

# Quarterly Investor Letter

## "The Great Debate"



**Alan Burke,**  
Chief Executive

If you mention the "Great Debate" today, people in this part of the English speaking world automatically tend to think of the televised debates that took place between the three leaders of the main political parties in the UK as part of the recent general election.

Sky in particular with its usual impressive hype appeared to turn the UK election into one large television poll where candidates' style, looks and charm were at least as important as the policy issues of the day. This is quite an impressive feat given the economic backdrop against which the election is taking place, where the economic challenges facing the new Prime Minister, David Cameron, are pretty monumental in scope and depth.

Away from the "Great Debate" in the UK and the glare of the television lights, there is another "Great Debate" taking place globally between economists and policymakers on the topic of inflation and deflation. This debate has been brought about as a result of the Great Recession and the enormous policy response taken to offset its effects, which naturally has people asking - what's next?

The extremes of the economic debate at the moment tend to broadly polarise into those who think we are inevitably in for a prolonged period of Japanese style deflation and those who think policy makers are sowing the seeds for a very nasty bout of 1970's style inflation. As is the case with the televised Great Debate, both sides can make very plausible arguments as to why they are right and the other side are at best wrong and at worst deluded and dangerous.

In Avoca, while we naturally have our own views, we can add very little to the wider economic debate about whether inflation or deflation is the most likely outcome of current policies. Thankfully, not being policy makers or economic forecasters, we are not required to. We broadly subscribe to Warren Buffet's dictum that "economic forecasts tell you more about the forecaster than they do about the future".

The wider question however, of inflation versus deflation is still very much relevant to us in our jobs as managers of European credit. Our job as stewards of investors' capital is to ensure that, whatever set of economic circumstances we find ourselves subject to, our portfolio can deliver acceptable economic returns. While we cannot predict with certainty which of either high inflation or deflation is more likely, we must adequately prepare for the impact that either of these scenarios might have on Avoca portfolio performance.

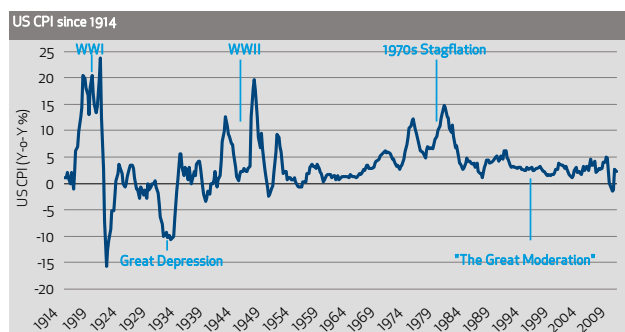
The purpose of this newsletter is to help answer three questions concerning inflation and deflation relevant to investors in European leveraged loans, namely:

- What are the likely macroeconomic effects of a prolonged period of either high inflation or deflation?
- What type of companies are likely to do best in either inflationary or deflationary environments? and
- How will the European leveraged loan asset class behave as an investment in either an inflationary or deflationary environment?

### 1. The macroeconomic effects of Inflation and Deflation

Inflation is usually defined as a general rise in the price of goods and services. The world over the last two centuries (and much further back) has gone through periodic bouts of periods of high and low inflation and also some periods of outright deflation. The graph below showing CPI movements since 1914 is specific to the US but broadly illustrates the fact that inflation/deflation have been consistent themes of economic life over the past century. In fact, the remarkably low and stable inflation of the past 25 years or so is the outlier in economic history rather than the inflation/deflation scenarios being discussed currently.

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Source: Bloomberg

The best known of these historical experiences for most investors are the outright deflation of the 1930s and the high inflation encountered in the 1970s. However, there are many other episodes in the history books such as the deflation of the 1920s (post World War I) and further back that of the 1880s and 1890s which caused the US presidential candidate in 1896 William Bryant to claim the US economy was being crucified on a "cross of gold", a reference to the rigorous enforcement of the gold standard of the time.

