The bond insurer's 1996 purchase of a stake in Capital Asset Research proved disastrous. Now, regulators reportedly are probing its guarantee of Capital Asset bonds after MBIA learned of that firm's woes.

MBIA's "Black Hole"

by Jonathan R. Laing

TWO MONTHS AGO, THE REGULATORY CLOUDS OVER the giant municipal and corporate bond insurer **MBIA** seemed to be dissipating. But looks, as the saying goes, can be quite deceiving.

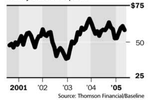
On Aug. 11, The Wall Street Journal reported that investigations of MBIA (ticker: MBI) by the Securities and Exchange Commission and New York Attorney General Eliot Spitzer might be about to end with a joint settlement. Even more heartening to bulls on the company's stock, a draft complaint sent by Spitzer's office to MBIA supposedly focused solely on a 1998 retrospective reinsurance deal that the company had reached with three European reinsurers to cover a $170 million loss. MBIA suffered the loss when the hospital chain Allegheny Health, Education and Research Foundation (Aherf) defaulted on a bond issue insured by MBIA.

Last March, MBIA acknowledged that $70 million of the $170 million in loss-offsetting reinsurance proceeds was, in effect, a loan and not reinsurance. As a result, it restated seven years of earnings, mostly lower.

Better still, the investigators apparently had dropped their interest in other areas of their inquiry, which, knowledgeable individuals say, included how MBIA might have underreserved against future claims, and whether it had improperly accelerated the recognition of advisory-fee income and improperly used a partially owned reinsurer, Channel Re, to artificially pump up its own results. The prospect of a reasonable settlement sent MBIA's stock up nearly 5%, to 60.55, on the day the Journal story appeared. It finished Friday at 60.62.

In recent weeks, however, the shares have been under pressure, largely because of the company's possible exposure to losses on bonds it insured in flood-ravaged parts of the U.S., and securities backed by the now-bankrupt Delta and Northwest Airlines. Another thing weighing on the stock is a probe by the U.S. Attorney's Office in Manhattan into whether there was any criminal misconduct in connection with Aherf. A recent Bloomberg story asserts that two former MBIA officers and a current one are being investigated as part of the probe.

MBIA (MBI - NYSE)
Weekly close on Sept. 29



Source: Thomson Financial/Baseline

Now, *Barron's* has learned that investigators from the SEC and Spitzer's office are looking into yet another area of possible impropriety at MBIA that could delay or alter the expected civil settlement. That probe revolves around MBIA's ill-starred $15 million purchase, in 1996, of a 46% interest in Capital Asset Research, a purchaser of delinquent municipal property-tax liens.

Over the past nine years, that investment has been a disaster. MBIA has lost almost $300 million on its original equity investment, capital advances to Capital Asset and insurance-reserve charges for horribly performing securitizations of Capital Asset tax liens guaranteed by MBIA.

To be sure, many of these losses weren't MBIA's fault. Capital Asset was poorly run, and collecting on delinquent tax liens is difficult. To end the mess, MBIA took over the company in late 1998, by buying the 37% owned by its founder and then chief executive, Richard Heitmeyer. In the summer of 1999, after failing to sell its interest in the company, MBIA put the business into "run-off" and took a $102 million writeoff.

In May, the Wall Street Journal reported that Heitmeyer had said MBIA hadn't disclosed its full exposure to his company. The article added that MBIA denied that anything improper had occurred.

Yet persons in a position to know contend that MBIA indeed made misleading disclosures to investors and rating agencies, covering up the enormity of its exposure to Capital Asset's problems. Failure to disclose material facts would violate securities law.

Investigators are believed to be looking into MBIA's decision to continue to guarantee the bonds of Capital Asset Research after learning in early 1998 of serious problems in that firm's tax-lien portfolio. In two subsequent securitizations, MBIA guaranteed some $328 million in bonds backed by Capital Asset Research tax liens. Defaults on the bonds probably will cost MBIA's New York-regulated insurance subsidiary $200 million in losses.

