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Klarman baits a hook

The bottom-fishing fleet continues to grow, with Carl Icahn, the aeronautical debtor, now reportedly buying junk bonds for the long pull. In Zurich the other day, Salomon Brothers tried to convince the stolid Swiss to do the same. Maybe the Swiss, who have 9½% domestic money-market rates, were moved to buy, and then again, maybe they weren't.

Seth A. Klarman, an investor of private capital in Cambridge, Mass., is now, and has been for some weeks, buying junk bonds—a few issues—with conviction. Here is news to ponder. Klarman, 32 years old, is president of The Baupost Group. He is an alumnus of Cornell University and of the Harvard Business School (graduating at the top of the Class of 1982). Before setting up in Cambridge, he worked for Michael Price and the .late Max Heine at Mutual Shares. Price, now president and chief executive officer, remembers the day when Klarman, then very green indeed, was presented with a bonus and a raise. Klarman's reaction was blunt and unexpected. He asked what the extra money was for. Told that it was in recognition of his good work, Klarman replied that he had not made the firm a dime. "You shouldn't pay people unless they earn and produce," he said, leaving his would-be benefactors somewhat slack-jawed.

Also, by way of full disclosure, Klarman is a fast friend of *Grant's*. He has spoken at our conferences and written in our pages and taken our telephone calls, even when he knew full well that the subject under discussion was going to be the end of civilization as we know it. Although himself estranged from the 1980s, Klarman managed to produce exceptional investment results in the long bull market by adhering to conservative investment principles.

In Klarman's case, conservative is not to be confused with Victorian. He and his partners have bought Mexican stocks, big-capitalization stocks, small-capitalization stocks, newly converted S&Ls and busted junk bonds. They have bought arbitrage stocks and have sold short the bonds of bank holding companies. A favored all-season investment of Klarman's is cash. Cash, he once wrote, is the "preferred steady state, with investments made only when provoked by a compelling opportunity." In the ransacked junk market, he thinks he has found this provocation. "We believe that there are absolutely compelling opportunities in the lower tier," he said recently. "Using conservative valuation techniques—where things would trade in the stock market assuming earnings decreases rather than increases, and assuming no positive asset sales—we think that there are things trading at absurd prices."

Klarman's declaration would be notable for his boom-time credentials alone. During the full-moon era, he was an outspoken bear, not on all junk at any price (for he dabbled in the securities of distressed companies) but on new junk at par. He was bearish not so much on financial leverage as on the financial-leverage fad. "So while we will not attempt to predict exactly when junk bonds will fall from favor," he and Howard H. Stevenson, the other general partner at Baupost, wrote in January 1987, "we confidently predict their demise." And in 1988, he and Louis Lowenstein, another leading bear on junk, wrote: "We believe that because of the tremendous growth in junk bonds outstanding, calculations of the default rate are understated. Bonds do not default immediately; cash must be squandered, and business must worsen (or at least fail to improve), both of which take time. Thus, the default numerator lags the rapidly growing total-junk-outstanding denominator in the default-rate calculation." And, from the same essay: "Since few of the junk bond mutual funds have significant cash reserves, when investors want their money, *the funds will have to sell, regardless of price*."

In Klarman's opinion, the climactic selling began a few weeks ago. He notes that the morale of the junk market is exactly the opposite of what it was. As recently as last summer, the downside was unimaginable. Now it's the upside of which no one can conceive. "The people selling these bonds aren't comparing price to value," he contends. "They just want to get out. It's really important to understand that people are selling them because they're down." He recently wrote to his investors:

> We believe there is considerable value in several of the bad junk bonds now being mercilessly dumped by holders. We analyze these situations for three possible scenarios: bankruptcy; survival; or exchange offer. We buy only if there is a margin of safety for us to do well under any scenario. We are psychologically bolstered by the knowledge

that most of these junk bonds are being sold for noneconomic reasons. As we mentioned in the year-end letter, junk is losing its lustre (it still amazes us that it had any).

It would not be quite accurate to call Klarman a "bull on junk." He is bullish on a few specific bonds at specific prices—on the securities that new-era enthusiasts, in their rush to abandon ship, have thrown over the side. The prices in each case are lower than 50, and Baupost has picked up some Bank of New England debentures at 10. (While many so-called bottom fishers will purchase junk bonds in the 80s, Baupost, generally, does not. David Abrams, a colleague of Klarman's, has theorized that the 80s are usually an elevator stop on a journey to lower floors, sometimes—as in the case of the junior Interco bonds—street level.)

