Part Six

Opportunities

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Wilbur Ross

The leaders in the new economy are the ones who are picking through the carnage to uncover opportunities at prices that may never be seen again in this generation. One investor who's known for having the panache to turn around ''bad'' investments is Wilbur Ross. For more than four decades, Wilbur has become the undisputable king in spotting troubled companies and turning them around. Although many people characterize him as a ''vulture'' investor, Wilbur really is the discerning judge of dying companies.

Wilbur's Wall Street fame began when he purchased the failing steel companies LTV and Bethlehem Steel and created International Steel Group (ISG). In 2005, he sold ISG to ArcelorMittal, the world's largest steel company, for $4.5 billion. His firm, WL Ross & Co., made $2.5 billion from that deal, and Ross himself took home a reported $300 million.

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After that, Wilbur created International Coal Group out of the bankrupt Horizon Natural Resources in 2004 and has since set his sights on the new economy's troubled assets: failing banks like BankUnited, struggling real estate finance companies such as Assured Guaranty and American Home Mortgage Servicing, as well as the auto suppliers.

Wilbur along with Richard LeFrak has combined their real estate and financial prowess in creating the joint venture WLR LeFrak. In addition to investing in failed Florida bank BankUnited, the group was part of a consortium that announced in October of 2009 they would acquire $4.5 billion in real estate assets from failed Chicago-based bank Corus Bank Real. Valuing around $2.77 billion, the transaction at the time was one of the largest acquisitions of distressed commercial real estate assets.

For about nine years, I have worked with Wilbur on the numerous corporate announcements he has made as well as his guest co-hosting gigs on *Squawk Box*. His approach to a deal is very interesting; I enjoy hearing about how he can slice through what many investors may think is garbage. He is able to buy a company and transform it into a profitable business—and that is what makes him one of the best businessmen of his time.

At 8:30 A.M. Singapore time on Monday, September 15, 2008, I was walking across Orchard Street from an interview on CNBC's *Asia Squawk Box* to my meeting with Madam Ho, CEO of Temasek and a major investment arm of the government. My BlackBerry rang with an excited call from our portfolio manager, David Storper: "Bank of America is acquiring Merrill, and Lehman will file bankruptcy tomorrow."

I was stunned. Bank of America had been expected to acquire Lehman Brothers, and there was not even a whisper that Merrill

Lynch needed to be taken over. In fact, CEO John Thain had raised billions of dollars of equity for Merrill Lynch—some of it from Temasek. David had checked on our exposures and reported that we had a small amount of dollar-yen swap with Lehman Brothers; Lehman Brothers was on the profitable side, and therefore we had no credit risk. One of our portfolio companies, Montpelier Reinsurance, also had some minor direct holdings. That was good news, because recoveries would likely be pennies on the dollar. But what did these surprises mean? We concluded that both Lehman Brothers and Merrill Lynch must have more severely toxic assets than had been thought. That meant the same would have to be true of other financial institutions—and with the economy already teetering, that could lead to a credit crunch with serious implications for all businesses. To protect ourselves against what could be a hostile credit environment, we promptly contacted the CEOs of each of our portfolio companies with the following suggestions:

"No one knows for sure how severe the problems of our financial system are, but we interpret the events of this past weekend as portending a new credit crunch on top of the economy's existing weakness. Therefore, please assume that you will likely find it challenging to achieve your budgets from now through 2009. As a result, prudence dictates slowing or eliminating capital expenditures for growth, even tighter working capital constraints, expansion of committed bank lines wherever possible, and drawing down lines well before you actually need the cash. Since these moves will impact negatively our immediate earnings, it is appropriate to modify downward the earnings target of your bonus formula. Finally, we must be even more conservative than usual in the earnings and cash flow assumptions on which we base acquisition bids."

As the Temasek meeting began, Madam Ho broke the ice by joking that since Bear Stearns had failed on my prior visit and Lehman Brothers and Merrill Lynch this time, that I should promise

not to return to Singapore soon because they did not want another crisis. The rest of the meeting went more or less normally.

Over dinner that night at the improbably named Palm Beach Crab House, my colleagues and I mainly discussed the implications again. The U.S. and Asian markets had tanked according to the news, and the talking heads were shocked. Like the rest of the investment community, and probably the broader public, our first questions were, ''Who's next?'' and ''How much of a domino effect will there be?''

It didn't take long to find out. By the time we got to Tokyo for our major investor conference, a domino had fallen—and a major one at that. AIG was taken over by the government because its enormous exposure to derivatives—which had been problematic even before Lehman Brothers collapsed—now became totally unmanageable. For as long as one could remember, AIG had been an unimpeachable AAA credit, and although it had gone through an accounting scandal a few years earlier, there hadn't been major rumors of its insolvency. One could only wonder whether AIG might not have failed if Lehman Brothers had been saved.

