

The Turnaround Letter

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USING POST-BANKRUPTCY WARRANTS FOR ADDED PRICE LEVERAGE

From time to time (most recently in the September 2010 issue), we have talked about the potential benefits of buying the stocks of companies that have recently emerged from Chapter 11. These stocks are usually overlooked by mainstream investors – sometimes even actively spurned because of their past history – and so they are often undervalued. If the company has made good use of Chapter 11 to clear up its problems, the new stock can perform very well after the end of the bankruptcy.

In addition to issuing new stock when they exit Chapter 11, many companies issue warrants as well, often as an extra sweetener to persuade creditors to agree to the plan of reorganization. (In the September issue we discussed TARP warrants, which are similar in that they were issued to the U.S. government as an incentive to make emergency loans during the 2008-09 meltdown.) These warrants are often well “out of the money” (i.e. the stock is trading well below the exercise price of the warrants) when the company first emerges from Chapter 11. But if the stock appreciates, the warrants usually have significantly more price leverage than the underlying stock.

Of course, warrants can be quite volatile. And like an option, a warrant will be worthless if the stock price is below the exercise price when the warrant expires. But unlike options, most warrants have multiple-year lives before they expire.

This combination of price leverage and relatively long life makes warrants attractive for aggressive investors who are willing to take on more risk to obtain potentially higher returns. Below we examine eleven warrants issued by companies that have gone through bankruptcy or a similar reorganization over the last few years.

IN THIS ISSUE:

Airlines.....3

Recommendations:

Buy: General Motors.....5

Sell: Global Crossing.....6

News Notes.....6

Performance.....7

AIG, the insurance giant, never actually filed for Chapter 11, but it might as well have. The federal government loaned the company \$182 billion in 2008-09 to keep it afloat and ended up owning 92% of the equity. Although AIG has sold a number of assets and taken other measures to strengthen its businesses, we’re not sure there is enough value left in AIG to provide much upside for stockholders. But others disagree. Some pretty savvy investors have taken big positions in AIG, and if they are right, the warrants could have a lot of gain potential.

(Continued on next page)

Post-Bankruptcy Warrants (continued)

Charter Communications is the fourth largest U.S. cable operator; it also offers a wide range of broadband communications services. Since emerging from the nation's largest pre-negotiated bankruptcy case in November of last year, the stock has rallied strongly with the cable sector. Revenues have grown, but profitability has been elusive. Paul Allen, the co-founder of Microsoft, is still a large shareholder, as are several noted distressed investing funds.

Federal-Mogul emerged from its asbestos-triggered bankruptcy in late 2007. The company is a maker of auto and truck parts, such as spark plugs, bearings, gaskets and brake pads. Operations have benefited from the general recovery in the auto sector, both in the aftermarket and new auto/truck sales. The stock has been one of the better performers in the auto-supply sector since the market's bottom in March 2009. Results have been somewhat lukewarm to date, but the stock continues to trade at attractive, below-market, valuation levels. Carl Icahn owns 76% of the stock, and he is shopping the company to potential buyers.

General Motors. See the Purchase Recommendation on page 5. Both warrants are currently "in the money," but they still have more upside leverage than the stock.

LyondellBasell Industries is the world's third largest chemical company, formed in 2008 by the merger of Lyondell Chemical and Basell. The newly-merged company couldn't handle its debt load in the weak economic environment, and it filed for bankruptcy in early 2009. When it emerged in April 2010, the reorganized company had reduced its debt from \$24 billion to \$7.2 billion, while keeping its operating assets largely intact. Recent operating results have been solid. The stock has performed well, but many think it is still undervalued.

Owens Corning, a maker of insulation and roofing products, emerged from its asbestos-related bankruptcy in late 2006 only to run into the worst housing collapse in memory. The stock was decimated, but it has rallied back as operating results have rebounded. When construction eventually picks up again, the stock should move up a lot further.