Still, Klarman isn't the bear that he was, and his friends have begun to worry about him. They worry that he might be early or wrong. Also knowing Klarman—they worry that he might be right. If Klarman is right, as he habitually is, they are wrong. If not wrong, they are less farsighted than Klarman, which would annoy them. Anyway, before calling him to gloat over the crack-up of this or that leverage artist, they must now ascertain whether he owns the fallen securities. Alternatively, a rally in the junk market is more likely to cheer him than to irritate him, and that, too, has taken some getting used to. Is this a new Klarman, or a new market? If there is now value in junk, won't there be more value by the time the bottom is plumbed? Or (is it possible?) could this be the bottom?

What simplifies these questions is that Klarman is a small-picture investor. If he has views on Gorbachev, the German bond market, the business cycle or the global yield curve, he does not call his broker because of them. He does not talk about "support" or "resistance" and he might worry as little about the Federal Reserve System as any white-collar worker in the greater Boston area. He invests from the "bottom up," as he says, not the "top down"—"I buy individual values."

The junk-bond market did not walk off a cliff in January. It began to tumble down a long flight of stairs last June, when Integrated Resources found itself shut out of the commercial paper market. The summer brought a succession of smaller crises (Simplicity Pattern, Ohio Mattress etc.) and then, after Labor Day, the Campeau default. The weekend following the Allied and Federated news, Klarman and his associates, Abrams and Paul O'Leary, got out the files they had accumulated during the boom. Surely, thought Klarman, the time to buy was at hand. But, he relates, "We didn't make a purchase the next day. Nothing happened. It was a big yawn. Most of the fall, it was a big yawn. Gradually, a few sectors of the market settled lower. We were not in the distressed market in any significant way. In fact, for the last couple of years, many of the securities in distress and bankruptcy have been overvalued—relatively few securities, a lot of new players, and they've held the prices too high. Companies like Integrated, Southmark, Maxicare, Coleco—you would have got clobbered in most of them. They all traded too high.

"Towards the end of the year, we nibbled at a few situations. We've had ongoing positions in a couple of situations for the last couple of years. We have bankruptcy investments in some of the Jones & Laughlin mortgage bonds, in some of the Wheeling Pittsburgh claims. A few other distressed securities. That was a small part of our portfolio.

"I would say that by November-December we started to see more things show up. Securities that perhaps had good value but without good covenants, for example, where you had to ask, 'Could you stand the chance of getting screwed based on the very attractive price that you were being allowed to get in at?' You were already down in some securities by 30-40 cents on the dollar, but with the lack of covenants, it wasn't clear what could happen to you."

Paradoxically, says Klarman, the contraction in speculative-grade credit—junk bonds and bank loans alike—has rebounded to the gain of investors. One ever-present worry for the buyers of junk was "event risk"—the possibility that the leveraged company in which they invested would decide to take aboard new senior debt to make an acquisition. "But that risk," says Klarman, "is really a small risk right now. So one of the big reasons that people knocked the bonds down had actually gone away. But the bonds didn't bounce back."

One cause of this selling panic, in Klarman's view, is the new junk-bond orthodoxy. In days gone by, all junk was good. Now some junk is bad, intrinsically. There are, in fact, three classes of junk: a top tier of the Krogers, a middle tier of RJRs and a bottom tier of Tracors or Intercos. The distinction is silly, Klarman contends, because it is an after-the-fact description rather than a before-the-event prediction. If it were clear in advance which junk would not default, people would buy only that. No matter: Unimaginative money has clogged the upper tier, creating opportunities down below. The sum of down-and-out junk bonds, according to Klarman, amounts to $50 billion at par, implying a market capitalization of not much more than $20 billion.

"Normally," says Klarman of the lowest of the low, "this is an opportunity-laden sector. It's under pressure anyway as people try to blow things out to keep defaults off their records, to window-dress, to get mistakes out of their funds before the statements come out. When a bond doesn't pay current yield, it drags down a portfolio's total return, so they sell. And then, on top of that, you've got this tiering effect, where anything bad is seen as triply bad, not only for all the normal reasons but also because it's not in the top tier, and the top tier, according to Wall Street, will do well. A diversified portfolio of top tier, and you'll have a great return. A diversified portfolio of bottom tier, and you'll do terribly. What they miss is that at some price, you will no longer do terribly. In fact, you will do quite well."

The still-unconverted bears, including us, have their doubts. They wonder if the downside in junk bonds must not bear some symmetrical relation (in duration, lunacy or both)to the upside. They ask, in effect, can a bubble of four or five years' making be deflated in only four or five months? Has the market adequately discounted the crises of Drexel Burnham, First Executive et al.? Is the bear market in junk bonds a self-contained event or a symptom of the broader distress in banking and credit? If the latter, might not the liquidation have considerably longer to run? In other words, is the junk-bond drama a play in one act, or the overture to a longer and noisier production?

