

## Marty Whitman: The Outlook for Distressed Securities

By Robert Huebscher

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Martin J. Whitman is the founder, Co-Chief Investment Officer, and Portfolio Manager of the Third Avenue Value Fund. He is a veteran value investor with a long, distinguished history as a control investor. His book, *Distress Investing: Principles and Technique*, which he co-authored with Syracuse University professor Fernando Diz, is available through the link above. We spoke with Mr. Whitman on June 29, 2009.



### **As a distressed investor, what is different about investing during the current financial crisis?**

I had never seen pricing as attractive as we saw last fall and this winter for performing loans – the type of distressed asset we prefer. We acquired debt with an 80% to 95% probability of yielding 25% or more to maturity or to an event [e.g., the bond being called]. In the 5% to 20% chance that we were wrong, and there would be a money default, we would still be okay in a reorganization. Pricing like that was never available before.

Another big change occurred in recent years in small bankruptcy cases – those less than \$300 million – where administrative expenses became so large that companies were forced to do a prepackaged bankruptcy or its equivalent. In the old days, much could be done through a conventional Chapter 11 even for smaller enterprises.

For companies in reorganization, whether in court or out of court, it has never been more expensive. Companies are getting ripped off by professionals – lawyers and financial advisors – and by management like never before. For distressed investors like us, this environment has created great opportunities to make capital infusions directly into poorly financed businesses. We are very active in this area right now.

### **You say that distress investing appeals because it involves analyzing the contractual and legal aspects of an opportunity, rather than macroeconomic factors. Is this still true in the current environment?**

We really haven't had to do much on the macroeconomic front. If you are an adequately secured creditor, the general economic environment doesn't figure in too much. Macroeconomics becomes more important as you go down the capital structure. It is crucial in most common stock investing.



The macroeconomic environment is the worst I have seen in my adult lifetime, which is why we have tended to invest in more senior securities than would otherwise be the case.

**At the end of last year you said you saw a once-in-a-lifetime opportunity to buy companies that meet your investing criteria. Is that still true today?**

We lost the unbelievable irrational pricing that existed in December of 2008, which was also when my book was finished. At that time, it was very easy to see exceptional opportunities in performing loans, such as those identified in the book: GMAC, Forest City, and MBIA, for example. These bonds offered yields to maturity or to an event of 30% or more. Now, when we buy comparable securities, the yields are closer to 20%. We are not buying a lot at 20%.

**Are you currently seeing more attractive opportunities in the credit or equity markets?**

In the equity markets, the Third Avenue Value fund has a little more than half of its assets in eastern Asia, including a huge presence in mainland China. These investments offer a much higher beta. Credit investing is different in two important respects. First, you get a cash return, and, second, a very attractive benefit is that you are insulated from crazy price fluctuations in the stock market. We can hold securities with a 30% yield to maturity, and if we are right we get 30% no matter what happens in the securities markets. This is a source of great comfort.

Academics fail to recognize the difference between cash return and total return investing. The only place we do cash return investing is in the credit markets. We don't invest in common stocks seeking a dividend return.

Credit investing doesn't have anywhere near as high a beta as eastern Asian common stocks. With those stocks we seem to have reasonable prospects for a 10-bagger at some point over the next five to seven years. We won't do that well in the credit markets.

For US-based taxpayers there is another important difference. In credit investing, any profits are taxed as ordinary income, whereas profitable equity investing almost always results in capital gains.

**One topic you discuss extensively is misconceptions about bankruptcy. From an investor's standpoint, what are the most important misconceptions?**

The biggest misconception is that the company will go out of business. That is typically not the case. Companies survive bankruptcy, stockholders very often don't.



Another great misconception is that companies are too big to fail. That is the wrong way to analyze these problems. The right question to ask is whether companies have become too big not to be reorganized. Failure can be defined as what happened in the cases of AIG and Lehman Brothers, when the common stockholders got wiped out. But these companies survived and their assets were put to other uses or other ownership. It doesn't make any sense to talk about "too big to fail."

**Has the government changed the game for bankruptcy investors through its handling of the Chrysler and GM bankruptcies? Have they set precedents that will permanently impair bondholder interests?**

I don't think so. You have section 363 and the rule of absolute priority. But when there is more than one class of claimants participating in a reorganization under section 1129, you can abrogate the rule of absolute priority with the requisite vote by holders of a class of senior claim. Senior lenders can be forced to compromise their rights pursuant to a vote of two-thirds of the amount of the secured class and over half of the number of class member. Clearly, in Chrysler's case, when the TARP banks voted for the reorganization, these tests (of two-thirds of the claims and 50% of the number of creditors) were met, whether or not they were forced to sacrifice because of a section 363 sale.

[Ed. Note: Section 363 of the bankruptcy code controls the use, sale, or lease of property and what constitutes cash collateral. The rule of absolute priority states that, in a bankruptcy, the claims of senior classes of creditors must be settled before those of more junior creditors. Section 1129 of the bankruptcy code controls the treatment of impaired classes of claims – claims that are not going to be paid completely or where some contractual right is altered.]

