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Musings

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Making Lemonade – Investing in Mid-Crisis

In a recent meeting in Dubai, a worldly and weary Sovereign Fund CIO leaned over and said "so, do you have any *good* news today?" Again and again in a week in the Middle East we entered tall cool buildings through a phalanx of limos packed with bankers and brokers imploring investment in collapsing public companies. Again and again our hosts were called away to listen to delicately worded political pressure from foreign governments and their own sovereign leaders.

We went bird-watching: found the "big birds" of five of the top dozen banks parked by the runway, each hoping to take off refueled with petrodollars to feed the starving shareholders in London, Paris, New York, etc. One reason we were in the region was to share our recent white paper "Financial Services Investing in 2008 – So What's To Love?" so we found it ironic that the trip we planned months ago was so coincidently topical.

Pity the CIOs of Arabia. Theirs is a painful narrative: "First a banker calls saying they have a household name, apple of the regulator's eye, but wounded – we are *lucky* to be invited to invest. Next we meet the (new) CEO who claims the worst is over and fundamentals are strong; our money is welcome but we must not differ with a board of go-along, get-along types, and of course we must never sell. My hedge fund guy says wait for better bargains, my staff says buy the bonds instead and my economists say the worst is yet to come. Then my leader calls to say we might unpeg to the dollar and what do I think of that?"

So we talk about financial services investing. Herewith the Cliff Notes version of the White Paper, provided as background. This Musings is more to relate our advice to Sovereign Funds than to restate the attractiveness of the sector, and that will follow. We love Financial Services because:

1. Demographics are the wind at our back, as are capital accumulations and conversions
   More people with more money with more need to invest – in existing and emergent middle classes. More commodity and agrarian assets converting to financial assets globally – at household, corporate and governmental levels.

2. Barriers to entry remain high, as do returns (go figure!)
   Regulators, capital markets and consumer mythology combine to make it very difficult to create a financial services business from scratch or from an industrial base (WalMart bank anyone?). Counter-intuitively, margins remain high – consumers see plenty of differentiation: Goldman's "magic", PIMCO's "insight", Wells Fargo's "discipline", Berkshire Hathaway's "homespun savvy", BGI's "quant methods", Fidelity's "continuous improvement", Farallon's "find-it edge", SAC's "contrary bet" and Blackstone's "relentless drive" are all tiny variations on a theme but they are enough to hold prices high and therefore enough to support margins. Maybe it takes not genius but consistency (with occasional insight) to succeed for clients.

3. Scale is incredible, which makes management the partners of capital
   The pay of leaders of these businesses confuses most observers we talked to (and this was before Merrill's latest hire!). If they deserve a million a week it is because scale benefits are so

substantial – the product is literally free to transport and scarcity is a pricing metaphor – that those who can drive the top line and create effective partnership with upper management are worth their weight in, well, whatever.

4. It is big, growing and global on a US pattern
   At 24% of US GDP, financial services is the largest US sector with $3 trillion in revenue, up three-fold from 1990. US financial services companies are world leaders, having exported capital market structure, economic theory and populist capitalism far better than the USA has exported democracy, literacy, health care or separation of church and state. There are regional/local differences in how the world banks, trades and finances but convergence is well into its second decade. Global "best practices" are American methods, globally the product matrix is the US product matrix, and globally the language of performance is the Greek and the acronyms of US operators, analysts and investors.

5. It's fragmented, available and liquid
   Of 40,000 companies, almost 90% are profitable, with 30%+ posting margins in excess of their peers (love those scale effects!). There are powerful reasons why these companies transact, including the fact that many were formed ten to thirty years ago as private enterprises (globally, the average aggregate quarterly M&A deal value from 1979 to 2002 was $102 billion in Financial Services vs. $66 billion in High Tech, $36 billion in Infrastructure/ Construction/Transport/Utilities, $43 billion in Population/Business Services and $29 billion in Traditional Services)[1]. Private equity firms have virtually ignored financial services, yet capital still flows from other investors. Public markets love the cash flows and margins of financial services. It is the largest component of the S&P 500 at 17% of market cap. Today, the S&P 500 is $12.5 trillion with financial services companies at $2.1 trillion, down from twice that level just a year or so ago.

So What is a Sovereign Fund CIO to Do??

