THIRD AVENUE MANAGEMENT
THE POWER OF ORIGINAL THINKING

INVESTMENT INSIGHT

The Fulcrum Security: What it is and Why it Matters

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Overview

While Third Avenue Management (TAM) investors may be familiar with our use of the term "fulcrum security", we think a review of this concept is useful from time to time. This piece provides a quick primer on the fulcrum security.

The fulcrum security is a concept long entrenched in the investment philosophy of TAM and written about by firm founder Marty Whitman over the years.[1] Marty Whitman defines the fulcrum security as the most senior security that will likely convert into equity ownership in a restructuring. The fulcrum security is the part of the company's capital structure which will ultimately control the company in the event of a reorganization, usually in the form of equity. One of the biggest challenges with the fulcrum security is that identifying its location in the capital structure ex ante is far from a trivial feat.

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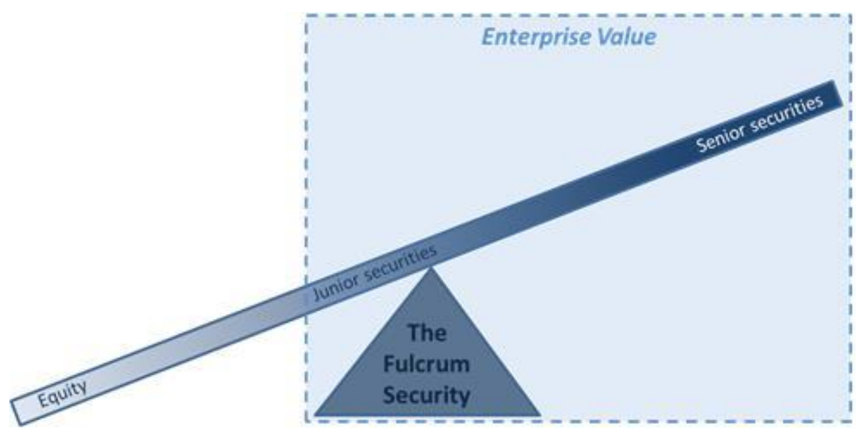
A see-saw provides the perfect analogy: the fulcrum is the device on which the board swings. The securities that reside higher up are most senior in the capital structure and are "in the money", while the side of the board that rests on the ground represents other securities (maybe more junior, unsecured securities and equity) that are "out of the money". The fulcrum is the security around which it all pivots, ultimately determining which securities have value (i.e., are up in the air) and which ones do not (i.e., are touching the ground), as depicted in the exhibit below.

The Fulcrum Security in the Capital Structure Relative to Enterprise Value, Pre-Restructuring



At Third Avenue we have been building and refining our skills and expertise in the distressed or restructuring space for many years, across all of our funds. As we scour the investment universe for ideas in this space, we gravitate towards this concept for a variety of reasons. Throughout our history, our funds have had a number of holdings that we believe are fulcrum securities. The process of searching for and ultimately identifying fulcrum securities is our primary focus when seeking opportunities that are likely to deliver outsized returns.

1 Marty Whitman discussed this concept and how it applies to Third Avenue's Funds in the Third Avenue Management shareholder letter published on July 31, 2000. A more formal discussion of the concept can also be found in Whitman, Martin J. and Fernando Diz (2009) "Distress investing. Principles and Techniques", Wiley Finance.

"Win-win" or the Opposite of Rock and a Hard Place

When properly identified, the fulcrum security should provide a positive outcome to an investor, regardless of whether or not a company enters restructuring. We like to shy away from clichés, but the phrase "Win-Win" sounds overly optimistic, so we would like to say the "opposite of rock and a hard place." Think of the story of Homer's Odyssey in which the heroes encountered a terrible choice: Scylla and Charybdis, a sea monster and a whirlpool. Neither option was really that good. Here, we have the reverse scenario: the potential for an attractive outcome whether or not the company enters restructuring. Imagine if Odysseus was faced with not a sea monster and a whirlpool, but instead, seeing his wife or a nice lamb dinner. If a company avoids restructuring, then the investment in the fulcrum security will likely be refinanced at par, and should generate a very appealing combination of interest and principal gain. Conversely, if the company does need to restructure, the fulcrum security investment that we have selected would be exchanged for equity in the new entity. Certainly, owning post-reorganization equity offers no guarantee of future gains, but we view the fact that we can potentially access that equity-upside in an improved capitalization as a real opportunity.

