A publication from EMPIRE FINANCIAL RESEARCH

EMPIRE Investment Report

This Embattled Stock Is a Potential Seven-Bagger in Waiting

It was the single best investment I've made in my career...

I bought more than 1 million shares of mall operator General Growth Properties (GGP) shortly before it filed for bankruptcy in April 2009.

My average purchase price was just $0.67 a share. By the end of the year, the stock had soared to $11.56 – and I had made more than *17 times* my money.

The shares of most companies that file for bankruptcy generally go to zero because they're insolvent, meaning the liabilities exceed the assets, leaving nothing for the equity holders.

But GGP was unusual. Its bankruptcy filing wasn't due to insolvency, but illiquidity. In such cases, the value of the business exceeds the liabilities... But if the company's assets are so illiquid that it can't come up with the cash to repay its maturing debt – and panicked debtholders won't roll the debt forward – a company can go bankrupt.

Just because debtholders force a company to file for bankruptcy, however, doesn't mean they get the company. They're only entitled to earn back the debt plus interest, nothing more. Shareholders get any value beyond this.

Throughout the recession and financial crisis of 2008-2009, GGP's malls continued to generate strong, stable cash flows that far exceeded what it needed to service its debts. Thus, even though the company wouldn't emerge from bankruptcy until November 2010, investors bid the stock up once the panic passed because they could see the value of the underlying business above and beyond its debt.

The higher GGP's stock went, the more valuable it became, because the high share price allowed the company to issue fewer shares to pay down expensive debt, resulting in less dilution to shareholders. It was a wonderful, virtuous cycle.

I haven't seen an opportunity like this in more than a decade – until now...

A similar setup is occurring today in the shares of **Fannie Mae (OTC: FNMA)**, which, along with Freddie Mac (FMCC), are the government-sponsored entities ("GSEs") that underpin the U.S. housing market.

Like GGP, Fannie and Freddie are wonderful businesses that generate huge cash flows. Like GGP, they encountered distress in 2008, which dragged their stocks almost to zero. And like GGP, as they prepare to emerge from what is effectively bankruptcy (their stocks

IN THIS MONTH'S ISSUE:

- Why everything changed in August 2012
- The recent groundbreaking victory in the Court of Appeals
- What happened since Trump was elected... and what it means for shareholders
- Raising our buy price

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currently trade on the pink sheets, as GGP's did), their rising stock prices create a similar virtuous cycle.

As a result, earlier this month, we did something we've never done before: We sent out urgent buy alerts on [September 5] and [September 9] telling *Empire Investment Report* subscribers to establish a 3% position immediately.

So far, we're up 23% on the blended position in a little less than two weeks. But given the bigger picture, we think the gains are just getting started. This month, we'll dive deeper into the Fannie/Freddie story.

Let's start with some background...

THE HISTORY OF FANNIE AND FREDDIE

Fannie Mae was established in 1938 as a government agency, with the mandate to support liquidity, stability, and affordability in the secondary mortgage market. In 1968, it was converted into a for-profit, shareholder-owned business.

Freddie Mac was created in 1970 to securitize mortgages issued by savings and loans institutions. In 1989, it, too, converted into a for-profit, shareholder-owned business.

Even after they were privatized, investors believed – correctly, as we learned in 2008 – that the GSEs had the backing of the U.S. government. This allowed them to access capital at lower rates than their private-sector competitors (banks, thrifts, insurers, etc.). Over the decades, they came to dominate the U.S. mortgage market, the largest debt market in the world.

The GSEs were immensely profitable because they had huge scale, accessed capital at ultra-low rates, and set aside almost nothing in reserves for losses.

They were able to get away with minimal reserves in part because high underwriting standards and rising home prices over the years insulated them from any meaningful losses.

But it was also due to the U.S. government's implicit backstop. Normally, lenders to leveraged financial institutions like the GSEs require meaningful reserves to ensure that their loans will be repaid in the event of a crisis. But lenders to the GSEs didn't have to worry about the possibility of losses because even if the GSEs failed, the government would bail them out.

Without the discipline of the marketplace, the GSEs did two things that eventually led to their downfall...

First, they engaged in fixed-income arbitrage, through which they issued debt, bought mortgage assets, and earned the spread between the two rates. Due to their ability to borrow at ultra-low rates (thanks to the government guarantee) and the high leverage the GSEs employed, this was highly profitable. But it was also risky... and led to $47 billion of losses in 2008.