Michael Harkins, a New York investor who, until recently, had seen eye-to-eye with Klarman on the junk market, remains bearish. "I've talked with Seth about this a lot," says Harkins. "First off, why do we need to stand in front of every freight train? To turn this thing around, you're going to need a whole new class of buyers for junk bonds, just as, in 1980-81, you needed a whole new class of buyers for Treasurys. So it's likely to be a long bottom, not a spike. Second, businesses have been severely damaged by these capital structures. So when you're paying 60 cents on the dollar, it's 60 cents of exactly what? Next, in paying 60 or 70 cents, aren't we just validating the peak prices that Henry Kravis or somebody paid in 1987, 1988 or 1989? For another thing, there are social costs in all of this—the loss of pension funds, for example—and won't that mean changes in the bankruptcy laws? And there's a practical side. In bankruptcy, a bond is a zero coupon with an unknown maturity date. All of the maturity dates are going to be pushed out into the future just because of the overloading of the courts. You can say, 'We'll get more judges and more courts,' but that will take time. Last, but not least, the public still hasn't caught on to this junk-bond business. Witness the fact that Bloomingdale's was held up Saturday night."

Klarman gives an answer in several parts. He begins by noting that nobody rings a bell at the bottom. "Just about everyone we talk to is saying to us, 'How do you know that they won't go lower? How do you know all of these things won't go down in your face?'" he says. "And my answer to that is, 'We don't know.' We are bottom-up, not top-down, investors. Top-down people would spend a whole lot of time looking at how bad the economy might get or how many sellers there might be. Bottom-up value investors basically look at the values they buy. They leave room to average down, but they buy, if they think the values are compelling. We think the values are compelling. Furthermore, we think that there's a chance that the likely continuing selling pressure in the market is already being anticipated by the market. If most buyers have stepped back, awaiting better bargains, that suggests that as soon as better bargains emerge, a lot of buyers will step forward. You never know where the bottom is."

As noted, Klarman is bullish in particular, not in general. He is most particularly bullish on Harcourt Brace Jovanovich, the leveraged publishing and insurance company, on which he was formerly bearish, or disdainful. At the Boston roadshow for the HBJ junk bonds in 1987, the company promised to sell its corporate aircraft. Klarman, listening impatiently, raised his hand and asked a direct question: "If you need the planes, why are you selling them, and if you don't need them, why did you buy them?" The promoters smirked, and the Boston fiduciaries squirmed (Klarman is rarely on the conventional buy-side wavelength. When Goldman Sachs unveiled a new electronic device a while back that would deliver direct to one's desk the very latest Goldman Sachs opinions on markets and companies, Klarman bluntly advised the brokers that he couldn't care less. The brokers were mystified.)

Bearish on Harcourt at par, Klarman is excited at a quarter of par. "We've bought the subordinated debt around current market prices, which are in the range of 26 to 30 cents on the dollar of claim," he says. "We think that even under a very adverse scenario—where earnings decline, where the stock market declines, where business values decline and they go bankrupt—we think we can still make a profit from our current purchase price. There aren't too many things in the world where, if the business gets worse, the multiple goes down, you can still make money from where you paid. How many do you know? Of course, this is not for the faint of heart.

"I'll walk you through the numbers," Klarman goes on, "but first I want to tell you how ridiculous the markets are. When Harcourt was good junk, which was at the end of August, the market capitalization of all the pieces of HBJ—bonds, bank debt, equity—was $4.6 billion. Harcourt was trying to sell its theme parks last summer. It ended up selling them to Anheuser-Busch for $1.1 billion. The market was expecting, say, $1.5 billion. Let's give the market the benefit of the doubt. Say they got the $1.5 billion. Then the $4.6 billion should have been reduced by the $1.5 billion that they would have used to pay down debt, leaving $3.1 billion of theoretical market cap. The $3.1 billion, since August 31, has dwindled to where you could buy every security of the company, in the market, for approximately $1 billion. So the market cap of HBJ, adjusted for the sale of the theme parks at the hoped-for price, has dropped from $3.1 billion to $1 billion, more than a 67% drop. In comparison, the results of the company have been somewhat disappointing but not by any means as disappointing as the change in market cap. I don't know what people were thinking about in August, but they were clearly making the world's most optimistic assumptions. Everything would go well. Every asset was salable. Businesses were annuities."

