Special Situation Investing

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Special situations are the happy hunting grounds for the simon-pure analyst who prefers to deal with the future in terms of specific, measurable developments rather than general anticipations.

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The period 1939-1942 was a heyday for operators in special situations and undervalued securities. During these years the trend was unfavorable to those owning standard issues, and the brokerage business was on the quiet side. By contrast, many bargain industrial stocks scored substantial advances—especially since the early war years brought proportionately greater business improvement to the secondary companies than to the leaders. In addition, quite a number of railroad and utility reorganizations were taking shape, and developing good profits for those who had bought their issues at unpopular times and consequently at basement prices.

By 1942 many in Wall Street had come to believe that the only real and dependable income was to be made in special situations. **As usually happens, this generalization proved wide of the mark.** In the ensuing four years there have been good profits in almost everything, and the spectacular returns have lately been shown in essentially speculative, as distinct from "special," operations. But perhaps enough interest remains in the latter type of activity to warrant an article on the subject.

The Meaning of Special Situations

First, just what is meant by a "special situation"? Convention has not jelled sufficiently to permit a clear-cut and final definition. In the broader sense, a special situation is one in which a particular development is counted upon to yield a satisfactory profit in the security even though the general market does not advance. In the narrow sense, you do not have a real "special situation" unless the particular development is already under way.

This distinction is readily apparent by reference to the wide fields of bankrupt corporations and preferred stocks with large back dividends. In the former case, "the particular development" would be reorganization; in the latter, it would be discharge of the arrears, usually by a recapitalization. Many practitioners will say that a company in trusteeship does not constitute a special situation until a reorganization plan has actually been submitted; similarly, there must be a definite plan on foot for taking care of dividend accumulations. Thus, *American Woolen Preferred* may have had interesting possibilities for years because of its very large back dividends, but it became a true special situation only when the buyer knew that a plan of repayment had been or was soon to be announced.

There is a logical and important reason for favoring this narrower definition of a special situation. By doing so we are able to conceive of these commitments in terms of an expected annual return on the investment. As will be seen, such a calculation involves quite a number of estimates in each case, and thus the final figure bears little resemblance to the bond yields taken out of a basis book. **Nevertheless, this technique is valuable as a guide to the operator in special situations, and it**

gives him an entirely different attitude toward his holdings than that of the trader, speculator or ordinary investor.

In one respect, however, the calculation goes beyond the lore of the yield book. If we are willing to make the necessary assumptions, the attractiveness of any given special situation can be expressed as an indicated annual return in per cent with allowance for the risk factor. Here is a general formula:

Let *G* be the expected gain in points in the event of success;
L be the expected loss in points in the event of failure;
C be the expected chance of success, expressed as a percentage;
Y be the expected time of holding, in years;
P be the current price of the security.

Then

Indicated annual return = GC – L(100% - C)/YP

We may take as a current example the *Metropolitan West Side Elevated 5s* selling at 23. It is proposed to sell the property to the City of Chicago on terms expected to yield in cash about 35 for the bonds. For illustrative purposes only (and without responsibility) let us assume (a) that if the plan fails the bonds will be worth 16; (b) that the chances of success are two out of three—i.e., 67% (c) that the holding period will average one year. Then by the formula:

Indicated annual return = 12 x 67% - 7 x 33%/1 x 23 = 24.7%

Note that the formula allows for the chance and the amount of possible loss. If only possible gain were considered, the indicated annual return would be 34.5%. *(Sequel: The purchase was affected, and the bondholders have since received $33.5 in cash, retaining also "stubs" currently worth about $5.)*

Classes of Special Situations

Let us turn now to a condensed description and discursion of the various types of special situations. These could be divided into two main categories:

(I) Security exchanges or distributions,
(II) Cash payouts.

Only in a rare case does a special situation, as we use the term, work itself out in a higher market without a cash of security distribution occurring somewhere in the picture. However, a more conventional classification may better serve our present purpose.

Class A. Standard Arbitrages, Based on a Reorganization, Recapitalization or Merger Plan.

In bankruptcy reorganizations, particularly those of railroads, the arbitrage has had a curious history in the past five years. In more than half of the cases the plans have been consummated and the expected profit realized—although almost always after a longer time lag than was originally anticipated. In the remainder the plans have been changed or dropped and the when-issued trades cancelled; or else such cancellation is now expected, chiefly as a result of the *Wheeler Bill*. Nevertheless, large profits were made by many arbitragers, even in the unsuccessful plans, because the old securities advanced greatly above the price they paid, in spite of the plan's failure. Thus what was intended to be an old-fashioned arbitrage turned into a successful bond speculation.

This experience illustrates one pleasing aspect of the special situation operation, which is that if your deal works out you are sure to make profits, but if it doesn't, you may still make a profit. The hazards of arbitraging increase as the general market level rises, because your chances of loss in the event of the plan's failure become correspondingly greater. To this important extent many types of special situations are tied-in with general market conditions; but it is still true that in the average or representative case the result depends upon corporate and not on market price developments.

