

## Dead Men Walking

August 25, 2008 Newsletter

**Dead Man Walking**—Originally, a phrase in a poem by Thomas Hardy in 1909, but later in a work of non-fiction by Sister Helen Prejean, A Roman catholic nun and one of the Sisters of Saint Joseph of Medaille. Prejean later wrote 'Dead Man Walking', which became a hit movie in 1995. The title comes from the traditional exclamation "dead man walking, dead man walking here" used by prison guards as the condemned are led to their execution.

**Death Row**—A term that refers to the section of a prison that houses individuals awaiting execution. It is also used to refer to the state of awaiting execution, even in places where a special section does not exist. As of 2008, there were 3,263 prisoners awaiting execution in the United States.

**The Last Mile**—"I guess sometimes the past just catches up to you, whether you want it to or not. Usually death row is called 'The Last Mile'. We call ours 'The Green Mile'—the floor was the color of faded limes." — Tom Hanks as Paul Edgecomb in 'The Green Mile'.

### Are There Corporations that are "Dead Men Walking"?

The title of this piece sums up how I feel about the current credit markets. When I first started in the industry in 1981 we were worried, but only about one company - the Chrysler Corporation. Prior to that, Continental Illinois was in the forefront. Later in my career, in 1998, it was Long Term Capital Management, the hedge fund founded by John Meriwether that captured our attention. Then we had Enron/WorldCom, and by early 2008 Bear

Stearns became a worry and then a problem that needed fixing.

All of these events were isolated, dealt with, often with either direct assistance from Uncle Sam or an effort coordinated by our benevolent/socialist government financial authorities. Markets would become unnerved, fear would grow, and then the Government would step in to make sure that the systemic risk that had finally come to the surface didn't melt the entire planet.

But this is where it is "different this time". Not only is it different, I think it may be unprecedented in nature. When I look at my Bloomberg monitor each day that contains my 100 most important indices, companies, commodities, bonds, bond spreads, preferred shares, etc, I shudder. **The reason I shudder is that my screen doesn't have just one "problem child". It looks like a screen that contains many "dead men walking".**

### The Failed Fannie Mae/Freddie Mac Experiment

I recently wrote a piece entitled [The Tale of Two Markets](#), where I talked about the "Fannie Mae/Freddie Mac Experiment". That experiment has now clearly failed and a bailout/privatization/nationalization of Fannie and Freddie is now being planned. While I have been expecting nationalization for quite a while, I am intrigued along with my peers and colleagues as to why the bailout is taking so long to accomplish. This is where it gets interesting and dangerous from a systemic point of view. My hunch is that the reason for the delay is that the Treasury Department is

“peeling back the onion” on Fannie/Freddie and finding out just how much of a mess the two of them are in.

At last count, Freddie had Level 3 Assets of \$151 billion while Fannie had \$65 billion, for a not-so-paltry sum of \$216 billion. When Freddie announced their results a couple of quarters back, they disclosed that most of their Level 3 Assets were of the “sub-prime” variety (the type of assets that started the whole Credit Crisis in the first place). They are also littered with Alt-A mortgages and are leveraged to the hilt.

Just how bad is the news at Fannie/Freddie? On Friday morning, Moody’s downgraded their outstanding preferred stock 5 notches from A1 to Baa3 (a slight gradation above junk) and their Bank Financial Strength Ratings (BSFR) to D+ from B- (one/half notch above D, which is reserved for companies in default). According to Moody’s, *“the downgrade of the BSFR reflects Moody’s view that Fannie Mae and Freddie Mac’s financial flexibility to manage potential volatility in its mortgage risk exposures is constricted.....in particular, given recent market movement, Moody’s believe these companies currently have limited access to common and preferred equity capital at economically attractive terms.”* **“Dead men walking” defined.**