Post-Bankruptcy Warrants Warrant Consideration:

Name	Symbol	Expiration Date	Strike Price*	Stock Price	Warrant Price	% Gain in Warrant IF Stock at Expiration is up		
						50%	100%	200%
AIG	AIG-WT	01/21	45.00	31.15	8.98	-81	+93	+440
Charter Comm.	CCMMW	11/14	46.86	58.94	17.25	140	312	653
Federal-Mogul**	FEMOW	12/14	45.82	26.51	0.42	-100	1614	7926
General Motors	GM-WTA	07/16	10.00	32.09	23.17	65	134	272
General Motors	GM-WTB	07/19	18.33	32.09	17.80	67	158	338
LyondellBasell Ind.	LALWF	04/17	15.90	44.50	28.95	76	153	306
Owens Corning**	OCWAW	12/17	43.00	37.84	4.92	180	564	1333
SemGroup	SEMXX	11/14	25.00	28.05	8.25	107	277	617
Solutia**	SOA/WS	02/13	29.70	26.35	3.39	190	579	1356
Visteon	VSTOW	10/15	58.80	67.43	21.25	99	258	575
Xerium Tech.	XRMWQ	05/14	19.52	23.06	6.00	151	343	728

* Subject to adjustment per dividends paid.

** Previous TL Recommendation

SemGroup provides what are known as “midstream services” to the oil and gas industries; it is also a maker of asphalt. Trading problems forced the company into bankruptcy in 2008. Since emerging in late 2009, the company has found some noteworthy investors, but it hasn’t yet developed a Wall Street following.

Solutia was formed in 1997 when Monsanto spun out its legacy chemical business. Monsanto also burdened the company with a heavy load of liabilities, and it succumbed to bankruptcy in 2003. It emerged in 2008, and management began to focus on specialty chemicals where the company has a leading position and sustainable competitive advantages. Despite the company’s post-bankruptcy success, the stock remains attractively valued.

Visteon too was a spin-out. In 2000 Ford set up the company to take over many of its automotive components and systems busi-

nesses. The new company was never truly viable, and despite a major restructuring in 2006, it ended up in bankruptcy court in May 2009. After emerging from Chapter 11 last October, Visteon is now a leaner company, and its customer base goes well beyond Ford.

Xerium Technologies is a small, but global manufacturer of specially engineered paper-making equipment. In one of the exceptions to the usual rule, Xerium’s shareholders were not completely wiped out by the firm’s 2010 bankruptcy; in a prepackaged plan of reorganization, existing shareholders retained about 17% of the outstanding shares and received warrants for another 10%. Xerium’s global presence – 31 manufacturing facilities in 13 countries – provides for intriguing opportunities.

Disclosure Note: Accounts managed by an affiliate of the Publisher own securities of several of the companies discussed above.

AIRLINE STOCKS: HEADED UPWARD AGAIN?

After rebounding sharply from their multi-year lows in 2008-09, most of the airline stocks have been weak over the last six months or so. Just as the planes were beginning to fill up again after the economic downturn, oil prices have jumped up because of unrest in the Middle East, and that has spooked holders and potential buyers of airline shares.

We believe that the selloff in the airline stocks is overdone. While fuel prices are undeniably a significant cost for all the airlines, the carriers now appear to have the ticket pricing power to overcome the rise in oil. Because the airlines have been disciplined and have not increased their capacity as the econ-

omy improved, most planes have been very full in recent months. As a result, travelers have been willing to endure fuel surcharges and other forms of price increases.

First quarter results have borne out this thesis, with most carriers posting good numbers for what is usually their seasonally weakest period. We believe that the airlines will continue to post solid results, even if oil prices rise further. And if oil begins to decline, the airline profits could soar.

