KILGOUR ADVISORY GROUP

Summary

Before New Year and in the recent MAV2 investors conference call, BlackRock disclosed that there is an initiative underway to develop a process whereby interested MAV2 Pooled Note holders would have an option to tender their notes in return for the proceeds of a pro rata liquidation of the MAV2 pooled assets.

This KAG Investor Bulletin explains the background and motivation for this initiative and how it may affect original investors.

An initiative conceived and driven by hedge funds…

US-based hedge funds have been the most active bidders for MAV notes and have accumulated significant, likely multi-billion dollars, positions in aggregate. These investors were early to recognize that the MAV notes were 'cheap' versus their risks. These funds provided liquidity to original holders, but the cost of that liquidity was that bids were heavily discounted relative to the 'fair' or intrinsic value of the notes.

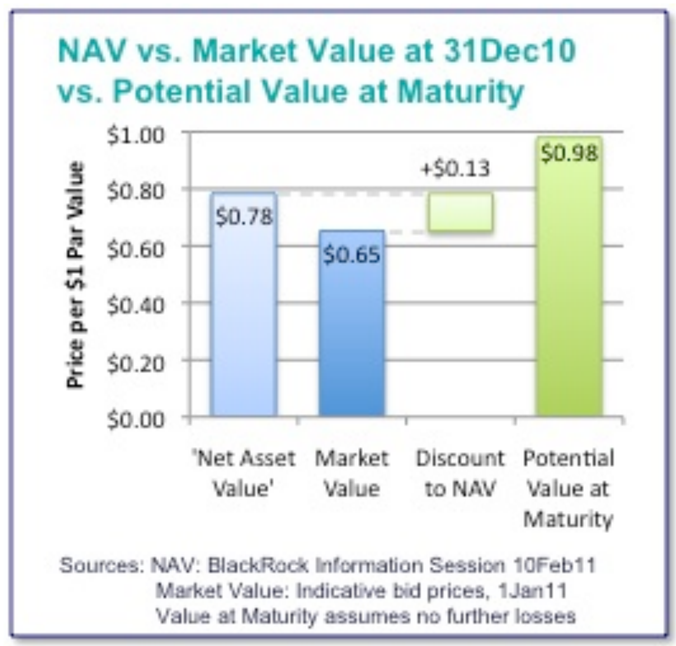
To date, these hedge fund investors have accrued significant paper profits as the market bid prices have roughly doubled since the first trades. However, they are not able to monetize these profits since there are no new buyers to whom they can sell their huge positions. To crystallize their profits, the 'hedgies' currently must wait until these assets mature in 2017.

Enter the vertical unwind…

The vertical unwind would allow the hedge funds to exit from their MAV2 Pooled notes holdings prior to maturity. Their idea is to create an optional tender process whereby they and any other investors could retire their notes in exchange for the liquidation value of a proportionate amount of MAV2 assets.

This is attractive to the hedgies for two reasons: it enables the early realization of profits and it will eliminate the current discount between secondary market value and net asset value.

As at year-end, a proportionate 'strip' of the A1, A2, B, and C notes was bid in the secondary market at a weighted-average price of $0.65 (see chart).



The Net Asset Value (viz. the total market value of the collateral assets minus the mark-to-market losses on the credit derivatives) was $0.78 cents. The vertical unwind, if implemented, would likely eliminate this trading discount to NAV.

It is worth noting as well that there is potential for the MAV2 'strip' to return 98 cents of principal at maturity in Jan-17, assuming no further losses in assets or collateral.

... may create a choice for 'original investors'...

We understand that discussions are taking place to develop a tender process. This negotiation will be complex and multipartite, including the investors, derivative counterparties, asset administrator, and margin funding lenders, amongst others. The effort is tantamount to 'restructuring the Restructuring' and is by no means a guaranteed success. For the negotiation to succeed, the tender process will require the explicit and unanimous approval from the asset providers and margin lenders as well as a suitable majority of noteholders.

If the vertical unwind does happen, it will impact all original holders of ABCP who were issued MAV2 notes regardless of whether they elect to tender. The most immediate impact would be that secondary bid prices would likely rise close to the liquidation value (essentially NAV). If liquidation at or near NAV was possible, there would be no reason for the current liquidity discount to persist in the secondary market. This impact is already being seen in the recent run-up in secondary bid prices.

There is a requirement for all noteholders to be treated equally, so original investors would almost certainly have an opportunity - but not a requirement - to tender their notes alongside the hedgies. Each holder will have to make a sell-versus-hold decision based on their own assessment of the returns from holding the notes to maturity versus potential alternative uses for the liquidation proceeds.

… but careful consideration is required.

If the initiative fails, it is possible in the near term that liquidity will leave the secondary market. While this would have no impact on the intrinsic risk of the notes or on their ultimate value at maturity, it would make selling notes more difficult and would potentially drive secondary market prices down. There could also be a negative impact on investors who mark the book value of their MAV notes from secondary market indicative bids rather than using a model-based valuation approach.

If the initiative comes to fruition, noteholders will have to make a decision to support or not support the vertical unwind. In assessing whether to vote for or against, considerations should include: Is the determination of liquidation value the result of an unbiased process? Will the collateral be apportioned fairly? Is it a one-time-only or regularly available tender? Will expenses be proportionately reduced so remaining noteholders are not unfairly burdened?

Stayed tuned...

No actions are required of noteholders at this time but we recommend that you monitor the progress of the vertical unwind initiative and consider the impact of its success or failure on your outlook for holding your notes.

Please call or email us directly if you have any concerns or questions regarding this process.

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