

Nathaniel's Beautiful Mind

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My partners, Tim and Dan, like to tell prospects and clients that they can meet with me anytime and ask any questions that they may have or simply see what I've been thinking about lately. In the same breath, they then caution the listener to carefully consider whether or not they want to go down that rabbit hole. They say this all in good fun, but unfortunately it is quite true. I can talk someone's ear off for hours on end about a single company that we may own for our clients or that I have done research on and is on our monitoring list waiting to be purchased at the right price.

For your reading pleasure, I'm going to write about one intriguing aspect in particular about the tracking stock^[1] Liberty Ventures ("Ventures") that most people may not be aware of: their exchangeable debentures. This particular tidbit will take up quite some space, but consider this – if Ventures' exchangeable debentures are going to take up this much paper, consider what Ventures in all its glory would take up, and then convert that from paper length to speaking time. Now, ask yourselves: do you really want to know what's on my mind?

I gave you a little taste of the Liberty entities in last quarter's commentary about the Liberty Media trackers. As I mentioned in that commentary, Liberty Media rested in the "too hard" pile for quite a while. I should have also mentioned that anything related to John Malone, Liberty Media's Chairman, lay in the "too hard" pile. That all changed after I read a quarterly commentary piece for the first quarter of 2014 written by Drew Weitz, of Weitz Investment Management, Inc., about Liberty Media (in its pre-tracker form, before the spinoff of Liberty Broadband) titled "Analyst Corner – A Perspective on Liberty Media Corporation"^[2]. After reading it, I realized that I wanted to learn more about the company and what it was comprised of. This, in turn, spawned my interest in the other Liberty entities, hence, Liberty Ventures.

By 1999, Ventures (actually, Liberty Media in a past form performed these transactions, and Ventures is the entity that holds the Exchangeable Debentures today) had invested in various companies' shares over the past few decades that they didn't really want to keep and also thought were trading at overvalued prices, but needed a way to monetize those shares' value without having to incur capital gains taxes by selling the shares. They decided to issue Exchangeable Debentures.

An exchangeable debenture is an exchangeable security that is convertible at the holder's option and delivered at the issuer's choice in the form of either the "reference shares" (e.g. the aforementioned unwanted shares), the reference shares' value, or a combination of both. From 1999 to 2001, Ventures enjoyed preferential tax treatment for these issued debentures (I'll get into more detail on this "preferential tax treatment" later), until the IRS put a stop to it.

For example, let's say Ventures wanted to realize the value of an asset, one share of publicly-traded Company A, that is priced at \$100 per share, and therefore the asset's total value is \$100. Ventures will issue an exchangeable debenture based on this one share of Company A for \$100, and in turn will pay 1% interest per year (\$1) of the face value (\$100) for the next 30 years to the debenture's holders. Ventures now has the ability to use this \$100 for other investments, and with their investment track

record, most likely be able to earn greater than the 1% interest they're paying the debenture's holders.

At the debenture's maturity 30 years later, Ventures has to pay the debenture's holders the reference share's value, whatever it may be. This can be a risk if the reference share's market value is less than the debenture's face value because Ventures would be liable to pay capital gains taxes for the difference, due to Ventures redeeming the reference shares at a price lower than the face value that they initially issued the debentures for 30 years prior. This scenario is perhaps preferable to the opposite, that is, if the reference share's market value is greater than the debenture's face value because then Ventures would have to either give up the reference share or its equivalent value in cash, which would be a greater hit to its balance sheet than the former scenario.

On the surface, these exchangeable debentures look like your typical bond, but they actually have significant tax benefits for Ventures. Using the previous example, if Ventures instead decided to issue a "fixed-rate debenture"^[3] in the corporate bond markets, they most likely would have had to pay a higher interest rate, say 5%. We'll call this 5% the "comparable interest" rate and the 1% the "cash interest" rate. Here is where the genius of Ventures' management truly shines. At the time of issuance (1999-2001), the IRS allowed Ventures to deduct the fixed-rate debenture's "comparable" interest rate of 5% on the exchangeable debenture's beginning value ($\$100 * 5\% = \5) for tax purposes despite actually paying only 1% cash interest ($\$1$). The difference between the comparable interest amount ($\$5$) and the cash interest amount ($\$1$) is called the "contingent interest" ($\$4$). Assuming a 38% corporate tax rate, Ventures can save $\$1.52$ in taxes ($\$4 * 38\% = \1.52) that is then counted as a deferred tax liability on Ventures' balance sheet that would be payable when either the debenture would mature or be retired.

