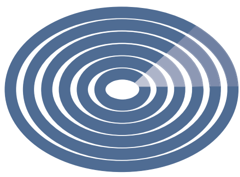

ODEON

Bove Briefing

Wednesday, September 04, 2019

REFERENCED COMPANIES

FNMA: $2.84
Rating NR

FMCC: $2.75
Rating NR

Time to Reconsider Fannie Mae and Freddie Mac Again
September Is Slated to Be a Busy Month

Decision Time

A number of events are expected this month clarifying the status of Fannie Mae and Freddie Mac.

- A decision from the 5th Circuit Court, possibly;
- The release of the President's report on these companies (could be tomorrow);
- A position paper from the Federal Housing Finance Agency (FHFA); and
- Congressional testimony by Treasury Secretary Mnuchin, HUD Secretary Ben Carson, and FHFA Director Mark Calabria concerning the status of these companies on September 10.

This activity after the summer hiatus suggests that the stocks could catch bids here. It is a good time to buy them because the return to heightened activity is likely to lead to an increase in investor enthusiasm. Plus, something more than "jawboning" might actually be done.

Courts

The current status of the court system is unclear. The facts of the cases as I see them are as follows:

- The government did engineer a take-over of these two companies in 2008 based upon the clear need to address severe problems in the financial system – not because they were in imminent danger of running out of cash or failing.
- In 2012, the government did lie to the courts concerning the financial outlook of these two companies as is now clearly shown by discovery documents.
- The government did break a contractual agreement with the two companies.
- The government has expropriated private property in this case on false pretenses without compensating the owners of that property.
- The government has ignored the law as written in the Housing and Economic Recovery Act (HERA) of 2008 to rebuild the supposed financial weakness of these companies.

Up to this point, a simple explanation of the court judgements in favor of the defendant, in the government sponsored enterprise (GSE) cases, has basically stated that the government had the right to take these actions. This view is, in part, based on the circumstance that these companies were/are in a conservatorship allowing the conservator (FHFA) to do whatever it deemed to be appropriate.

It is hoped by many, including myself, that new evidence revealed in discovery documents is causing the courts to rethink its positions:

- The Federal District Court in Washington D.C. has now requested a new trial based on the concept that the holders of investments in the GSE had no expectation that the government would take away their holdings. Judge Lamberth has now requested that the government come up with 70,000 documents.
- The Federal Claims Court, also in Washington D.C., has set a November 17, date to review the case. It is possible that Judge Sweeney is ready to start looking at the substance of the case.
- The Fifth Circuit Federal Court in Houston has taken the unusual step of requiring a so-called

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"en banc" hearing of the plaintiffs' claims because the court was uncomfortable with prior judicial findings. The fact that there has not been a decision here suggests that there may be in-fighting among the justices suggesting that it is not a "slam/dunk" that the plaintiffs will win.

In sum, it appears that the courts are now viewing the plaintiffs' charges more favorably but that does not mean that decisions will change in favor of the plaintiffs. Moreover, decision time still seems some time away even in Houston.

Congress

It is not expected that Congress will take any action. That, however, is a positive. Over the past 7 years there have been numerous bills presented in both the Senate and House of Representatives as to what to do with the GSEs. These bills have attempted to achieve the following:

- The creation of highly complex systems to regulate the activities in the nation's housing markets; and
- The elimination of government guarantees to the mortgage markets.

What has emerged from the analysis of these legislative thrusts is some core understandings:

- The government must support the 30-year fixed rate mortgage and be paid for doing so.
- The most reasonable solution to the problems in the secondary markets is to rely on Fannie Mae and Freddie Mac.

In sum, the Congress has rejected any major restructuring of the secondary mortgage markets as being too difficult and basically unnecessary. This is a major step forward for the GSEs because it, in essence, recognizes that they are required. By the way, in all of the comments I have written over the past decade on this subject I come down to these points:

- The current system works; and
- Changing it will create major economic disruption.

It is this belief that drives my conviction that owning equity in these companies makes sense. They simply are too critically important to the mortgage sector, housing, the wealth of American households, and the United States economy to be eliminated.

Administration

After a flurry of statements when Mark Calabria was appointed Director of the FHFA and when Treasury Secretary Mnuchin commented on the report he has prepared for the President, nothing has happened in the Administration this past summer either related to the GSEs. There is an excellent report, however, prepared by a group called Value Investors Club, which captures a number of the public statements made by Administration officials concerning the GSEs. Based on these recorded statements one is able to obtain a sense of what the Administration is likely to propose this month. My guess is the following:

- The 30-year fixed rate mortgage will be guaranteed by the government for a fee.
- Fannie Mae and Freddie Mac will remain at the core of the nation's secondary mortgage markets.
- Opportunities will be made available so that other companies might enter the business with the same powers as the two GSEs
- The Net Worth Sweep whereby the government takes all of the profits of these companies will be eliminated.
- The senior preferred stock that the government owns in the two GSEs will be declared paid in full.
- The $200 billion Treasury draw facility for each company will remain in place.
- The "patch" arrangement will be grandfathered.
- The junior preferred stock holders will receive some payments
    - Probably in common stock; and
    - Probably at a slight discount to their par value.

