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SPECIAL SITUATIONS

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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 also 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 the 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

$$\text{Indicated annual return} = \frac{GC - L(100\% - C)}{YP}$$

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:

$$\text{Indicated annual return} = \frac{12 \times 67\% - 7 \times 33\%}{1 \times 23} = 24.7\%$$

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 52%. [*Sequel:* The purchase was effected, and the bondholders have since received 33½ in cash, retaining also "stubs" currently worth about 5.]

Classes of Special Situations

Let us turn now to a condensed description and discussion of the various types of special situations. These could be divided into two main categories: (I) Security exchanges or distributions, (II) Cash pay-outs. Only in a rare case does a special and consummation. Though it yielded the expected profit in dollars, the time ment made the outcome far from brilliant.

[1] Margin trading was restored after the publication of this article.

APPENDIX

situation, as we use the term, work itself out in a higher market with [illegible] 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 operation consists of buying old securities and selling the "when-issued" securities. [illegible] arbitrage has had a curious history in the past five years. In most cases the plans have been consummated and the expected profit realized—almost always after a longer time lag than was originally anticipated. [illegible] der the plans have been changed or dropped and the when-issued trading [illegible] or else such cancellation is now expected, chiefly as a result of [illegible]. Nevertheless, large profits were made by many arbitragers, even in [illegible] 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 [illegible] into a successful bond speculation.

This experience illustrates one pleasing aspect of the special situation [illegible] which is that if your deal works out you are sure to make a profit, [illegible] you may still make a profit. [illegible] mar[illegible] rise [illegible] correspondingly greater [illegible] are tied in with general [illegible] representative [illegible] the result depends upon corporate [illegible] development.

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

In the utility field [illegible] what similar arbitrages have been available [illegible] exchange offers made by holding companies for their preferred stocks. [illegible] examples are United Corporation and the American Superpower.

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

It will be noted that the industrial, utility and rail arbitrages fall [illegible] three distinct classes with regard to the time element. 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 & Power arbitrage. Here [illegible] bought a share of old preferred and sold five shares of new common [illegible] against it, at an initial spread of about 10% net. Because of litigation [illegible] the Supreme Court, this utility recapitalization took fully two years [illegible]

Class B. Cash Payouts, in Recapitalizations or Mergers: A recent example of this type is Central and Southwestern Utilities 2nd Preferred. Under a recapitalization and merger plan, presented to the S.E.C. 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 include (a) S.E.C. approval; (b) court approval; (c) ability to secure an 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 of his shares; 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 weakness in this type of operation. [*Sequel:* The plan was carried out, and the preferred holders who asked for cash received $223 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 is 46%, against 37% for American P. and L. Preferred. The latter, however, has the advantage, first, of paying a current dividend ($4.50) and, second, of havi[redacted]ctual 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 indefinite 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 off 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 exceeds 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 space to discuss the reasons in detail.) In the case of a sale for cash on a going concern basis, the large profits are most often to be made by those who buy before the negotiations 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 the 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 [illegible] less than the amount recovered. A protracted liquidation of this kind has been under way in Ogden Corp., showing a very good percentage profit to those who bought at an early stage. Brewster Corp. is an example in the industrial field. At this writing the tax liabilities of Brewster have not been determined. As a result [illegible] stated book value of 5 and a market price of about 4½, the current expert [illegible] of ultimate realization ranges between 5½ and 6. [*Sequel:* The stockholders have since received $5.75 per share in cash, and are expected to realize [illegible] additional.]

Class D. Litigated Matters. There are fairly numerous cases in which the value of a security depends [illegible] the outcome of litigation. This may involve a damage or other claim [illegible] International Hydro-Electric, Inland Gas Co.); disputed income [illegible] Gold and Stock Telegraph, Pittsburgh Incline Plane; 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, and 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.

The unique feature [illegible] profit in them depends upon the principle that a holding company is worth more dead than alive—i.e., that its separate assets, net, will sell for more [illegible] company securities. This has brought about the paradoxical situation [illegible] holding companies bitterly fighting dissolution—presumably for the [illegible] their owners, the shareholders, have been depressed [illegible] have advanced when they lost their fight.

[illegible] sets these situations apart from others is the fact that [illegible] estimate or forecast of the market value of securities which are to [illegible] 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 [illegible] shares come on the market. (An example of this is Philadelphia Co. [illegible] the curb-market price for the [illegible] factor in the valuation of Standard Gas and Electric [illegible] issues. The curb-market price for the 3.2% minority interest may or may not be representative of the value of the entire issue.)

[illegible] improvement in the art of utility analysis, favored by the relative infrequency of [illegible] looked-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 conditions. Thus the hazard in [illegible] these breakup situations grows largely out of the uncertainty element [illegible] attendant possibility of an unfavorable change in market conditions before the [illegible] are received.

Class F. Miscellaneous Special Situations. This catch-all category includes everything we have not already specified. 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 [illegible] two additional varieties by way of example only. A [illegible] one would be the other major field of hedging operations—most characteristically the sale of common stock against ownership of a convertible bond or preferred stock. [illegible] parity-ex[illegible] 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 glamor, 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.