Thain jettisons major bane

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By Frayser White

Less than a month after purchasing $9.3 billion in assets related to CIT Group Inc.'s home lending unit, affiliates of Lone Star Funds inked a deal with Merrill Lynch & Co. Inc. to buy a large block of the Wall Street firm's most illiquid assets, including U.S. asset-backed collateralized debt obligations with a gross notional value $30.6 billion.

The Dallas-based private equity group bought the CDOs in a 75% seller-financed deal for $6.7 billion, or about 22 cents on the dollar.

"Every CDO is a bit unique, so just because Merrill had to sell their products at a certain level, it doesn't mean other products that are similar, but not identical, won't trade higher," Guy LeBas, a fixed-income analyst with Janney Montgomery Scott said of the deal's valuation. He said that while 22 cents on the dollar represented a "sharp," 40% discount to the $11.1 billion carrying value of the CDOs, Merrill Lynch had been assigning a higher carrying value, about 36 cents on the dollar, to the products than the average value assigned by some of its peers.

Merrill's July 28 agreement to sell the assets came as part of a three-pronged plan to raise capital and reduce risky assets following $18.68 billion in losses over the past four quarters, placing it high on the list of financial institutions whose balance sheets have been hardest hit by recent credit-related events.

Recent distressed asset sales such as Merrill's July 28 U.S. ABS CDO sale, are being driven by multiple factors, according to Jeffrey Levine, a managing director with Milestone Advisors LLC. "Some transactions, even if priced at a minimal or no premium to current net book value, remove assets and shrink the balance sheet, generating capital and liquidity in a way that is non-dilutive to existing shareholders," Levine told SNL.

The pricing of the CDO sale, which will require Merrill to take $4.4 billion in additional write-downs in the current quarter, came less than two weeks after Merrill Chairman and CEO John Thain received pressure from analysts, including Oppenheimer's Meredith Whitney, to purge illiquid assets, raise capital and "start fresh."

"I did not create any of these CDOs," Thain said during a July 17 conference call to discuss second-quarter results, including a $4.65 billion loss stemming from more than $9 billion in write-downs on various debt instruments. "I don't think we want to do dumb things," Thain said with regard to Whitney's suggestion that Merrill "set a market" by taking whatever cash bid was out there for illiquid debt instruments, including CDOs, "just to get it over with."

Whitney has subsequently applauded the asset sale, saying "the hardest work" was now completed for the firm following the sale of the CDOs. She said the sale will reduce Merrill's ABS CDO exposures to $8.8 billion, or $1.6 billion net of hedges, compared to $19.9 billion at the end of the second quarter. Whitney maintained her rating on Merrill at "underperform," however, telling clients in a July 29 research report, that while Merrill's stock still sells at a premium to book value and is "expensive" in her opinion, she believes the stock is "getting closer to fairly valued levels as now the hardest work is behind the company."

The ABS CDO sale was most notable for its size, according to Janney Montgomery's LeBas, who said the pricing, which came at what could fairly be described as a "distressed level," was driven lower by the scale of the transaction. "Anytime you have to move $11 billion of a product, it's very reasonable to accept a discount to market," LeBas said.

Merrill provided financing to Lone Star for about 75% of the purchase price, and will be on the hook for the assets if the private equity fund were to go under. The recourse on the loan will be limited to the assets of the purchasing fund, which will not own any assets other than those sold pursuant to this transaction. The transaction is expected to close within 60 days.

"There'd be more activity and higher prices offered in buying these assets if there was more financing available in the market," Milestone's Levine said with regard to an industry trend toward more seller-financed deals. "Financing enhances levered returns to the buyers who in turn can pay a higher price for the assets," he added. "You've just got to make sure you've done your due diligence on who the counterparty is," Levine said, pointing out that it was important to make sure the buyer "has some skin in the game," so that, in the worse case if the buyer defaults, the seller is no worse off than before.

In addition to the ABS sale, Merrill said July 29 that it will raise $8.5 billion through a common stock sale and terminate hedging agreements with monoline guarantor XL Capital Assurance Inc.

As a result of the transactions, the company expects to record a pretax write-down in the third quarter of approximately $5.7 billion. The write-down is comprised of a $4.4 billion loss associated with the sale of CDOs, a $500 million net loss on the termination of hedges with XL Capital Assurance and an approximately $800 million maximum loss related to the potential settlement of other CDO hedges with certain monoline counterparties.

In the third quarter, Merrill also expects to record an expense of $2.5 billion related to its reset payment to Temasek Holdings Pte. Ltd. and $2.4 billion of additional dividends as a result of the exchange of certain existing mandatory convertible preferred stock for common stock as described under an offering agreement. Merrill will exchange the outstanding mandatory convertible preferred securities for common stock or new preferred securities, which eliminates the reset features in the original securities. Temasek, Merrill's largest shareholder, will purchase $3.4 billion of common stock in the public offering, a portion of which is subject to receipt of regulatory approvals.

Merrill's stock rose 7.89% to $26.25 on July 29 on heavy volume. *i*