The second big mistake the GSEs made was to lower their standards as the housing bubble inflated. From 2004 to 2007, their competitors were taking share by making risky subprime and Alt-A loans, so the GSEs began guaranteeing and buying them. By 2007, 13% of Fannie Mae's guarantee portfolio comprised these mortgages, which accounted for nearly *half* of the company's credit losses the following year.

It was these two mistakes, *not* the GSEs' core businesses, that led to the big losses that exceeded their miniscule reserves and put them on the edge of bankruptcy in late 2008.

That September, to avoid their collapse, the government had to decide whether to put them into "receivership" or "conservatorship." The former would have entailed taking over the GSEs and winding them down. Instead, in large part because it wanted to avoid putting the GSEs' combined $5 trillion loan books on its balance sheet, the government chose conservatorship.

In doing so, it provided the GSEs with open-ended lines of credit in exchange for 10% interest on any monies advanced (which ended up totaling $191 billion), plus warrants for 79.9% of each of their stocks. This was an important and necessary action – similar to what the government did with distressed insurer AIG (AIG) – that helped stabilize the housing market and financial system. (I shudder to think of what would have happened had the government not stepped in.)

Critically, however, the government didn't wipe out shareholders. Rather, it left them with a little more than 20% of the stock – the minimum necessary to avoid consolidating the GSEs' debt on the government's balance sheet. This decision has had important implications, as we'll discuss later.

Remarkably, the GSEs didn't go away... In fact, they thrived! With most of their competition weakened or bankrupted in the financial crisis, they were able to grow their market share to 70% in 2009 (it's now around 50%), charge more for their guarantees, and strengthen underwriting standards – all of which dramatically boosted their profits. At the same time, the housing market stabilized and began to recover, reducing losses.

By the second quarter of 2012, the profits finally exceeded the losses and both GSEs reported their first profitable quarters since the financial crisis.

WHY EVERYTHING CHANGED IN AUGUST 2012

Just as shareholders were set to benefit from the GSEs' improving fortunes, however in August 2012, the government announced something called the "Third Amendment" in which it would take all of the GSEs' profits going forward. This so-called "net worth sweep" left shareholders with nothing and the GSEs without the ability to rebuild their capital. Since then, the GSEs have sent the government a total of $301 billion, far more than the $191 billion the government advanced.

For those keeping score at home, the GSEs have now repaid the government in full... *plus* interest... *plus* the government still owns warrants for 79.9% of their stocks... *plus* the government has pocketed *additional tens of billions* from the companies.

By imposing the Third Amendment, the government achieved two goals: One, it solved a political problem. It wouldn't have looked good for big hedge funds – who were the GSEs' largest shareholders by that point – to make billions from investments in entities bailed out by the government. And two, the government got access to tens of billions of dollars each year that it could spend as it saw fit.

While this has been great for the federal budget, shareholders are understandably furious. They bought the stock based on the terms of the 2008 bailout, in the same way that private investors bought shares of other financial institutions and automakers that also received bailouts like AIG, Bank of America (BAC), and General Motors (GM).

But then, in the case of the GSEs – and *only* the GSEs – the government, without warning, arbitrarily changed the terms of the deal. So a number of large GSE shareholders – mostly hedge funds – filed suit, challenging the net worth sweep on a number of grounds.

In our opinion, the shareholders' lawsuits should have been slam-dunk victories for reasons outlined beautifully in the May 2016 issue of my friend Porter Stansberry's excellent newsletter, *Stansberry's Investment Advisory.* As he concluded...

> The government may try to frame this as billionaire hedge-fund managers versus taxpayers... but justice and common sense will ultimately prevail. All it takes is about 90 seconds of researching the actual facts to figure out who's the real bad guy.
>
> Treasury officials clearly stole from shareholders. Fannie and Freddie executed a political mandate to make housing affordable, and got wiped out doing so. To take their property now would be the worst kind of abuse. And mountains of evidence will show that the government has repeatedly lied in court and court filings.
>
> This can't possibly go the defendant's way.

The government's primary defense is that its actions were essential to avoid a "death spiral" in the national housing market.

This is nonsense! By 2012, the crisis had passed, the housing market was recovering, and the GSEs were having no difficulty accessing the capital markets. In reality, the government's actions weren't driven by the fear that the GSEs were going to post ongoing losses... *It's because the GSEs were about to become massively profitable*.

If the government was honest about why it implemented the net worth sweep, a court would surely overturn it, so the government's attorneys continue to make the death spiral argument.

