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Who's cleaning up MCIWorldCom?

Much has been written about the financial scandals that rocked the US economy last year. In the aftermath of huge financial losses, has anyone come out of the debacle with their shirts still on their backs? Certainly the Enron employees invited to pose for Playboy didn't.

It is hard to believe that MCI, which is currently valued at around US\$5.5bn is all that is left from the MCIWorldCom behemoth of yesteryear, which was once valued at \$190bn. It is well documented how this giant conglomerate of greed, financial engineering, blatant opportunism and investment bank folly came tumbling down. It is interesting to see who waded into the chaos of what was left and how they fared. We have even got a South African connection in there.

After Bernie Ebbers (former CEO) resigned on April 30, 2002 the market value of MCIWorldCom's equity and bonds came tumbling down. Towards the end of 2002 you could buy MCIWorldCom's bonds for less than 15 cents on the dollar. It was at this stage that vulture investor MatlinPatterson started buying up the bonds through its MatlinPatterson Global Opportunities hedge fund. The fund is thought to be worth somewhat north of \$2bn.

David Matlin (in his early 40's) together with Mark Patterson started MatlinPatterson. David has been running vulture funds, since 1994. First for CSFB until 2001 and then MatlinPatterson's from 2001 onwards. It has been said that his departure was prompted by the arrival of John Mack (commonly referred to as Mack The Knife) who was brought in to restructure CSFB. However I doubt there was any serious fallout, because CSFB apparently still supplied over \$200m of MatlinPatterson's initial funds under management.

The South African connection lies with Mark Patterson (also in his early 40's), who studied law and economics at the University of Stellenbosch. He then earned his MBA at New York's Stern School of business and for the next twenty years gained commercial and investment-banking experience with firms such as Bankers Trust and Salomon Brothers. He then moved to CSFB and served as a managing director from 1994 to 2002.

MatlinPatterson's approach sounds deceptively simple. It generally tries to take control of the bankruptcy process by buying the junior bonds in the capital structure. These are cheaper, because they are riskier. However, if you get enough of them then you can get a 'blocking position'. A 'blocking

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position' comes courtesy of American bankruptcy law, which stipulates that two thirds of creditors have to accept any reorganization under Chapter 11. Chapter 11 is a section of the bankruptcy code, which allows a company to get rid of some or most of its debts to eventually resurface and continue trading rather than to go out of business permanently. Once in control MatlinPatterson will roll up their sleeves and get down to business sometimes with, but mostly without existing management.

It is hard to get a handle on exactly how successful MatlinPatterson has been. David Matlin is generally thought to have racked up a 40% return per annum during his time with CSFB. However, the only returns I could dig up on MatlinPatterson's Global Opportunity Fund were the \$25m investment in 2001 by the University of Texas Investment Management Company, which has grown to \$25.65m by June 2003. On the one hand this is not exactly fireworks, but on the other it is also a very short time over which to measure performance, especially for a newly formed company. We also don't know what happened over the last 12 months. Matlin stated that only 30% of their investments pay out really big and unless he holds to an off the chart definition of 'big' my calculations show that the MCIWorldCom investment is paying off pretty damn big.

MatlinPatterson's Securities and Exchange Commission (SEC) filings show that it converted bonds worth \$2.16bn in face value (face value is not what they paid) for 17.8m shares and new notes with a face value of US\$393m in the reorganisation. In newspaper articles it frequently states that they invested around \$300m in MCIWorldCom bonds. This further corroborates reports that bonds were going for 13.5 to 27 cents at the time MatlinPatterson accumulated its stake (\$300m/\$2,16bn suggest around 14 cents on the dollar).

Currently the bonds are selling at face value (think \$1) and that together with the current valuation of MCI shares at \$17 brings the total value to roughly \$700m. That equates to a compounded growth rate north of 50%. That's pretty big in my books.

Mark Patterson maintains it is not as difficult as it looks to get a 'dead' corporation breathing again. He feels that one of the most common problems with troubled companies is management's denial: "In fact, one of the most common problems in struggling companies is management's refusal to acknowledge the problem. Denial is a terribly common phenomenon, but an honest assessment of the situation is vital to solve the problem. Find out what the true value of the company is, then exercise your operating options: defer accounts payable as long as possible without violating contractual obligations. The restructuring of aggregate debt is a number one priority, and the fiduciary obligations shift from the stockholders to the creditors."

It looks like MatlinPatterson have more or less got what they wanted from MCIWorldCom. It recently stated that it would consider selling. This

statement was prompted by the filing by Leucadia National, expressing their interest in buying a stake of up to 50% in MCI. Many feel that Leucadia does not have the muscle to take up such a large stake in MCI, considering Leucadia's current valuation of \$3.5bn. I don't consider that a valid argument, because Leucadia has access to Warren Buffett's wallet. Warren Buffett teamed up with Leucadia to take out Finova. The deal worked out very nicely. I believe the real reason for their interest lies buried deep within their balance sheet. However, those details are guaranteed to bore the living daylights out of you and go way beyond the scope of this discussion. Consider yourself lucky!

Who said bankruptcy is a bad thing? Bankruptcy can be very profitable!

Full disclosure: Baobab Global Fund holds MCI stock.

God Speed,
Martin van Blerk