Transcript: A New Fannie Mae Play

Featuring: Gabriella Heffesse

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Synopsis: Gabriella Heffesse, chief operating officer at ACG Analytics, updates her home-run trade on Fannie Mae. She analyzes recent developments, considers risks to the thesis and highlights a new way to take advantage of the opportunity, in this interview with Brian Price. Filmed on February 12, 2019.

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BRIAN PRICE: Welcome to Trade Ideas. I am Brian Price here for Real Vision joined today by Gaby Heffesse, COO of ACG Analytics. Gaby, great to have you back with us in 2019.

GABY HEFFESSE: Thank you for having me back.

BRIAN PRICE: So back in December we were talking about Fannie Mae, Freddie Mac. You had a trade. It's worked out OK for you.

GABY HEFFESSE: Yeah.

BRIAN PRICE: More or less.

GABY HEFFESSE: Depends who's judging.

BRIAN PRICE: Well, in this case, I'll be the judge, and I'll say you came in talking about it. It hit your target of $2.40, continued upwards to about $3.00. It's taken a little bit of away downwards, trading right back about where your target was. That said, walk me through what drove that price action.

GABY HEFFESSE: Well, there's been a lot of changes in the policy space. So I work for the firm ACG Analytics. We're based out of Washington. I'm based out of New York. And we work with asset managers for these trades that are very policy-driven trades.

And this, as I mentioned last time, is probably the most policy-driven trade in the last decade. And whether it works or doesn't work depends completely on what happens in Washington on the administrative level and, potentially, Congress.

So after we met, Joseph Otting was put in as acting director of FHFA and came out a few days later and said two very important things. The first one said I'm on the same page as Mark Calabria. We agree with things, so we can get going because he'll just take over once he is confirmed. Mark Calabria was nominated to be the director of FHFA.

The second thing he said and Mnuchin said and we've heard across the administration since then was we think we can have a plan in a few weeks to take Fannie and Freddie out of conservatorship. Now that's a big, big thing to say.

BRIAN PRICE: That's ultimately the road to privatization.

GABY HEFFESSE: It's the road to privatization. It's the road to being able to do Mick Mulvaney's OMB plan, which we spoke to last time. It's the road to recapitalization, which is probably, for investors, the most important part of privatization because, in order to recapitalize them, you're giving them value, and you're stopping the sweep, and you're doing a number of things that will make this trade work.

So the move from $1.12 to $2.40, $2.47, that's expectations that this is going in the right direction and that it could happen faster than people were expecting.

BRIAN PRICE: Do you remain bullish at this point, and if so, for the same reasons or are you looking at other aspects within your thesis?

GABY HEFFESSE: So I think given the price change, at the beginning it was very easy to trade off of perception. And on media headlines and perception, I would say the common stock will probably outperform and overshoot the junior preferreds. But when you're getting closer to a real resolution or a real plan that tells you how it plays out, I would say there is a lot less risk in having the junior preferreds with, depending on how they do it, potentially equal upside.

The common stock could get diluted in many ways. It can get diluted by the senior preferreds, technically, by the junior preferreds, by the capital raise, depending on the volume of it and how quickly they need to do it. And at what point does the government exercise their warrants? So you really don't know.

Now, I don't think that they will get completely diluted and that the government will take every opportunity it gets to dilute the common equity because if you look at the market cap, there's just not that much. You're crushing them for maybe no reason. But it is possible. They can do it within their bounds, and I think there's less ways the junior preferreds don't get paid out should this happen.

BRIAN PRICE: So Gabby, you mentioned risk. I was wondering if you can drill down a little bit more on that for me. How do you calculate it? How do you assess it? What's your approach?

GABY HEFFESSE: So the way I've been looking at risk with this trade is kind of looking at the qualitative moves that can happen that could make the trade worthless. So one of the big ones for the junior preferreds is what the government decides to do with the senior preferreds. Back when the government made the entire move, it gave the enterprises $187 billion. So they have this loan, the senior preferreds, which is now $190 billion.

So in return for that, they've been sweeping all the earnings for the last 10 years. So every time there's earnings quarter, it goes straight to the Treasury. So in that, they've gotten back almost $300 billion.

But they don't necessarily need to say this is paid back. I think they will do that because I think it will be kind of part of settling the litigation, which is another aspect of this trade. But that is a risk because you have, in Fannie and Freddie, the total worth is around $39 billion, and this is 190. So if you're going to write off $190 billion off the balance sheet off the liabilities side, that's a very big difference for the junior preferreds in how quickly they will get paid out.

BRIAN PRICE: So let's move to risks for the common stock. Can you walk me through that?

GABY HEFFESSE: So you also have that risk of the senior preferreds because you're last on the food chain and they're first, and if you have this extra $190 billion that's not written off from the liability aspect, then that's big. But you also don't know how much capital needs to be raised, how they'll do it, and how quickly they will do it. And depending on how they decide that, you're at risk for a lot of dilution.

Now the prices for the common stock are priced in such a way where there is an ability to dilute them, and they should still be worth significantly more. But then there's a couple other points where you can also get into dilution. So should the junior preferreds convert into common stock, that could also dilute them.

