**FANNIE MAE PREFERRED SHARES "S" SERIES**

Investment Summary

**Event driven investment opportunity with an asymmetrical payoff profile:**

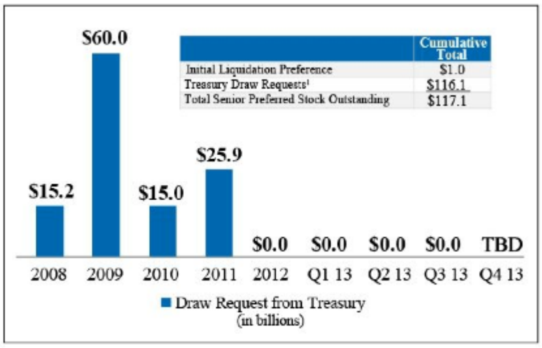
- Fannie Mae "S" series Preferred Shares currently trades at a significant discount at 31 cents on the dollar as Fannie Mae has been placed under conservatorship. This means that all its profits goes to US Treasury
- More and more pressure on US Treasury to distribute profits to other shareholders as the amount of dividends Fannie Mae pays back US Treasury is likely to exceed the amount US treasury injected into Fannie Mae in Q12014. Some large investors are suing US Treasury for not allowing profits to be distributed as well.
- If US Treasury allows profits to be distributed, "S" preferred shares would receive an effective dividend of 24% (the dividend rate is 7.75% on the dollar) plus significant capital gain.
- Downside risk if US Govt decides to wind down the GSEs in a manner that wipes out shareholder value. Nonetheless, there is no consensus yet on how to do this and it would take significant time to decide on a new structure.

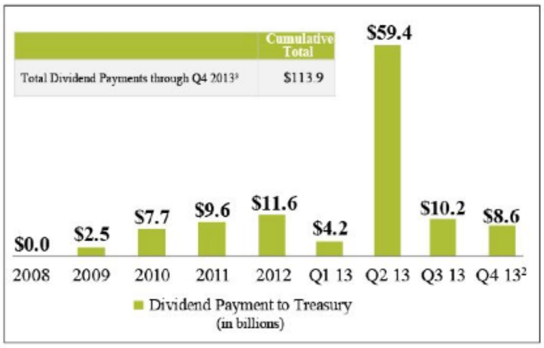
Company Background

The Federal National Mortgage Association (FNMA), commonly known as "Fannie Mae", was founded in 1938 as a Government-sponsored enterprise (GSE), to provide liquidity, stability and affordability to the US mortgage market. Fannie Mae has been a publicly traded company since 1968 and its purpose is to expand the secondary mortgage market.

*Placed under Conservatorship in 2008.* However, in 2008, Fannie Mae suffered losses due to the Subprime crisis as the underlying loans that Fannie Mae had guaranteed suffered huge defaults. In response, the US Treasury placed Fannie Mae under conservatorship in 2008, with a promise to inject up to $200 billion to fund Fannie Mae's deficit. For each amount injected, US Treasury would receive an equivalent amout of 10% dividend Senior Preferred Shares. Further, as part of the deal, US Treasury received warrants to purchase up to 80% of common stock. To datae, US Treasury has injected $117b into Fannie Mae.

*Sweep Amendment.* In 2012, US Treasury amended the terms of the agreement to replace the 10% dividends with a "full income sweep" from 1 Jan 2013 onwards. **This means that all of Fannie Mae's profits would be flow to US Treasury as dividends from 1 Jan 2013 onwards.** In total, Fannie Mae has paid $114 billion in dividends to the US Treasury (see chart below).






Source: Fannie Mae

*Return to profitability.* For the first time since 2008, Fannie Mae reported annual profits in 2012. Further, profits are expected to grow with the recovery of the US housing market. As of Sep 2013, Fannie Mae's net income stood at $77.5 billion[1].

<u>Sources of Income</u>

To provide liquidity to the housing market, Fannie Mae purchases mortgages that meet a certain minimum standard from Banks, which in turn allows the banks to make new loans, giving the housing and credit markets flexibility and liquidity.

Fannie Mae has 2 key sources of income:

- **Guaranty Fees**. For majority of the loans purchased from the banks, Fannie Mae packages the loans into Mortgage-Backed Securities (MBS) and then sells the MBS to investors. Fannie Mae guarantees these MBSs for a fee based on the loan value guaranteed. In guaranteeing the MBS, Fannie Mae sets aside provision for credit losses to cater for defaults of the underlying loans. As such, if the default risks increase, Fannie Mae would incur losses if the guaranty fees are not sufficient to make up for the credit losses provisioned for.

