

BONDS VS. STOCKS IN A VALUE PORTFOLIO

Ben Graham Centre's 2013 Value
Investing Conference

BONDS VS. STOCKS

- I hunt for bargains and it has been my experience that when I find an undervalued stock often other parts of the company's capital structure are undervalued as well.
- In stressed environments you can oftentimes get equity like returns with much less risk by purchasing securities that are more senior within the company's capital structure.
- Senior securities like bank debt are more illiquid, so if there is a forced seller the price can be impacted dramatically. During the financial crisis many investors were forced to sell securities to either deliver or meet investor redemptions. In this period of time only the highest quality securities could be sold and they were still sold at deep discounts.

Investors are short changing themselves big time if they do not look at debt securities.

CAPITAL STRUCTURE

Key areas of focus:

- Find a company you can understand and one in which you have faith in management's capital allocation practices.
- Focus on which piece of the capital structure you think is the *most* mispriced relative to the risk you are taking.

In general an investor would think about capital structure along the following lines:

1. Bank debt
2. Secured debt
3. Unsecured debt
4. Junior debt
5. Preferred Shares
6. Common equity

CAPITAL STRUCTURE

- If a company's common equity is undervalued we often find senior debt is also trading at a discount to its intrinsic value with an attractive YTM.
- If the company's common equity is trading at a low multiple of earnings, the debt is often trading at an even more attractive multiple.
- Prices can vary within the same seniority class due to the coupon rate and maturity. It is prudent to buy the lowest dollar debt in the same class of seniority.

Our experience shows that you should buy the most senior debt possible that is commensurate with safety and the returns you are seeking. It is better to sacrifice some return for a greater margin of safety.

AGENDA

1. Overstock.com
2. UTStarcom
3. Interpublic Group
4. Wells Fargo
5. Goldman Sachs
6. Bank of America
7. Dex West

OVERSTOCK.COM

Overstock.com is an online retailing company offering discount brand name, non-brand name, and closeout merchandise. It operates a website similar to Amazon.

OVERSTOCK.COM

Income Statement		
	Dec '08	Dec '07
Sales/Revenue	834.37	760.16
Cost of Goods Sold (COGS) incl. D&A	714.13	632.59
COGS excluding D&A	691.46	603.10
Depreciation & Amortization Expense	22.67	29.50
Gross Income	120.24	127.57
SG&A Expense	73.34	97.43
Other Operating Expense	57.82	59.45
EBIT (Operating Income)	(10.91)	(29.32)
Nonoperating Income (Expense) - Net	3.10	4.70
Nonoperating Interest Income	3.16	4.79
Other Income (Expense)	(0.07)	(0.09)
Interest Expense	3.46	4.19
Unusual Expense (Income) - Net	1.38	12.28
Financial Assets Impairment	0.30	--
Reorganization and Restructure Expense	--	12.28
Other Unusual Expense	1.08	0.00
Pretax Income	(12.66)	(41.09)
EPS (diluted)	(0.55)	(1.90)

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OVERSTOCK.COM

Balance Sheet		
	Dec '08	Dec '07
Assets		
Cash & ST Investments	109.57	147.39
Total Accounts Receivable	8.24	13.81
Inventories	17.72	25.93
Other Current Assets	10.46	11.14
Total Current Assets	145.98	198.28
Net Property, Plant & Equipment	23.14	27.20
Total Investments and Advances	0.52	0.03
Long-Term Note Receivable	0.00	4.18
Intangible Assets	2.81	2.84
Other Assets	0.00	0.00
Total Assets	172.45	232.53

Liabilities & Shareholders' Equity		
ST Debt & Curr. Portion LT Debt	0.00	3.80
Accounts Payable	62.12	70.65
Income Tax Payable	0.53	0.49
Other Current Liabilities	43.65	52.11
Total Current Liabilities	106.30	127.04
Long-Term Debt	66.56	75.62
Other Liabilities	2.57	3.03
Total Liabilities	175.43	205.70
Preferred Stock (Carrying Value)	0.00	0.00
Common Equity	(2.99)	26.83
Total Shareholders' Equity	(2.99)	26.83
Total Equity	(2.99)	26.83
Liabilities & Shareholders' Equity	172.45	232.53