AMR, the parent of American Airlines, has been the industry laggard for some time now. Its costs are relatively high, per-

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Airlines Grounded but Ready to Take Off:

<u>Company</u>	<u>Symbol</u>	<u>Recent Price</u>	<u>52-Week Range</u>	<u>Market Cap. mil.</u>	<u>Price to Sales</u>	<u>Debt to Equity</u>
AMR Corp.	AMR	5.87	8.98 – 5.44	1,960	0.08	NSE
Delta Air Lines	DAL	10.38	14.54 – 8.91	8,670	0.26	17.08
JetBlue Airways	JBLU	5.66	7.60 – 5.14	1,670	0.42	1.83
SkyWest	SKYW	16.52	17.28 – 11.38	891	0.32	1.33
Southwest Airlines	LUV	11.75	14.32 – 10.42	8,790	0.70	0.51
United Continental Hold.	UAL	22.82	29.75 – 16.39	7,540	0.27	7.63
US Airways Group*	LCC	9.09	12.26 – 5.70	1,470	0.12	NSE

* *Previous TL Recommendation*

NSE = Negative Shareholder Equity

haps because it did not have the opportunity to cut them via Chapter 11 as did several of its competitors over the past decade. It has also been hurt by its battle with the online ticket vendors. Ironically, however, the poorest performers often have the greatest stock appreciation when their sector comes back into favor.

Delta is one of the world's largest airlines following its merger with Northwest in 2008. Delta has taken its time integrating the two carriers, but it is now beginning to reap the benefits.

JetBlue, as a newer, lower-cost carrier, has a number of advantages compared to its older competitors. As a result, it did not fall as far as some of the legacy carriers in the 2008 downturn, but it has not rebounded as rapidly either. JetBlue continues to gain market share, and the stock should perform well if industry conditions remain favorable.

SkyWest is a smaller airline that serves as a feeder for many of the larger carriers, particularly Delta and United. Its balance sheet is better than those of many of the large airlines, and as a result its stock has been somewhat less volatile.

Southwest is no longer the small, industry upstart. By many measures, it is one of

the largest airlines in the world, and it is getting bigger with the completion of the acquisition of AirTran. The company's image – and stock price – has been hurt recently by maintenance problems with some of its planes. But Southwest remains a price-leading, consumer friendly carrier, and we expect its stock to rebound nicely.

United Continental is still in the process of integrating the two partners in the recent merger, and so the cost savings and synergies are several quarters away. However, the carrier's strong position in the lucrative Asian market bodes well for its long-term performance.

US Airways continues to make steady progress. The integration of the old US Air with America West has been very slow, but it now appears to be bearing fruit. We recommended US Airways in the May 2009 issue, and we still like it despite the strong gain in the stock. We are making the stock a "buy" again up to 12.

Disclosure Note: Accounts managed by an affiliate of the Publisher own the securities of a number of the companies discussed in this article.

RECOMMENDATIONS

Purchase Recommendation: General Motors

Category: Large-Cap (\$49.9 Bil.)

Symbol: GM **Exch.:** NYSE

Business: Auto Manufacturing

Annual Rev.: \$135.6 Bil. (12/31/10)

Earnings: \$4.67 Bil.

4/29/11 Price: 32.09

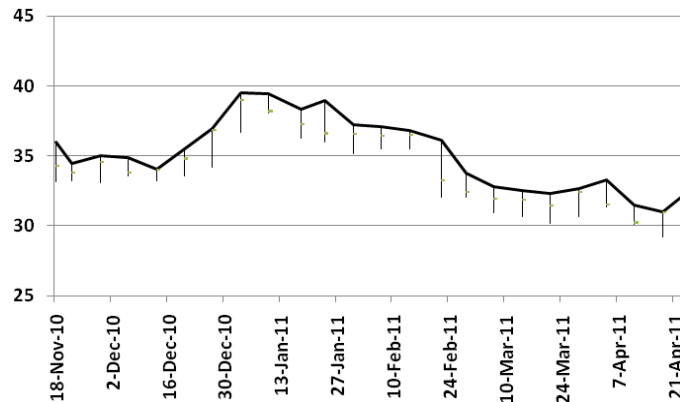
12-Mo. Range: 39.48 – 29.17

Max. Rec. Price: 40

Est. Div. Yield: Nil

Address: 300 Renaissance Center, Detroit, MI 48265-3000, Telephone (313) 556-5000

Internet Site: www.gm.com



Background: General Motors came into being in 1908 with the merger of several small automobile manufacturers. The company grew over the years to become the world's largest auto maker, a title it held for 77 consecutive years from 1931 to 2007.