The securitizations delayed MBIA's recognition of the losses. The company has been taking small reserve charges on the tax liens, quarter-by-quarter, and will do so until 2008, when the last securitization matures.

MBIA's top officials, when contacted by *Barron's*, took vigorous exception to any inference that the company's disclosure of its mounting problems with Capital Asset's tax liens was wanting. In fact, they claimed in a written response to our queries that they saw little peril in the asset class back in 1998, when Capital Asset did the first of the two securitizations now under scrutiny. And, they said, the 1999 securitization met investment-grade standards under MBIA's own valuation criteria and those of a third party, which MBIA executives have declined to name. So, its insurance sub wasn't unfairly treated by the holding company despite the heavy losses the insurer has suffered, according to the officials.

Despite MBIA's protestations, material reviewed by *Barron's* seems to indicate some questionable dealings by the company. One item is a four-hour videotape of a climactic meeting of Capital Asset's board on Sept. 24, 1998, during which MBIA representatives on the Capital Asset board tried unsuccessfully to oust then-CEO Hietmeyer. Unbeknownst to the MBIA team, a concealed videotape machine picked up interesting conversations among the MBIA operatives during recesses when the official audio tape recorder for the meeting was turned off, inviting a certain candor. Both the SEC and Spitzer's office have copies of the video recording.

In one supposedly private exchange, a transcript of which *Barron's* has read, then MBIA chief investment officer and now president and CEO Gary Dunton tells a new Capital Asset director, Matthew Poiset, how MBIA, through no fault of its own, had about $500 million of total exposure to Capital Asset, including its $15 million equity investment, "close to" $100 million in subordinated debt it had furnished to Capital Asset, a $100 million "first loss" guarantee on a $400 million bank line Lehman Bros. had advanced to Capital Asset and a guarantee on a $328 million securitization of tax liens done by Capital Asset in 1997. "So, if you think we don't have the best interest of the company in mind, you are sorely mistaken," he told Poiset, reportedly an associate of Hietmeyer. Earlier in the exchange, former MBIA executive and Capital Asset director Christopher Tilley complains of the Capital Asset investment, "We're [MBIA] losing our shirts."

Yet, on an MBIA investor conference call on Sept. 11, just 13 days before the Capital Asset board meeting, to deal with the mushrooming Aherf crisis, Dunton painted a different picture of MBIA's exposure to Capital Asset. He took a question from the seemingly omnipresent Poiset of the New York brokerage concern Tradition Inc., who asked how much money MBIA had at risk as a result of its equity investment, sub-debt advances and securitization guarantees involving Capital Asset and other parts of MBIA's Muni-Service division.

According to a transcript of that conference call, parts of which *Barron's* has also seen, Dunton replied: "Collectively these businesses represent a little over $40 million of equity investment (Capital Asset apparently represented $15 million of that total)...Collectively, we have made available to these companies something in order of $100 million or so in financing of one type or another...Not that it's [the municipal-service business] a big deal today, but we think over the long-term [it has] some significant potential."

His $140 million—the $40 million investment and $100 million in financing—falls far short of $500 million, and includes equity and sub-debt exposure of three other units in addition to Capital Asset.

Also, MBIA presumably knew that Capital Asset's remaining tax-lien portfolio was badly damaged goods when it transferred the risk on the remaining $328 million of tax-lien assets to its insurance sub, MBIA Corp. This was accomplished through two securitizations, one in late 1998 and one in the third quarter of 1999. With a bit of whimsy, MBIA dubbed the special-purpose vehicle through which the $196 million 1999 securitization was done "Caulis Negris," an incorrect Latin translation of "black hole."