OVERSTOCK.COM

OVERSTOCK.COM:	
Stock Price	\$20
Shares Outstanding	23 million
Market Capitalization	\$460 million
Total Cash	\$147 million
Available Cash	\$70 million
BONDS PURCHASED IN JULY 2008:	
Rating	Unrated
Coupon	3.75%
Purchase Price	\$0.65
Yield	18.03%
Date Sold	Feb 2011
Selling Price	\$0.99

- Overstock.com's common equity was trading at 0.6x revenue versus internet retailing peers at 1x revenue.
- The company had negligible bank debt of \$3 million.
- **Total debt outstanding was \$76 million; I bought it at \$50 million (if I were to buy all the debt at \$65).**
- **The cash covered all of the debt plus its YTM was 18%.**
- In most cases you do not have to wait until maturity to reap your gains. Within a year or two most of them will increase by 50% or more.

OVERSTOCK.COM



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UTSTARCOM

Lets look at another 'CRAP'
(Cannot realize a Profit) company.

UTSTARCOM

Income Statement (Industrial)	Dec '05	Dec '04
Sales/Revenue	2,929.34	2,703.58
Cost of Goods Sold (COGS) incl. D&A	2,491.58	2,117.53
COGS excluding D&A	2,393.03	2,041.33
Depreciation & Amortization Expense	98.55	76.20
Gross Income	437.76	586.05
SG&A Expense	619.42	523.25
Research & Development	247.13	219.05
Other SG&A	372.29	304.20
Other Operating Expense	0.00	0.00
EBIT (Operating Income)	(181.66)	62.80
Nonoperating Income (Expense) - Net	50.76	21.60
Nonoperating Interest Income	7.09	6.17
Other Income (Expense)	43.67	15.43
Interest Expense	16.76	6.92
Unusual Expense (Income) - Net	217.03	12.90
Pretax Income	(364.70)	64.59

- There is nothing special in the income statement to talk about.
- In 2005, both the stock price and the debt security started weakening because of concerns regarding operations.
- Doubts about management's ability to fix the problems.
- In this scenario, balance sheet is key as long as there are no significant cash outflows.

UTSTARCOM

Balance Sheet (Industrial)	Dec '05	Dec '04
Assets		
Cash & ST Investments	713	732
Total Accounts Receivable	525	834
Inventories	666	789
Other Current Assets	99	298
Total Current Assets	2002	2652
Net Property, Plant & Equipment	233	269
Total Investments and Advances	26	36
Long-Term Note Receivable	21	12
Intangible Assets	78	279
Deferred Tax Assets	--	17
Other Assets	5	51
Total Assets	2366	3316
Liabilities & Shareholders' Equity		
ST Debt & Curr. Portion LT Debt	199	351
Accounts Payable	321	408
Income Tax Payable	34	144
Other Current Liabilities	580	632
Total Current Liabilities	1133	1535
Long-Term Debt	275	411
Other Liabilities	21	0
Total Liabilities	1429	1946
Common Equity	929	1365
Total Shareholders' Equity	929	1365
Accumulated Minority Interest	8	5
Total Equity	937	1370
Liabilities & Shareholders' Equity	2366	3316

KEY POINTS:

- UTStarcom had cash of \$732mm in 2004.
- The company had hidden assets, such as real estate assets, of \$150mm.
- It had bank debt of \$350mm.
- The convertible debt totaled 0.875% of \$402mm. This is the one we are considering buying at \$0.62.
- No preferred shares.
- Shareholders equity of \$1,365mm.
- Any other liability, like deferred revenue or cash advances, should be netted out against cash and hidden assets.

UTSTARCOM

	2004 (as stated)	At market
Bank debt	\$350	\$350
Convertible debt	\$402	\$250 (at \$62)
Total debt	\$752	\$600
Cash		\$732
Market cap		\$880
Stock price		\$20

- Bank debt of \$350 million.
- The debt we are thinking of buying is trading at \$0.62. We are buying it more as if it were a straight debt rather than a convertible.
- Therefore, if you buy this debt, you are buying the whole company for \$600mm, considerably less than the \$732mm of cash on the balance sheet, without counting what the operating business could be worth.
- They do have some deferred revenue and cash advances which are balanced out by undervalued real estate assets.

At \$0.62 you get a return in excess of 60% in less than 3 years, when this paper matures in March 2008.