However, the company's dominance began slipping several decades ago. Poor product design and quality, indulgent labor practices and ineffectual financial management weakened the company to the point where it was forced into bankruptcy by the economic downturn in 2008-2009.

In an unusual government-dominated Chapter 11 case, GM was able to dramatically restructure the company in a short period of time. Among other actions, it reshaped labor contracts, shed debt, replenished cash, eliminated several brands and slimmed down its dealer network. As a result, the key parts of the business were able to emerge in July, 2009, only about a month after first filing for Chapter 11. The U.S. government provided \$50 billion of support for the company during

its reorganization, and upon emergence from bankruptcy the government owned 61% of GM's stock. The company offered a portion of its stock to the public last November.

Analysis: Back in the December issue, we looked at the GM stock when it first began trading. Our recommendation then was to wait on GM, to consider some of the automotive parts suppliers instead. That turned out to be pretty good advice. Since the end of November, GM stock is down about 6% while the nine suppliers that we high-lighted are up an average of about 28%. (The S&P 500 gained 15.5% over the same period.)

Now, however, we are ready to recommend the GM stock. We have always been impressed by how dramatically the company was reshaped during its brief bankruptcy, but we wanted to get a better sense of several things, including how management would perform, how the stock would trade and where the global car market was headed. Most of our concerns have now been alleviated.

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GM (continued)

GM's new management team has brought a level of discipline to the company that it hasn't had in decades. Operations are now leaner, and the finances are better managed than they have been in at least a couple of generations.

The company's product line appears to be experiencing good success both domestically and abroad. Its new models in the U.S. have been well received, and it has others in the pipeline. GM's joint venture in China is the leader in that burgeoning market.

Worldwide auto sales are expected to continue growing nicely over the next several years, and GM is well positioned to participate in that growth. Even if auto sales stagnate, the new, leaner GM should perform decently.

Valuing GM is still a little tricky, given its recent history, but the stock appears to be trading at around three times EBITDA (Earnings Before Interest, Taxes, Depreciation

and Amortization, a widely used measure of cash flow). We think it will eventually trade at five times EBITDA or higher.

Of course, not everything is going to be rosy for GM. Rising gas prices and rising raw material costs could be a stumbling block. Also, the government still owns about 27% of the GM stock. How well the government manages the disposition of those shares could have a significant effect on the stock price.

All that said, we like what we see at GM now. We recommend buying General Motors stock up to 40. Investors looking for more price leverage – and willing to take on additional volatility – should also look at the GM warrants discussed in the first article above.

Disclosure Note: Accounts managed by an affiliate of the Publisher own General Motors securities.

Sale Recommendation: Global Crossing

Global Crossing agreed to be acquired by Level 3 Communications in an all-stock transaction. The Global Crossing stock moved up sharply on the announcement of the deal, and we recommend selling the stock at this time.

While Global Crossing and Level 3 could be a good fit, we see a couple of signifi-

cant risks for shareholders. First, the deal may not go through. The companies must obtain many regulatory approvals, and a number of those approvals will not be slam dunks. Secondly, for years Level 3 has been over-leveraged and struggling to grow into its debt-heavy capital structure. The merger may help, but the success of the combined entity is far from a sure thing.

NEWS NOTES & UPDATES

Several of the names on our recommended list have moved above their maximum buying prices. We think the following stocks have further to rise and we are increasing our buy ceilings to the levels noted: **DuPont – 60; Emerson Electric – 65; Motorola**

Solutions – 49; Federal-Mogul – 28; and Tyco – 52. We are making **Sara Lee** a “hold” for the time being. It has become more of a buyout stock recently, and we wouldn't chase it until its future becomes clearer.