Moody’s went on to say, **“The GSE’s more limited financial flexibility also restricts their ability to pursue their public mission of providing liquidity, stability and affordability to the US housing Market. Fannie Mae and Freddie Mac currently make up approximately 75% of the mortgage market in the US. A reduction in the capacity of these companies to support the US mortgage market could have significant repercussions for the US economy. In an effort to thwart broader economic effects, Moody’s believes the likelihood of direct support from the United States Treasury has increased.”**

Let me put it this way. “We the people” are about to become owners in Fannie and Freddie, whether we like it or not. The capital markets have shut on them both as their stocks trade in the \$2-5 range, down from the \$70-80 level just a year ago. And the yield on the outstanding preferred shares hovers in the 18-23% range, quite the bargain if they keep paying, but also it is the market’s way of saying “beware the value trap”, as the preferred shares may pay another dividend or two, but that is about it.

When the Treasury peels back the onion, I believe they will find a hornet’s nest. I think we will see an initial bailout of \$100 billion or so, with 2/3-3/4 going to Fannie (as it is a larger organization). The scenario I foresee however, just as happened at Merrill Lynch, Lehman Brothers and Morgan Stanley, is that they came to the financing window expecting to have borrowed enough, but then find they have to keep coming back repeatedly until the buyers go away or until “We The People” have thrown at least \$500 billion at Fannie/Freddie to get them back on their feet again. This will also likely take an Act of Congress to raise the Treasury’s Debt ceiling quite dramatically.

I will now identify who might be the other “*Dead Men Walking*”.

### **More Dead Men Walking—Is There a Pattern?**

What strikes me the most about impaired companies, whether they are automakers, airline companies, banks, brokers or GSE’s, is that they seem to sing the same tune, or have the same pattern of behavior. This is how I have attempted in the past to identify what would be in trouble in the future (whether that was just to avoid their stocks and bonds from the long side or to try to profit from their missteps on the short side). It is a pattern that is not terribly dissimilar from the emotion charts I like to focus on so much. In the graphic below, I will offer my “recipe for disaster” for a bank or brokerage firm. I would like this cycle to be called, “The Dead Man Walking Cycle”.

The first tip-off or “tell” is when a company releases earnings or some sort of positive announcement and the stock falls. Another important tell is the credit spreads of the debt as the company begins to widen. Then, the company will usually announce that “all is well” and is so great that they will buy back stock and not “cut the common dividend”. After this comes the “acceptance” phase and write-offs/write-downs are announced and then some Sovereign Wealth Fund or Private Equity firm will inject capital or that a company within the same group will buy a “strategic stake”. After a brief pop in the stock and short covering rally, the stock begins to fall further and credit spreads begin to blow out and preferred shares get hammered. Then, uh-oh, more write-downs and more write-offs and yes, another capital raise and finally a dividend cut to ‘preserve capital’.

Sound familiar yet...?

All of this goes on for quite some time, until your stock price is so low that you would have to issue so many shares in a secondary offering that you dilute your shareholder base until it is unrecognizable. With this new share offering your credit, while still rated investment grade, trades like junk, and your preferred shares rise to double digit yields. Further, the former strategic buyers, Sovereign Wealth Funds and Private Equity firms have taken such a beating that there are no further buyers.

Yet the write-downs and write-offs continue unmercifully as the economy slows and credit is all but cut off. Eventually, dividends go to zero and you are a “*Dead Man Walking*”.

There are only a few things that can happen to the companies that are walking “The Green Mile”. Either you make it to the electric chair (in the movie “The Green Mile” it was called “Old Sparky”) and cease to exist or you are eventually forced into the arms of a better capitalized institution. Over time, I expect a bit of both but mostly of the latter.

Keep in mind that if too many are allowed into the arms of Big Sparky”, it will have a systemic effect as all the institutions are so intertwined because when one group of institutions are forced to mark their bonds to market, others are forced to do the same, ending in an ugly daisy chain. I think the chain has formed and that many are about to “walk the mile”.

