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Lack of Transparency = Shareholders Get Ratcheted

MARKETS AT A GLANCE

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Ratchet (financial definition): An anti-dilutive provision where an investor is granted additional shares of stock without charge if the company later sells the shares at a lower price.

Screw (Sprott definition): A highly **dilutive** provision where an existing investor is granted, without his approval or knowledge, an increasingly smaller share of the company at an increasingly lower exit price (usually the result of a **ratchet** bestowed on other investors).

Is it a ratchet or a screw? We'll let our readers be the judge. But whatever you call it, and punning aside, the evidence grows daily of a disturbing trend in place that is leaving existing shareholders nailed. As the troubled financial sector continues to post massive loss after massive loss, and inundate the markets with equity offering after equity offering after equity offering, it would appear that transparency has taken a back seat to the banking industry's desperate need to raise capital from whomever would buy it and at whatever terms would cinch the deal – even if it involves selling their souls to the devil. Unbeknownst to the shareholders of these financial institutions, they are having the wool pulled over their eyes by being subjected to the possibility of bottomless dilution with less than forthright disclosure. As we've long written, we believe the banking system is effectively **bankrupt**. They are **dead men walking**. The fact that they are unable to raise capital the old-fashioned way (selling common shares at market prices) is proof positive of our thesis. Instead, they have to *compel* investors to buy their sorry shares through either way-below-market rights issues (an abhorrent abuse of capitalism that invariably results in a freefall) or by baiting new investors with no-brainer can't-lose ratchet provisions. Either way, existing shareholders are taking it on the chin. But the banks don't care. Neither do the regulators nor the Treasury nor the Fed. Capital must be raised come what may! It's gotten so bad that the very viability of the financial system seems to hinge on whether or not the next equity offering can be pulled off without a hitch. It's a misallocation of capital of tremendous proportions, for the sector that is currently in the greatest need of capital is also the sector least worthy to receive it.

The horrendous performance of financial stocks of late speaks for itself – perhaps the markets aren't so easily fooled. But those investors tempted to bargain hunt best beware. Due to lack of transparency running amok, investing in the financial sector is chalk full of minefields. One example that immediately comes to mind is an article in the Wall Street Journal last week titled "Banks Find New Ways to Ease Pain of Bad Loans". Have the banks done something value-added here? Have they actually found ways to mitigate their losses by improving their recoveries of bad loans? ¹ Not at all. The article is about how some banks, even big ones like Wells Fargo, are using accounting gimmicks to make it seem like things are getting better. For example, "improving" the write-off rate of nonperforming home equity loans by changing the past-due time period (after which they are deemed to be in default) from 120 days to 180 days. Or offloading troubled loans onto subsidiaries, thereby erasing them from their own books and improving their regulatory capital level, even though the bank is still fully accountable and liable for the losses that are

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¹ "Banks Find New Ways to Ease Pain of Bad Loans", Wall Street Journal, June 19, 2008, p. C1.

eventually incurred from these bad loans. It's a wonderful magic trick – now you see them... now you don't! Would that all bad loans can be made to disappear so easily. Unfortunately for the banking industry, accounting trickery does not reality make. They are merely gaming the system to make things look better than they really are, in the hopes that unwary investors will be lulled into believing that things are improving when they are not. Another recent example that got our goat is courtesy of Lehman Brothers. On the day of closing their \$6 billion equity offering, they announce a management shake-up whereby the CFO and the President and COO are replaced.² We would question why such a material decision, which seems unlikely to have happened overnight, wasn't mentioned before the offering. Could it be that the spirit of full disclosure, lest it hinder the equity offering, must fall by the wayside?

But the most egregious example of lack of transparency (a.k.a. turning the screws on existing shareholders) is the "full ratchet" provision that has recently come to our attention and, doubtless, is currently making the rounds of many of the recent equity offerings in order to sweeten the deal for reticent investors who have sizeable cash to invest. It would appear that in order for the equity raise to succeed, lead investors are being given preferential treatment at the expense of existing shareholders who are being subjected to the potential for limitless dilution should financial stocks continue to go down in value. Such provisions are appalling, but what is even more appalling is that the existence of these not inconsequential provisions is only coming out of the woodwork in the footnotes of subsequent 10-Q's. It's an abomination of supposedly free and transparent Western financial markets.