Among the unimpeachable signs of trouble, Lehman all through 1998 was cutting the size of the warehouse credit line to Capital Asset and threatening to call the loan and liquidate all of Capital Asset's unsecuritized tax liens. MBIA, in turn, had sought unsuccessfully to find new warehouse lines for Capital Asset from four other leading Wall Street firms.

Once it gained control of Capital Asset in late 1998, MBIA hired DLJ to look for other credit lines or find a buyer for the company. The two expressions of interest MBIA received were deemed unsatisfactory. Perhaps this was because the bids would have entailed the company recognizing an immediate large loss close on the heels of the Aherf calamity.

So MBIA resorted instead to the Caulis Negris securitization based on its own "valuation analysis" that was also reviewed by a "third-party financial advisor" MBIA declines to identify. In contravention of its usual operating procedure, MBIA didn't have Caulis Negris rated by S&P or Moody's before applying its insurance wrap to make the securitization Triple-A. MBIA likes to brag that it won't insure any bonds that aren't of investment grade on their own without any credit support as part of its much-ballyhooed but conspicuously-unachieved corporate philosophy of "no-loss" risk underwriting.

MBIA's financial fast-stepping allowed it to limit the charge it took on Capital Asset in the second quarter of 1999 to just $102 million, representing mostly a write-off of the $96 million subordinated debt it had spooned into Capital Asset. Since then MBIA has reported "case reserve" charges related to the tax securitization of around $130 million, an accumulation of tiny quarterly charges that should continue up to Caulis Negris' sunset in 2008. MBIA is still on the hook for about $70 million in tax-lien-backed bonds guaranteed by MBIA's insurance unit or held by the company in its "other assets" account.

These bonds represent the dregs of Capital Asset's tax-lien portfolio and will likely remain uncollected. Perhaps a former MBIA vice chairman, Richard Weill, put it best when he was recorded on audio tape at the fateful, Sept. 24, 1998, Capital Holding meeting observing that all that would likely be left at the end of any tax-lien securitization was "nuclear waste." ■

The Bottom Line

Did MBIA conceal the full extent of its exposure to troubled Capital Asset? If regulators find that it did, the bond insurer's troubles are likely to grow.

Elwood Smith for *Barron's*

a barrel and gas fetches $14 per million BTUs].

What about Chevron?

Marcin: Chevron [CVX] has been one of the poorest performers among the mega-cap energy stocks in the past 12 months. Chevron was criticized for supposedly overpaying for Unocal in the spring, but that was when oil was in the 40s. We think Chevron's production profile, which has been viewed as one of the worst in the group, will change dramatically as it brings some large new fields into production. The Unocal acquisition will help. With Unocal, Chevron purchased an excellent reserve base. In the next 12 months, Chevron should go from being one of the worst stories in the sector to one of the best.

How is Chevron valued?

Marcin: It's 64 now. The annual earnings run rate is now around $8. Most estimates are anywhere between $7 to $8 per share for Chevron for 2006 and 2007, and we're comfortable with that.

How does Chevron stack up versus Exxon?

Marcin: Chevron is about 20% cheaper than **ExxonMobil** [XOM] on the basis of P/E and cash flow. Chevron and Conoco represent two of the cheapest energy plays out there. Another point is that exploration and production companies and independent refiners both have higher P/E ratios today than the integrated oils. Historically, the integrateds like Chevron traded at a valuation premium because of lower earnings volatility. The Super Majors have become big uglies of the energy group. We think that represents an excellent opportunity.

Could Chevron hit $80 in a year?

Marcin: Yes. Chevron could easily trade at a 10 or 11 multiple on an $8-a-share run rate of earnings.

Bob, you've been bullish on Motorola from the low teens into the low 20s. It's now 22. Is the move over?

Marcin: No. We don't think the market fully appreciates the turnaround potential in the company's earnings. Motorola's revenues and earnings should continue to surprise people. **Motorola** [MOT] could make $1.75 in 2007 and trade at 20 times earnings. So that gets the stock into the mid-30s. We put out the $1.75 estimate internally about nine months ago, when Wall Street was at $1.08. [The Street consensus has since moved up to $1.37 for 2007.]