To me, AIG's failure was the more frightening of the two, because AIG was a problem not just for Wall Street but also for Main Street. It was the largest U.S. insurance company and had millions of policy holders in the United States and Asia. My forthcoming speech became even more bearish than the earlier draft. As far back as January 2007, I told attendees at a Credit Suisse Asset-Backed Securities Conference that the bubble was bursting. It had seemed clear even then that the lack of inflation-adjusted median income growth from 2000 to 2006 had caused American families to over-leverage themselves, because that was the only way they could live a little better each year. Rising residential real estate prices and ever-more-generous mortgage securitizations continually inflated each other's bubbles and made this leveraging possible. Securitizations accounted for half of all the consumer credit in the United States, and many of the

credit derivative swaps (CDS) were issued to hedge the credit risk of securitizations. Thus, the CDS market disruption would create yet another problem for securitizations to overcome. With less credit, the outlook for home and automobile sales would become very weak. For example, in 2007, 1 million cars were purchased by families using proceeds from remortgaging their homes. Compounding the problem would be the loss of consumer confidence as household name financial institutions went up in smoke.

For all these reasons, we decided to temporarily suspend new commitments in the WLR Recovery Fund IV, our most recent long-only fund. It was about 25 percent committed, and because it cannot sell stocks short, the only way for it to be defensive was to stay uninvested. The commitments that it had made were generally in non-public companies, so there was no realistic way to sell them.

We also decided to sharpen our focus and to put our major efforts into financial services. That was clearly the epicenter of the economic earthquake and most difficult to analyze, because it required one to make judgments about how bad and for how long the economy would get and then translate that into credit judgments about the portfolios of individual institutions. That level of complexity and risk taking would keep most investors out, especially given that the recent rounds of both private and public financings in that sector had already produced terrible results. For example, Lehman Brothers had privately raised some $5.5 billion of private equity less than six months before it folded and rendered these investments worthless. We had participated that weekend in a whirlwind round of due diligence but fortunately dropped out because we concluded that management was not sufficiently candid about their real estate holdings. As it turned out, real estate was the principal cause of their demise.

We initially settled on four sectors: mortgage servicing, monoline insurance, commercial banks, and thrifts. We already had invested in American Home Mortgage Services. It had met or exceeded budget each month, so we were comfortable about

analyzing servicing and achieving high rates of return from it. The analytical keys were: (1) to estimate the so-called roll rate—at which borrowers who were paying on time would become progressively more delinquent; (2) to forecast how many of those would be foreclosed; (3) to determine how long it would take to foreclose and sell the property; and (4) to determine what percentage of the good payers would sell their homes voluntarily or refinance them. These factors would determine both how long we would retain the stream of monthly servicing fees and how much capital would be tied up making advances on behalf of delinquent borrowers. The advances were creditworthy because they rank senior to the mortgage and must be paid first, but they did consume capital at a low rate of return. It turned out that we were able to buy a lot more servicing at a high all-in rate of return. As of May 2009, eight months after Lehman Brothers fell—our company has become the largest independent servicer of non-prime mortgages at $106 billion and is earning at the rate of $130 million per year. In a different environment, it probably would have taken several years to achieve that level of earnings.

Monoline insurance was our second target. There had originally been half a dozen of these companies that had AAA ratings and provided credit enhancement to municipal bonds, securitizations, and infrastructure project financings. Most of them were being downgraded—in some cases, by several notches—because of poor risk management. The municipal part of the business had a relatively low-risk profile, but many of the securitizations, especially ones backed by mortgages, proved to be quite toxic. Most of the monolines, such as Ambac, committed a cardinal sin of risk management by owning in their portfolios similar credit risks to what they were insuring. This meant that if their default rate assumptions proved to be too low, as they did, then the monoline would be hit by the double whammy of insurance and portfolio losses. The insurance exposure alone was many times the shareholders' equity, so the specter of insolvency loomed large.

But one company seemed different: Assured Guaranty. Its CEO, Dominic Frederico, had a home a few miles from my principal residence in Palm Beach, so I asked another Palm Beacher, Bill Bartholomay, the Vice Chairman of Willis Group Holdings (an insurance brokerage group), to make the introduction. Dominic came to my home, and we hit it off personally; but more importantly, I was impressed by his command of details of both the insurance and investment portfolios, and by their concepts of risk management. The investments were, on average, AA rated and substantively different credits from the A and BAA issues they typically enhanced. After a few more meetings and field due diligence, it seemed clear that in an imploding industry, Assured Guaranty would be the last one left standing with high credit ratings. That meant it was in a position both to gain market share organically and to either reinsure or acquire existing insurance volumes from companies with capital problems. Assured Guaranty's stock was down 30 percent from its high 12 months earlier. It also seemed statistically cheap, because it was trading modestly below its book value, but at only half the sum of its book value and the present value of its future premiums (PVP).