You might think the courts would see through this obvious lie, but for years they rejected the shareholders' lawsuits for a simple reason: Judges are humans, and they'll do almost anything to avoid enriching billionaire hedge-fund managers, who aren't exactly sympathetic plaintiffs.

THE RECENT GROUNDBREAKING VICTORY IN THE COURT OF APPEALS

Until 12 days ago, the situation remained a stalemate. But then, on September 6 – 11 years after the GSEs went into conservatorship – the U.S. Court of Appeals for the Fifth Circuit issued a judgment that was a huge victory for shareholders.

In it, the Court of Appeals overturned a lower court and ruled that the net worth sweep violated the law and remanded the case back to the lower court "for further proceedings."

It's worth noting that the Court of Appeals also ruled that the structure of Fannie and Freddie's regulator, the Federal Housing Finance Agency ("FHFA"), is unconstitutional because of job protections for the agency's director, but this is less important.

Here are excerpts from the decision:

> We hold the Shareholders stated a plausible claim that the Third Amendment exceeded statutory authority. Transferring substantially all capital to Treasury, without limitation, exceeds FHFA's powers to put the GSEs in a "sound and solvent condition," "carry on [their] business," and "preserve

> and conserve [their] assets and property." We ground this holding in statutory interpretation, not business judgment.
>
> In adopting the net worth sweep, the Agencies abandoned rehabilitation in favor of "winding down" the GSEs... this "wind down" exceeded the conservator's powers and is the type of transaction reserved for a receiver.
>
> As a textual matter, the net worth sweep actively undermined pursuit of a "sound and solvent condition," and it did not "preserve and conserve" the GSEs' assets...
>
> [The] net worth sweep continues transferring the GSEs' net worth indefinitely, well after Treasury has been repaid and the GSEs returned to sound condition. That kind of liquidation goes beyond the conservator's powers.

The decision is already having an impact...

The following Monday morning, Treasury Secretary Steve Mnuchin said in an interview that the Treasury is "in the process of negotiating with" the FHFA. "We expect a near-term agreement to retain their earnings," he said.

Then, last week, when asked about negotiations to end the net worth sweep, Mnuchin said (emphasis added):

> That's something that the FHFA and we are working on. We are actively negotiating an amendment, and I think our objective is to try to get it done by *the end of the month.*

BACKGROUND ON THE TRUMP ADMINISTRATION'S EFFORTS TO PRIVATIZE THE GSES

The last two months of 2016 following President Donald Trump's surprise election-night victory were a boon to the stocks of both GSEs.

The new administration indicated that it wanted to strike a deal to liberate the GSEs from government control, which caused the shares to double from less than $2 to around $4. Here's an excerpt from an interview Mnuchin did with CNBC anchor Maria Bartiromo shortly after the election...

> **Bartiromo:** Would you move to have these privatized?
>
> **Mnuchin:** Absolutely. We gotta get Fannie and Freddie out of government ownership. It makes no sense that these are owned by the government and have been controlled by the government for as long as they have. In many cases, this displaces private lending in the mortgage markets and we need these entities that will be safe. So let me just be clear, we'll make sure that when they're restructured they're absolutely safe and they don't get taken over again, but we gotta get them out of government control.
>
> **Bartiromo:** This is a big deal. These are huge institutions. You think that... if we saw that as not complicated, wouldn't that have happened already... that it would get out of government?
>
> **Mnuchin:** Well, I think with [the Obama] administration, it hasn't been a priority. If it had been a priority, it would have. And in our administration, it's right up there in the list of the top 10 things that we're going to get done and we'll get it done reasonably fast.

For the next two years, however, Mnuchin made little progress. Shares of both GSEs drifted lower to around $1 by the end of 2018.

This year, shares have rallied on renewed hopes that the Trump administration will act unilaterally, without Congress passing a bill, to recapitalize and release the GSEs from conservatorship.

On March 27, the White House released a "Memorandum on Federal Housing Finance Reform," which directed Mnuchin to "develop a plan for administrative and legislative reforms to achieve the following housing reform goals." Those included plans to end "the conservatorships of the GSEs upon the completion of specified reforms."

Two weeks ago – coincidentally, the day before the Court of Appeals ruling – the Treasury issued its plan, which was an important step in the privatization process. But the devil will be in the details: What can be done administratively (i.e., without Congressional action, which is unlikely)? How much capital will the GSEs have to raise? How and when will they raise it? And how much will the government charge for its backstop?