UTSTARCOM

- **A hypothetical question:** Why would you buy the common stock when the debt is so cheap?
- From May 2005 to March of 2008, the common stock tanked from \$24 to \$8 due to concerns about operations and management's ability to fix them.
- Meanwhile, this debt went from \$0.62 to \$1.00 when it matured in March of 2008.

If you are an equity investor, like I am, it is imperative to look at the capital structure and check what the different classes of debt securities are selling for before making a decision on the common stock.

UTSTARCOM



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ARE YOU A SKEPTIC?

- Now you must be thinking, you only get such good deals because you are looking at unrated securities, esoteric securities, and small capitalization stocks which institutions cannot participate in due to size restrictions.
- Let me to provide four examples that are going to surprise you. They are large caps with debt rated investment grade (BBB or better). At the time of purchase they were rated 'A' paper and at one time or another Warren Buffett had invested in all of them. In fact, Buffett has common stock investments in 3 of them at this time.

INTERPUBLIC GROUP

- Interpublic Group is an advertising agency. As Buffett once said, it is a royalty stream on advertising dollars.
- It doesn't need a lot of capital to run the business, one of Buffett's tenets on a good business.
- Buffett understood that advertising agencies make a vital connection between consumers and corporations.
- In 1973, Buffett bought the stock at 2x pre-tax earnings, and at one time owned 15% of the company.

INTERPUBLIC GROUP

Balance Sheet (Industrial)	Dec '08
Assets	
Cash & ST Investments	2326
Total Accounts Receivable	4846
Other Current Assets	316
Total Current Assets	7488
Net Property, Plant & Equipment	562
Total Investments and Advances	--
Intangible Assets	3343
Deferred Tax Assets	417
Other Assets	316
Total Assets	12125

Liabilities & Shareholders' Equity	
ST Debt & Curr. Portion LT Debt	333
Accounts Payable	4023
Other Current Liabilities	2522
Total Current Liabilities	6877
Long-Term Debt	1787
Other Liabilities	986
Total Liabilities	9650
Preferred Stock (Carrying Value)	525
Common Equity	1951
Total Shareholders' Equity	2476
Liabilities & Shareholders' Equity	12125

- Interpublic's stock was selling at PE of 7x.
- Interpublic's bond's YTM > 20%.
- If this is the case, why the need to buy common stock?

- The company had cash of roughly \$2 billion and debt of \$2 billion. Most of the \$2 billion in debt was the senior unsecured, the same class as the 6.25% I was buying. So, at \$0.525, the whole company was selling at \$1 billion.

**6 months later, we sold it for \$0.93,
proving how quickly the price can rebound.**

INTERPUBLIC GROUP



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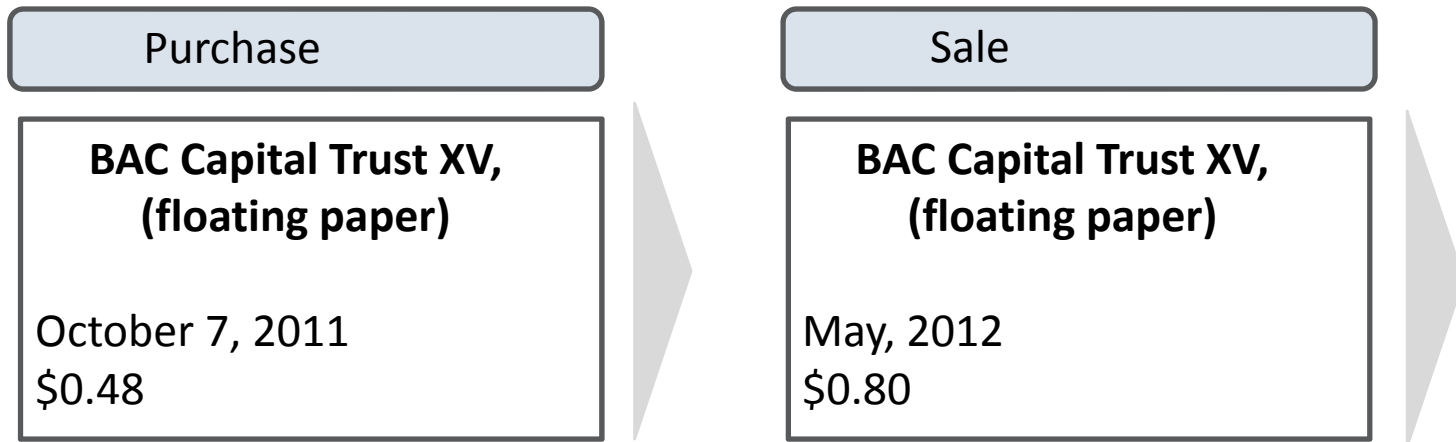
THE BANKS

Lets fast forward to the banks.