Plan A: DO NOT: Buy Equity You Cannot Sell; Don't be Flattered by Entanglement;
INSTEAD: Anonymously Buy Liquid Equity, at Market Entry Price if Necessary

It completely eludes me why any sovereign wealth fund – or any source of big bucks – would play this crisis by buying the equity of wounded institutions in bulk on the terms offered. Why reject a mouth-watering entry price and pandering invitations? Well, let's play a game: It's 1991 and Citibank is in the tank for reasons related to foreign debt, real estate, unregulated activities and bad strategy. You own a couple of hundred million dollars of stock – fully saleable.

For roughly $600 million you buy up to a total position of 10% in convert form. We will ignore the prior position and mark your position at that date. Assume your purchase was equivalent to public equity except that you get an 11% preferred dividend. While your investment is widely announced ("an honor, an opportunity, an obligation" you say) you accept that you are a passive holder – no

[1] Kara, Alper, Marques, David, Altunbas, Yener and Walkenhorst, Dominik, "Does the Financial Sector Drive Non-Financial Sector M&A Activity?" (August 24, 2007).

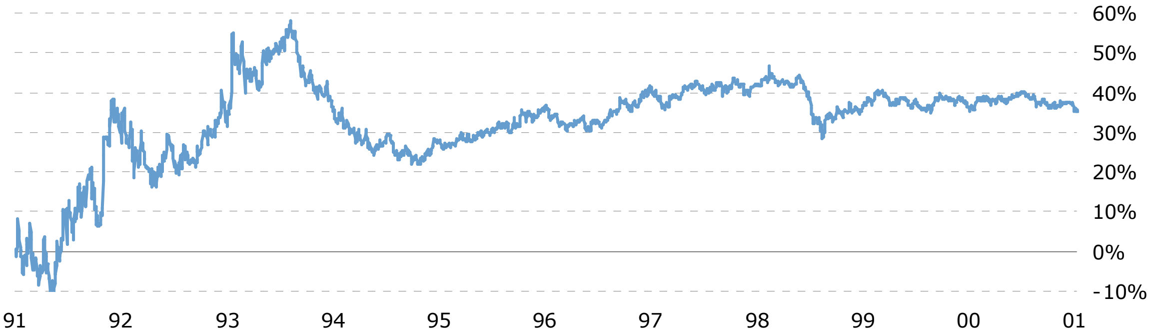
Board seat but promises of lots of access and lots of respect. You have made a private – yet very public –investment which impresses regulators, quiets market tremors and reassures clients.

The CEO is a 52-year old John Reed – brainy architect of a passionless behemoth that loves technology, decries narcissism and is schizophrenic about risk. It is a big business, but not so big or so diverse that it cannot be led effectively by the moderate standards of the day.

It takes a while to get used to being an insider – shareholders sue you in 1992, but eventually you satisfy them and regulators. You are brought into the inner circle at last. This fits your urbane style and is natural in your culture of palace intrigues, public respect and long-term relationships.

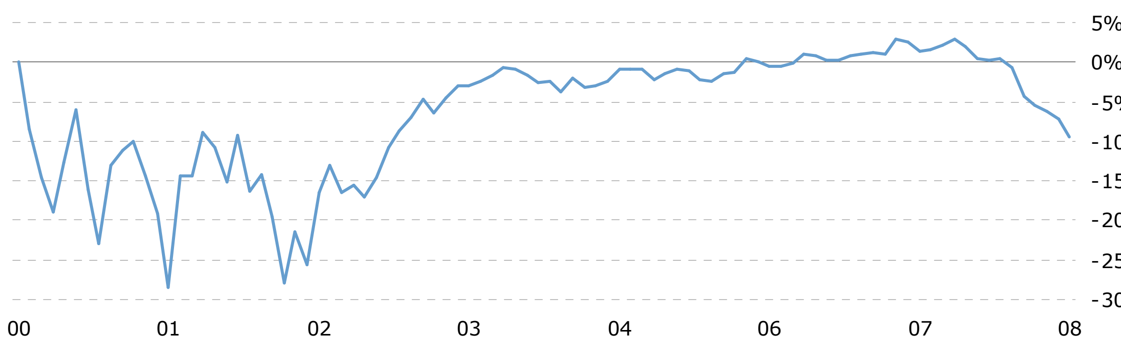
Fast forward to August 2000: the CEO is 67-year old Sandy Weill, who has transformed the bank into a global, fluid, energetic investment/merchant bank: Citigroup. You have realized, with dividends, an IRR of 40%. You are more than a hero, you are an iconic investor.