The answers to these questions, which will be determined via negotiations among many different stakeholders – shareholders, the White House, Treasury, FHFA, Congress, advocacy groups, etc. – will largely determine how much value remains for shareholders.

That's why the legal victory two weeks ago was so important. It not only greatly strengthens the shareholders' negotiating position, but also gives Mnuchin and FHFA head Mark Calabria the political cover they need to do what they want – namely, implement a recapitalize-and-release plan that treats shareholders fairly and causes the GSEs' stocks to go up for the two reasons outlined below.

Prior to the ruling, if their plan had led to a substantial rise in the GSEs' stocks, they would be accused of acting to enrich their Wall Street buddies. But now they can say that, in light of the Fifth Circuit ruling, their hands are tied. They have no choice but to treat shareholders fairly, because otherwise they risk further losses in court.

MY INTERVIEW WITH LONGTIME FANNIE EXPERT MICHAEL KAO

For further insight on the GSEs, I turned to Michael Kao, who runs hedge fund Akanthos Capital.

In May 2011, Michael gave a brilliant presentation on the GSEs at my Value Investing Congress, pitching their preferred shares when they were trading at six cents on the dollar (and their common stocks were at $0.43).

Michael first bought the preferreds in 2008 and has owned them ever since. Suffice it to say he's one of the leading experts on the subject. He was kind enough to take time out of his day to chat with me recently. Here are excerpts from our conversation...

On the recent ruling by the Fifth Circuit Court of Appeals

> It was obviously a huge positive, though I wish it had just mandated the end of the net worth sweep rather than remanding to the lower court to do it.
>
> Everything else was super positive, though I have no idea whether Mnuchin will appeal to the Supreme Court.
>
> On the one hand, I could easily see him not appeal and use the government's legal defeat as a pretext for what they have to do in terms of cleaning up the liabilities and settling with shareholders. On the other, it wouldn't surprise me if he appealed. I just don't know how politically stuck he is to show that he's not overtly in support of shareholders.
>
> If he does appeal, given the makeup of the Supreme Court, I would tip the odds in favor of the Court upholding of the Fifth Circuit decision.

On Mnuchin

> He has been very careful, especially coming from Goldman Sachs. It was the same thing with former Treasury Secretary Hank Paulson, if you remember. I think these guys have to be careful not to seem partisan to big banks and hedge funds. Mnuchin is walking a tightrope.
>
> The big issue over the last couple of years is that he has had almost zero political cover to do anything. But now, it seems like the stars are all aligning in our favor, especially with Calabria, and that the loud anti-GSE voices have somewhat quieted down.

Whether Congress will do anything before the 2020 election

> No. At the recent Senate Banking Committee hearing, where Mnuchin, Calabria, and Housing and Urban Development Secretary Ben Carson testified, Senators were lambasting Calabria about how Fannie and Freddie could have gotten to this point of 1,000-to-1 leverage after 11 years of conservatorship.
>
> If the government pillages their capital structures to the tune of $310 billion over 11 years, of course they're not going to have a capital cushion! No one bothered to even talk about that. The depth of ignorance in Congress is incredible, especially after all this time. I think most members of Congress simply have no clue what a bad actor government has been here.
>
> The banks that received Troubled Asset Relief Program ("TARP") funding from the government were basically paying a 5% dividend, so even the 10% that the GSEs had to pay prior to the net worth sweep was usurious.

> Even so, eventually they would have had the earnings power to overcome that 10% dividend. I predicted that in 2011, and it came to fruition by the second quarter of 2012. But I never expected that just as they started to blow out their earnings, making profits beyond the 10% dividend, they would be ransacked two months later with the Third Amendment. I was appalled.

What could go wrong

> The one negative here with respect to the Fifth Circuit decision is that the president can now terminate the FHFA director for any reason, not just for cause. This elevates the risk if Trump isn't reelected. If, say, Sen. Elizabeth Warren wins the election and fires Calabria, we're back to square one, unless Mnuchin and Calabria move so quickly that a new administration can't "unscramble the egg." All of these things conspire to bolster their urgency argument.
>
> I agree with and endorse your theory that Mnuchin and Calabria are urgently taking administrative actions and negotiating a deal with the shareholders to resolve the lawsuits. They want to get Fannie and Freddie far enough along the recap-and-release bandwagon that a new president can't reverse it.

