Exploratory Note 20

Growth and Value – A Contrarian View

**INTRODUCTION**

Most of the time, it is assumed that there is a direct relationship between growth (in terms of firm size) and value. Interestingly enough, however, this is most certainly not always the case. This note presents a contrarian view of growth in the context of restructure-oriented and/or distressed investing and also illustrates some of the mechanics of the LBO strategy, again in unique context, presented earlier this evening.

**RESTRUCTURING (DOWNSIZING) AND VALUE**

First and foremost, what situations offer opportunities to create value by shrinking the size of a firm? What conditions can cause size to actually be detrimental to value?

***A Liquidation Example Involving a Poorly-Performing Airline***

Taking things to an extreme, consider the following example (which incidentally illustrates the mechanics of an LBO). Assume that a publicly traded airline (UDAir) has a ***market capitalization*** of $500,000,000, ***long-term debt*** of $1,000,000,000 (enterprise value = $1,500,000,000), and a ***breakup value*** of assets of $2,200,000,000. What could lead a firm to trade for less than breakup value? What is the possible gain to be made here by an investor if he or she is willing to break it up (and successfully endure the wrath which will undoubtedly accompany such a move)?

Now, just because the market cap is $500,000,000, could an investor buy all of UDAir’s stock for that number? Why or why not?

So, a ***tender offer*** for half (or more—depends on the corporate charter) will need to be made, and it will need to be made at a premium to the current market capitalization. What other costs will likely arise—especially if the deal is hostile?

Now, let us assume that a tender will be successful if $800,000,000 is paid to the shareholders (assume these folks do not want to take the risk of sticking around to see if the investor is successful when it comes to liquidating the company or not—there is risk that this effort will fail). Assume further that it will cost $150,000,000 to wind down the company and liquidate the planes, hangers, technology, and other assets of the firm over the course of a year (also, do not forget that the existing debt has to be paid back!). How much profit is left for the investor?

|  |  |
| --- | --- |
| **Liquidation Value** | **$2,200,000,000.00** |
| Clear Existing Debt | $1,000,000,000.00 |
| Recovery of Invest. | $800,000,000.00 |
| Fees | $150,000,000.00 |
| **Total Investment** | **$950,000,000.00** |
| **GAIN (LOSS)** | **$250,000,000.00** |

If the raider used 100% equity ($950,000,000), the return (I am striking the TVM from consideration—this would limit the gains further due to **RISK**—think high discount rate!), would be fairly paltry (especially given the risk):

|  |  |
| --- | --- |
| **Liquidation Value** | **$2,200,000,000.00** |
| Clear Existing Debt | $1,000,000,000.00 |
| Recovery of Invest. | $800,000,000.00 |
| Fees | $150,000,000.00 |
| **Total Investment** | **$950,000,000.00** |
| **GAIN (LOSS)** | **$250,000,000.00** |
| **ROI** | **26.0%** |

Of course, 26% is OK, but it could be better—that is where debt come into play. Assume that the investor uses $100,000,000 in equity and $850,000,000 in junk bonds with a 12% coupon ($102,000,000 on an annualized basis). Now, the numbers look as follows:

|  |  |
| --- | --- |
| **Liquidation Value** | **$2,200,000,000.00** |
| Clear Existing Debt | $1,000,000,000.00 |
| Recovery of Invest. | $800,000,000.00 |
| Interest on Junk | $102,000,000.00 |
| Fees, Etc. | $150,000,000.00 |
| **Total Investment** | **$100,000,000.00** |
| **GAIN (LOSS)** | **$148,000,000.00** |
| **ROI** | **148.00%** |

So, you make fewer dollars, but the return is approximately 6 times greater! This is a really good reason to use debt. With a war chest of only $100,000,000, an investor could buy a company with a breakup value 23x larger! Or, with a war chest of a billion dollars (needed to do a 100% equity deal), an investor could theoretically do this deal about ten times—**leading to gains of $1,480,000,000!**

**FINDING VALUE AMONGST THE RUINS**

In order to grasp the significance of the Allegheny International case that I suggested you take a look at over the weekend, an understanding of the US bankruptcy laws for corporations is necessary. What do you know about corporate bankruptcy in the United States?

Is bankruptcy always a bad thing for the ownership group? Why or why not?

The case of Allegheny International is truly compelling. Who can tell me about it? What role did bankruptcy play in the case?

What type of investment strategy did Japonica pursue? What label(s) is/are usually attached to this type of investment strategy?

What are the potential benefits of this type of investment strategy? What are the potential drawbacks?

**CONCLUSIONS**

Distressed investment is not for everyone, but it does yield significant opportunities for those with the skillsets and appropriate appetite for risk.