But first, here's a skill-testing question for our readers: Even though hundreds of billions of dollars of capital have been raised by the financial sector over the past several months, which of the investors in a financial institution have made money since their initial investment? Answer: Zero. We can't think of one. They are all underwater. When Abu Dhabi first invested \$7.5 billion in Citigroup last November, Citi's stock was \$35. Subsequently, when Citi did their \$14.5 billion raise in January, the stock was trading at \$30. Today Citigroup's stock is under \$20... and it keeps falling. Merrill Lynch did a combined raise of \$12.8 billion in December and January at \$48. Now the stock is under \$35... and also falling. Warburg Pinkus made their now infamous \$1 billion investment in MBIA at \$31 per share. MBIA has fallen over 80% since and is now trading at under \$5 per share. Those who participated in Ambac's \$1.5 billion rights issue in March are down a similar amount, 80%, as the stock now hovers under \$2. Bank of America made their initial investment in Countrywide Financial last August at \$18 per share (rather surprising to us, given that Countrywide looked to be going bankrupt if BofA didn't come to the rescue). Bank of America subsequently made a takeover offer in January. Today Countrywide shares can be got for under \$5 per share. TPG invested in Washington Mutual to the tune of \$7 billion at \$8.75 per share, a substantial discount at the time to WaMu's stock price of \$13. Today WaMu's stock is \$6. Last month AIG raised \$20 billion when their stock was trading at \$37 per share. Today AIG stock is just above \$30 per share. Even those who participated in Lehman Brothers' \$6 billion equity offering last week at \$28 per share are already underwater, with LEH currently trading below \$24 (year-to-date Lehman's stock is down over 60%). Smaller banks have fared no better. The shares of Colonial BancGroup, East West Bankcorp, Huntington Bancshares, and UCBH Holdings have all fallen by over 40% since their initial equity offerings. The list goes on. It's neverending carnage. Ironically, thanks to full ratchet provisions, this promises to lead to further dilution and even weaker stock performance going forward.

We always wondered who in their right mind would invest in a financial institution that is scrambling for capital just when the news is clearly going from bad to worse. As we already mentioned, we believe the banking system is bankrupt. Thanks to overleverage, if all their assets were to be marked down to what the market would be willing to pay for them, we believe they would have no capital. Save for government Treasuries, there isn't an asset class on bank balance sheets that hasn't fallen precipitously in value. What capital the

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² "Lehman Brothers Removes Finance, Operating Chiefs", Associated Press, June 12, 2008.

banking system does have is from recent raises, but this will likely disappear when future massive writedowns are announced. Who would be fool enough to invest in banking shares?

The list is growing shorter. But there were at least some smart investors who noted the downward trend and successfully negotiated for downside protection. We know of at least two cases (though there are doubtless others); namely, Merrill Lynch's \$12.8 billion investment from Temasek (the Singapore sovereign wealth fund) and Washington Mutual's \$7 billion raise from TPG (a private equity firm). Quite unbeknownst to the general public at the time, downside protection was built into these equity raises to protect these investors. They are called "look back" provisions or "full ratchet" compensation. We believe it is more accurate to call them "death spiral" securities. They work as follows. The investors in the equity raise would have their investment "protected" by a provision which states that should the bank afterwards raise money at a lower price than what they paid, these investors would be compensated retroactively by having their initial investment priced at this lower price, thereby being issued new shares for free. It doesn't take a mathematician to see how these provisions can result in massive dilution should the bank subsequently raise even a paltry amount of capital. A new offering will trigger a lower price because of the dilution it would cause, which would trigger even more dilution because of the lower price, which would then trigger an even lower price because of the even higher dilution, etc. This is why we call such securities a death spiral. They hurt the price of any and all future equity offerings and open the door for potentially limitless dilution of existing shareholders if and when the bank goes to the markets for more capital at ever-lower prices.

However, unless the bank goes bankrupt, these investors can't lose. And we already know to what lengths the Fed will go to prevent a banking bankruptcy. It's heads I win, tails I win. They can even short the stock in the expectation that it will go down and still not lose. At the next financing, which is sure to come, they will be made whole... even making money on the short! It's a perverse situation. Even if they don't short (or aren't allowed to short) they still can't lose. It's like being given a free put option written by existing shareholders. They get all the upside and existing shareholders (insult to injury) pay them on the downside! It's the worst way to raise equity. We wouldn't even call it equity. It comes at a tremendous cost to the already beaten up shareholders of these financial institutions. How did this happen? Because these are "private" transactions, and thus no prospectus was required at the time of the offering. The banks disclosed only what they wanted to disclose. It is only after the fact, in the footnotes of subsequent 10-Q's, that shareholders (if they dig deep enough) will realize that they got nailed/ratcheted/screwed. How many other financings were done on this basis? Only time will tell.

In the meantime, it is little wonder that banking indices are in freefall and the demand for new bank equity is becoming increasingly muted. Investors are finally beginning to say: *no mas!* When regulators have to get involved in order to push financings through (for instance, Bradford and Bingley in the UK), it is a signal for ordinary investors to steer clear of the financial sector. It's a misallocation of capital... good money chasing bad... that can ultimately only be resolved by a massive central bank bailout. You don't want to be a shareholder when this happens... and in the interim be subjected to an unacceptable lack of transparency. Financial shares, if they weren't already, are now toxic. They will become only more so with each equity offering.

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