As Klarman does the numbers, HBJ is worth between $1.2 billion and $1.7 billion, "and possibly more." The insurance division produced earnings before interest and taxes—EBIT—of $55 million last year. With a book value in the low $200 million range, it would fetch, he contends, $225 million to $275 million. As for publishing, EBIT totaled about $105 million. The company has promised $30 million in cost-cutting this year. Thus, Klarman continues, economies coupled with no gain in income would yield EBIT this year of around $135 million. (Depreciation of $100 million and capital spending almost constitute a wash.) Based on recent asset sales, says Klarman, HBJ—publishing alone—could easily fetch $1.5 billion to $1.7 billion as a multiple of cash flow, not including the $250 million or so attributable to the insurance division.

"However," he goes on, "to be much more conservative, you might say, 'Let's turn HBJ into a stock.' Let's assume no leverage at all and EBIT of $135 million. If you assume a corporate tax rate of 35%, you'll have approximately $90 million of after-tax income. If you then applied a market multiple to that, you get $1.1 billion. If you applied a better-than-market multiple, which I think you can reasonably do—there are a couple of public comparables that trade at 15 to 17 times' earnings—this thing, totally unleveraged, would command, I think, a 15 multiple, then you'd be looking more at $1.3 billion or $1.4 billion. But even if you wanted to use an even more pessimistic value—if you assume that EBIT of $100 million, or $65 million after tax, down from $90 million after tax—and put a 12 multiple on that, you're still looking at $780 million, which, plus insurance, makes $1.03 billion. At that level, you wouldn't do particularly well, but you wouldn't lose any money. But I think pretty strongly that a 12 multiple is way below what this thing would fetch in a takeover, based on any one of a number of recent transactions.

"But the point I want to make is that with a value ranging, I think conservatively, from $1.2 billion to more optimistically $1.8 billion and possibly as high as the low two billions, the company has only $1.65 billion of total debt, and I think that there's a good chance that the debt is covered. The capital structure is very important here. There's $200 million of 13% debt, there's $500 million of 13%% senior subordinated debt and then there's $950 million of subordinated debt, so there are three classes. There is no bank debt, there is no secured debt. There are two interesting implications of that. One is that if they did go bankrupt, because there's no secured debt, no one would accrue interest in bankruptcy, in all probability. If they filed, cash would go up and would ultimately benefit the subordinated holders. So if they did ever file, it would actually be a big positive for the subordinated debt. Cash would stop going out above them, and there is no cash that goes out below them.

"The company, I think, has a lot of flexibility. It has, at this moment, $190 million or so of EBIT with only $122 million of cash interest expense. That cushion will remain until Sept. 15, 1992, when the payment-in-kind debentures and the 'zero-slash' debentures begin to accrue interest in cash. The first cash interest payment isn't due until March 1993, so they have a three-year window. That's a lot of time for something to happen.

"They have some tight covenants, but they have a lot of flexibility in terms of potentially bringing in some senior debt above everybody, and using that money to retire some of the outstanding debt at a discount. It would be at a discount, but it would have to be considerably above today's trading levels. And I think there's plenty of value, plenty of room, for them to do just that. There are other ways out of it. They could do an exchange offer and convert some of the debt into equity. You could have a raider type come along, scoop up a lot of the debt and engineer a similar type of restructuring. A bankruptcy may be the best option, because it would eliminate the free riders and would provide an effective means of handling the preferred and common without giving them a lot of value."

Klarman spoke before Drexel made the evening news, but he had anticipated some such turbulence and decided to invest anyway. "How did we know in October 1987 that buying Pennzoil at 41, as we did, was a good bargain?" he asks. "How did we know that it wouldn't be 31 or 21 the next day? How did we know that Texaco bankrupt bonds at 90 were going to be a good bargain where we ended up getting 130? How did we know that? The answer is, you never know how low things might go. But it's exactly when all investors are standing around, looking at each other, asking that question, rather than spending their time putting pencil to paper and figuring out the values that you may be getting the best values of your life.

"The activity of the past month, where people have been hitting bids and acting fairly irrationally, getting out of anything that looked like bad junk, in our view, is probably one of the best opportunities you will ever have. Ideally, if you knew there was going to be a liquidation of Columbia Savings & Loan or First Executive, you would love to stand there until they were hitting bids and there were no buyers. You'd not only want to know that they were going to liquidate but also that there were going to be no buyers that day. Then you'd get better bargains than we've had so far. On the other hand, I wouldn't wait until the end of that day to start getting in."

Very well, then. This may or may not be the beginning of the end of the junk bear market. Almost certainly, it is the end of the beginning.

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