In the end, perhaps years from now, many banks and brokers will be merged into an international list of “good banks” or “*Live Men Walking*”. Who are the Live Men Walking? They are likely Bank of America, Bank of New York, JP Morgan Chase, Northern Trust, State Street, US Bancorp, ABN Amro, Deutsche Bank, BNP Paribas, Royal Bank of Scotland, Barclays, Allianz and a few others. The following cycle is how the cycle goes from good bank to ‘Dead Man Walking’.

## The “Dead Man Walking” Cycle



### Who Are the Dead Men Walking?

Above, the cycle begins with denial, and ultimately ends up in despair. At first, the company denounces that anything is wrong, but Mr. Market has a way of sniffing out who is imitating Pinocchio. Ultimately, the company ends up in despair when they need/want to raise capital to just be able to function normally, but alas, they cannot because the window of opportunity to raise capital has shut.

Let's use Lehman Brothers as the poster child of this sort of behavior. I wrote a piece last week that singled out National City, Washington Mutual and Lehman Brothers which can be found here--[Three Other Problem Children](#). Before the credit crisis started,

Lehman, at the time known for its savvy timing, suddednly came to market for \$5 billion of long-term bonds when they didn't need capital—or did they know something was awry as I suspect? Last year, with the Credit Crisis in its infancy, Lehman announced a \$100,000,000 stock buyback. The shares, as you would expect, popped on the news, but of course no stock was ever re-purchased. As the stock began to sell off, they kept saying that capital was not needed.

Then, on June 9, 2008 they sold 143,000,000 shares at \$28 per share. As hedge fund manager David Einhorn said, "They've raised billions of dollars they said they didn't need to replace losses they said they didn't have." In

between was an enormous preferred stock deal—75,900,000 shares at \$25 per share at a rate of 7.95%. Those shares now change hands at \$15 per share for a yield of 13.1%. Its pretty hard to turn a profit when your cost of capital is greater than 10%.

During this time, in January, the company actually raised its common dividend by 15% year-over-year. They have written off north of \$8 billion since the Credit Crisis began and when they release earnings (or lack thereof) next month, estimates are for another round of \$2-4 billion of write-downs. They have reportedly been trying to shop \$40 billion of impaired real estate and they are mired in all sorts of Alt A, sub-prime, CMBS and CDO's and CLO's.

The best part is that they said they “shrank their balance sheet” when in fact they were sold to an “off balance sheet subsidiary” that they own part of. The bonds weren't sold, they were just “relocated”. I sure wish I could do that when I make a mistake. And lets not forget that the Federal Reserve opened up the discount window to primary/dealers so that they could off-load a bunch of nuclear waste on to the Fed's balance sheet, which now looks like one big hedge fund in drag. And then the SEC temporarily changed short selling rules for ‘the Group of 19’ (the GSE's and Primary Dealers) for a few weeks, resulting in a short squeeze, but their shares still hobble along at recent lows.

On Friday, there was a rumor that the Korean Development Bank would buy Lehman, but again that turned out to be hogwash. And if they wanted to raise debt, like they say, “lotsa luck”. Their bonds trade around +500 basis points to treasuries but my guess is that even if they could get deal done, they would have to come in the 10% range, again, uneconomic.

So now we have the recipe and an example for “Dead Men Walking”:

- Common stock too low to issue new shares.

- Preferred stock yield too high to issue new shares economically.
- Issuing debt is uneconomic.
- More write-offs coming in days to come.
- Business trends are awful.
- Denial.

Now that we have identified the “poster child”, let's find a few more... Or sadly, more than a few.

### **Zions Bancorp**

- Equity has traded down from \$75 to \$25.
- Tried to issue a \$200 million preferred stock offering at 9.5% but only was able to sell \$47 million.
- Their debt trades in the open market approximately 1,000 basis points above Treasuries, IF you can sell them, or 13-14%.
- They are geographically in Utah, but spread out to Florida, Nevada and Arizona at the top of housing to take advantage of great opportunities.
- They say they need \$200-300 million capital. Good luck.
- They maintained their common dividend.

