LITMUS TESTING

Addressing Failed Auction Securities

EXECUTIVE SUMMARY:

The auction market relies heavily on investor confidence. Once certain bonds were perceived to be troubled, similar securities, even those with well run programs, may see their auctions at risk.

The scenario of a bond ultimately curing itself with a successful auction is unlikely. It is unrealistic to assume that dealers will eventually buy investors out at par value.

We envision the following courses of action for failed auctions:

a. Waiting it out
b. Restructuring
c. Cutting losses

Impairment and "illiquid" asset classification may be issues to consider for corporations with failed auction bonds.

The mismatched funding model of "borrowing short, lending long" again failed the litmus test on auction rate securities.

January 7, 2008

Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.3488
lpan@capitaladvisors.com

LITMUS TESTING

Addressing Failed Auction Securities

OVERVIEW OF THE ARS MARKET

Auction rate securities (ARS) refer to a kind of debt security with nominally long-term maturities and variable coupon rates. Periodic Dutch auctions held by the underwriting dealer, often every 28 or 35 days, set the coupon rate for each period and allow bondholder redemptions in a successful auction. Municipal bonds, asset-backed securities and preferred stocks are several of the security types that use auctions to issue debt and set rates.

ARS are usually marketed and sold by a single bond dealer with no resale market other than a subsequent auction or a courtesy purchase by the underwriting dealer. Industry estimates place the size of the ARS market in the U.S. at between $250 billion and $360 billion[1].

CAUSES FOR FAILED AUCTIONS

A failed auction occurs when active bids for a given bond are outnumbered by requested redemptions. This results in a failure to establish a clearing bid level. All existing bondholders are then paid a pre-established above-market rate until the next auction date. Prior to 2007, auction failures were rare and considered extreme credit events. Once an auction fails, successive auctions are more likely to fail due to the associated stigma. Therefore, dealers have strong incentives to minimize the risk of a failed auction. In addition to lost access to their funds, investors may be concerned with an issuer's ability to pay the penalty coupon rates if auctions continue to fail.

Since the onset of the subprime credit problems in the summer of 2007, there were published reports of at least 30 auctions worth $6 billion that failed in August alone [2]. The frequency and magnitude of industry-wide auction failures is difficult to assess since dealers typically do not share such information with other dealers or investors. Based on the limited public information available, we believe the following factors may have contributed to some of the recent failed auctions.

a. Direct subprime credit concerns: Some bonds were issued by specialty finance entities offering credit protection to firms engaged in subprime mortgage credit activities. They did so with either derivative contracts or reinsurance arrangements that may have sustained losses as the subprime crisis worsened.

b. Indirect exposure through investments: In some cases, issuers invested cash from investors in securities affected by the contagion from subprime. Some of the investments, including asset backed securities (ABS), asset-backed commercial paper (ABCP), structured investment vehicles (SIVs) and collateral debt obligations (CDOs), may have lost value as a result.

c. Complex and non-transparent structures: Several of the failed bonds we reviewed were complex legal entities with limited-to-no public disclosure. These financing "vehicles" involve a web of financial players and layers of structures that are difficult to untangle for outside investors. Many such bonds are Rule 144A securities, which are privately-placed investments that are not required to file with the Securities & Exchange Commission. Limited auction disclosure and a jittery credit market last fall may have made the lack of transparency a greater handicap.

d. Concerns with AAA credit ratings and bond guarantors led to a lack of investor confidence: As credit rating agencies faced scrutiny for the triple-A credit ratings they assigned to certain ABS, CDOs and SIVs, investors may have become concerned with the level of protection offered by the triple-A ratings backing the bonds they owned (some securities continued to carry the coveted top ratings even after auctions had failed). Bonds receiving AAA ratings from bond guarantors including MBIA and AMBAC also began to cause concern as the guarantors themselves were caught in multi-billion dollar subprime mark-downs and now risk losing the triple-A ratings.

