

When High Tech Firms file for Bankruptcy what Assets might a Distressed Investor find?

# Syracuse Distress Investing Talk on Nortel

# May 2013

- This item is the starting point for this talk!
- **When Nortel filed for bankruptcy in January 2009, one set of the Company's bonds climbed from less than 14 cents on the dollar to a high of 118 cents. The value climbed as bankruptcy lawyers, led by the law firm Cleary Gottlieb, organized a series of auctions that netted billions of dollars more than the opening bids.**

# What is Nortel?

- Alexander Graham Bell invented the telephone in Brantford, Ontario Canada July 1874... a mere 140 years ago.
- Nortel emerged as the Bell Labs of Canada in 1895.
- By the 1990's Nortel was a multinational equipment manufacturer employing 95K people worldwide. By the summer of 2000 its stock made up over 33% of the TSX Capital Weight!

# Nortel Stock Price 1998 to 2003



- Sept 1 of each year.

# Nortel Stock Price A Sad Story

- Sept 1 1998 \$200
- Sept 1 1999 \$1274
- Aug 1 2000 \$8147
- Sept 1 2000 \$6023
- Sept 1 2001 \$561
- Sept 1 2002 \$54
- Most Canadian Investors Owned Nortel Stock.

# What Happened?

- Nortel Meridian is/was a private branch exchange. It provided these features. This was communications in the 1970's to 1990's.
- Voice and data connectivity, LAN and CTI, and information services for communication applications ranging from 60 to 80,000 lines.
- Out of the office Voicemail, Conference Calls, Call Forward, Call Display and Radio Paging!
- Hello Text Messaging
- Nortel's labs were inventing more features in Toronto and new patents were also added via acquisitions.
- However by 2000/2001 they had been leapfrogged.

# Technological Change and the Problem of Company Size.

- Nortel lost its ability to innovate.
- Size and Bureaucracy.
- Defending the current products and the market moved.
- Does the firm have interesting Intellectual Property?
- Where is IP and is it being defended?

# Look at a Bankrupt Company?

- Equity or Bonds?
- What is real on the Balance Sheet?
- Why is the Capital Structure so important?
- How do Portfolio Managers and a Research Team work together?



# Nortel Assets in 2009

- What happened to the biggest company in Canada?
- By 2008/2009 some 7 years after accounting issues, management changes and the introduction of mobile phones as mobile offices what was left?
- Why buy securities of a Company that will file for bankruptcy?

# Convertible Arbitrage.

- Let's make sure we all know this investment strategy.
- Why "GO" long the bonds and short the stock.
- The math of "Delta" Options Pricing
- Convertible Bonds are a favorite of high tech bankers. Cheap debt with an equity kicker.
- Investment process is to find over-priced stock linked with bonds that have value.

# Convert Players

- Are they Equity Analysts?
- Are they Bond Analysts?
- Are they just Quants?

# Nortel Convert Arb in 2008

- PMs take a small position in early 2008 stock is at \$8.50. The convert is at 81 cents.
- This trade will go from a Convert Investment to a Distressed Investment.
- A good researcher/analyst/portfolio manager sees both trades.
- Once Nortel enters bankruptcy in late 2008 no reason to short the stock... it is at pennies.

# GAAP Accounting

- What the Balance Sheet reflected
- Cash, A/R, Inventory.
- What the Balance Sheet did not reflect.
- Intellectual Property.
- How come?

# The Real Assets

- The Bankruptcy Administrators sold off the operating companies for \$3.2 Billion.
- Those Companies had made a \$5.8 B loss in 2008. They had Debt Outstanding of \$4.5B
- Cash, Accounts Receivable and Inventory was valued at \$6.6B, of that \$2.6B was cash.
- The goodwill (IP) from acquisitions was carried on the 2008 balance sheet at \$180M written down from \$2.5B and intangibles had a value of \$143M.

# How Does This Math Work?

- Sale of the Operating Companies gets the inventory, receivables, plant and equipment off the asset ledger with the short term payables off the liability side.
- The bankrupt Holding Company is left with the cash, intangibles, long term debt and the pension liability.

# Intangibles and Goodwill

- Nortel held 9000 patents developed in their labs or by acquisitions of Companies like Bay Networks.
- The CA/CPAs in the face of Nortel's losses and the financial crisis felt intangibles and goodwill were of little value.
- Accountants are not engineers or tech salesman.
- If only someone would bid on this stuff!



# Setting up a Stalking Horse

- This process run by the Bankruptcy Law Firm is similar to a minimum bid at an Art Auction.
- If only you can get a bidding war.
- Which Engineers and Tech Sales Teams have an ego and need for product?
- How about Google vs a Consortium of Apple, Microsoft, Blackberry, Ericsson and others?

# Stalking Horse Becomes Google

- Google is the Minimum Bid \$900M
- Consortium makes the Winning Bid \$4.5B
- That was for the 6000 Wireless Patents.
- This strategy was used for the entire portfolio of Patents with multiple separate auctions.

# The Bond Investment

- On news of filing, the Converts fell from 81 to 10 cents for every \$1 of Par. Remember the convertible arbitrage desk is also short the stock. It was still a bad day!
- Hedge ratio or the Delta was 20%
- PMs buy more CBs at 12 to 20 cents for every \$1 of Par.
- Takes work and courage!

# Sum of the Parts

- Cash \$2.6B
- Patents Sales ?
- Debt \$4.5.
- At least 25 to 50% coverage.
- Decide to buy more Converts across the trade desk across the portfolios. Now PMs start looking at High Yield Bonds.

# End Game

- Even with \$1B in legal and accounting fees cash available after all patent and operating company sales over \$7.5B
- Some Converts are sold for 95 cents in 2012.
- Some of those proceeds swapped into High Yield Debt bought at 105.
- Today Converts are at 100, High Yield at 118.

# What did we learn?

- Hi Tech and Telecom can be a high wire act.
- Technological change can leapfrog your product.
- Companies may not see the future.
- The future might be in the lab.
- Management almost always protects the annuity for lack of courage, vision and size burdens.
- Is it happening again at Blackberry ?
- What's up with WhatsApp?

# Is This An Investment Thesis?

- Do you short the stock of the annuity protecting tech and telecom firms?
- Do you go long the bonds of the firms that are failing?
- Quick Overview of SGI and assets no one thought about
- Stanford University Adjacent Real Estate
- Undefined Flat Screen Patents