PERFORMANCE

The tables below and on the next page show the performance of all of our currently active recommendations, plus recently closed out recommendations. The categories are based on market capitalization on the recommendation date, except that recommendations made prior to August, 2004 are categorized by their 8/20/04 market cap. For copies of past recommendations, at \$15 per copy, please call (617) 573-9550 ext. 550.

SMALL-CAP (under \$1 billion) - CURRENT RECOMMENDATIONS

RECOMMENDATION	Symbol/ Exch (1)	Rec. Issue	Price at Rec.	4/29/2011 Price	Total % Return (3)	Current Status (2)
Bristow Group	BRS/N	11/86	0.75	46.40	+6087	Hold
Kadant Inc.	KAI/A	4/02	14.28	30.85	+116	Hold
Primedia	PRM/N	6/03	19.80	4.90	-71	Buy (6)
On Assignment, Inc.	ASGN/O	1/04	5.15	10.99	+113	Hold
Zhone Technologies	ZHNE/O	5/05	11.40	2.69	-76	Buy (5)
Presstek	PRST/O	6/05	8.58	1.82	-79	Buy (6)
Newpark Resources	NR/N	6/06	5.65	9.03	+60	Buy (10)
Electro Scientific Ind.	ESIO/O	2/07	21.24	16.45	-23	Buy (20)
CTS Corp.	CTS/N	11/07	12.54	10.99	-9	Buy (15)
Midas	MDS/N	7/08	13.50	7.27	-46	Buy (20)
Solutia	SOA/N	9/08	15.58	26.35	+69	Hold
US Airways	LCC/N	5/09	3.79	9.09	+140	Buy (12)
Global Crossing	GLBC/O	9/09	11.49	23.38	+103	Sell
Wet Seal	WTSLA/O	10/09	3.93	4.40	+12	Buy (6)
Winn-Dixie	WINN/O	1/10	10.14	7.09	-30	Buy (15)
ACCO Brands	ABD/N	3/10	7.17	9.71	+35	Buy (12)
M/I Homes, Inc.	MHO/N	7/10	10.08	13.29	+32	Buy (20)
Superior Industries	SUP/N	9/10	14.75	25.27	+75	Buy (30)
Kemet	KEM/N	2/11	14.75	15.73	+7	Buy (23)
Drew Industries	DW/N	3/11	23.13	24.07	+4	Buy (33)

MID-CAP (\$1 billion to \$10 billion) - CURRENT RECOMMENDATIONS

RECOMMENDATION	Symbol/ Exch (1)	Rec. Issue	Price at Rec.	4/29/2011 Price	Total % Return (3)	Current Status (2)
Newell Rubbermaid	NWL/N	6/04	23.24	19.06	0	Buy (20)
Goodyear Tire	GT/N	7/04	9.14	18.15	+99	Buy (20)
Tenet Healthcare	THC/N	9/04	10.27	6.93	-33	Hold
Janus Capital Group	JNS/N	8/05	15.27	12.17	-19	Buy (17)
Portland General	POR/N	11/06	25.70	24.96	+14	Buy (33)
Interpublic Group	IPG/N	12/06	11.94	11.75	-1	Buy (14)
Tellabs	TLAB/O	2/08	6.66	4.90	-25	Buy (10)
RadioShack	RSH/N	4/08	15.87	15.81	+4	Buy (23)
Federal-Mogul	FDML/O	5/08	21.00	26.51	+26	Buy (28)
Old Republic	ORI/N	6/08	14.64	12.67	+1	Buy (20)
Terex Corp.	TEX/N	2/09	12.57	34.78	+177	Hold
Tyco International Ltd.	TYC/N	3/09	20.05	48.74	+152	Buy (52)
Calpine	CPN/N	12/09	11.12	16.75	+51	Buy (18)
Lear	LEA/N	6/10	33.84	51.14	+51	Buy (58)
Boston Scientific	BSX/N	8/10	5.60	7.49	+34	Buy (9)
Owens Corning	OC/N	12/10	26.31	37.84	+44	Buy (40)
MGIC	MTG	1/11	10.11	8.66	-14	Buy (17)