It should be noted that the auction market, more so than the capital markets in general, relies heavily on investor confidence. Once certain bonds were perceived to be troubled, similar securities, even presumably, those with well run programs, may have seen their auctions at risk. Against the backdrop of potentially large demand for liquidity, the reluctance of the dealer community to take failed bonds off of an investor's hands at par value may have been the most probable cause for auction failures. Incidentally, this was during the same time several major securities firms faced capital and liquidity challenges of their own.

POTENTIAL COURSES OF ACTION

Because of the stigma of a failed bond, we think the scenario of a bond ultimately curing itself with a successful auction is unlikely. Investors should not expect to receive the full value of their investments on exit, at least for the foreseeable future. We also think, during today's market conditions, it is unrealistic to assume that issuers will call the outstanding bonds or that dealers will buy investors out at par value. For Auction rate security investors/holders, we envision the following courses of action:

a. Waiting it out. For bonds with strong credit underpinnings, notably guarantees by credible AAA bond guarantors, an investor may choose to wait until credit markets improve. The approach requires confidence in and close scrutiny of a bond guarantor's ability to pay the higher coupon rate should the issuer default. The investor also must have other means of cash liquidity to wait out the rough patches.

b. Restructuring. For less credit worthy issuers, default risk increases with time as the coupon rates may become too heavy a burden to bear. Investors may find it in their interest to work on a restructuring plan to turn an auction bond into one tradable on the secondary market. The investor may choose to hold the new bond, or sell it at the prevailing market price. This approach may require a group of investors taking activist measures to push for a restructuring plan and fight for favorable terms.

c. Cutting losses. For investors seeking to limit their credit exposure immediately, there may be limited opportunities to sell the bonds to interested parties at prices agreed to by both sides. Intended buyers may include the underwriting dealer, other institutional investors or value investors such as hedge funds. The value discovery process may take time and the price concession may be steep in these private transactions.

ACCOUNTING FOR SECURITIES IN FAILED STATUS

How corporate investors account for bonds in failed status and how they disclose them as significant accounting events remains to be seen. We think at least two aspects need to be considered: impairment and classification. Impairment refers to marking securities as temporarily or permanently impaired assets and applying a valuation "haircut" to them. The classification issue may include a decision to move a bond from a "short-term investment" to an "illiquid asset," which would allow the bond to be treated as a long-term asset. Such treatment may affect liquidity ratio testing for firms with bond covenants, among other considerations.

We would also stress that, as an investment advisor, we are not qualified to provide accounting or tax opinions on corporate investments. Investors should refer to their accounting professionals for such advice. Meanwhile, financial statements from publicly traded firms known to have failed-auction bonds may be useful. As of the third quarter 2007, at least three firms reported such investments - Qwest Communications (Q), Synaptics Inc. (SYNA), and Xethanol Corp (XNL). For example, in its 10Q reporting, Xethanol disclosed that it sold its $13.3 million auction investments to Deutsche Bank, the auction dealer, at a loss of $1.6 million (12% haircut) in late August 2007.

CONCLUSION - APPLYING THE LITMUS TEST

Time and again, history shows the perils of financing long-term debt with short-term obligations. Like money-market CDOs and SIVs, the use of Dutch auctions added another twist to the "borrow short, lend long" model. The auctions allowed issuers to obtain lower funding costs on long-term debt obligations in the short-term credit market. Cash influx in the early 2000s and growth of home equity and student loans provided both the currency and the asset collateral for the auction market. When the credit tide turned and liquidity dried up, these products with mismatched funding models again failed the litmus test.

We should note that although this credit commentary addresses securities already in failed status, some of the same credit and liquidity concerns exist in other parts of the ARS market. We suspect lax enforcement from the Securities and Exchange Commission on auction irregularities may have contributed to increased risk-taking in the auction market[3]. It is not unreasonable to argue that insufficient risk disclosure was at least partially responsible for cash investors investing in complex structured credit products that eventually resulted in failed status.

---

1 Rigged Bids, SEC Help Dealers as Auction Bonds Fail, Bloomberg, November 21, 2007.
2 Bond Tumult Is Jostling Auction-Rate Securities, the Wall Street Journal, October 5, 2007.
3 SEC Allows Auction-Rate Manipulators with Disclosure, Bloomberg, March 16, 2007.