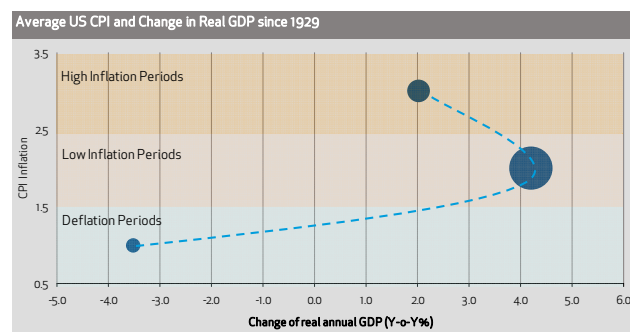
There are many theories as to what has caused these inflationary and deflationary periods throughout history. A more detailed discussion on the causes is beyond the scope of this newsletter but suggested factors include money supply, war and natural disasters, fiscal spending patterns, inflation expectations and technology and productivity changes to name but a few.

All of this is very interesting for those of us engaged by such matters. The debate about inflation or deflation however, while important, is subject to many variables and possible outcomes. There can be no certainties, only opinions, given the complexities, feedback loops and interactions between the various economic actors. At Avoca, we prefer to look at the potential effects of the range of outcomes rather than predict which path is more likely.

The first relevant question for us to ask in assessing potential company and portfolio performance is - Do periods of inflation or deflation impact real economic growth?

### Do periods of Inflation or Deflation impact real economic growth?

We have looked at the performance of the US economy over a 90 year period, dividing that period into three categories, deflation (defined as negative growth in CPI), years when inflation was less than 5% per annum, and years when inflation was greater than 5% per annum. The performance of the economy over these broad periods was as follows:



Source: Bloomberg. The size of the bubbles represents the number of years in each sample. The analysis excludes 1941-42.

Firstly, let's deal with the easy one, deflation. Deflation is a general reduction in the price of goods and services. It is usually caused by a reduction in aggregate demand. Its pernicious effect on real output was best seen in the period 1929-1933 in the US when real GDP fell by 27% from peak over a 4 year period. Clearly, extreme deflation left unchecked can be pretty disastrous for real levels of GDP and demand in the economy.

In relation to inflation, the evidence is less clearcut. Clearly hyperinflation is pretty disastrous for economic activity as seen recently in Zimbabwe and historically in Weimar Republic Germany. However, the vast majority of serious economic experts today are not suggesting that the world as a whole is in for a period of hyperinflation. Much more likely, even for the inflation bears, is a period of persistently high inflation but not disastrous hyperinflation.

Rising price levels in theory could have no impact upon output levels as people's behaviour and the level of activity simply adjusts to the new equilibrium. In practice, however the evidence suggests that high inflation is generally negative for real GDP growth. Again, the reasons for this are complex and are beyond the scope of this newsletter, but broadly centre around increased uncertainty impacting investment and consumption decisions.

Our first conclusion is that outright deflation and hyperinflation are both, not surprisingly, negative for real GDP. Moderate to high levels of inflation are definitely a negative but not disastrous for the aggregate level of real GDP.

From our perspective, unless you believe in the "Goldilocks scenario" of stable but low inflation such as that we have enjoyed for much of the past 25 years, the prudent base case operating assumption for the environment in which companies are likely to operate should be that we are most likely in for a period of below trend real economic growth.

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### 2. The impact of inflation and deflation on individual company performance

We have already seen that the first effect of a high inflationary or a deflationary environment will likely be below trend or possibly a decline in real GDP levels. This means that there will be natural economic headwinds into which all companies in such an environment will be sailing. In essence, volume growth for most companies is likely to be subdued.

However, volume is only one (albeit an important one) of the variables that determine company performance. Of equal importance in determining a company's overall performance are:

- The price it can charge for its goods and services
- The cost of its key inputs and
- The flexibility of its cost base

#### a) *The price it can charge for its goods and services*

A company's ability to maintain or increase its prices to customers irrespective of the economic or price environment can be summed up in two words - pricing power.

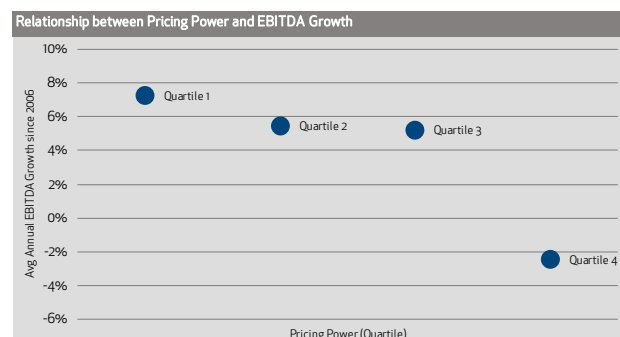
While simple in theory, the reasons why some companies exhibit pricing power and others do not is complex. Factors that can cause a company to exhibit enduring pricing power can include:

- Monopoly or controlling market positions
- Strong brands with enduring customer loyalty
- The presence of a licence or other barrier to entry
- Low product deferral and substitution risk and generally high barriers to switching

Unregulated companies exhibiting pricing power will usually exhibit above average EBITDA margins and depending upon the nature of the company and structure of the industry, high Return on Tangible Capital Employed (ROTCE). Examples of companies with high pricing power include branded consumer companies such as Coca Cola, (EBITDA margins 30%, ROTCE 40%) and Gillette prior to its takeover by Proctor and Gamble (EBITDA margins 30%, ROTCE 80%).

