TREASURY | PARTNERS

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# Special Situation: Volkswagen

## Capturing a Fleeting Opportunity


**Richard Saperstein**
Managing Director/Principal
+1 917-286-2777
rsaperstein@treasurypartners.com

**Salvatore Martone, CFA**
Executive Director
+1 917-286-2787
smartone@treasurypartners.com

**Daniel Beniak, CFA**
Associate Director
+1 917-286-2783
dbeniak@treasurypartners.com

**treasurypartners.com**


In Q4 2015, we published our views on Volkswagen ("VW") in two separate advisories: *Advisory – Volkswagen AG* on Sep. 22nd and *Advisory – Volkswagen AG* on Oct. 1st. At the time, VW was reeling from their acknowledgment they sold cars specifically designed to illegally dupe government emissions tests. As a result, bond prices dropped and we added positions to portfolios at attractive risk-adjusted prices. In this update, we recap our original rationale, and provide an update on how a representative VW holding has since performed.

### Background

In September, 2015, US regulators announced several models of VW diesel-engine cars included software which hid the fact they produced up to 40 times more emissions than legally permitted. The initial allegations covered over 500,000 VW cars sold within the US, but the vast majority of VW's vehicles are sold abroad and were soon found to feature similar software.

As a result, the magnitude of the cheating and potential financial consequences were thought by some to represent a threat to the company's future. While the potential civil and regulatory fines were still unknown, the markets imposed a severe penalty on VW securities, with its stock falling over 42% by the end of September, and the price on VW's senior company debt (A3/A- at the time) decreased by several dollars, pushing the bonds to high-yield, "junk" levels.

### Our Strategy

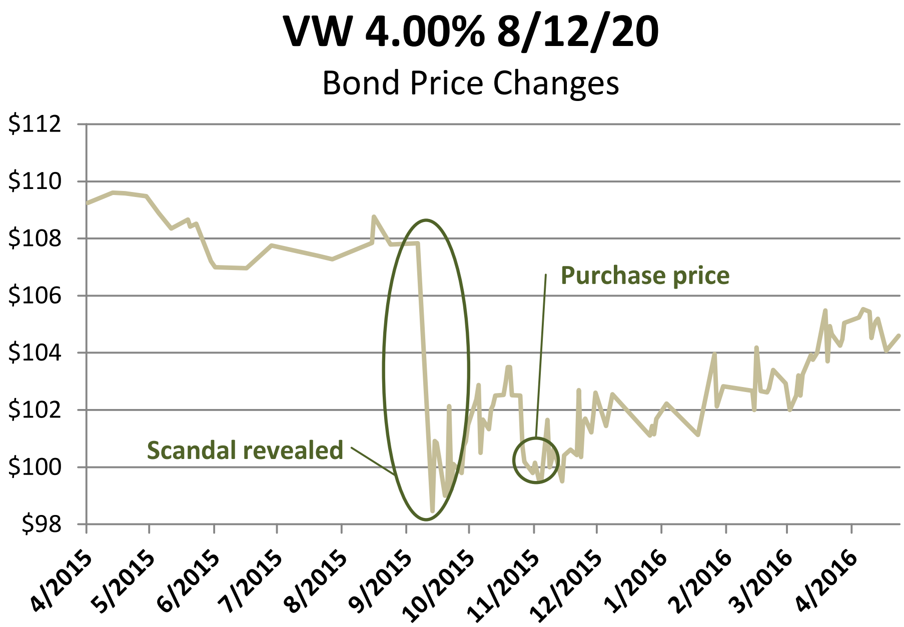
Certain clients had existing exposure to VW debt. Therefore, once the scandal broke we performed a thorough credit review to determine whether to maintain these positions. We built a comprehensive financial model incorporating rigorous sensitivity analyses that stress-tested the company's resiliency.

Our research revealed VW had a very strong balance sheet, robust free cash flow generation, and significant financial flexibility. Over the prior twelve months, VW's Automotive Division had produced an estimated €24 billion in EBITDA, €11 billion in operating profits, and €24 billion in operating cash flow. In addition to owning significant physical assets which could be sold as needed, VW also had substantial liquidity, including €28 billion of cash, a €5 billion revolver, and €3.1 billion in credit lines. Furthermore, 20% of the company is owned by the German State of Lower Saxony, ensuring a stable and powerful government benefactor.

After this review, we concluded that VW had more than enough strength to weather the likely financial consequences. Importantly, the market had adjusted the price of VW's bonds to junk levels, leading to a situation where VW debt traded at a 3.90% yield that was higher than the 3.45% being demanded from much lower-rated competitor General Motors (rated Baa1/ BBB-). This was a compelling opportunity for us to buy additional investment-grade bonds at speculative prices.

**Performance to Date**

As an example, in early November 2015 we purchased the VW 4.00% coupon 8/12/2020 bonds at approximately $100.5. Since then, the market's view on VW has clearly moved more in line with our assessment, as the price has rebounded over 4% in just over six months. The corresponding yield has declined from 3.90% to 2.85%.




*Source: Bloomberg, ISIN USN93695BL23*

**Conclusion**

As many of the VW bonds in our client portfolios have several years remaining until they mature, Treasury Partners will continue to diligently monitor developments in the ongoing settlement negotiations and resulting financial implications. Nevertheless, we feel we are beyond the peak of the crisis and remain comfortable maintaining VW positions in client accounts.