February 1991 – August 2000: Annualized Total Return on Citigroup Common Stock



The problem is the bank is a shambles of personalities and big egos; an executive corps rife with incompetence is riven by politics: showmanship has replaced meritocracy. Leave aside the passion play, the facts are daunting: declining market share, increasing costs, increasing leverage, show-stopping middle manager stupidity in London, Tokyo and elsewhere. Even America's sleepy regulators are starting to notice, as are star-struck regulators in other markets around the globe. What can you do? Our hero cannot sell without personal, institutional and national repercussions.

August 2000 – March 2008: Annualized Total Return on Citigroup Common Stock



Bob Rubin, brought in to help with people, demonstrates a tin ear for quality (turns out you can take the guy out of Goldman *and* Goldman out of the guy). A new CEO takes over – an internal lawyer who "knows the ins and outs of every business" and thus is administration substituted for leadership. The Board loves the idea of a quiet time of "consolidating the gains" but it is not to be.

Another wave of top manager defections – as if the challenge is not big enough for more than the handful of political "winners"! Five more years of sliding sideways and we come to 2007. That year Citi pays $800 million to recruit a new management team. The whole $800 million will be written off in 2008, as the team is transferred elsewhere and Old Lane investors, glad no longer to be trapped in the dud funds, flee en masse. The goodwill "revaluation" will go unnoticed alongside asset write-downs, despite the fact that goodwill written off will never be recovered while the assets written down will likely be written up eventually.[2]

Your return on the convert through March 31, 2008 is under 20% – nearly ten years of return has been given back. If only you could actually lighten your exposure – at least once in ten years! As attractive as the entry price was, did you realize the "bargain" included the "never sell" promise? What resolves this Prisoner's Dilemma? If you sell you arouse the press and the regulators, and undermine client loyalty while unsettling a twitchy management team, <u>but you can buy, of course</u>. This makes a grisly kind of sense: if you cannot sell at the top, buy at the bottom!

Sovereign wealth funds should not buy big private stakes because their culture, their civility, their unwelcome visibility and their old-fashioned sense of honor will work against them – every time.

Plan B:	DO NOT:	Fund Another "Distressed" Team Start-Up
	INSTEAD:	Add Mandates to Existing Firms for One or Two Years

Buying the paper issued by clients of banks and brokers is a big opportunity – equivalent to Leon Black's gains on high yield back in the day. But this train has left the station: over $30 billion last year and the same amount so far this year. A sovereign wealth fund head of Alts showed me a list of over thirty new firms and new teams within boutiques that he had seen in the last month – one every day on average. As he said "If every man Jack out there is chasing the same discount, how long will spreads stay wide; how long will collateral or bonds be deeply discounted?"

And anyway, you are likely already involved: your bond manager is already playing. The average recovery time of the last three crises was just under two years. This time it may be shorter because the infrastructure for the fixed income world has grown very sophisticated – the explosive growth of asset-backed issues requires NASA-level analytics. At the same time the number of different ways to play has grown too. Bond or CDS? Onshore or off? Which issue, which layer? Maybe the converts or the preferred equity? How about a structured solution? How about a

[2] A quantitative portfolio management friend of mine points out that in portfolio management your mistakes get smaller, while most business management mistakes get bigger. So far, Pandit has cost Citi over $1 billion in purchase price and compensation contract. He had better be *damn* good!

package of whole loans?[3] These are decisions that are not wisely left to a new firm or a group of disaffected traders re-potting themselves for a few years.

Buying the bonds and equity of financials is a good idea if done quietly. But we are in for a long period of increasingly exaggerated swings of public pricing around long term value – you need to be ready to sell and watch the changing circumstances every day. We assert that the right way to buy is through the mandate of a specialist hedge manager (Tosca is the best in the world, the FrontPoint financial team is as good and there are several others).

Be prepared to mandate long only active as well as hedged investing – this industry has lovely characteristics for top-down global macro portfolio structuring. Your manager can buy using overlay and other top-down macro bets because the industry itself is materially undervalued.

In short: feed your alpha, not your ego – get the best managers on-side and let them work their magic. This will be an extraordinary time for the managers who have spent decades in Financial Services. Do not, ever, trust a repotted executive or banker as a portfolio manager of liquid portfolios. Avoid like the plague the "last roundup" crowd: fifty-plus white guys with lots of corporate boards and maybe a book or two under their belt – guys who say "fire in the belly" and "entrepreneurial juices" while filching your wallet and leaving their own money safely at home.

Plan C:	DO NOT:	Commit Another Dime to Generalist Private Equity
	INSTEAD:	Invest in Mid-size Deal Specialists and Load Up on Mezzanine Funds

The financial services industry has multiple layers of regulations, specialized products, complicated business models, complex distribution strategies and numerous competitors. These are an opportunity for specialists who live and breathe the industry and are not put off by the moderate-to-small deal sizes.