Within the Avoca portfolio, companies exhibiting the characteristics of pricing power include Phadia, (Healthcare - EBITDA margin 39%, ROTCE 46%), TDF (Telecoms infrastructure - EBITDA margin 49%, ROTCE 20%) and Springer (Scientific publishing - EBITDA margin 33%, ROTCE 30%) to name just a few.

In the following chart we analyse the relationship between pricing power (using historic EBITDA margins and Return on Tangible Capital Employed at the time of investment as a proxy) and EBITDA growth from 2006 to the end of 2009 for the Avoca portfolio.



Source: Avoca Deal Database

The graph shows the positive correlation between our proxy measure of pricing power and EBITDA growth over the past four years. The companies in the top quartile (i.e. those with highest EBITDA margins and ROTCE) exhibited the largest EBITDA growth while those with the lowest EBITDA margins and Return on Capital Employed showed negative growth.

Pricing power was clearly a crucial factor during this Great Recession in determining how well companies performed. It will no doubt be an equally crucial factor in determining company performance during any future inflationary or deflationary periods.

#### b) *The cost of its key inputs*

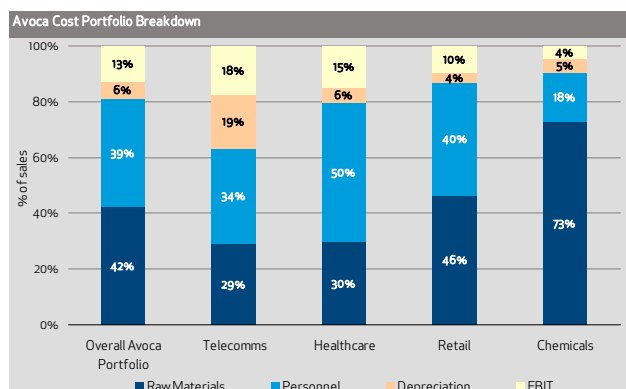
I grew up in the 1970s and was a student during the 1980's. Annual inflation peaked at north of 20% in Ireland in the early 1980s and as such I was too young to remember its direct effects but unfortunately was old enough to have to study "Inflation accounting" theory for my graduate accountancy degree in the late 1980s and early 1990s.

With apologies to my college professors, inflation accounting essentially differed from historic cost accounting in that all of the inputs used to calculate profits or losses were recorded at current replacement cost rather than historic cost. The key upward adjustments in an inflationary environment were typically to reflect current (i.e. rising) raw material costs and depreciation charges.

All company costs ultimately break down into one of the principal factors of production namely, Raw Materials, Labour or Capital (e.g. machines, factories etc.). Raw Material costs are measured directly in Cost of Goods Sold (COGS), Labour is generally split between COGS and SG&A expenses, while the Capital cost is usually measured through Depreciation and /or a Rent charge.

The cost breakdown for the overall Avoca portfolio and for certain selected sectors is shown below.

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Source: Avoca Deal Database. Note that 'Raw Materials' includes Transport and Energy costs. General administration and marketing costs are included in 'Personnel'

There are a number of points to note from the above graph:

- The key costs for Avoca Companies are Raw Materials and Labour (c.40% of Sales each). Capital costs (e.g. machinery, premises) are a much smaller percentage of total portfolio costs at just 6% of Sales. This broadly reflects Avoca's natural bias towards low capital intensity, high ROTCE businesses.
- Cost structures vary significantly from sector to sector. This could be important for example if you believe that we are likely to be in for a nasty bout of Raw Material inflation (e.g. oil, energy, commodities) but are not likely to be exposed to general wage inflation given current levels of unemployment in Europe. In such circumstances, low Raw Material usage sectors such as Telecoms, Cable and Healthcare for example would be less exposed to inflationary pressure than say high Raw Material cost sectors such as the Retail, Chemicals, or Packaging sectors.
- Certain high capital intensity sectors (e.g. Telecoms, Cable) could be heavily exposed to capital goods inflation. In a general inflationary environment, the Depreciation charge may effectively understate the real replacement cost of their asset base. Real cashflows and returns to investors through the asset replacement cycle could be materially lower than those suggested by Historic Cost accounting.