THE BANKS

- The reason for showing you the debt securities of the 3 banks is that you can buy them at really cheap prices. They are investment grade, A Rated paper. There is a misconception that you can only buy junk securities below \$0.70 on the dollar. In my experience, that is not true.
- Buffett currently has common stock ownership in all 3 of them.
- We will start with Bank of America. I will skip the details because Prof. George has warned me that I cannot go beyond my allotted time.

BANK OF AMERICA (BAC)



A 67% return!
(This was in 2011, not in 2008).

BAC FLOATING CAPITAL TRUST XV 2056



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GOLDMAN SACHS (GS)

- Similarly, we bought GS 5.793% in October 2008 for \$0.43 and in February of 2011, we sold them for \$0.86.
- This purchase was made in the panic of the Great Recession of 2008.

GOLDMAN SACHS



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WELLS FARGO 7.7%, 2049

- Now we come to the last one.
- This is arguably the best run bank in the United States.
- The company had many strengths including the lowest cost deposit base in the country, a culture of high underwriting standards for loans on its books and a history of conservatively stated financial statements.
- Warren Buffett was the largest shareholder and was buying WFC common stock in the open market.
- You wouldn't believe the price I paid for this one.
- **I paid \$0.37 in March 2009 and sold them for \$1.03 in April 2011.**
- In summary, as I said earlier, investors are short changing themselves big time if they do not look at debt securities.

WELLS FARGO 7.7%, 2049



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WHAT CAN WE BUY NOW?

- The prices for debt securities are fully priced now. I wouldn't buy any unless it is event related or has special features.
- I don't think I am allowed to get away without providing at least one idea, so I am going to present Dex West Media.

DEX WEST MEDIA TERM LOAN

- Dex West term loan is complicated so I am going to simplify it.
- You can buy the common stock of the holding company Dex One, and you can make an argument that you can make 5 times the money – a five bagger so to speak -- but I feel so much safer with this bank term loan.

DEX WEST MEDIA TERM LOAN

Maturity	December 31, 2016	December 31, 2016
Interest Rate (1)		
2013-2014	L+425 bps (3.0% Floor)	L+500 bps (3.0% floor)
2015-2016	L+450 bps (3.0% Floor)	L+500 bps (3.0% floor)
Mandatory Amortization		
2013	\$4.832 million per quarter	\$11.25 million per quarter
2014	\$4.832 million per quarter	\$11.25 million per quarter
2015	\$4.832 million per quarter	\$11.25 million per quarter
2016	\$4.832 million per quarter	\$11.25 million per quarter
Mandatory ECF Sweep	50% of ECF, quarterly	50% of ECF, quarterly
Discounted Prepayment Portion of ECF Sweep (2)	N/A	30% of ECF, quarterly
Borrower's Discretionary Portion of ECF (3)	50% of ECF	20% of ECF
Leverage Covenant	6.0x in all periods	3.5x in 2013 declining to 2.5x in 2016 (4)
Interest Coverage Covenant	1.0x in all periods	2.0x in all periods

DEX WEST MEDIA TERM LOAN

	Pro Forma					
	2012	2013E	2014E	2015E	2016E	Total
Free Cash Flow		113	107	99	92	346
Amortization		45	45	45	45	180
Par Portion of ECF Sweep		22	23	21	22	88
Discounted Prepayment Portion of ECF (2)		13	14	13	13	53
Principal Payments		80	82	79	80	321
Cash Interest		35	29	21	14	100
Cash Returned to Lenders		115	111	100	95	421
Bank debt owing		446	367	276	188	99

- Term Loan owing \$446mm.
- Free Cash Flow \$113 million.
- This term loan is selling at \$0.76.
- Coupon is at 8%.

- In the first year, \$80 million will be bought back at par. In other words, close to 18% of the bonds that you are buying for \$0.76 will be bought back at \$1.00, plus interest of 8%. Notice, at \$0.76, the current yield is over 10%.
- In 3 years, so much of this debt will be reduced that it will be trading for 1x free cash flow, even if it is priced at par.

QUESTIONS?

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