That's a big jump in profits. The company is expected to earn about $1.10 this year. How will it happen?

Marcin: We believe Motorola can achieve a 23% market share in cell phone in two years, up from 18% today. And it could achieve its target of 13% to 15% operating margins, up from about 11% now.

What is Motorola doing right that it wasn't doing a few years ago?

Marcin: The new CEO, Ed Zander, has created an intensity level and passion inside the organization that it had lacked. Marketing and execution have improved. Right now the RAZR is by far the hottest cellphone in the world. Not just in New York, L.A. or Chicago, but in Korea, China and Europe. The RAZR is not a product, it's a platform. Motorola is going to have multiple ultra-thin handsets based on the RAZR platform. Motorola also has a candy-bar phone coming out that's going to be very thin. It's termed the SLVR and it could make the RAZR look like a piker in how much growth it achieves over the next two or three years.

The RAZR is a clam-shell design?

Marcin: The RAZR is an ultra-thin, clam-shell handset that is prized for its functionality but also is thin enough to put in your pocket. Motorola doesn't look like a 10 P/E stock, but if you strip out the $3 a share in cash on its balance sheet, it's about a 10 P/E on our 2007 estimate.

Seagate, the largest disc-drive maker, is down to 15 from 21 earlier this year.

Marcin: And the run rate of earnings is $2.20 a share.

Defiance's Picks

Company Ticker	Ticker	Recent Price	Earnings Est. 2005	Earnings Est. 2006	P/E Ratio 2005	P/E Ratio 2006	Defiance's View
ConocoPhillips	COP	$70.91	$8.92	$8.83	7.9	8.0	Oil company has one of the industry's lowest P/Es
Chevron	CVX	65.77	7.04	7.56	9.3	8.7	Unocal deal a plus. Much cheaper than Exxon-Mobil
Motorola	MOT	22.21	1.09	1.24	20.4	17.9	Company's revival still has legs, could earn $1.75 in '07
Seagate Technology*	STX	15.58	1.37A	1.99	11.4	7.8	Plenty of upside if company hits 2006 profit estimate
Terex	TEX	47.28	4.06	5.58	11.6	8.5	Mini Caterpillar set to boost margins, earnings
Too	TOO	27.74	1.49	1.72	18.6	16.1	Tween retailer has strong niche, solid balance sheet

*Fiscal year ends in June

Source: Baseline

So this is a classic Marcin, Defiance stock?

Marcin: It's a classic stock where the P/E is too good to be true. One of two things has to happen. The stock price has to go up meaningfully, or the earnings have to degrade materially. We believe that the investment community has it wrong this time on **Seagate** [STX].

What's the knock against Seagate?

Marcin: The knock is that the disc-drive cycle is as good as it gets. And Seagate is doing so well from a profitability and competitive perspective that it can't possibly do any better. We think that's silly. What's the reality of the disc-drive business? Seagate is the market leader with a 30% market share. Unit growth is accelerating because of consumer-electronic applications and pricing degradation is slowing.

For the first time in five years, the industry is experiencing double-digit revenue growth. Yet there are only two companies making money, Seagate and **Western Digital** [WDC]. The others—**Toshiba, Fujitsu, Samsung** and **Maxtor**—are losing money or breaking even. There is no incentive for the industry to embark upon a price war when the industry on the whole is only breaking even.

What's going right for the industry?

Marcin: Well, the consumer-electronics market, which was only two million units two years ago, could be 75 million units this year. Disc drives are in MP3 players, set-top cable TV boxes. The home-run application would be cellphones. We don't know whether small disc drives or flash memory takes over the storage function of a cellphone handset. Nokia makes a phone that has a hard disc drive in it. If the industry gets 10% of the cellphone market in three years, that'll be 100 million of hard drives in cellphones. If that story plays out, Seagate, with its 30% share, would be a major beneficiary.

