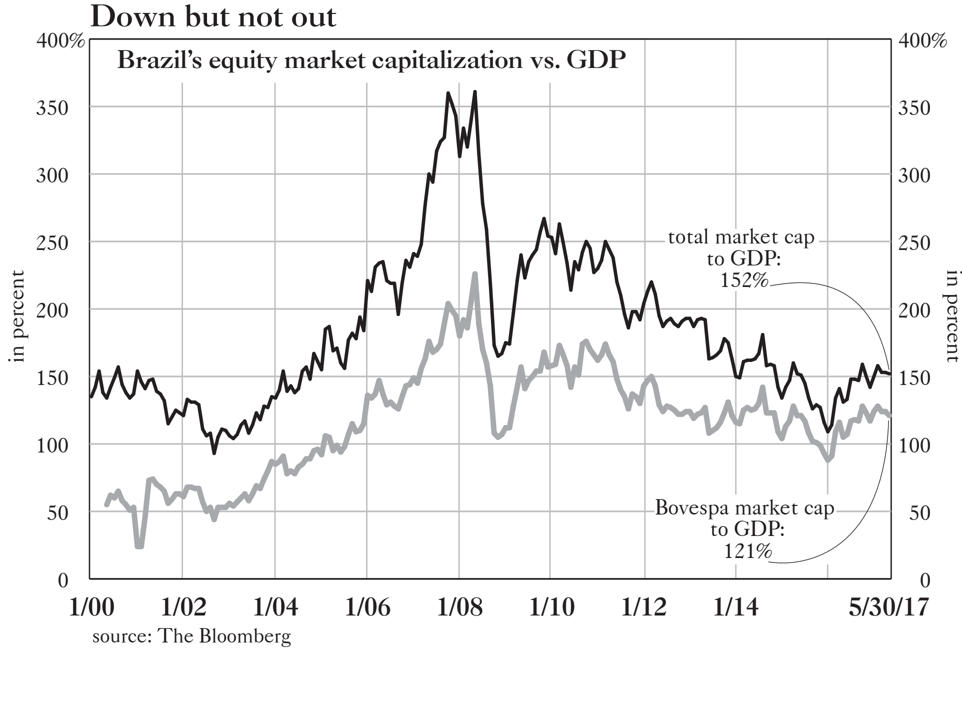
Down but not out



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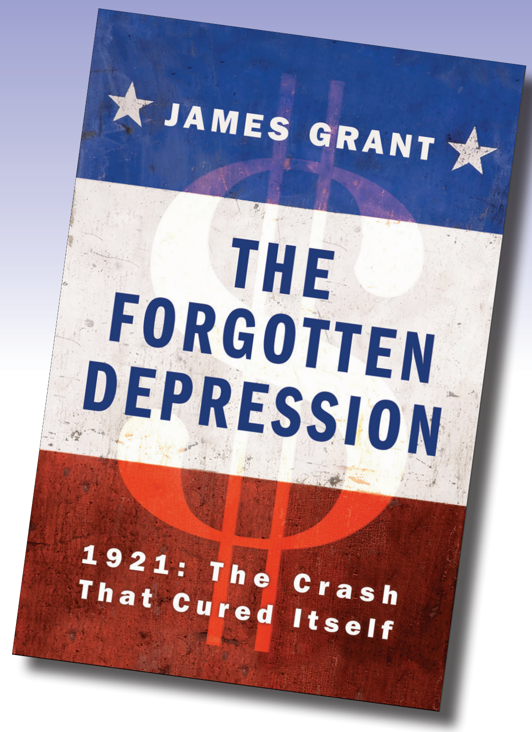

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