What could stop this

> I have no idea how to predict something like a lawsuit that would require congressional action to release the GSEs. This has been such a long journey, filled with lots of unexpected plot twists. During Calabria's testimony, he pointed out that the longest bank conservatorship lasted 18 months. Yet here we are, going on 12 years...
>
> They have to do *something*. There will be hell to pay if we experience another housing crisis and the GSEs are still naked with no capital buffer. No one wants to own the next housing crisis where Fannie and Freddie suffer delinquencies and require another bailout. Then, fingers will get pointed about whose watch this happened under and who could have stopped it. No one wants to own that.

The GSEs' potential earnings power

> It's huge. In the short term, earnings power is likely to be dampened due to the flat/inverted yield curve. But in a more normalized environment with a normal-shaped yield curve, net interest margins could explode for businesses that borrow short term and lend long term.
>
> Then, of course, there are the guarantee fees. The government wants to foster competition and have private capital step in, but private capital is just not interested in competing with the GSEs at the current fee level. If they really want to privatize this, those fees have to go up – and if that happens, the leverage on earnings power for the GSEs is *massive*.
>
> I'm kind of skeptical that we're going to see a lot of new competition. We either won't see that much competition at this level (in which case the oligopoly is effectively maintained) or we'll see more competition (but at a higher price). Either protects the moats of these two companies.
>
> One final note... Expect the unexpected. I never would've guessed that this would've been an 11-year hold for me. When I presented at the Value Investing Congress, I had already held the preferreds for two-and-a-half years, and I thought maybe this was going to take another two or three years... not eight or nine!

WHAT TO DO WITH THE GSES

We've seen dozens of ideas about what to do with the GSEs, including winding them down and letting private companies and capital replace them. But over the past decade, it has become clear to nearly everyone that the GSEs are too big and entrenched, too systemically important, and too good at what they do to replace them.

In particular, they make possible affordable, 30-year, fixed-rate, pre-payable mortgages that Americans have come to know and love – and which no politician will risk jeopardizing. Love 'em or hate 'em, the GSEs are here to stay.

If they're not going away, what should be done with them?

Bill Ackman, my college friend and manager of hedge fund Pershing Square, laid out the right answer in a 111-slide presentation at the Ira Sohn Conference in May 2014. He called for requiring increased capital levels... limiting certain risky business activities such as speculating in fixed-income arbitrage... increasing regulatory oversight, including annual stress tests... and improving governance and compensation plans that discourage risk-taking.

So why hasn't this happened? To some extent, because the various parties disagree about what should be done... But mainly for two reasons: disagreement over whether Congressional action is necessary, and the appeal of the status quo to politicians and regulators.

The GSEs and the housing market have recovered from the financial crisis and are doing reasonably well, so they're unlikely to require another bailout. Plus, many in government are *delighted* to keep collecting $20 billion-plus a year from the GSEs.

Despite the comfortable status quo over the past decade, we're confident that big changes will happen because Trump's administration wants to recapitalize and release the GSEs from conservatorship and even if it didn't, the recent court ruling will force the government to act.

Mnuchin and Calabria are the two key players. Mnuchin has long pushed for administrative action to release the GSEs from conservatorship, but he was stymied by former FHFA director Mel Watt, who was adamant that Congressional action was needed.

Calabria, who was appointed head of FHFA last December and confirmed in April, has the opposite viewpoint. He has publicly questioned the legality of the net worth sweep and pushed hard to get the GSEs out of conservatorship.

WHAT THIS MEANS FOR SHAREHOLDERS

Though the GSEs' stocks are up big this year, they're still deeply depressed due to uncertainty about whether Mnuchin and Calabria will be able to implement their plan – and whether it will be good for shareholders.

We're optimistic on both fronts and thus think that Fannie's shares still have multi-bagger upside potential.

That said, the plan isn't going to be a giveaway to shareholders. It will require the GSEs to rebuild their capital – so taxpayers will never again have to bail them out – by raising billions of dollars and requiring them to retain all earnings for many years. Plus, the government will charge the GSEs a fee for its explicit backstop. But these businesses are so dominant and profitable that there will be plenty of value left for shareholders.

To a large extent, however, the analysis here isn't of the companies, but of Mnuchin and Calabria. If they wanted to, they could implement a plan that would crush the GSEs' stocks by forcing them to do a large capital raise that dilutes shareholders into oblivion, for example.

A key part of this analysis is understanding Mnuchin and Calabria's incentives. If we assume that they view themselves as fiduciaries for the American people (which they are), it would make no sense to implement a plan that would hurt the stocks, for two reasons. First, the government still owns 79.9% of the common stock (via warrants), a stake that could be worth more than $100 billion. Why would it want to destroy this value?