The problem you have is the plan has to be proposed in good faith. In the case of Chrysler, answering the question of whether or not it was proposed in good faith is up to the judge, and he decided it was. Creditors have to be assured of getting more from the plan on the table than if the assets were liquidated. There was no valuation hearing but, if the assets were put under the hammer, the claim was that they would certainly be worth no more than \$1 billion. But the senior creditors got \$2 billion, so they were better off with the deal they got.

The risks borne by Chrysler's creditors are the kind of risks creditors have always taken.



**You say that bankruptcy often fails to “fix” a company. Do you expect either Chrysler or GM to emerge as truly competitive companies?**

I am a prejudiced observer. We own a lot of Toyota Common. Both GM and Chrysler seem to be toast. They have to be able to sell cars and there is no demonstration that they will be able to do that. Fixing their financial problems doesn't solve this problem. Success for GM and Chrysler doesn't look to have a strong probability from where I sit.

**As a distressed investor, have you found any of the US banks attractive?**

We haven't done anything because, insofar as we have had investable funds, those opportunities have not been attractive against the background of the other opportunities we were seeing. Performing loans that are likely to stay performing loans with 25% yields are better opportunities. We haven't paid much attention to equities because we have been using available funds to buy performing loans.

Going forward we will be very interested in bank common stocks, assuming we have investable funds.

**I realize you were faced with large redemptions last year. Was that mostly a reflection of investors failing to have the proper long-term focus?**

We had huge redemptions, and went from 180 to 129 million shares outstanding. This has eased up lately. In 2008, we were more in the cash management business than in the investment management business.

There is no question that investors refuse to focus on the long term. If I ever had my life to live over again, I would not manage investments in a structure that allows daily redemptions. The public sells when they should be buying, and buys when they should be selling.

**Your Third Avenue Value Fund has a large stake in Hong Kong real estate companies. Do these fit with your distress investing discipline? As a value investor, are you able to get the level of disclosure that you require, at least of your US-based investments?**

What we do in equities is a direct outgrowth of my background in distressed credit and my desire to be in the most senior issue to participate in a reorganization. But if a company has an exceptionally strong financial position, then we want to own the common stock. We only buy the common stock of companies with exceptionally strong financial positions and when we can buy at a huge discount to net asset value, with growth rates projected to be 10% or more per annum compounded.



Indeed, companies in Hong Kong are all blue-chip institutions, audited by the Big Four, with statements published in English. All our investments are active in real estate and private equity. For our purposes, international accounting standards are a lot better than U.S. GAAP, especially when it comes to income-producing real estate. Under international standards, income-producing properties are carried at appraised values, which are a lot more helpful than GAAP, where they are carried at historical cost less depreciation, less any impairments.

We buy common stock at a discount to readily ascertainable net asset value, and those net asset values are a lot more ascertainable in Hong Kong than in the US.

**Are you positioning your portfolio in anticipation of increased inflation? Do any classes of distressed securities (e.g., bank loans or junk bonds) become more appealing if inflation becomes a greater threat?**

Buying assets at a big discount to their net asset values is the best way to guard against inflation.

In the late 1970s and early 1980s, the SEC adopted a supplement to financial statements called current value accounting. They had the idea that companies were grossly understating earnings because of inflation, by taking inadequate depreciation charges. It was a nice theory except when I lived through that era I found that companies with a lot of sunk costs were very well protected against inflation. New entrants couldn't come in and build new plants. Things were not as simplistic as the SEC believed they were.

If we buy a lot of sunk costs cheaply, in general it will be the best inflation hedge we can have.

As to buying performing loans with 25% yields – for that not to be a good hedge against inflation we need Weimar Republic-type inflation, not just 1970s-type inflation.

**You recommend a number of changes to the bankruptcy code that you say are necessary to address problems such as excessive expenses for lawyers and other professions, and to shorten the overall process. To enable the process to help companies emerge stronger and healthier, which changes do you believe are most important to address first?**

I regret that I did not add a chapter to our book on Canada, where they have monitors and courts have a lot of authority.



A big improvement would be to amend section 503, so that professionals would not be permitted to rip off companies. We should go back to Chapter 10, and let professionals get paid at the end of the case, and only for substantial contributions.

Rewards to professionals are so great – I should have stayed a professional instead of becoming an investor.

Management should be forced to stand for reelection. A shadow trustee should be appointed in Chapter 11 (Canada requires a monitor). One of the big advantages as a creditor in performing loans is that in the US outside of a court proceeding, usually Chapter 11, nobody can take away a creditor's right to monetary payment unless the creditor consents. But this is not so in Canada. Being a creditor, I like the US and this makes US bonds are more attractive. In the US, management is very reluctant to use Chapter 11 and lose large elements of control. There is a strong tendency for performing loans to stay performing loans. Voluntary exchange offers don't work well.

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