- The capital position of the two companies will be bolstered by
    - The build-up in retained earnings;
    - Possibly the conversion of the junior preferreds to common;
    - A tiny contribution as the government converts its warrants into common stock; and
    - Possibly a stock offering.

The rules laid out by HERA indicate that the Administration can take most of these steps without the backing of Congress. The guarantees and the authority to issue new GSE-like charters is Congress' purview. However, if history is any guide, the markets will assume the guarantees are still in place even if Congress does nothing. There were no real guarantees in place for the 38 years up to 2008 (the companies grew well above the $2.5 billion each that was guaranteed) and no one ever assumed that they did not exist.

Investment Strategy

Let's assume the following in order to decide how to invest in these companies:

- The courts effectively do nothing:
    - The Fifth Circuit Court decision is unclear as to what the government must do.
    - The Federal District and Claims Courts continue to ruminate without decisions.
- Congress refuses to touch the issue having exhausted all of its legislative thrusts.
- The Administration begins putting a plan in place much like what is being suggested here.

What then is the appropriate investment strategy?

- Junior preferreds
    - Buy them now.
    - Sell them as the Administration puts its program in place.
- Common stock
    - Avoid it at present.
    - Buy it 6 to 12 months following any stock offering.

<u>Preferred</u>

It is my assumption that the preferreds will increase to 75% to 90% of stated par when indications are made public that some payment will be made. Then they may drop back in value if the payments are to be in common stock.

The likelihood is that all preferred shareholders will receive the same amount irrespective of terms or coupons. Therefore, it may make sense to buy the low-coupon, off-the-run preferreds if it is expected that the preferreds will receive payments. The illiquidity risk is higher here but it may be worth the risk.

<u>Common</u>

This is a more complex transaction. In the table below I assumed that

- The required capital will be equal to 4% of assets. This is based on what the current requirement is at present at Fannie Mae.
- The retained earnings at each company will be 2 times H1 2019 net income.
- The junior preferreds will be converted into common at $2.50 per share.
- The common stock offering will also be at $2.50 per share or approximately 12x after my all event earnings estimates.

The numbers are shown in the table on the following page. One can adjust them for any series of reasons but these are the key concepts that must be dealt with. Plus, of course, these numbers assume that once the decision is made to pay the preferred shareholders, all of the court cases disappear.

	Fannie Mae			Freddie Mac	
	Capital (mil)	Shares (mil)		Capital (mil)	Shares (mil)
Estimated Requirement					
Required 4% of assets	$140,000			$85,000	
Sources					
Current	$3,000	1,158		$3,000	726
Retained Eranings Year 1	$12,000			$6,000	
Warrant exercise	$47	4,735		$25	2,508
Preferred Conversion @$2.50/Share	$19,130	7,652		$14,109	5,644
Stock Offering @$2.50/Share	$105,823	42,329		$61,866	24,746
Amount raised	$140,000	55,874		$85,000	33,624
Estimated EPS		$0.21			$0.18
Estimated Dividend		$0.10			$0.09
Estimated ROEs	8.6%			7.1%	

Source: Odeon Capital Group

After the Offering

Once the offering is over the analysis of the companies shifts from legal predictions to more traditional =security analysis. The outlook for the newly privatized companies is good if one is looking at dividends but not so good if one is seeking growth.

The dividend is likely to be based on the cash flow from the existing portfolios of these companies. It, in turn, is based on guaranty fees and interest income. One might argue that the portfolios are pristine after 10 years of rigorous and disciplined risk testing.

The future earnings will be challenged by multiple developments. These include:

- Increased prepayment speeds if mortgage rates go lower.
- More competition if the big banks are allowed to create subsidiaries that compete directly with the new GSEs.
- The need to support low income housing.
- A housing market that is deeply troubled due to:
  - The lack of construction loan funds.
  - The lack of profit in originating loans at the primary level.
  - High housing prices.
  - The restrictive Qualified Mortgage Rules.
  - The need to keep giving a portion of the guarantee fees to the general U.S. Treasury account.
  - Low returns on equity.
  - Deteriorating PE multiples.

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Rating	Equity	%	Definition
Buy	10	76.92%	Anticipated total return of 10%+ over the next 12 months including dividend payments and/or the ability to perform better than the leading stock market averages or stocks within its particular industry sector.
Hold	2	15.38%	Anticipated trading levels at or near the current price and generally in line with the leading market averages and/or will perform less well than higher rated companies within its peer group.
Sell	1	7.69%	Anticipated depreciation of 10% or more in price within the next 12 months, due to fundamental weakness perceived in the company or for valuation reasons and/or are expected to perform significantly worse than equities within the peer group.

Ratings definitions revised as of May 7th, 2013.

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Changes to government policy, changing macroeconomic conditions.

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