Second, in order to raise the tens of billions of dollars needed to rebuild their reserves and exit conservatorship, the GSEs need to attract new investors to provide this capital. How are they supposed to do that if they crush the old shareholders? Instead, it makes far more sense to adopt a plan that causes the stocks to go up over time.

WHAT IS FANNIE MAE WORTH?

Normally, valuing a stock involves a hard step (valuing the business) and an easy one (dividing by the number of outstanding shares).

But in this case, the latter is actually more difficult than the former.

Fannie Mae returned to profitability in the first quarter of 2012 and has been profitable every quarter since then (though we've seen big fluctuations due to changes in interest rates, adjusting reserves, etc.).

This makes it hard to estimate normalized profits. But if we start in 2014 – which excludes huge one-time gains in 2013, as the company reversed reserves booked during the financial crisis – the average quarterly profit has been $3.25 billion, or $13 billion annualized.

Interestingly, Fannie Mae's trailing 12-month profit is almost exactly this amount ($13.1 billion), so let's use this number for normalized earnings. This is conservative, as earnings could grow substantially if the GSEs raise their guarantee fees and the yield curve normalizes.

The market is likely to put a below-market multiple of 13 to 16 times on Fannie Mae's earnings, at least for the next few years while the recap-and-release plan plays out and the company retains its earnings to rebuild capital. Multiplied by $13 billion, this yields a market capitalization between $169 billion and $208 billion. Divide that by 5.9 billion shares outstanding (which factors in the government's 79.9% stake), and **that yields a share price between $29 and $35 – a seven- to nine-bagger from here.**

It's time to back up the truck, then, right? Not so fast...

The problem is, when all is said and done, Fannie Mae will almost certainly have more than 5.9 billion shares outstanding.

For one, the government is going to require the GSEs to build substantial reserves before releasing them from conservatorship. (Recall that today, they have almost none, because the government has been taking all of their profits since 2012.) Ending the net worth sweep is an important step because it will allow the GSEs to build reserves by retaining earnings.

Plus, Mnuchin and Calabria's plan will likely require the GSEs to do a stock offering to raise capital quickly. How much dilution this causes will depend on how much in total reserves the GSEs need to eventually have, how much they are required to raise now, and at what price.

It's hard to know what the total reserve requirement might be – Mnuchin and Calabria have been cagey about it – but estimates have ranged between $100 billion and $200 billion, so let's take the midpoint of $150 billion. Splitting that between the two GSEs based on relative assets, Fannie Mae's share would be $93 billion. If it continues to earn $13 billion annually, it could raise this amount in seven years... But I suspect the government will want the GSEs to get there sooner, so let's assume a $10 billion capital raise for Fannie Mae as part of the recap-and-release plan.

The dilution that occurs will depend on the share price. Mnuchin and Calabria will likely put forward a plan that removes a great deal of uncertainty, and then take both companies public, which will take their stocks off the pink sheets. This will make them must-own securities for institutions and index funds. At this point, the IPO price would probably be around $10 a share, resulting in a relatively minor dilution of 1 billion shares. Raising $10 billion would increase the outstanding share count to around 6.9 billion.

The other wildcard that could materially affect the share count is what happens to the various tranches of preferred stock, which are currently trading at roughly 50 cents on the dollar. Fannie Mae has $19.1 billion of face value outstanding and Freddie Mac has $14.1 billion. Some preferred shareholders think that, as part of the recap-and-release plan, the government will convert the preferreds to common stock at par.

If this does happen, it would dilute shareholders by nearly half at current share prices, since Fannie Mae's market cap today (5.9 billion shares x $3.95/share = $23.3 billion) is only slightly higher than the face value of the preferreds. That said, I seriously doubt this will happen. Mnuchin and Calabria aren't stupid, and there's no reason to convert the preferreds at all. They're a lousy security for the preferred holders (and good for the GSEs) for a variety of reasons: They're non-voting (unlike the common), non-participating (meaning their dividends are capped, unlike the common), and most important, "non-cumulative," which means that if the GSEs choose not to pay a dividend – which has been the case ever since the financial crisis – no payments accrue (unlike debt).

While, the GSEs can't pay a dividend to the common stockholders without also paying a dividend to the preferred shareholders, this is a moot point for the foreseeable future, as the GSEs will be retaining all earnings for many years to come. Thus, I think the government will leave the preferreds outstanding and not pay them any dividends for many years.