LARGE-CAP (over \$10 billion) - CURRENT RECOMMENDATIONS

RECOMMENDATION	Symbol/ Exch (1)	Rec. Issue	Price at Rec.	4/29/2011 Price	Total % Return (3)	Current Status (2)+
Carnival Corp	CCL/N	1/01	30.50	38.07	+49	Hold
AT&T, Inc.	T/N	5/03	23.05	31.12	+85	Buy (44)
Bristol-Myers Squibb	BMY/N	8/03	26.07	28.10	+43	Buy (35)
Ford	F/N	12/03	13.00	15.47	+27	Buy (20)
Schwab	SCHW/N	3/04	12.20	18.31	+68	Buy (20)
Time Warner	TWX/N	12/04	53.46	37.86	-9	Buy (40)
Campbell Soup	CPB/N	4/05	28.14	33.59	+39	Buy (42)
Taiwan Semiconductor	TSM/N	12/05	9.29	13.50	+69	Buy (14)
Sara Lee	SLE/N	4/06	15.28	19.20	+42	Hold
Microsoft	MSFT/O	10/06	27.94	25.92	+1	Buy (40)
Pfizer	PFE/N	3/07	25.84	20.97	-4	Buy (25)
General Electric	GE/N	7/07	38.12	20.45	-38	Buy (25)
Motorola Solutions	MSI/N	8/07	68.52	45.88	-33	Buy (49)
Amgen	AMGN/O	10/07	56.56	56.85	+1	Buy (70)
DuPont	DD/N	1/08	45.07	56.79	+38	Buy (60)
Sprint	S/N	3/08	8.09	5.18	-36	Buy (7)
Kraft	KFT/N	8/08	31.82	33.59	+16	Buy (40)
Bank of America	BAC/N	10/08	35.00	12.28	-64	Buy (21)
Emerson Electric	EMR/N	8/09	36.03	60.77	+78	Buy (65)
Sysco	SYYS/N	11/09	27.01	28.91	+13	Buy (36)
Marsh & McLennan	MMC/N	2/10	21.71	30.28	+44	Buy (35)
Applied Materials	AMAT/O	4/10	13.45	15.69	+19	Buy (20)
ExxonMobil	XOM/N	10/10	61.79	87.98	+44	Buy (90)
Fifth Third	FITB/O	11/10	12.56	13.27	+6	Buy (17)
Coca-Cola	KO/N	4/11	65.72	67.46	+3	Buy (80)

RECENTLY CLOSED OUT RECOMMENDATIONS (ALL CATEGORIES)

RECOMMENDATION	Symbol/ Exch(1)	Rec. Cat.	Buy Issue	Price at Buy	Sell Issue	Price at Sell	Total % Return (3)
Disney	DIS/N	Large	4/09	19.06	4/10	35.10	+84
Qwest Communications	Q/N	Mid	11/08	2.74	5/10	5.23	+105
RehabCare	RHB/N	Small	6/07	16.07	6/10	22.76	+42
ADC Telecom	ADCT/O	Mid	1/02	31.78	8/10	12.73	-60
Rite Aid	RAD/N	Mid	8/04	4.87	10/10	.94	-81
Parametric Tech.	PMTC/O	Mid	5/04	11.63	11/10	21.52	+85
Flextronics International	FLEX/O	Mid	1/09	2.27	1/11	7.87	+247
Teradyne, Inc.	TER/N	Small	12/08	3.79	2/11	16.23	+328
Motorola Mobility	MMI/N	Large	2/11	57.29	2/11	29.59	-48
JDS Uniphase	JDSU/O	Mid	2/05	17.52	3/11	24.67	+41
Williams Companies	WMB/N	Mid	6/09	16.25	3/11	30.36	+92
Ariba	ARBA/O	Mid	5/10	14.27	4/11	33.96	+138

Footnotes:

- (1) Exchanges: N = New York; A = American; O = OTC; (2) Maximum recommended buy prices in parentheses
(3) Total Return includes dividends as well as price changes

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