Arbitrages in industrials generally grow out of mergers or recapitalizations and involve the sale of existing rather than when-issued securities. In the recent *Raytheon-Submarine Signal* merger, one could buy *Submarine Signal* and sell *Raytheon* on announcement at an indicated spread of about 18%. That arbitrage was successfully consummated within sixty days. Similarly, when the *General Cable Recapitalization Plan* was announced, one could buy a share of A stock at 52 and sell four shares of common for 59—A spread of about 13%--with consummation in 45 days. However, such operations have as a <u>pre-requisite</u> the ability to borrow the stock for the duration of the arbitrage. Under present conditions of no margin trading, cash borrowing is so difficult as to prevent many (though not all) of these deals.

In the utility field, somewhat similar arbitrages have been available as a result of exchange offers made by holding companies for their preferred stocks. Recent examples are United Corporation and American Superpower.

There are, of course, various hazards involved in all these arbitrages. They include possible rejection by stockholders; possible legal action by minority holders; possible disapproval by the S.E.C, etc. The experienced operator does not ignore these hazards, but attempts to <u>measure</u> them carefully in the particular circumstances of each case.

It will be noted that the industrial, utility and rail arbitrages fall respectively into three distinct classed with regards to the <u>time element</u>. One might almost say that the first is usually a matter of weeks, the second of months, and the third of years.

An exception to this rule was the *United Light and Power* arbitrage. Here one bought a share of old preferred and sold five shares of new common "when issued" against it, at an initial spread of about 10% net. Because of <u>litigation</u> that reached the Supreme Court, this utility recapitalization took fully two years between proposal and consummation. Though it yield the expected profit in dollars, **the time element made the outcome far from brilliant.**

Class B. Cash Payout, in Recapitalization or Mergers.

A recent example of this type is *Central and Southwestern Utilities 2nd Preferred*. Under a recapitalization and merger plan, presented to the SEC on Feb 5, 1946, the holders were given the option of taking the full redemption value in cash or the equivalent in new common stock at the syndicate offering price. The current redemption value was $220 per share, against the market price of 185. Thus the expected profit would be 19%, plus interest at about 3% per annum for the duration of the operation. The hurdles to be surmounted here in include:

(a) SEC approval;
(b) Court approval.;
(c) Ability to secure underwriting of new common stock at a specified minimum price;
(d) Miscellaneous delays, most frequently caused by litigation.

If the plan should fail, the buyer risks a fall in the price; but contrariwise in the typical preferred stock or bond pay-out, there is virtually no chance of getting more than the redemption value accorded under the plan. We must recognize here an inherent <u>weakness</u> in this type of operation. (*Sequel: The plan was carried out, and the preferred holders who asked for cash received $233 in February 1947.)*

The experienced analyst knows that the chance of ultimate loss diminishes to the extent that the preferred stock is cushioned by the presence of a proportionately large common stock equity. Thus he should feel differently as regards *Cities Service 1st Preferred* selling at 132, with total claim of 181 (or 193 at call price) as compared with *American Power and Light $6 Preferred* selling at 117 with a total claim of 145 (or 160 at call price). The maximum indicated gain for *Cities Service Preferred* selling is 46%, against 37% for *American P. and L. Preferred*. The latter, however, has the advantage, first, of paying a current dividend ($44.50) and, second, of having an actual plan on file for paying off the issue.

On the other side of the picture is the important fact that each dollar paid for *Cities Service Preferred* is now (October 5th) backed by $1.20 in market value of common stock; while each dollar paid *American P. & L. Preferred* is backed by only 20 cents of common stock. If continued weakness in the stock market should result in the definite postponement of the *American P. & L.* plan, the purchaser of *Cities Service Preferred* will undoubtedly fare the better of the two *(Sequel: the pending plan for paying off the American Power & Light Preferred was withdrawn, and the $6 issue sold at 91 at the end of 1947.)*

Conversely, a plan was proposed and carried out for paying of the *Cities Service Preferred* issues. As a consequence the *First Preferred* was exchanged for bonds, making it worth $157 per share at the end of 1947.)

Class C. Cash Payments on Sale or Liquidation.

In most cases where a company sells out its business to another or merely liquidates its assets piecemeal, the ultimate amount received by the security holder <u>exceeds</u> the market price at the time the sale or liquidation is proposed. (This condition grows out of the nature of the price making factors in the security market; we do not have the space to discuss the reasons in detail.) In the case of a sale for cash on a going concern basis, the largest profits are most often to be made by those who buy before the negotiation are begun or completed. **But even after the terms are announced, there is often an interesting spread to be realized if the sale is consummated.**

Quite a number of such sales have recently taken place in the textile-mill field. At this time the most recent example is a bid of $365 per share for stock of the *Luther Mfg. Co.*, contingent on acceptance by not less than 95% of the stock. A week before the purchase offer was made public the stock was quoted at $150 bid. *(Sequel: the purchase at $365 was consummated.)* Most of these purchase offers, even though contingent on acceptance by a large majority, have become effective; and those which failed generally did so because a still higher bid was forthcoming from other quarters.