This doesn't make them bad investments... I think they're likely to eventually be converted at par, which would result in the share prices doubling, but this could take years.

Meanwhile, I expect the stock to be far more than a double. Based on the assumptions above, if Fannie Mae's share count increases to 6.9 billion, this would result in an intrinsic share price of $25 to $30 – still a potential six- or seven-bagger.

Despite the big upside from here, we need to size this position small because of the many risks, including...

- The housing market could take a dive, turning the GSEs' profits into losses and requiring more capital from the government (since they have almost no reserves).
- Mnuchin and Calabria's plan could run into opposition and nothing happens, in which case the stocks could drift back to $1, where they were at the beginning of this year.
- The government's recap-and-release plan could call for huge capital raises and/or conversion of the preferreds that leads to massive dilution, crushing the GSEs' stocks.
- A new president could try to nationalize the GSEs, which could wipe out shareholders entirely.

This story will no doubt feature twists and turns along the way, and it will likely take years to play out. But ultimately, we think shareholders will end up owning almost 20% of two dominant, highly profitable, well-capitalized businesses serving the largest debt market in the world, whose stocks will soon be trading multiple times higher than their current levels.

We initially had a maximum buy price of $3.50, but in light of the court ruling and Mnuchin's comments since then, we're raising it to $4.50.

That said, there is a great deal of uncertainty here. It's not out of the realm of possibility that shareholders could suffer large, permanent losses, which is why this needs to be sized accordingly – currently a 3% position in the *Empire Investment Report* model portfolio. If you haven't already done so...

ACTION TO TAKE

Buy Fannie Mae (OTC: FNMA) up to $4.50 a share, making it a 3% position.

PORTFOLIO UPDATE

It was a strong month for our portfolio, driven in part by a strong rotation in the market away from momentum stocks toward some beaten-down value ones.

There was little news of note among the stocks in our portfolio, other than with our old friend **Lumber Liquidators (NYSE: LL)**, where developments have been unfolding rapidly, whipsawing the share price around. In last month's issue, I wrote...

> Over my 20-plus years on Wall Street, I've owned dozens of stocks in which the financials and the share price went into freefall... But a case like this – where there's a huge disconnect between a crashing stock versus a business with stable fundamentals – doesn't come along often. These are the kind of mistakes the market occasionally makes where long-term-oriented investors with strong nerves can make multi-bagger returns...
>
> We're not the only people who see how cheap Lumber Liquidators is...
>
> Just yesterday, Tom Sullivan – the company's founder and former chairman and CEO – revealed in a Schedule 13D filing with the U.S. Securities and Exchange Commission ("SEC") that he had bought more than 1.3 million shares (equal to 4.7% of the total shares outstanding) in the eight trading days starting on August 7... just after Lumber Liquidators' earnings release...
>
> Any way you cut it, this is great news for the stock. While Sullivan wasn't a great manager, he built a heck of a business from nothing, with revenue exceeding $1 billion. He had great instincts and knew how to move product. In short, he was a great salesman – and that's what Lumber Liquidators desperately needs right now.

At the time, the stock was trading around $9. Two weeks later, Sullivan announced that he had increased his stake to 7.7%, was interested in taking the company private, and was in discussions with bankers and private equity firms. This caused the stock to close as high as $13 last week.

Then, in a surprise filing with the SEC, Sullivan disclosed that he had dumped nearly all of what he had just acquired, reducing his stake to a mere 1.6%, noting that "due to the significant price appreciation of the stock, [he believes] that the Common Stock is no longer undervalued." He said his plans to buy the company "are now less prudent at these elevated levels." The shares tumbled and are back down around $9.

What the heck was Sullivan doing?

I don't know for sure. Perhaps it was just a classic pump-and-dump scheme – he did pocket almost $5 million in less than a month – but I doubt it.

I think he'd really like to take Lumber Liquidators private for three reasons...

1. He has a personal attachment to it. It's his baby, he's furious that he was ousted, and he wants it back.
2. He's frustrated that the company is performing so poorly and believes he could fix it – and make a lot of money doing so.

3. Lumber Liquidators is suing him for $10 million for violating an agreement that his new business (Cabinets to Go) wouldn't sell flooring, which Lumber Liquidators claims it's now doing.

I suspect the reason Sullivan quickly reduced his position is because he realized that by revealing his plans, he had caused the stock to run up so much that he couldn't get a deal done.