The ideal company in an inflationary environment from a cost perspective would have:

- High EBITDA margins - meaning less overall costs to control
- High Gross Margins - meaning the company is less exposed to Raw Material price inflation
- A flexible labour force cost - reducing exposure to either general or localised wage inflation and
- Low capital intensity i.e. a low depreciation figure and a low level of working capital to sales.

### c) The flexibility of its cost base

Of the three micro-economic factors important in determining how a company performs in either an inflationary or deflationary environment, the first of these, pricing power is important in either environment. The second, the nature of its cost base, is crucially important in an inflationary environment, particularly if one believes that inflation is going to be concentrated specifically in one of the three factors of production. The third factor, flexibility of cost base is a crucial determinant of performance in a deflationary environment.

In theory, a company faced with declining volumes and prices in a deflationary environment, could maintain profitability if its cost base was flexible enough to adjust to its new circumstances. The technical term for the sensitivity of a company's cost base to movements in volumes is operational leverage. In practice, operational leverage is dependent upon the level of fixed costs in its business and how "flexible" these fixed costs are in practice.

Sectors with high natural operational leverage for example include:

- Automotive – high level of fixed costs in the form of skilled workforce and a high fixed asset base
- Retail – good flexibility on Raw Material costs offset by rigid staff costs and fixed depreciation/rent costs
- Cable - high fixed cost base due to a high level of fixed asset investment on the balance sheet

Examples of sectors within the Avoca portfolio that performed particularly well and relatively poorly from an operational leverage respect over the past 2 years were as follows:

Weighted Average Change since June 2008	Revenue	EBITDA
<b>Flexible Cost Structures</b>		
Telecommunications	-2.7%	2.9%
Radio & Television	-3.3%	8.4%
<b>Rigid Cost Structures</b>		
Lodging & casinos	-8.5%	-21.7%
Building & Development	-17.4%	-39.2%

Source: Avoca Deal Database

Telecommunications operational leverage was lower than we would have expected due to firms ability to cut payroll costs, most probably as a result of their legacy as being mostly formerly state owned enterprises with cost reduction potential. Radio and Television exhibited a very strong ability to control programming costs (as any of us tired of watching re-runs of popular movies can attest to). At the other extreme, Lodging and Casinos suffered from a high exposure to lowly paid Labour (where it is hard to cut costs given minimum wage requirements etc). Building Materials suffered generally from a hard to downsize and inflexible manufacturing footprint.

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Overall, the majority of Avoca owned portfolio companies performed very well at the EBITDA level during the Great Recession despite on average marginally falling Revenues.

While recognising that a lot of the cost saving initiatives employed by private equity owned firms over the past 3 years could be described as one off in nature and would be hard to repeat in a prolonged deflationary environment, our experience has been that cost bases in Europe may be more flexible than people generally give them credit for.

Overall, our second conclusion is that the impact of inflation or deflation on company performance will be broadly dependent on the micro-economic characteristics of company. Key to performance will be;

- Strong pricing power (both inflationary and deflationary environments)
- An ability to control costs (inflationary environment) and
- A flexible cost base (deflationary environment).

### 3. How will inflation and deflation impact the asset class of European leveraged loans?

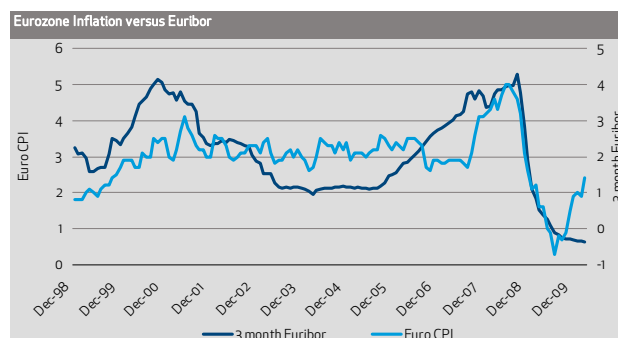
There are essentially two aspects to the total return from a leveraged loan. The first is the Euribor element, the second is the spread, net of credit losses that the investor expects to receive.

