KAPSTREAM
A JANUS CAPITAL Group Company

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Never fall victim to one of the classic blunders

In managing a strategy focused on providing low volatility and capital preservation as its primary goals, we've developed a set of investment doctrines aimed at avoiding problem issuers and sectors as we seek to continue providing a 'sleep at night' experience for our investors.

As with Vizzini's classic blunders from 1987's cult classic *The Princess Bride*:

- Never get involved in a land war in Asia (note to Donald Trump…)
- Never go in against a Sicilian when death is on the line

We at Kapstream also see classic blunders in the bond world, amongst which have included:

- Never invest in the European banking sector
- Never invest in securities issued under local laws we don't understand or which aren't fully developed
- Never rely on regulators to do the right thing

Recently, we've seen how these classic blunders have destroyed some European bank returns and wonder how investors can continue to hold European bank paper in today's world. Aside from the basic mistakes European banks have made since the GFC, i.e. not raising enough capital and not recognising the extent of bad debt on balance sheets, the lack of credible bank regulation and oversight will continue to weigh heavily on this sector.

While more than €1.6 trillion has already been pumped into troubled European banks since the GFC (according to the European Commission), Portugal's Novo Banco is the perfect model for the problems still facing the European banking sector and we think it's worth reviewing the shocking combination of mismanagement and misinformation which has occurred as an example of the hurdles European bank investors will face over the coming years.

Banco Espirito Santo/Novo Banco

Prior to mid-2014, Banco Espirito Santo (BES) was Portugal's 2nd largest bank, majority owned by Credit Agricole (25.8%) and Espirito Santo International (ESI) (25%), the family vehicle which founded the bank.

In May 2014, a Portuguese central bank audit of ESI revealed accounting irregularities, some of which were related to an ESI loan for the purchase of new BES equity. To make things worse, Rioforte, a holding company which owned 49% of ESI, declared bankruptcy due to an inability to repay a €847 million debt to Portugal Telecom.

While such a complicated, interlocked ownership structure isn't uncommon in the European banking sector, a significant amount of credit analysis would have been required on underlying ownership structures if one were to invest in these types of institutions.

BES itself had the following exposures to founding family ESI:

- €1.2 billion in direct loans to ESI
- €0.85 billion in debts held by BES retail clients
- €2 billion in debts held by BES institutional clients
- Potential liability for the €2.85 billion in EIS debt sold by BES to their retail customers through their retail branch network.

A growing problem in the European banking sector relates to higher yielding subordinated paper mis-sold to retail depositors as 'safe' investments (bank hybrids, Tier 1, Tier 2). The pages of European newspapers are littered with stories regarding catastrophic losses incurred by mom and pop investors in these assets, while regulators bury their heads in the sand and ignore the growing problem – and even provide their stamp of approval of banks passing capital adequacy tests. Not unexpectedly, when rates are zero or negative, bankers will find high-yielding junk to shove down the throats of unsuspecting retail investors in order to support their increasingly floundering operations, all with the seal of approval from their bank regulator.

Incredibly, as the BES crisis further unfolded in 2014, regulators announced BES would conduct another capital raising in July, expecting €2 billion in new capital – while the shares were trading around €0.45, down 60% over the prior 2 months. This announcement was probably the death warrant for BES – as markets rightly concluded that regulators were so inept and delusional that they believed BES could raise twice the capital of their last rights offering while their stock was down 60%.

While that obviously wasn't going to work, BES and the Portuguese central bank said all was good – it still had enough capital at €6 billion Tier 1, which equated to a 9.8% Basle III Tier 1 ratio, which was €2.1 billion above the minimum requirement.

Following a well-worn European regulatory story, a few days later, it was announced that BES were suddenly €2 billion below their regulatory requirements. Nonetheless, the Portuguese government stated they would not bail out BES, and that recent upgrades to the EU Banking Resolution Mechanism provisions meant that private investors would be forced to bail-in BES.