The Highest Yield Palatable with Any Restructuring Risk

Another way to look at the fulcrum security is that it typically[2] provides the highest yield that is reasonably attainable in a structure that could potentially go through a restructuring. As a company approaches the zone of insolvency, securities will trade at different yields due in part to their seniority in the capital structure. This scenario will provide investors with many options to choose from. The highest yielding securities are attractive from a yield perspective, but the yield is subject to the entity staying solvent, so the principal will be at greater risk. If the company goes bankrupt, a high yielding security at the bottom of the capital structure could end up worthless. Conversely, lower yielding securities sitting higher up in the capital structure could be made whole, even in case of bankruptcy, but would not generate as high a yield. As previously discussed, TAM chooses to resolve this trade-off by investing in what we believe to be the fulcrum security. Where we think the fulcrum is will determine the level of yield with which we are comfortable within a company facing distress. This combination of yield and downside protection guides our risk management for distressed and restructuring securities.

Time Can Be On Our Side, Thanks to Liquidity Runway

Liquidity runway does provide an exception to the prior guideline. We view "liquidity runway" as the amount of time a company can sustain its cash expenses given its current operations, access to cash, and current cash obligations. For distressed investments, if a company has a substantial amount of liquidity runway, and we believe that management is in the process of fixing its operations, we may choose to invest in a segment of the capital structure that is not the fulcrum at that precise time but likely would be at some point in the future. This extra time provides additional coupon payments and also another opportunity for the company to become more viable. We take these coupon payments in conjunction with an estimate of future potential recoveries on a restructuring as key determinants of the investment decision conjunction with an estimate of future potential recoveries on a restructuring as key determinants of the investment decision.

2 Sometimes the fulcrum security may not have a current yield. In those situations, its attractiveness lies on the potential returns it could generate if converted to equity in case of a restructuring.

Today, TAM holds Clear Channel Communications debt. In 2009, one of TAM's funds owned guaranteed notes which may or may not have been the fulcrum at that point; we were not sure. We were pretty certain, however, that regardless of what happened, the company had several years of runway to get their operations in order, and that this time period created option value. As it turned out, Clear Channel Communications has been diligently paying its coupon, its earnings have been improving with general economic activity and, should this trend continue, some de-levering could even occur organically. In sum, TAM will sometimes take a bit more insolvency risk in return for a higher yield if we believe the company has the time to sort out its issues. We can be patient, if we are being paid for that patience.

The Fulcrum as a Control Security

Over the long history of TAM and its predecessor, we have at times used the fulcrum security to drive a different agenda: get control of a business. Why would we want to do that? Firstly, we love the company. Secondly, we love the business so much that we want the balance sheet cleaned. That process would involve having all debt extinguished/ exchanged for equity in the reorganized entity. As a debt free company, a sharp management team will be able to have the freedom to prudently grow the business as well as the patience to avoid mistakes. TAM was a pioneer in the use of the fulcrum as a tool for control, and that same practice continues to be used by TAM and other investors.

Understanding where to find the fulcrum security has a key role in Third Avenue's investment process. There are two caveats. First, it is far from obvious which part of a company's capital structure will ultimately prove to be the fulcrum security ex ante. Second, it is also not possible to predict with certainty what the long-term economic value of any entity is. Thus, Third Avenue's investment team spends a considerable amount of time and effort in analyzing the capital structure and valuing the companies we invest in so that, when we invest in securities that are distressed or may restructure, we can benefit in both restructuring and non-restructuring scenarios and obtain the highest level of yield subject to bankruptcy risk and liquidity runway; or maybe once in a while gain control of a business we just love.

If you would like further information about Third Avenue Management's Credit strategy, please contact your relationship manager or email clientservice@thirdave.com or visit our website www.thirdave.com