Twitter Thread by Michael Kao



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Re: Fannie/Freddie-The Path Is Actually Clearer NOW. On its face, this claim may sound ludicrous off the back of a precipitous drop in valuations due to what some interpret as SM losing his nerve and punting to a hostile Admin. In this thread, I posit the exact opposite.

First, the economic realities: 1) GSEs are the bedrock behind our housing market which in turn is the bedrock behind our economy, 2) after 12 years and $300 bn, gov has thus far squandered the opportunity to recap, 3) this economy recovery is VERY long in the tooth.

When Trump took office, we all hoped that he would usher in a regime change from the Admins that enacted conservatorship and then the Net Worth Sweep. Well, he actually did that with the appointments of SM and MC.

Yet, what always bothered me about SM was his perfect poker-face. For those of you following me for awhile, you know I've been saying that I couldn't tell whether he was just playing bad cop or really was Darth Vader incarnate.

The primary consensus exit preconditions were: 1) there has to be a demonstrable path to meeting cap reqs, 2) the SPS needs to be forgiven, 3) court cases need to be settled.

My biggest worries have been: 1) Pref/common caps telling totally different narratives, 2) How do you engineer the recap without unduly disrupting the cap structures/MBS markets?

In my former life as a manager of a cap structure agnostic hedge fund looking for asymmetry in the fulcrum securities of distressed companies, I've learned that you need to put yourself in the shoes of would-be New Money investors first and foremost.

And this is what kept gnawing at me: 1) Fast Recap Path requires a write-down of SPS (which would likely moot derivative claims) BUT it would also jack up valuations that would likely Big New Money checks from coming in.

2) Slow Recap Path entails a multi-year effort to "retain & recap," which sounds good in theory, but why would you invest in common when prefs are still seriously impaired? Furthermore, why would you invest under a perennial cloud of "the next $25-$50 bn raise"?

One theory to break this logjam was: 1) SPS gets written down, 2) a heavy commitment fee gets exacted simultaneously to engineer a Fast Recap at a low EV. This might've worked, but it still didn't resolve litigation overhang and might have been disruptive to MBS.

So SM was stuck between 1) a potentially market disruptive Fast Recap path or 2) an even worse Slow Recap Path that is fraught with more dangers than successfully navigating an asteroid field.

This is why I've labeled SM's "Escalating Escrow" mechanism in the form of the upticking SPS as "diabolically brilliant." Ironically, my biggest concern about how SM was going to break the logjam has now been addressed.

The assertion that SM just wimped out and punted doesn't hold water to me. The LA has too many "tells" to be mere "coincidence": 1) specific cap req target, 2) settlement of all litigation except for the claims they know won't settle (~$5 bn direct claims)…

3) ...required exercise of Tsy warrants, 4) carveouts to raise newco equity in amounts that just happen to coincide with cap req targets net of retained capital thus far, 5) and a specific target date of 9/30/21 to propose end to conservatorship.

So ask yourself: 1) Why would SM have done that if he didn't have JY's blessing, 2) Why would SM have let MC uselessly spin his wheels for the last 2 years while lauding those same efforts?

As it happens, the day before the LA came out, I heard a rumor that SM/JY had come to a consensus plan to eventually allow for 1:1 SPS forgiveness with New Money raised. In a vacuum, I would've dismissed this.

But when the LA came out worded the way it was worded and a separate story corroborated the meeting with JY, I believe this scenario is exactly what happened behind-the-scenes.

SM to JY: "I've been dutifully baking this cake, but rather than serve it half-baked, I'm setting up a mechanism that allows you to finish the baking and take credit for it."

Imho, this LA accomplishes exactly that goal: Upticking SPS = "Escalating Escrow" designed to force parties to the table, because the alternative "Do Nothing" scenario is "Lose/Lose."

Why is "Do Nothing" considered "Lose/Lose"? 1) Economic "Rainy Day" is long overdue — especially as the last dose of COVID stimulus wears off, 2) with SCOTUS hammer pending, neither side should want to risk a loss.

By providing the "Key" to unlocking the "Escalating Escrow," SM has provided a setup akin to what convertible arbitrageurs call a "Happy Meal" raise: a perfectly hedged capital raise that doesn't entail market risk.

The path I now see: Big New Money comes in and replaces equivalent amount of SPS. How much SPS remains if any can be a lever for JPS settlement. It is akin to Indiana Jones replacing that goblet with a sack of rocks instantaneously to avoid collapsing the temple.