A vote to liquidate assets by piecemeal sale is rather infrequent, except that we have had a number of such liquidations of public utility holding companies under statutory pressure. In such cases the amount of cash to be realized for the assets, less the corporate liabilities and expenses, is subject to estimation and consequent error. Where estimates are made by management, they are customarily on the conservative side. In most instances, the market price at the time of the vote to liquidate proves to be appreciably less than the amount recovered. A protracted liquidation of this kind has been under way in *Ogden Corp.*, showing a very good percentage profit for those who bought at an early stage. *Brewster Corp*. is an example in the industrial field. At this writing the tax liabilities of *Brewster Corp.* is an example in the industrial field. At this writing the tax liabilities of *Brewster* have not been determined. As against a state book value of 5 and a market price of about 4.25, the current "expert" estimate of ultimate realization ranges between 5.5 and 6. *(Sequel: The stockholders have since received $5.75 per share in cash, and are expected to realize something additional.)*

Class D Litigated Matters.

There are fairly numerous cases in which the value of a security depends largely on the outcome of litigation. This may involve a damage or subordination suit (e.g., *International Hydro Electric, Inland Gas Co.)*; disputed income tax liability (e.g., *Gold and Stock Telegraph, Pittsburgh Incline Plane*); an appeal from a reorganization plan wiping out stock issues (e.g., *St Louis Southwestern Ry.*, *New Haven R.R.*). **In general, the market undervalues a litigated claim as an asset and overvalues it as a liability.** Hence the students of these situations often have an opportunity to buy into them at less than their true value, to realize attractive profits—on the average—when the litigation is disposed of.

Class E. Public Utility Breakups.

These have been a very important group of special situations in recent years. They are an essentially temporary phenomenon in that they will pass out of the picture when compliance with *Section 11 of the Public Utility Holding Company Act* has been completed for the industry.

Their unique feature is that the profit in them depends upon the principle that a holding company is worth more dead than alive—i.e., that it's separate assets, net, will sell for more than the parent company securities. This has brought about the paradoxical situation that the stocks of holding companies bitterly fighting dissolution–presumably for the sake of their owners, the shareholders—have been depressed in price by this valiant battle and have advanced when they lost their fight.

The technical quality which sets these situations apart from others is the fact that they usually depend upon an estimate or forecast of the market value of securities which are to be distributed and are not now traded in. In some cases there is a narrow market for existing minority shares, but it may not be too informing in relation to conditions after the majority shares come on the market. (An example of this is *Philadelphia Co.*, which is the central factor in the valuation of standard *Gas and Electric Preferred* issues. The curb-market price for the 3.2% minority interest may or may not be representative of the value of the entire issue.)

Improvements in the art of utility analysis, favored by the relative infrequency of unlooked for developments in the field, makes it possible to calculate fairly dependably what any operating company stock is likely to sell at under current market condition. Thus the hazard in exploiting these breakup situations grows largely out of the uncertain time element, with the attendant possibility of an unfavorable change in market conditions before the distributions are received.

Class F. Miscellaneous Special Situations.

This catch-all category includes everything we have not already classified. There is no point in trying to make our descriptions comprehensive since a good deal depends on one’s personal definition of “special situation.” We may suggest two additional varieties by way of example only.

A peculiar one would be the rather major field of hedging operations-most characteristically the sale of a common stock against ownership of a convertible bond or preferred stock. (Here the security-exchange feature operates to protect against loss rather than to create the profit.)

Another, more limited, would be the purchase of a guaranteed security on the expectation that it will later be made exchangeable into a bond on attractive terms, in order to save a heavy corporate income tax. (This occurred in the case of *Delaware and Hudson* and *D. L &W*. leased-line stocks.)

Conclusion

At the outset of this article we grouped special situations and undervalued securities together. The reader will have noticed that we do not consider these terms as synonymous—although it may be held that special situations constitute a major subdivision of undervalued securities. **The essence of a special situation is an expected corporate (not market) development, within a time period estimable in the light of past experience.** Thus here, as almost everywhere else in finance, wide experience is a major factor in lasting success; it must be supplemented by careful study of each situation and the possession of sound though somewhat specialized judgment.

Special situations, as we define them appeal mightily to one class of temperament for the very reason that they leave other people cold. They lack industrial glamour, speculative dynamite, or more sober growth prospects. But they do afford the analyst an opportunity to deal with security values very much as the merchant deals with his inventory, calculating in advance his average profits and his average holding period. In this sense they occupy an interesting middle ground between security purchases for ordinary speculation or investment and security purchases for resale in syndicate or dealership operations.

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 Email: Aldridge56@aol.com