While there are and will be deals that consume $1 billion in equity, the bulk of high-return deals will use $50 to $300 million of equity (assuming conservative debt financing – say 3:1). Deal sizes below $1 billion total are not attractive to the largest – ever larger – funds. Better prices and better returns, risk-adjusted, are available in the smaller transactions.

While industry complexity keeps investors out of the market, it creates better buying opportunities for seasoned investors. Experienced investors add more value to a financial services investment, and it is dramatic in the IRRs actually achieved. So how does one recognize an experienced manager, cutting through all the spin?

- In US banks there is Flowers (Big), CapGen (Big-Mid) and Belvedere (Mid-Small). For the next few years trust no one else. US Banks are very dangerous in structural subjugation terms for equity. Outside the US the picture is better but the risks are higher, and local/regional factors

[3] Loan-level accumulation is an exception, since no one is really prepared to do it loan by miserable loan, totally bottom-up, using proprietary technology. There are only a very few teams qualified and experienced enough to make this work (We have maybe got one on the launch pad, I confess).

are crucial. Although it goes against my general argument I would say go with regional specialists rather than industry specialists (especially in the BRIC world).

- In Broker/Dealers there is no one – yes, that's right, no one. Broker dealers are unfinanceable (remember Refco?) and toxic when public. Stay clear. And yet be aware there are brokers who are not brokers but advisors (think LPL, or the Merrill of fifty years ago) – these are advisors in mufti, not brokers – their interests are aligned with the client rather than against the client.

- Insurance, asset management, wealth management, specialty finance
  This is a huge, lucrative, underinvested sector. There are a dozen or more firms who falsely claim to have done deals. Here is my guide to winnowing the unworthy:

  - Cross them off if they have not done at least three deals with the same team in the subsector;

  - Cross them off if all personnel come from Wall Street and not industry – these times demand real business knowledge and contacts, not slick financing;

  - Cross them off if they do not have the majority of their personal wealth alongside your money – ignore percentages and get personal. Ask about each layer of the firm;

  - Cross them off if they talk about negotiations instead of investing, deals instead of trends, financing instead of value, and the boardroom instead of the management.

- Financial Technology, including Exchanges and Business Services
  These are very specialized sub-sectors, where the "three-deal" rule should be expanded to a dozen deals – also the most lucrative stage of investing is early-stage (under $100 million equity investment). This is below the minimums of many firms.

Hellman, Crestview, Reservoir, TA Associates, Lovell Minnick and a few others (yes, Grail) qualify in the "sweet spot" of the private equity financial services market: insurance, asset management, wealth management, specialty finance. These sweet spot sectors are people-intensive and strategy-intensive. Proper business models create significant operating leverage – leverage that can add extraordinary value – but must be done in partnership with management.

Some companies – specialty lenders and insurance – have capital intensive business models. These companies offer investors the opportunity to deploy a sizable amount of capital with very favorable risk/reward characteristics. Despite recent headlines to the contrary, these businesses have controllable risk. Certain sub-sectors such as credit cards and consumer loans offer protection through asset sales. These markets are usually more liquid and robust than the secondary markets in other industries (although we need the capital markets to unfreeze a bit!).

Aging populations in the U.S. and Europe will continue to drive the asset management business; increased cross-border transactions will drive FX trading; robust Indian and Chinese economies will create opportunity for credit markets, insurance companies and asset management as the middle class grows in wealth and size.

Musings

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Down times are great for private equity returns in financial services. In 2001 (-12%) and 2002 (-25%) investments in financial services private equity achieved IRRs approaching 30%, compared to a historical average of 18%. These are going to be good times for those who play the crisis correctly: in the sweet spot sectors that means investing with specialists who are seeking high-IRR, mid-range deals and who deal all over the cap table, including early stage and mezzanine.

And in financial services when investing fails – as it will a large proportion of the time – the result is almost never a complete loss. Unlike so many other high-potential sectors, financial services is very able to weather a downturn or survive a failed strategy. Some subsectors – portfolio management, wealth management, life insurance, business services, etc. – have such strong cash flows that you "cannot kill them with a stick" and investors rarely lose all they invested. High cash margins cover a multitude of sins and protect the innocent and the guilty alike!

So yes we are in a crisis, yes we will be in the muck for at least another year or more. And yes, this is the time for financial services overweighting, BUT as the nursery rhyme says "only go down to the end of the town" with those who know where they are going and care about the outcome – no opportunists allowed!

DHP