We have seen from Questions 1 and 2 that the company specific return in an inflationary or deflationary environment essentially depends on the careful selection of sectors and companies best suited to perform in either scenario. While a low and stable inflationary environment is the best investing environment for all asset classes, companies operating in stable sectors with pricing power and a controllable and flexible cost base can perform relatively well in both inflationary and deflationary environments.

The company specific element of total return in an inflationary or deflationary environment is going to be ultimately determined by how well the investor selects and manages the portfolio which will be the same for all credit asset classes. The key total return differentiator between leveraged loans and other credit asset classes all else being equal is therefore going to boil down to the question – *Is Euribor likely to be a good hedge against inflation or deflation in the future?*

Firstly, in relation to deflation the answer is easy. In a world of negative price movements and a zero bound minimum on Euribor, the real return to investors from the Euribor element of a leveraged loan in a deflationary environment will be positive. A Euribor based product such as a senior secured leveraged loan is likely to be a good deflation hedge.

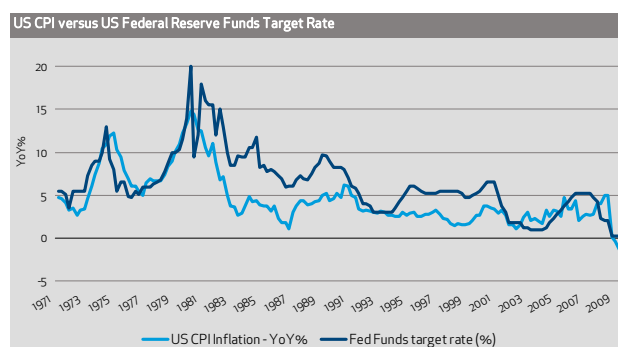
In relation to Euribor and inflation, the question is more complex. The first place to look when answering such a question is naturally the relationship in the past. The Euro has only been in existence for 11 years or so and only 8 years as a separate currency, so it is not a very long data set. The evidence to date is as follows:



Source: Bloomberg

Generally, in its short history to date, Euribor has been a reasonably good proxy and hedge against inflation, with some timing lags. In particular, it is interesting to note the determination of the ECB under Trichet to get ahead of possible inflation concerns in the Eurozone in the period from early 2006 through to September 2008. The hike in Euribor to 4.25% in June 2008 when the European economy was clearly already in recession indicates the strong natural anti-inflationary bias existing within the ECB.

While accepting that the two regions are "slightly" different, there is a longer data set available regarding the correlation of US Federal Reserve Target Rate and inflation in the US since 1970.



Source: Bloomberg

Again, the evidence suggests that US Libor has over the past 40 years been a good proxy and hedge against CPI inflation.

We have also looked at longer data sets for the two largest regions in the current Eurozone, Germany and France and while the data varies from time to time, the correlation between inflation and the discount rate in these countries has also been pretty good historically.

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Overall, with some outliers, the data from Europe and the US suggests that Euribor/LIBOR have both been a pretty good proxy for inflation in the past. This is consistent with theory and what our natural expectations might be.

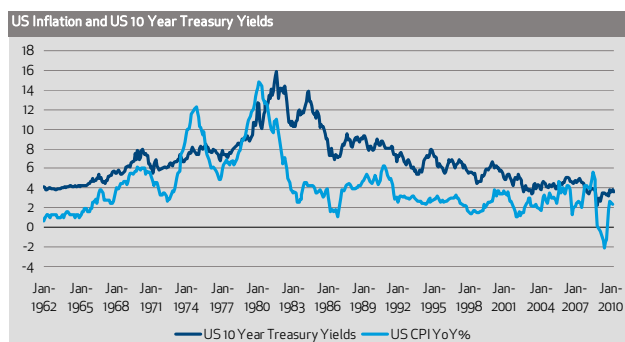
The question as to whether this relationship is likely to hold true in the future is one for debate. In theory it should, but unknown factors at play could include:

- the desire of the monetary authorities to maintain below normal rates due to the current weakness of the European economy and the banking system
- the need for the monetary authorities in Europe to protect the stability of the currency
- the very strong anti-inflation bias of the Bundesbank and the fact that the next head of the ECB is likely to be German

Each investor can have their own view on the impact and the importance of the above factors. However, the fact remains that all available historical data suggests that Euribor and by extension the return on leveraged loans is likely to be a good hedge for inflation in the future.