Could Seagate hit $25 in a year?

Marcin: It could be a $30 stock. The stock was at $30 two years ago when it had a run rate of earnings of $1.50 a share. It wouldn't be unreasonable to put a 13 or 14 P/E on $2.20 of earnings for a globally dominant technology company with double-digit growth ahead of it.

Tell us about Terex.

Marcin: Terex [TEX] is the third largest construction-equipment company in the world behind **Caterpillar** [CAT] and **Komatsu**. Terex makes earth-moving equipment, mining equipment, aerial work platforms, cherry pickers and cranes. It was the product of a series of acquisitions. The company has been rebranding everything under the Terex name.

The stock is around $47.

Epstein: It's very similar to the Motorola situation. Terex is cheap on Wall Street's earnings estimates and our estimates are significantly higher than the Street's.

Let's start with 2005.

Epstein: This year Terex should earn $4 to $4.25 a share. Next year the Street is at $5.40 and we're at $6.50. For 2007 the Street is at $6.25 and we think the company is capable of making $8 to $9.

Marcin: At 47, the stock trades at a single-digit price-earnings ratio. The company is aiming to get operating margins up to the 10%, where they were in the late 'Nineties, from 6% to 7% now. Terex has double-digit revenue growth ahead of it and a high degree of probability of achieving its operating-margin targets. If the company can get margins to the 10% level, it can earn $8 to $9 a share in 2007. We expect senior management to focus as much attention on improving the operating margins of the businesses as they did in buying them.

Where could the stock be if you're right on earnings?

Marcin: It could be a $100 stock in two years if the company delivers. There's also a major deleveraging story. The company's had $1 billion of net debt in 2003, but it could be essentially debt-free by mid-2007.

What's Terex's issue with the SEC?

Marcin: Part of the reason that Terex is so cheap is that investors are concerned because the company is in the process of doing an audit to restate historical results.

Will the restatement be significant?

Marcin: We don't think so. It's fairly complicated and it has to do with their net-operating-loss positions and internal transfer pricing in 2000, 2001 and 2002. The restatement will not impact the income statement or balance sheet for 2005. It could involve tens of millions of dollars on a company that will generate $6 billion of revenue this year.

Too is the kids' clothing retailer that was a spun out of Limited. It's now around 27.

Epstein: Too [TOO] caters to fashion-conscious "Tween" girls [preteens]. The company is coming off a period of depressed sales and margins and it doesn't have a lot of competition. This is another situation where we have a significantly higher earnings estimate than the Street. For 2006, we see Too earning $2.08 a share, versus the Street at $1.71. So it's trading for about 13 times our 2006 estimate. The company also has $4.50 a share in net cash. Strip out the cash and it's trading around 11 times our estimate of next year's earnings. Too also is expanding another division, called Justice, that is lower-priced than the Limited Too stores.

This is a growth retailer?

Epstein: Comparable-store sales growth is running at 5%-plus, square footage is going to accelerate to the teens. You're talking about 15% to 20% top-line growth.

Where could the stock be in a year from now?

Epstein: It could be at $37 to $42, or 18 to 20 times next year's earnings.

What about financials?

Marcin: We own **Citigroup** [C]. It's a great business and a very attractive stock. It's a question of when, not if, you're going to make money with Citigroup. We also own **St. Paul Travelers** [STA] and **AIG.**

Epstein: We think financials are cheap, but we don't think it's time to make a major commitment to banks given the Fed tightening and the unfavorable shape of the yield curve. When the Fed is done tightening, our position will change dramatically.

What don't you like?

Marcin: There is a fair amount of the stock market that we think is a better sell than a buy today. We think the average company growing revenues at 6% to 8% and trading at 17 to 19 times earnings is a better short than long. Electric utilities are one of the most overpriced sectors of the market.

Thanks, guys. ■