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Latigo's David Sabath, left, and David Ford have come away from the troubles at American Airlines and Royal Bank of Scotland with big gains.

Gary Spector for Barron's

Talking With **David Ford, David Sabath**

Founders, Latigo Ultra Fund

Taking the Big Shots

by Eric Uhlfelder

David Ford and David Sabath were two 30-something distressed-investment specialists back in 2000 when they were evaluating the soundness of bank loans from the famous sporting-goods maker Spalding, which had fallen on bad times after a leveraged buyout by Kohlberg Kravis Roberts. Ford, then working for hedge fund Och-Ziff, and Sabath, of Goldman Sachs, decided to take a break from wading through documents at Spalding's Chicopee, Mass., headquarters and headed over to a gym where the company tested its basketballs. While shooting hoops to blow off steam, the two got to talking and discovered they both dreamed of running their own shop.

Ford and Sabath started their event-driven Latigo Ultra fund in late 2007, right before the credit markets shuttered in 2008, causing a 20% loss. But focused on restructurings, bankrupt-

cies, mergers, and other deep-value plays, the managers found it had no shortage of opportunities. In 2009, the New York-based fund's performance bounced back like a Spaldieen, with a 70% rise. They were on their way.

Ford, 48, and Sabath, 50, today run a total of about \$470 million, with half of that in the Ultra fund and the rest in two similar separately managed accounts and a less-concentrated version of the fund, Latigo Advisors. With decades of event-driven trading experience, the two feel confident taking big positions, both long and short, that range from 4% to 8% of the fund's assets. They believe that risk is best controlled not by casting a wide net but by focusing on the best ideas.

"We target compelling event-driven opportunities largely in the U.S. with a bit in Europe," explains Ford. "In the process, we study the various layers of a company's capital structure to determine the best risk-reward options." While credit-oriented, the managers are asset-class agnostic, buying unsecured debt, convertible bonds, preferred stock, or common shares, depending on the situation.

To date, the fund's performance has borne out the strategy's merit: Ultra's one- and five-year annualized returns through July have been 18.03%, and 15.18%, respectively. That compares

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with gains of 7.86% and 4.97% over the same periods for the HFRX Event Driven Index, a hedge-fund benchmark.

American Airlines Group (ticker: AAL) is a good example of their approach and their strong convictions. The airline declared bankruptcy in late 2011, and shortly thereafter, discussions started about a merger with another embattled giant, US Airways. As a possible deal started to take shape in 2012, Latigo saw an opportunity in the 6.25% convertible bonds of American's parent company. The bonds were backed both by American's operating and holding companies, but were selling at levels well out of the money. Bankruptcy didn't jeopardize their convertibility, but it was unclear what—if any—value the “old” stock would have if it did convert, since American was expected to issue “new” shares to replace them. Existing shares are usually worthless in such cases.

Bucking consensus, Ford and Sabath bought the bonds in 2012 and 2013. “American wanted to avoid a potential fight between its creditors and equity holders,” says Ford. As a result, “the bankruptcy was structured to provide outsize returns to pre-[bankruptcy]-petition equity holders once all creditor claims had been fully satisfied.” The old shares' valuation was to be based on the performance of the merged firm. On that score, the partners were optimistic, believing that the merger, formally unveiled in February 2013, would produce \$1.4 billion in synergies. By May, Latigo had 7% of its assets invested.

Then, in August 2013, came a test. The Justice Department threatened to block the merger. The fund sold half its position to lock in profits and reassess its risk, then went back and bought more: Its average cost was a postconversion price equivalent of \$2.29.

Not only did the company continue to

improve, but in November, the Justice Department dropped its objection. American shares were recently trading around \$35.

Latigo sees more gains. About 3.25% of its assets remain invested in the airline on the belief the U.S. recovery will drive American Airlines shares further. Consolidation has given the carriers more pricing power, and they are generating more revenue by unbundling services such as baggage, notes Sabath.

The near collapse of Royal Bank of Scotland Group (RBS.UK) in 2008 created new opportunity. After the United Kingdom Treasury bailed out the bank, the European Union Competition Commission forced a two-year suspension on RBS's preferred-share dividends. The price of the shares sank.

But Ford and Sabath realized (as did Barron's, in “Playing Royal Bank's Dividend-Suspended Preferreds,” April 11, 2011) that the freeze had turned the preferreds into zero-coupon-like bonds, though the market was pricing them as if they were distressed. In January 2012, Latigo bought \$25 par preferreds with an average coupon of 6% and strong credit support. Its average cost: \$13.

Dividends were reinstated in June 2013, helping Latigo realize an annualized rate of return above 30%. Here again, the managers retain a 6% position. They think the shares will be replaced at par with new preferreds convertible to stock if RBS has a problem.

Sometimes a position just doesn't pan out. Ford and Sabath didn't have a lot of faith in the changes that Pershing Square's Bill Ackman was pushing at J.C. Penney (JCP) in 2010. “While activists can bring about positive changes,” says Sabath, “paying down debt usually isn't on their agenda, and we felt this could weigh on Penney's bonds.”

Penney's five-year junk-rated debt was trading at par and yielding less than 6%, which they believed was too low. So the fund purchased a five-year credit default swap, at a cost of 2.75% a year, which would gain value if Penney's creditworthiness fell.

In little more than a year, Penney revamped its pricing strategy and broke up its stores into shops within shops, with greater emphasis on upscale merchandise. The results were catastrophic. First-quarter 2012 same-store sales fell nearly 20%—beginning a trend that accelerated over the year. By December, the stock had lost half of its value, while the cost of the CDS widened to 9.75%. They added to their CDS position and, in early 2013, started shorting the stock.

Shortly thereafter, Penney's board changed course, forcing out the CEO who designed the changes and bringing back a former CEO. Despite big losses in the first half of 2013, Penney started to stabilize. It has been able to issue new debt and equity, and same-store sales began to rebound in the final quarter of 2013. By the second quarter of 2014, with the U.S. recovery gaining steam, the managers finally cashed in their chips, realizing a 0.90% loss on their investment.

Latigo has a blemish. Ford and Sabath had to close their initial event-driven fund, which came through 2008's crisis relatively well, having lost less than half the stock market's 37% nose dive. But its fund-of-funds investors lost their leverage and were forced to redeem. As it wound down in 2009, the fund still managed a 24% gain and all investors were made whole. Those who stayed have been well served.

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