In the meantime, the $\$1.52$ would be invested alongside the original issuance amount of $\$100$. The issue price of the bond (the face value stays the same) would be adjusted by adding the contingent interest ($\$4$) to the year's beginning value ($\$100$) to equal $\$104$. This cycle would repeat for the next 29 years. Year 1's end-adjusted issue price of $\$104$ would become Year 2's beginning-adjusted issue price, and would be multiplied by the comparable yield of 5% to equal $\$5.20$. This, in turn, would equal $\$1.60$ saved in taxes, and subsequently be applied to future investments. At the end of the 30 years, assuming that the debenture was not called by the debenture's holders, these tax benefit flows (e.g. $\$1.52$ and $\$1.60$) would have compounded and have accrued to $\$100.99$ in tax savings!

Now, one may ask how is this a good deal? Ventures not only owes whatever the reference share is trading at in 30 years' time, but also owes a huge $\$100.99$ deferred tax liability. In the meantime, that debenture's face value and deferred tax liability are burning huge holes on Ventures' balance sheet. I would argue an investor should ignore the face value of the deferred tax liabilities, and instead discount the future value of the annual contingent interest's tax benefits and deferred tax liabilities back to the present value utilizing appropriate discount and growth rates for the annual contingent interest tax benefits and an appropriate discount rate for the deferred tax liabilities.

This is the proper way to value these tax benefit cash flows and deferred tax liabilities. The chosen discount rates and growth rate can be extremely subjective, but an investor must be realistic in their assumptions. Once a realistic set of assumptions have been applied, one finds a drastically different valuation for Ventures than simply subtracting the face values of its liabilities from its assets.

Another interesting use of exchangeable debentures is the instrument's ability to be used as a tax shield. For example, as it stands today, Ventures and QVC are tracking stocks of Liberty Interactive. Ventures is not an income-generating entity, but QVC has annual taxable earnings of ~ 900 - $1,000$ MM. Via an intergroup tax sharing agreement, Ventures' exchangeable debentures' contingent interest provide a tax shield for QVC's taxable earnings for which QVC compensates Ventures in a cash

payment equal to the amount that QVC saves in taxes. As of 2015's tax year, Ventures has a \$1,129 MM deferred tax liability^[4], and at the end of Ventures' three remaining exchangeable debentures' maturities (maturing in 2029, 2030, and 2031, respectively), Ventures will have a total deferred tax liability due of ~\$5,368 MM. In the meantime, they have annual cash payments from QVC starting at ~\$136 MM in 2016 and increasing to ~\$440 MM by 2029^[5].

That's a total amount of ~\$4,239 MM of almost-certain cash flows over the next 13-15 years to be invested at growth rates that will most certainly be greater than the cash interest rates that they are actually paying on the exchangeable debentures (3.5% - 4%). One could argue that Ventures is already seeing success with the investment of these cash payments in deals such as their \$2,400 MM investment in Liberty Broadband (related to the Charter & Time Warner Cable merger that closed May 18, 2016), and they always have their eyes out for the next deal that has historically returned double-digit annualized returns to shareholders. Time will tell if Ventures' can pay its exchangeable debt and deferred tax liabilities upon maturity, but we have confidence that they will invest the proceeds appropriately in the meantime and most likely come out ahead at a sizeable profit.

^[1] You remember last quarter's write up on Liberty Media's tracking stocks, right? Same thing with Liberty Ventures.

^[2]

https://weitzinvestments.com/resources/documents/Literature_and_Publications/Reports/Annual-Reports/AnnualReport0314.pdf?1475958323656

^[3] because Ventures' exchangeable debentures were backed by another company's shares that they owned, they were able to pay lower interest rates whereas if they had issued fixed-rate debentures with no underlying assets, the risk to the debentures' holders would increase and thereby Ventures would have incurred a higher interest rate

^[4] this is the amount in tax benefits that Ventures has already received and invested

^[5] this amount will subsequently decrease in 2030 and 2031 due to those debentures' respective maturities