# Special Situations

In my last month's article, I had recommended that all investors must allocate a part of their portfolios to cash and cash equivalents in order to take advantage of opportunities produced by a volatile equity market. An alternative to holding cash is to invest money in "special situations."

A special situation is an investment operation whose results depend primarily on the happening or the non-happening of one or more *corporate events* as opposed to *market events*.

There are two chief advantages of investing funds in special situations as opposed to investing in equities. First, the expected returns can be estimated in advance. This is normally not possible in conventional equity investments because a very large proportion of the returns on such investments is determined by unpredictable stock prices. Second, the investment results of special situations are either completely immune, or almost immune from market risk i.e. the risk of a severe decline in the general level of stock prices.

I like to view special situations as an alternative to holding cash or short-term fixed-income securities. This means that I invest in a special situation only when I believe that the realised pre-tax return from it will be well in excess of what I can earn from holding cash or short-term fixed-income securities. Currently short-term, high-grade, fixed-income securities offer an annualised return in the range of 12%-14%, while holding cash offers an annualised return of about 8%-9%. Currently, my hurdle rate for a special situation is 18% p.a. All special situations must pass this hurdle rate before I recommend them to my clients.

I classify special situations into the following types: (1) Guaranteed Securities; (2) Mutual Fund Arbitrage; (3) Merger Arbitrage; (4) Warrants Arbitrage; (5) Corporate Restructurings. Below, I give a brief explanation of each type along with real examples.

## Guaranteed Securities

These are securities which are bought from the secondary market at a price which is at a discount to a price guaranteed by a credit-worthy person or institution. The discount may be small, but if the turnaround time is also small, then the expected annualised return become very attractive. Also, guaranteed securities are completely immune from the risk of a market crash.

Example: Anagram Finance

In May 1998, Anagram Finance agreed to be acquired by ICICI. Under the terms of the agreement, certain companies belonging to the promoters, made a cash offer of Rs 18 per share to all the shareholders of Anagram Finance. In June 1998, the shares of Anagram Finance were quoting at Rs 15. A purchase at that price for subsequent tender at Rs 18 resulted in an absolute return of 20% over a turnaround time of approximately six months. The annualised return came to 40%.

Example: Bharti Telecom

This company is in the process of being taken private by its promoters. Since June 1998, the promoters have made three open offers to the public shareholders at Rs 96 per share. The shares of this company were available in the market at prices as low as Rs 86. An investment of Rs 86, converted into Rs 96 in three months, translated into an annualised return of 46%.

Example: SBI Magnum Triple Plus

The sponsor of this mutual fund had made a promise in the original offer document at the time of redemption the investors in the fund would receive the NAV or Rs 300, whichever is more. In April 1998, the shares in this fund could be acquired in the market at Rs 247. The sponsor has kept its promise to pay Rs 300 and the annualised return over a turnaround time of 13 months came to 20%.

## Mutual Fund Arbitrage

This type of special situation is not completely immune from a risk of market crashes. Nevertheless, its is a much safer way of investing in the market than a direct exposure in equities. There are two main types of mutual fund arbitrages: (1) Open-endings of closed-ended funds; and (2) Listed open-ended fund arbitrage. Two examples of the first type are given below.

Example: UTI Masterplus

In July 1998, a few months before the redemption date, UTI announced its intention to open end Masterplus with effect from 1 October 1998. UTI *always* open-ends its closed-end funds a few months before the maturity date. Immediately after the announcement, the shares of this fund were quoting in the secondary market at Rs 17 even though the NAV was significantly higher. In January 1999, I tendered these shares were tendered to the UTI for repurchase at Rs 20.50. The realised, annualised, pre-tax return came to 52%.

Example: UTI Mastergrowth

This is a current example. The units of this scheme are available at Rs 13.65 in the secondary market even though the NAV is Rs 17. The scheme is due for redemption in April 2000 but is likely to be open-ended before then. If the open-ending takes place in January 2000 and even if the repurchase price at that time is 10% less than the current NAV of Rs 17, the annualised return of an investment operation involving the purchase at Rs 13.65 for tender in seven months time at Rs 15.30 will come to more than 20%.

## Merger Arbitrage

In this type of special situations, the shares of a company can often be "created" by the investor at a price which is at a discount to the prevailing market price.

Example: Ponds India

Recently Ponds India is merged with Hindustan Lever (HLL). According to the merger scheme, for every 4 shares of Ponds, 3 shares of HLL were to be allotted to Ponds shareholders. In mid-January 1999, on the last few days on which Ponds was listed, Pond's shares were quoting at Rs 1,254. The cost of four shares came to Rs 5,016. For this Rs 5,016 investment, three shares of HLL shares were to be received, in three months time. The cost per HLL share came to Rs 1,672. At that time HLL was quoting at Rs 1,962. Therefore, the investor was able to create his own shares of HLL by paying 15% less than the price prevailing at that time.

The icing  on the cake in this transaction came in the form of a subsequent surge in the stock price of HLL. In six months, the shares created at a cost of Rs 1,672 have risen to Rs 2,400. The annualised return comes to 60%.

## Warrants Arbitrage

Often, it is much more attractive to buy the warrants of a company than the underlying shares and then sell the shares received on the conversion of warrants. There are several examples.

In October 1993, Ranbaxy Laboratories Limited offered non convertible debentures (NCDs) with warrants to its shareholders on a rights basis. Each NCD was issued at a face value of Rs 200 and carried an interest rate of 15% a year. Along with each NCD, and for no extra payment, came with a warrant which gave the holder the right to buy one new equity share of the company for Rs 125 during specified periods between three and five years from allotment of the NCDs.

Fast forward to 1996, that is, three years after allotment. The warrant-holders were invited by Ranbaxy to exercise their right to buy its shares for Rs 125 each. Many warrant-holders promptly did so and, in the process, made a killing. That's because they ended up buying Ranbaxy shares for Rs 125 at a time when they were quoting at Rs 540 each.

In November 1995, Exide Industries Limited offered equity shares with warrants to its shareholders on a rights basis. Like in the case of Ranbaxy, the warrant-holders in this case too made a killing. That's because each warrant gave to its holder a right to buy a share of the company for Rs 60 each against the market price of the shares of Rs 168 at the time of conversion.

Often the warrants can be purchased from the secondary market at a significant discount to the price of the underlying shares. Indeed, the pricing of warrants in India sometimes is so faulty, that a professor of finance who teaches Black and Scholes Model of derivatives pricing based on the efficient market hypothesis would be puzzled.

## Corporate Restructurings

Corporate restructuring often produce potentially profitable special situations. This area is too vast to be covered here but I will give a few examples.

Example: Spin-offs and De-mergers

In a spin-off, the assets and liabilities of a business division of a company are lodged in a separate entity, and the parent company then distributes shares of that entity to its own shareholders for free. In a de-merger, the assets and liabilities of a business division of a company are lodged in a separate entity, and the new entity then issues shares in itself to the shareholders of the parent company. Often it is found that the value of the shares received in the new entity plus the value of the shares of the old company is well in excess of the value of the shares held prior to the spin-off. There have been plenty of examples where such transactions have resulted in highly profitable opportunities. Three examples that come to mind are that of HLL- Stephan Chemicals (now called Hind Lever Chemicals), Sandoz-Clariant and Apple-Aptech deals.

Example: Asset Sales

Sometimes, a company sells a business division for cash and then distributes a large proportion of that cash to its shareholders as a special dividend. The markets tend to reward such companies by increasing their market values. Two examples that come to mind are that of Glaxo selling its food business and Max India selling its cellular licence. In both cases, the shareholders are rewarded through large special dividends.

**Note**

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