Fixed Income products simply cannot make this claim as they are inherently offering a fixed return at the time of initial investment and investors are taking an implicit and fixed view (whether they know it or not) about future inflation at their time of purchase.

The Graph below shows the 10 Year US Treasury bond rate tracked against US CPI inflation and illustrates this point clearly:

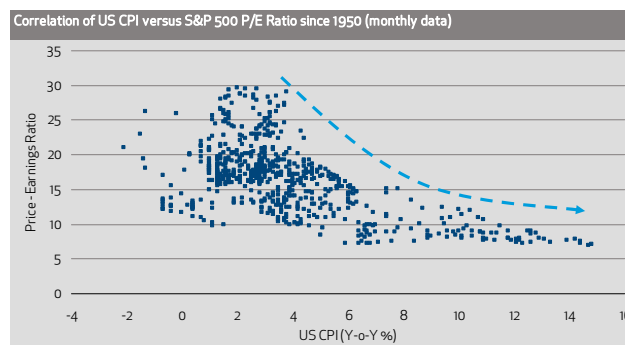


Source: Bloomberg

An investor for example, who invested in 10 Year US Government Bonds at an apparently healthy nominal yield of approximately 5% in the late 1960's faced inflation in the US averaging 7% per annum over the next decade.

US 10 year Government bonds today yield approximately 3.4%. The average rate of inflation in the US since 1940 has averaged over 4% per annum. Fixed income products in the developed economies today are statistically not a good investment bet (unless you believe deflation is a likely outcome of our current economic situation).

Finally, one additional observation as it relates to high levels of inflation or deflation is that either scenario would be unlikely to be a good environment for subordinated debt. The reason being that in a deflationary world, the real burden of debt principal will increase while in periods of both deflation and high inflation, valuation multiples will contract. The following graph shows the correlation between US inflation and P/E ratios for the S&P 500 since the 1950s.



Source: Bloomberg

The data shows that the average P/E ratio since the 1950s for the S&P 500 is c.16.5x. However, when inflation is greater than 6%, P/E multiples contract by over 40%. As a result subordinated debt which is naturally more exposed to valuation multiples and refinancing risk than senior debt has the potential to underperform senior debt in both a high inflationary or a deflationary environment. Low starting debt multiples for senior debt (3-4x EBITDA) and first ranking security will cushion the valuation contraction effect that would take place in either a deflationary or inflationary environment.

### Conclusion

So what is Avoca's contribution to the Great Debate regarding inflation and deflation?

One might say "Choose good companies". If that were the only message investors were to take from this Newsletter then we wouldn't be all that disappointed. "Good" companies operating in stable sectors with pricing power and control over their costs have tended to perform well in our experience whatever the economic gods throw at them.

What is clear is that unless we are to revert to the low and stable inflation of the past 25 years, the economic headwinds are going to increase, and these headwinds, (price level driven or otherwise) have historically been the enemy of the mediocre business.

The other key take away from us in this Debate is that in both a high inflationary or an outright deflationary environment, we expect senior secured leveraged loans to outperform other high credit spread asset classes (notably High Yield Bonds) due to their floating rate nature and their senior position in the capital structure.

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A fixed income investment promises you a fixed nominal return on your capital for a specified period of time. It does not promise to retain your purchasing power over the holding period of the investment – the first requirement in our opinion for any investment worthy of the description.

Finally, an admission. I do have a personal view on which of the twin threats of deflation and inflation is **more likely**. Personally, I have a bias towards inflation as being more likely, driven mainly by cynicism about the willingness of governments to go down the path of least resistance in creating inflation rather than protecting the rights of creditors. More importantly, the man who matters most, the current Chairman of the Federal Reserve also has an inflation policy bias. Those interested should log on to a short 2002 article written by Bernanke at [www.federalreserve.gov/newsevents/speech/2002speech.htm](http://www.federalreserve.gov/newsevents/speech/2002speech.htm) entitled "Deflation: Making Sure It Doesn't Happen Here".

However, irrespective of whether Ben, the man with his finger on the electronic printing presses for the world's reserve currency is successful or not in preventing deflation, Avoca will attempt to position the portfolio to prosper whatever the outcome of this Great Debate.

Our next newsletter, due in July, will focus on some of the key lessons learnt from the performance of the Avoca portfolio during the credit crisis and the implications for future Avoca portfolio construction and management.