PVP is unique to the monoline insurers. It arises from the fact that municipalities pay a single premium at the time the coverage of the life of the bond issue is underwritten, sometimes as long as 30 years. But the accounting rules require the premium to be taken into income proportionately over the life of the bond, thereby locking in many years of 100 percent predictable revenues. Assured Guaranty had generated a non–balance sheet asset of PVP roughly equal to its book value, which was growing daily; so at less than one half the sum of book value and equity, it seemed very attractive. We agreed to invest $250 million at a discount from market and committed to invest another $750 million over the next year for deals at a discount from the then-market, subject to a floor and a ceiling price, and Assured Guaranty's retention of its AAA stable ratings. This gave the company the war chest it needed for

acquisitions. A few months later, we helped them negotiate the highly complex but also highly accretive acquisition of FSA from Dexia, a large European financial services company. FSA's insurance and investment portfolios had manageable problems, but like AIG, they had written vast amounts of guaranteed investment contracts and other derivatives in their financial products division that were billions of dollars under water—and getting worse every day. The trick was to pay for the insurance business in stock, a deal that would be highly accretive to Assured Guaranty, but to insulate the merged company from the toxicity of the financial products division. Ultimately, the French and Belgian governments, who had by now nationalized Dexia, provided Assured Guaranty with indemnification.

Banks and thrifts were the other targets. We already had made a joint venture with John Kanas to find a regional bank, infuse capital into it, install John as the CEO, and then roll up other depositary institutions in the same region, creating one large enough either to trade actively on the New York Stock Exchange at a decent multiple or to be acquired by one of the major domestic or foreign holding companies. John, 62, had taken charge of North Fork Bank in Mattituck, Long Island, when it had $20 million of deposits and built it up to $60 billion before selling it to Capital One at 3.5 times its book value. He had made a couple of hundred million dollars for himself out of the deal and had served out his non-compete agreement. He didn't need a job, but he needed a big pocketbook; so we agreed to back him for up to $1 billion. Combining a meaningful capital base with John's excellent reputation with bankers and regulators meant that we would get a look at essentially every troubled bank.

But there were some difficult regulatory issues that needed to be resolved. Since we believed that our targets would be billions of dollars insolvent, we would need the Federal Deposit Insurance Corporation (FDIC) to seize the institution and fill a lot of the hole. Otherwise, more private capital would be required than

could be justified by future earnings. The problem was that FDIC's practice had been to confine the bidding for failed banks to other banks and to seize the failed institution on a Friday evening and reopen it as the acquiring bank on Monday at 9:00 A.M. But our fund was not a bank or a bank holding company—and did not want to become one. Doing so would have required us to divest of our non-financial assets and never acquire any in the future. To avoid this problem, we could not own more than 24.9 percent of the holding company. That problem could be solved by joining with other investors, as we soon did with Blackstone, Carlyle, Centerbridge, LeFrak Organization, and others. But, how do you become qualified as a bank or a bank holding company without being one so that you can be a bidder?

Eventually, we reached an agreement with the regulators that the management team and investors would file a holding company application that would be complete, except for the identity and deal terms of the target. The regulators then would do their background checks, etc., and be ready to approve the application concurrently with FDIC approval of our bid.

On Thursday, May 21, 2009, at 6:00 P.M., the FDIC announced that we had taken over BankUnited for an investment of $900 million immediately after the FDIC had seized it. FDIC also announced that they estimated that the cost to them would be $4.9 million. BankUnited is the largest independent depositary institution in Florida, with $12 billion of deposits and 85 branches running north along the east coast of the state from Boca Raton. It has about 2 percent of all the deposits in Florida, even though there are many important markets, like Tampa, Orlando, St. Petersburg, Palm Beach, and Jacksonville, where it is not yet represented. In addition to the potential of de novo branches, Florida has more than 60 banks, which we believe are or soon will be insolvent and therefore distressed takeover targets. They, like BankUnited, are being brought down by bad real estate investments, one of the main reasons why Lehman Brothers failed and Merrill Lynch had to be

taken over in September 2008. The long-term objective would be to create a holding company that was making a sufficiently high return on capital that it would be worth two or more times a book value higher than today's because of retention of earnings. Given the quality of management, the due diligence that was performed by a 20-person team, and the loss sharing arrangement with FDIC, the downside seems very limited. Therefore, the risk-adjusted rate of return is very high.