When he bought the stock slightly below $8, he might have figured that the board and shareholders would accept a buyout price of $12 – a 50%-plus premium to the share price at the time. But when the stock ran up to $13, he would have had to pay, say, $15, which he was unwilling (or unable) to do.

So Sullivan pocketed a cool $5 million, and now he waits, hoping the stock falls enough that he can offer a substantial premium, yet still steal the company with a lowball bid. Under this scenario, he'll keep future purchases under 5% of the shares outstanding so he doesn't have to publicly disclose what he's doing. Then he'll line up a fully financed bid and spring it unexpectedly.

This possibility will likely provide some support for the share price, but going forward we expect that the stock will trade in line with the fundamentals.

One final note on Lumber Liquidators...

Last week, I met again with CEO Dennis Knowles. Joining us was my friend Donovan Royal, a longtime industry veteran (and LL shareholder) who has been my best source of insight on the company and the industry.

Donovan and I did a deep dive with Dennis, seeking to better understand the company's challenges and what he and his team are doing to overcome them.

Externally, Lumber Liquidators' biggest headwind is the trade war with China and the 25% tariff.

At first glance, one might think that this could severely affect the company's margins and profits, but there are some important offsets. First, Chinese suppliers have made substantial price concessions. Second, China's currency has weakened quite a bit against the dollar. Lastly, upstream supply costs (which are not subject to tariffs) – the largest of which is shipping – account for a substantial percentage of the cost of goods sold for a bulky product like flooring.

When you combine these factors, Donovan estimates *half* of the tariff impact has been mitigated already.

Dennis also told us that the company is starting to receive meaningful amounts of product from South Korea, which isn't subject to tariffs. Another headwind he mentioned a number of times was the sharp sales decline in bamboo flooring, but he expressed optimism that this has since stabilized.

While the headlines are focused on the external issues, we're more concerned with internal things Dennis can control: an apparent lack of urgency at the store level around converting foot traffic into sales, high overhead costs, and additional store openings when the current model needs to be fine-tuned.

We emerged from the meeting cautiously optimistic that Dennis is up to the task of turning Lumber Liquidators around.

Even modest progress could lead to the share price doubling from today's levels, and we're now more confident that our downside is protected because there is little doubt that Tom Sullivan would happily take the company private at a minimum of $10. (For perspective, the company went public at $11 in 2007... and the company now has four times the number of stores!)

We continue to recommend shares of Lumber Liquidators (NYSE: LL) up to $14.

Best regards,

Whitney Tilson
September 18, 2019

Prices as of September 17, 2019

Position	Ticker	Description	Reference Date	Reference Price**	Dividends	Recent Price	Return*	Advice
Alphabet	GOOGL	Tech Conglomerate	4/17/2019	$1,242.70	$0.00	$1,229.88	-1%	Buy up to $1,350
Amazon	AMZN	E-Commerce Giant	4/17/2019	$1,864.39	$0.00	$1,822.55	-2%	Buy up to $2,000
Berkshire Hathaway	BRK.B	No. 1 Retirement Stock in America	4/17/2019	$201.41	$0.00	$210.15	4%	Buy up to $230
Facebook	FB	Social Media Titan	4/17/2019	$178.16	$0.00	$188.08	6%	Buy up to $200
Lumber Liquidators ^	LL	Hardwood Flooring	4/17/2019	$10.93	$0.00	$8.96	-18%	Buy up to $14
Howard Hughes	HHC	World-Class Real Estate	5/15/2019	$111.27	$0.00	$128.76	16%	Buy up to $125
Rosetta Stone #	RST	Language Learning	6/19/2019	$21.94	$0.00	$19.22	-12%	Buy up to $26
Allison Transmission	ALSN	Automatic Transmissions	7/17/2019	$45.78	$0.15	$46.91	3%	Buy up to $52
Capri Holdings	CPRI	Luxury Goods	8/21/2019	$27.97	$0.00	$31.69	13%	Buy up to $33
Fannie Mae ^^	FNMA	Government-Sponsored Entity	9/5/2019	$3.21	$0.00	$3.95	23%	Buy up to $4.50

** Includes dividends.*
*** Reference price is the volume weighted average price (VWAP) for the day after a recommendation is made. VWAP considers volume and share price to calculate a stock's average trading price throughout the day.*
^ Added to position on 6/19/19 and 8/21/19.
 # Added to position on 8/21/19.
^^ Added to position on 9/9/19.