Opportunistic Value Investing:

Special Situations

What are they?

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We periodically are asked to define what Opportunistic Value Investing means to Hudson Value Partners. This two-part white paper series defines the two largest components of the approach, **franchise businesses** and **special situations.**

Special Situations

In our previous white paper, we discussed the elements of franchise businesses, and how we define them at Hudson Value Partners as - *a business where the whole, is worth more than the sum of the parts.* The standard for franchise businesses is a lofty one and great care goes into identifying them. During this research process, many companies we analyze may not measure up, but still present interesting value investment opportunities.

Special Situations come in many forms, but most share the same characteristics:

- There is a defined event or corporate action
- The potential investment return is roughly calculable and time limited
- The security is undervalued

At Hudson Value Partners, we define special situations as the converse of a franchise business: *a business where the parts, are worth more than the sum of the whole.*

There are periods of time when special situations are plentiful in markets and times when there is a drought. Experience and flexibility in considering a wide variety of situations is key to our approach. We will briefly describe the broad categories of special situations we consider investments in.

Merger Arbitrage

While many mergers end up being long-term destroyers of shareholder value, investment opportunities exist when a deal is announced. In public markets, companies may merge or acquire one another through cash, stock, or a combination of the two. Deals take an increasingly long time to close given how the global nature of many businesses compounds the regulatory hurdles that must be met. In a cash deal, an investor may purchase shares of the to-be-acquired company (the target) and wait until the deal closes to receive their cash proceeds. The difference between the deal price and their cost is known as the spread. In an all stock or cash and stock deal, the spread varies based on the share price performance of the acquirer.

Merger Arbitrage trades historically provide a return of 2-3x the risk-free rate (10-year Treasury in US markets). While there can be ups and downs along the way, most announced deals – even in recessionary environments – have gone through to completion. Deal risk becomes a larger factor in merger arbitrage investing than ordinary market risk.

Bankruptcies, Liquidations, and Restructurings

These are three words that no equity holder wants to hear regarding one of their positions. But as other investors race towards the exits, in the wreckage, valuable assets may remain. These investments often take place across the capital structure – the equity stub may be attractive, but the firm's debt securities may provide interesting options as well. It is next to impossible to generalize between situations of this nature, the value investor's edge here derives from knowing the details of the situation intimately enough to be comfortable holding on until there is a resolution.

Spinoffs and Divestitures

Under-researched and often promptly cast aside, spinoffs and divestitures are among the favorite hunting grounds for an Opportunistic Value Investor. From time to time, larger companies (parents) will separate a certain division of the business and distribute it to shareholders as its own publicly traded company. Often this division was not part of the core business, had been underinvested in, and not given the resources to thrive. Spinoffs are typically small to mid-cap companies. Many institutional investors and indexes cannot hold the spun-off company and the position received is of too little value to matter to them. This can put substantial selling pressure on a spinoff as soon as it starts trading. These companies also tend to be less well researched than their parents. The combination of forced selling of an under researched security, with the prospect of new management focused on and willing to invest in the business can be a powerful one. It is essential to take note of any spinoff transactions announced and monitor those deals before and in the few months following the spin to determine whether an attractive investment opportunity is emerging. A spinoff is the very essence of the parts being worth more than the whole.

Convertible Securities

Convertible securities are a type of fixed income investment that pay the holder current income in the form of interest and give the holder the option to convert those bonds to common stock at a given price and time. When the common stock trades above the conversion price, a convertible bond will trade up along with it. When the common stock trades below the conversion price, the bond will trade in line with similar fixed income issues based on its coupon, maturity, and credit quality. Convertibles also exist in the form of preferred stock and function similarly. In exchange for potential equity upside, convertibles often offer a lower interest rate than a traditional bond. The convertible marketplace is substantially smaller than the equity or the traditional fixed income market and may offer a more conservative way to invest in high-tech and growth companies.

Warrants, Contingent Value Rights, and Long Dated Options

Warrants and Contingent Value Rights (CVRs) are derivative securities typically issued in connection with a transaction, deal, or to incentivize current investors with potential future upside. Like a spinoff, some investors may be unwilling or unable to hold warrants or CVRs within their portfolios and will sell them in the open market immediately. These derivatives are tied to an event, have a time constraint (expiration), and may have undue selling pressure – a textbook special situation. Value investors with favorable insight into the underlying company may use the derivatives to invest while tying up less capital than they would by buying the common stock. Long dated options may be purchased in the listed market on many companies allowing investors to create their own derivatives, with characteristics to their specifications.

Take Privates and Take Publics

Sentiment is often the most significant factor in these types of transactions. From time to time, different industries become so out of favor in public markets, that the entire enterprise may achieve a higher valuation in private markets. Acquirers may include privately held competitors or private equity & leveraged buyout funds. Similarly, some industries and types of companies achieve dramatically higher valuations in public markets than private markets. A take private or take public is a potential special situations catalyst. Value investors may seek to capitalize on the valuation discrepancies that the same business may offer in different ownership structures.

Asset and Commodity Plays

A value investor always starts with the balance sheet. Out of the all the accounting statements and SEC mandated disclosures, the balance sheet is least susceptible to manipulation, and in the absence of abject fraud, is a true statement from a specific moment in time. In times of crisis and panic, companies may trade far worse than their balance sheet would suggest they should. While sometimes the market is right, the value investor may find an asset play – where regardless of the value of the ongoing enterprise, the assets – property, plant, equipment, intellectual property – may be worth more than the total selling price of the business less all liabilities. Alternatively, a business in a temporarily, but not terminally challenged industry, may trade below its replication value. Such an instance presents an interesting investment opportunity provided the investor has the appropriate time horizon and can identify the catalyst necessary to close the gap.

Real estate whether in private markets or publicly traded Real Estate Investment Trusts (REITs), is one area where asset-plays and replication value can be useful tools.

While commodities are rarely involved in franchise businesses, as there are few competitive advantages among producers of fungible goods or inputs, commodity producers may trade below their asset values, particularly when sentiment regarding that commodity is excessively bearish and investors lose sight of the value of reserves, distribution, and long-term contracts.

Special Thanks

We at Hudson Value Partners are continually awed by the generosity of value investors in sharing their insights and their craft. Perhaps it is because the discipline requires a very specific temperament that most are willing to share, knowing that few will have the patience and persistence to endure. We want to highlight the academic leadership of Professors Benjamin Graham, David Dodd, Roger Murray, Jack McDonald, Bruce Greenwald, James Kelly, and Tano Santos, whose collective body of work has taught generations of value investors. We are grateful to the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School and Fordham's Gabelli School of Business for their decades of quality programing to keep the intellectual tradition alive and thriving. The writings and resources shared by Mario Gabelli's GAMCO and Thomas A. Russo of Gardner, Russo & Quinn we consider invaluable.

We humbly submit these white papers into the long tradition of generosity of thought within the value investing community.

Further Reading

How to Profit from Special Situations in the Stock Market (1959/2017) by Maurece Shiller

Deals...Deals..And More Deals (1999) by Regina M. Pitaro

Warren Buffett and The Art of Stock Arbitrage (2010) by Mary Buffett & David Clark

Merger Masters: Tales of Arbitrage (2018) by Kate Welling & Mario Gabelli

Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor (1991) by Seth Klarman

You Can Be a Stock Market Genius (1999) by Joel Greenblatt

Global Convertible Investing (2001) by Hart Woodson

Investing in REITs (2011) by Ralph Block

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