In general, we had correctly identified the opportunities that the financial malaise would create for us; but we did underestimate the problems that would arise for the auto industry. Our principal investment in that arena was International Automotive Components (IAC), which we had begun creating in October 2005. We did so by buying parts of the notorious bankruptcy of Collins & Aikman and supplementing them with Lear Corporation's Interior Plastics Division, by buying Mitsuboshi Belting Kaseihin in Japan and by restructuring PLASCAR in Brazil. In 2007 and the early part of 2008, all of these units were operating in line with or better than budget, and we were on our way to about $5.5 billion of sales.

But the American Axle strike in the second quarter shut down some GM plants, creating a minor problem. Our real problems in both the United States and Europe started within weeks after the fateful phone conversation in Singapore. People simply stopped buying cars. In retrospect, it should have been obvious that a credit crunch would be especially bad for autos, since a car is most households' second largest purchase after a house. We now have had to undergo four rounds of downsizing and salary cuts and have been forced to infuse a bit more capital into the company. The good news is that, like Assured Guaranty in monolines, IAC will be among the few entities left standing when the industry turns around. IAC, like most of our portfolio companies, is relatively unleveraged—because we believe that high levels of debt are inappropriate for companies that are highly cyclical and have commodity price risks to boot. Once it became clear that GM

and Chrysler needed federal bailouts, we joined with both of them, the unions, and other suppliers to lobby for federal guaranty of the money owed to suppliers by GM and Chrysler; for other federally assisted restructuring of the two companies; and for the cash for clunkers program to encourage people to scrap old cars and buy new ones. This is green in both the environmental sense and in terms of the economy. With or without that program, IAC has been gaining market share, with $300 million of current business having been transferred to it in the past 90 days from failed or failing competitors. While this is not nearly enough to make up for the huge drop in unit production, it does convince us that IAC will be fine when volume returns to a more normal level of 13 to 14 million cars per year in the United States. Our country scraps between 12.5 and 13 million cars annually and there is also population growth, so unless there are fewer and fewer cars per capita, the annual average sales must be in the range of 13 to 14 million, versus the 9 million or so that will be sold this year. We also acquired in Europe Stankiewicz a high quality € 150 million producer of automotive acoustical products. This will enhance our market share in that segment and bring us additional technology.

We now are moving more aggressively to commit our portfolio, although I must admit, most importantly and most surprisingly, to the new government-assisted programs. In the fall of 2008, when Treasury Secretary Paulson correctly announced a program to buy from the banks the kinds of toxic assets that slew AIG, Bear Stearns, Citibank, Lehman Brothers, Merrill Lynch, and the Reserve Fund, the Bush administration changed its emphasis to direct investment in hundreds of banks. I continue to believe that neither the financial system nor the housing market will straighten out until there is a clearing event for the toxic assets. The Troubled Asset Relief Program (TARP) is a good way to fill the holes, but just pumping in more TARP money is treating the symptoms rather than curing the disease. Banks will not lend with normal

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aggressiveness until and unless they believe that their existing portfolio will not blow up even worse. The only way to give them that confidence will be the public-private investment portfolio (PPIP) proposed by Treasury Secretary Geithner, coupled with the additional TARP money needed to replace the loss on the sale of toxic assets. We are seeking to be big players in the PPIP, just as we were in the Term Asset-Backed Securities Loan Facility (TALF).* We closed in September 2009 on close to a $1 billion in Public-Private Investment Funds (PPIFs), which were created under the Legacy Securities Public-Private Investment Program (PPIP). Invesco is among the firms the government has selected to help get toxic assets off the balance sheets of troubled banks. Our equity will be matched 50/50 by TARP money.

TALF has reopened the asset-backed commercial paper (ABCP) market, and if applied with aggressive encouragement of the banks to sell, PPIP will reopen the longer-term securitization market big time. That is what we need to get the economy going again, especially now that commercial real estate loans, in general, and commercial mortgage-backed securitizations, in particular, are about to blow up, with $750 billion due through 2011 and $1.5 trillion due through 2013.

In the first TALF auction, we were a major buyer of Ford Motor Credit ABCP. The yield on it was 6.05 percent, and the government guaranteed a non-recourse loan for 90 percent of the purchase price at 2.70 percent. The yield on the equity sliver was about 35 percent. Auto ABCP had been essentially unsalable for many months, so this made funding available, albeit at a high price. Each subsequent auction developed increasingly lower asset yields, so we did not buy any. In fact, in the fourth auction, we had American Home

** Author's note:* Term Asset-Backed Securities Loan Facility (TALF) was created by the Federal Reserve to add liquidity back into the credit markets by meeting the credit needs of small business and consumers. The Fed would issue them asset backed securities (ABS).

Mortgage issue $600 million at about 3 percent to cut its costs of financing advance.

In September 2009, I had to make another trip back to Singapore and I dreaded the idea that I would get another urgent phone call about another major institution failing. If that was the case, I would be banned from Singapore forever. Thankfully, I was welcomed back to Singapore without another crisis.