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Firms caught in money lockup

Failed auctions make cash stashes illiquid; as much as $6 billion tied up

By Megan Johnston

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Companies that have been using auction-rate securities to boost yields on their spare cash may soon find that cash tied up for who knows how long, as the credit crunch undermines one of corporate treasurers' favorite cash-management techniques. At least 60 auctions involving as much as $6 billion in securities have failed in recent weeks, preventing long-term bonds and other illiquid instruments from being converted to short-term, money-market-like vehicles.

That's what happened to Synaptics, a technology company in Santa Clara, Calif., according to its most recent 10-K filing. The $1.2 billion in market cap company disclosed that it had $13.5 million invested in double- and triple-A rated auction-rate securities that had failed. Auction-rate securities are bonds and other instruments that have been turned into short-term investments through auctions.

As a result, the interest rate on Synaptics' investment will reset to a cap, as much as Libor plus 100 basis points, as is typical on auction-rate securities. But the added interest is not much compensation for an illiquid investment.

"In the event we need to access these funds, we will not be able to until a future auction on these investments is successful," the company said in the filing, adding that if the issuers were unable to successfully close future auctions, the company could have to take an impairment charge on the investment.

Actually, Synaptics is lucky only to be unable to get its money out. According to the interpretation of Financial Accounting Standards Board rules, auction-rate securities are usually counted as short-term investments. But in the case of illiquid securities, they may have to be reclassified as long-term investments. That might violate debt covenants, which rely on a ratio of short-term to long-term debt.

While Synaptics has some debt, it is not subject to covenants. So the company said in its filing that it did not anticipate the lack of liquidity to affect its business. Synaptics CFO Russell Knittel did not return a call seeking comment.

Auction-rate securities have had their share of controversy in the past. In 2005, the major accounting firms moved to reclassify auction-rate securities from cash equivalents to short-term investments. And in 2006, the Securities and Exchange Commission fined 15 broker-dealers for intervening in the bidding process. The firms neither admitted nor denied the charges.

Now the securities have new problems, as they have experienced some of the same disruptions that have befallen certain segments of the asset-backed commercial paper market.

At least 60 auctions have failed in recent weeks, which could represent as much as $6 billion, said Peter

G. Crane, founder of Crane Data, which tracks money market and other cash investments. The total auction-rate securities market is an estimated $300 billion.

Auction failures are rare. The last major failure occurred in 2002, when a Zurich Financial auction-rate issue failed because there were fewer buyers than sellers. It's difficult to identify such failures, since some occur in the private placement market. But lately buyers have avoided auction-rate securities that are linked to anything with the taint of subprime mortgages, including those backing collateralized debt obligations and commercial paper.

"One failed auction may cause investors to shy away from the market altogether," said Lance Pan, director of investment research at Capital Advisors Group, which specializes in corporate cash investments.

One source, who declined to be named, said several auctions held by Merrill Lynch, Lehman Brothers and Deutsche Bank have failed within the last month. If an auction fails, the dealer has no obligation to clear it. Some in the industry speculate that banks have allowed the auctions to fail because they already have too much exposure to impaired assets on their books. Spokesmen for the banks did not respond to calls for comment.

Clearly, however, banks are not afraid to market such securities to investors. In a research report last month, Merrill strategist Kevin J. Conery acknowledged that several auctions failed at a few broker-dealers, but wrote that "turmoil in the auction market should lead to opportunities for short-term investing."

Auction-rate securities are a form of collateral—be it long-term variable-rate bonds, preferred stock or CDOs—tied to short-term interest rates that are reset every seven to 49 days through a Dutch auction process that's similar to that commonly used for Treasury auctions. According to sources, some companies have several hundred million to more than $1 billion invested in auction-rate securities.

"It's almost like an autopilot investment," said Adam Dean, managing director of SVB Asset Management, which manages fixed-income portfolios for corporations. "If you want to keep holding, it's as simple as not picking up the phone," he said.

Until recently, that is. But the inherent risks that have abruptly come to light are scaring some corporate cash managers away.

For one thing, the securities are marketed almost entirely by single broker-dealers, who also underwrite the securities. So if the dealer fails, so much, perhaps, for the auction, said Mr. Dean, who added that SVB has not invested its clients' money in auction-rate securities since 2004.

"If you don't have buyers equaling the number of sellers, the auction would fundamentally be at risk," he said.

And if the auction fails, the investor is essentially stuck holding the illiquid security until another auction clears. That could theoretically be in another seven to 49 days, but an auction won't clear until there is sufficient investor interest. **FW**

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