As you might expect, two weeks later BES received a €5 billion government bailout. Theoretically this was not from the taxpayer – but from an underfunded bank guarantee fund supplemented with untapped funds from a former aid programme. Incidentally, since that initial payment the total bailout has reached €9.4 billion, so far…

On the positive side, a fall-back plan involving investor bail-in provisions worked exactly as European regulators intended. BES was split into the new good bank, the aptly named Novo Banco, which received the good assets, the depositors and senior unsecured debt (totalling about €12 billion in senior bonds) – and the now bad bank, BES, which received the bad assets. By August 2014, equity and subordinated debt was moved to the bad bank – virtually wiping out all value.

With the bail-in provisions working as envisaged, junior debtholders and equity holders were effectively wiped out, and all was good for senior debtholders who were made whole in the new bank. Until November 2015 that is, when the ECB announced Novo Banco had (surprise) another €1.4 billion capital shortfall!

In December 2015, the Portuguese central bank then announced that they would take the unprecedented step of moving 5 of 52 of Novo Banco's senior bonds to the bad bank – virtually wiping out all value in these senior securities. These 5 bonds moved from a price of about 94 cents on the dollar to 7 cents on the dollar the very next day! The other 47 senior bonds remained near 94 cents.

In picking these seemingly random 5 bonds, the regulator said many of the bank's outstanding senior bonds were sold to retail investors or issued under foreign laws. It said, "retransferring retail bonds would have been highly prejudicial to Novo Banco's franchise, potentially causing a loss of customers and deposits and a loss of confidence in Novo Banco."

The 5 bonds transferred were issued under Portuguese law with minimum lots of €100,000, meaning they were more likely sold to institutional investors – which for some unknown reason will not cause "a loss of customers and deposits and a loss of confidence in Novo Banco."

In transferring these 5 bonds, the Portuguese central bank destroyed a sacred fundamental bond concept of 'pari passu' (Latin for equal footing) – that is all bondholders are treated the same, or no preferential treatment. It appears to us that European bondholders are now at the mercy of arbitrary, random decisions of regulators, with little bearing to common sense or fair treatment or rule of law.

At Kapstream, we've been reluctant to consider any foreign issuer which issued under local law, preferring US, UK and Australian law (that we understand), and bankruptcy code enshrined in both legislative code and court decisions – laws which cannot be changed by the whims of weak regulators (see Argentina, Greece and now Portugal).

Other regulatory uncertainty

As 2016 progresses and risk markets continue their sell-off, we expect the European banking sector to remain in the news, and not in a positive way. The biggest current story centres around Deutsche Bank, particularly their subordinated debt.

In theory subordinated debt was supposed to absorb losses in order to keep a bank viable during downturns as coupon payments were contingent upon continuing profitability. In periods of weak profitability subordinated paper wouldn't receive coupons and in really bad cases (like BES) would be turned into equity or placed into a bad bank – meaning they would become virtually worthless.

In the case of Deutsche Bank, equity and subordinated bond prices fell with their profitability decline. Deutsche's perpetual hybrids, callable in 2022, fell to 72 cents on the dollar, from 93 cents at the beginning of the year as investors anticipated missing coupon payments in coming years.

Despite decreasing profitability, credit downgrades, and a share price down almost 40% YTD, Germany's finance minister said he had "no concerns" about Deutsche Bank and the bank was "absolutely rock-solid." Furthermore, Deutsche Bank CEO incredibly said he saw "no need" for increasing capital. So did Dick Fuld at Lehman in 2008.

There are now discussions regarding changing regulations to allow Deutsche Bank to continue to pay subordinated bank coupons, despite the lack of profitability. It appears to us that European regulators are making up laws as they go, ignoring basic rules that have governed capital markets since their inception. In the case of Deutsche, the regulator believes they are too big to fail, so they will likely change the rules to allow them to pay subordinated debt holders. In the case of Novo Banco, they weren't too big to fail, and the regulator didn't care about basic bond rules or protection of investors.

We're in a new, more uncertain world where bond managers, in addition to their normal fundamental credit analysis, now need to develop a sixth sense in fathoming the idiosyncratic motivations of regulators.

At Kapstream we feel there is too much risk and uncertainty and 'unknown unknowns', in trying to guess what an unstable regulator might come up with next. That makes it unlikely that you'll see European banks in our portfolios anytime soon!

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