### **KeyCorp**

- Common Stock has traded down from \$40 to \$11.
- Preferred Stock trades at 13%.
- Debt trades in the market at 10-11% dividend.

- Cut dividend in half in July, still yields 6.5% even while they lose money.

- Needs to raise \$2 billion, according to Sanford Bernstein.

### **Fifth Third Bank**

- Equity has traded down from \$60 to \$14.
- There are no preferred issues outstanding.
- Debt trades in 10-11% range if you can sell it.
- Cut dividend by 75%.

### **General Motor/GMAC**

- Equity has traded from \$80 to \$10.
- Preferred stock trades in 18% area.
- Short-term debt trades in 25-30% range.
- Long-term debt trades in 17% range.
- Eliminated common dividend in July.

### **Washington Mutual**

- Equity has traded from \$40 to \$3.
- No preferred outstanding except convertible preferred.
- Debt trades in the 20-25% range.
- Cut the dividend to \$0.01 per share in April.
- Has admitted they will lose money for the next several years.

### **Ford/Ford Motor Credit Co**

- Equity has traded from \$60 to \$4.
- Preferred stock trades in 16-17% range.
- Long term debt trades in the 18-20% range.
- Eliminated common dividend in September.

### **National City**

- Equity has traded from \$40 to \$5.
- Preferred stock trades at 13-15%.
- Sold a huge amount of shares at \$5 per share in April.
- Cut dividend to \$0.01 per share in April.

### **Wachovia**

- Equity has traded from \$60 to \$14.
- Issued a \$3.5 billion “hybrid security” in February that now trades at 11%.
- S&P has stated they cannot issue any more hybrids.
- Sold 92,000,000 shares of a preferred stock in December at 8% that now trades \$18 or 11%.
- Cut common dividend twice since February to \$.05 a share or 90%.
- Debt trades at 9.5-10.5%.

### **Regions Financial**

- Equity down from \$40 to \$8.
- Preferred Stock Trading at 10%.
- Debt trades in the 10-11% range, if you can sell it.
- Cut dividend by 75% in June.

### **CitiGroup**

- Equity has traded from 60 to 9.
- Preferred Stock trades in 12% range.

- Outstanding debt trades in 12-14% range.
- Cut common dividend by 66%.
- Sold 91,000,000 shares of common at \$11 in April 2008.

### **Who are in the “Limping but Not Dead Man Walking Crowd”?**

These companies would include those that may be ‘too big to fail’, have enough quality assets to sell, a franchise that is worth something to an acquirer or could just be broken up into pieces. They include:

- Citi
- Merrill Lynch
- Morgan Stanley
- Suntrust
- Legg Mason
- Capital One
- AIG
- MetLife
- Prudential

### **Summary—This is NOT Shaping Up to be a Pretty Couple of Years**

I am certain that I have missed a bunch of names on the “Dead man Walking List”, but the pattern is rather easy to discern. As I stated early on, when we have one or two firms in trouble, we can deal with it. But when we add rising unemployment, explosive debt growth in recent years and non-performing assets to many hobbled financial institutions with trillions of dollars of exposure, it is hard not to be concerned.

For this reason, we remain cautious towards credit, expect a hard sell-off in stocks into 2010, consolidation in the financial services industry and some pain, like it or not. I am just not sure where the capital will come from to bail everyone out simultaneously. And even if the capital showed up, it would likely come at a cost that is uneconomic and would likely be dilutive for many years to come.

It is why we expect much lower than consensus earnings across the board and lower stock prices ahead. In the meantime, we sit with our historically cheap GNMA’s at the widest spreads in 20 years and continue to add to that position.

In the meantime we position our portfolios so that if we are wrong, the most we can lose is opportunity, not precious capital.

Bennet Sedacca  
President

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