  In 2012, Fannie Mae guaranteed a total of about $2.7 trillion of MBS and the guaranty fee of $7.4 billion earned comprised about 33% of Fannie Mae's net Income. Moving forward, the income from guaranty fees is expect to increase due to better quality loans and increase in guaranty fees from 27.9bp to 53.1bp and Fannie Mae expects this to be the **primary source** of revenue in the future.

- **Interest differential**. Fannie Mae holds a smaller portion of the loans (about $700 billion) for investment purposes instead of securitizing them and selling it off. For this segment, Fannie Mae profits from the difference on the interest earned versus the debt cost. Given that market perceives that Fannie Mae enjoys an implicit government backing as a GSE, Fannie

[1] Mainly due to a release of the substantial majority of Fannie Mae's valuation allowance against their deferred tax assets in the first quarter of 2013, which resulted in a benefit for federal income taxes of $47.2 billion

Mae can borrow at relatively low cost. Overall, the debt cost in 2012 was about 2.25% whereas the interested earned on the mortgage portfolio is about 2.93%, giving a net positive interest differential of 0.93%. Further, Fannie Mae would gain if the fair value of its loan portfolio increases.

In 2012, Fannie Mae held a portfolio of loans of about $700 billion and generated about $14.2 billion in net income, comprising about 60% of its total net income. However, as part of the conservatorship agreement, Fannie Mae has agreed to slowly decrease its loan portfolio over time, to $250 billion over a 5-year period. Hence, we expect that the profits from its loan portfolio to diminish over time.

**Overall, Fannie Mae expects net income to remain strong as the increase in guaranty fees to offset the decrease in interest differential.** Further, the US housing market shows signs of recovery - overall mortgage market serious delinquency rate has trended down since peaking in the fourth quarter of 2009, albeit remaining historically high at 5.9% as of June 30, 2013. Further, based on Fannie Mae's estimation, home prices continue to improve on a national basis, increasing by 9.2% in the first nine months of 2013 and by 9.4% from the third quarter of 2012 to the third quarter of 2013.As the US housing market recovers, credit quality of the underlying loans would improve, increasing overall profitability of the guarantees that Fannie Mae issued on the MBS.

<u>Investment Thesis</u>

In total, Fannie Mae has issued $19 billion in preferred shares prior to the crisis, in various tranches. Since the subprime crisis, Fannie Mae's preferred stock has been trading significantly below its stated value. At its depressed prices, the preferred shares represent an event driven investment opportunity with an asymmetric payoff profile.

*Why "S" Series.* We focus on "S" series preferred shares for several reasons:

- **Liquidity**. Of the tranches of preferred shares, it is the most liquid with an issuance size of $7 billion. In comparison, the rest of the preferred shares are much smaller, ranging from $150 million to $2.5 billion.

- **Dividend Rate.** "S" series has a fixed to floating rate of <u>7.75%</u> or <u>3m LIBOR+4.32%</u>, whichever is higher. This is the second highest dividend rate of the tranches of preferred shares.

- **Price**. It is currently trading at about $8 per share, which is 32% of its stated value of $25. This gives it an effective dividend rate of about 24%.

*Potential Upside if US Treasury allows profits to be distributed to preferred shareholders*. Currently, the sweep amendment allows the US Treasury to receive all of the profit Fannie Mae earns, while preferred shareholders get nothing (Fannie Mae has not distributed profits to preferred shareholders since 2008).

However, if US Treasury allows distribution of profit, the “S” preference shares will enjoy an effective dividend of 24% and will likely to increase in value as well.

*Increasing pressure on US Treasury to distribute profits*. Pressure will increase when Fannie Mae has fully paid back the amount injected (likely to be in Q12014), which is likely if housing market continues to recover. Already, some large preferred shareholders (Fairholme Fund and Perry Capital) are suing US Govt over sweep amendment. If successful, sweep amendment could be overturned and profits distributed

*However, downside risks depend on the larger discussion on how to restructure the GSEs.* General intent of US Treasury is to reduce the role of public capital in housing market. However, there is no consensus in Senate or Congress on how to restructure the GSEs as yet. The discussions are still preliminary and there are no firm solutions on how to replace GSE’s role. Even if GSEs are restructured, it is not certain whether US Govt would do so in a way that wipes out shareholder value, given that Fannie Mae has already returned to positive networth. Overall, would take some time before new role of GSEs in housing market is decided. Further, it is not likely that this would be decided before the US Congressional elections in Nov 2014. Even then, debate on restructuring of the US housing market is complex and would likely continue for some time.