And then the other question is at what point do you exercise the warrant? So of the common stock, the government has 79.9%. But that doesn't necessarily mean that it's 79.9% of the current outstanding stock. So you don't know if they do a capital raise that already has it kind of intertwined that they know that the government will then take 80%. If that happens, then the common essentially goes to zero.

Again, I don't think they'll do it because it seems like more work. It seems just like a malicious thing to do just to be malicious and not good policy, and I think what they're really looking for is what is a way to get this capital to make the enterprises safe and sound, to take them out of conservatorship, and to recapitalize them quickly?

BRIAN PRICE: So with that, how does the plan come to fruition?

GABY HEFFESSE: So there's a few things that we're looking for. So on Thursday, Mark Calabria will have a hearing. He is nominated to take over as FHFA director. So I think the line of questioning that he receives and also whether the vote out of committee is a little bipartisan or just along party lines, that will give us a view of timing for when he comes in. Now Otting has already said they're not necessarily going to wait for Calabria.

So what else are we looking for? It's our understanding that Treasury is looking for a financial advisor. So that's a huge signal to markets because you want to put math before a plan. So Treasury hiring an FA means that they are working on this restructuring and they're trying to figure out how to do it.

On March 31, you have Q4 earnings. So in the past, everything has been swept to the Treasury. So one of the things that we're definitely looking for is do they say, well, don't give this payment because we want you guys to start retaining capital? Do they use this quarter as the first of that? And I think that will depend on how ready they are. And then after that, I think– or maybe before that what we will see out of Treasury and FHFA is maybe kind of a outline, a plan of what they intend on doing.

So the other thing that has changed since we last spoke is the litigation aspect of the trade, which also goes back into why the junior preferreds might have a better seat at the table because they have a voice. So they just had a hearing at the Fifth Circuit in New Orleans. It's a pretty conservative court. And the consensus was that it was not a good day for the government.

So now the government has this risk that this also might get out of their hands if they lose. If they see a real risk of losing these cases, they can't do the plan. So does that push the government to settle?

BRIAN PRICE: Can I just ask what made it a bad day for the government specifically?

GABY HEFFESSE: It was a line of questioning from the government. It was asking about the constitutionality about the sweep, the constitutionality of the acting director. It was– I wouldn't say accusatory, but it was definitely digging in to what happened a few years ago and whether that was legal in a harsher way than we've seen in the past. So if the government does see a risk in this, then you might want to settle the litigation. The other reason you might want to settle the litigation is because in order to start your capital raise, it's very difficult to do when you have an outstanding litigation.

So the junior preferreds are in this position where they're the other side of that table, and what do they want? They want the government to deem the senior preferreds paid back. So like we said earlier, they've given $190 billion. They've gotten back around 300, a little less, which is over their– gets them their 10% return. So do they want just to say, OK, we'll write that off. They're not asking pay us a check for every extra penny. They just want that to be done.

The other part of it is to stop the sweep because if you can't retain the earnings, then you can't start building capital, and you can't start taking them on the road to privatization.

Probably the other part of this is it could be easier to capitalize them without this liability– we also spoke about that– and trying to incentivize them into becoming assets, so trying to convert them into equity. And in order to do that, you would probably need to amend the warrants. Well, before that, you need to give them a price that gives them their proper value. You need to get them up to $25 in the form of equity. And then you need to protect them against dilution because they're not going to convert if then they think that in the next capital raise that's going to be worth half the value.

So the junior prefs are kind of in a seat where, should the government engage them to settle, they can do that. And I truly believe that the government wants to do this and soon to have the economic benefits, to have it as another achievement of the president, and to keep it far enough away from the election cycle. So if you want to do it soon, the litigation is a key component to consider.

So I still do think both parts of the structure will go up. I just think given the current landscape, the junior preferreds might be a more strategic move than the common. As I said in December when we were here, you either believe that this is going to happen or it's not going to happen. There's not so much in between.

BRIAN PRICE: And you're a believer.

GABY HEFFESSE: And I'm a believer.

BRIAN PRICE: So with that belief in mind, walk me through your positioning and what you're anticipating with some price action to come.

GABY HEFFESSE: So I think the junior preferreds are on the run to around $9.50. Par is $25. So I think that you can get up to– I really do think you'll get above $20.

BRIAN PRICE:$20.

GABY HEFFESSE: Yeah. I keep coming on here and giving all these big calls, but as long as they keep working out, I should keep doing it.

BRIAN PRICE: Hey, keep rolling the dice.

GABY HEFFESSE: Yeah. No, I do believe it will happen, and I think they do need close to par. For what they want to raise, it's not that much.

And one of the counters is people say there will be headlines about Mnuchin helping his Wall Street buddies, but it seems like a two-day headline to me.

BRIAN PRICE: Two-day headline.

GABY HEFFESSE: Yeah.

BRIAN PRICE: Well, Gaby, you've given us a lot to think about once again, a lot to consider. We always appreciate hearing from you on Real Vision.

GABY HEFFESSE: It's always great to be here.

BRIAN PRICE: Thanks so much.

So Gaby is still bullish on Fannie Mae. Specifically, she likes buying the junior preferreds, ticker symbol FNMAS, at $9.50 with a target price of $20 over the next six months.

That's Gaby Heffesse, COO of ACG Analytics, and I am Brian Price for Real Vision's Trade Ideas. Thanks, as always, for watching.