Source: Risk Arbitrage by Guy P. Wyser-Pratte pages 125-129

Liquidation and the Creation of Stub Stocks

There are three types of arbitrage situations based on the potential for future distributions of either cash or stock—after the legal closing of a merger—in addition to what is received immediately upon consummation. These **potential future distributions** are called "**stubs**," and may be generated (a) in contingent interest payments to the Bride's *(the "Bride" is the company being acquired)* shareholders after consummation, (b) through escrow agreements in mergers, and (c) in liquidations.

When the Groom *(the "acquirer")* wishes to give the Bride a tangible incentive to be "productive" in earnings, or when a Bride is too demanding as to her value during the course of the negotiations, there is often the basis for compromise by the adoption of an exchange ratio which consists of future distributions in addition to the major distribution of stock, based upon what is called an "earnings formula." Upon consummation, the Bride's transfer books are closed, the latter's securities exchanged for those of the Groom, with the right to these future distributions being passed on to the Bride's shareholders as *"certificates of contingent interest."* These rights are the resulting "*stubs*." They are often readily marketable securities that can be traded over-the-counter, usually on a "due bill" basis.

There are many formulas upon which "stubs" may be predicated. Those most often encountered occur when successive distributions are to be made annually relative to earnings performance for the respective year and when one balloon type payment is to be made at the end of a prescribed period, based upon aggregate earnings over that period.

The arbitrageur's interest is to create the stubs before the merger is consummated, as he can normally create them more cheaply, or sometimes even for nothing, by arbitraging the Bride against the Groom's initial distribution. The merger of *Hayes International* into *City Investing* in Feb. 1967 provided just such an opportunity. Each share of *Hayes* was to receive 2/7 of *City Investing* common plus one non-transferable **Contingent Interest Certificate**, each of which called for the additional distribution of up to $6.74 market value of *City* common stock. The level of earnings required for the maximum distribution was the aggregate of $7,500,000 for the five years ending Sept. 30, 1971. Lower aggregate earnings would entitle certificate holders to receive proportionately less of the $6.74 value in City common, for example.

If the total earnings were $5,000,000, each certificate would receive 2/3 of the $6.74, or $4.50. For the calculation of the market value of *City* common, the average price (over a twenty day period) was guaranteed down to a price of $15. Below this the average price would be figured at the minimum of $15 per *City* common.

At the outset arbitrageurs were able to create the stub at a discount. With *City* at $42 and *Hayes* at $11, selling 2/7 of a *City* would yield $12, or a spread of $1 per *Hayes ($12 of City minus $11 of Hayes)*. This situation did not last for long, however, as it became

apparent that the *Hayes* stub was a valuable piece of property. There was, in fact, a very high probability that the earnings goal of $7.5 million would be easily achieved by 1971.

The probability of achieving this figure is naturally a preoccupation of the arbitrageur. The records show that over the preceding five years, *Hayes'* net income had advanced from $502,242 to $1,014,242, representing a compounded annual growth rate of roughly 15%. Sales over the same period had advanced approximately 30 percent. In order to achieve the required level, *Hayes* would have to earn at an average rate of $1.5 mil. For each of the five years, or more representatively, would have to experience compounded earnings growth of 12 percent per year, which would result in earnings of roughly $1.7 mil for fiscal 1971. As *Hayes* was primarily a government contractor in aircraft parts and aerospace, it was assumed that, with the Vietnam War accelerating and with the heavy budget outlays for the Mercury and Apollo space program, the five-year prospect for Hayes was fairly bright.

Yet, to be *conservative*, assume that *Hayes* experiences a drop in its annual earnings growth rate by one-third, so that the earnings would increase by 10 percent over the next five year period. This would result in aggregate earnings for the period of $6.9 mil., which would entitle holders of the certificates to 88 percent of the maximum participation, or $5.93. A figure similar to this could have been arrived at by assigning various *probabilities* to different aggregate earnings levels for the five year period, the sum of which would yield an expected value. It is to this expected value that one must once again apply a subjective rate of capitalization, in order to determine the present value of the predicted level of earnings. Let us say that the arbitrageur requires, in this type of situation (the results of which will be taxable as a long-term capital gain) a return before taxes of 20 percent per annum. The present value is thus $2.38.

If the arbitrageur in fact valued the stub at $2.38, he was, as mentioned above, able to create the stub, for a certain time at zero or better cost. As time developed, and as the merger approached its consummation, by buying *Hayes* at $12 and selling 2/7 of *City* common at $28.50, one was creating, or paying $1 for the stub.

Liquidations are predicted primarily on the same idea. Normally, when a company liquidates, it will establish a schedule of the amounts of the liquidation payments—in either cash or stock—along with the expected distribution dates. **The job of the arbitrageur becomes one of properly discounting these distributions in order to arrive as a present value for the "stub."** In addition, there is the more delicate determination of the expected value of the various distributions that are often based upon the sale of fixed assets whose real market values are uncertain. The task becomes one of determining the probable market value of these assets and deducing the various liquidation payments; the latter are then discounted at a subjective rate of capitalization. One must again be mindful that liquidation payments will usually be set so as to come within the provision of the IRS Code entitling capital gains treatment. Thus the arbitrageur is in a position to make long term capital gains.

One of the truly sizable liquidations was that of *Peabody Coal Company* which was acquired by *Kennecott Copper* in 1968. The financing arranged by *Kennecott* consisted of a Production Payment that was to yield an initial distribution of $45 per *Peabody* share upon consummation of the acquisition, plus a **liquidating distribution of $2.50** within eight months after that consummation. The latter distribution would be a long-term capital gain. As consummation of the merger approached and after Federal Trade Commission objections were disregarded, Peabody traded in the open market from upwards of $44, or a negative cost for the stub to $47 or $2 for the stub (47 – the initial distribution of $45). Thus, arbitrageurs were counting on a long term capital gain of $0.50. After consummation, and after the stock *Peabody* was delisted, the stubs were traded over-the-counter, where a bid of $2.35 was not uncommon.

Escrow agreements are regarded by arbitrageurs as more of a headache than as a potential source of profit. While they indeed fall within the definition of "stubs," and they can usually be created at a zero cost basis, their existence often appears in a merger agreement after an arbitrageur has established a position. For all practical profits, as the escrow hold-backs are there for a good reason: To meet the contingent liabilities of the Bride. One can safely assume that at least half of the stock or cash held in escrow will never be simply to completely discount the escrow, and if it would indeed yield something over time, so much the better. Stubs emanating from escrows are so <u>highly</u> discounted that there is hardly ever an over-the-counter market in them.

Of more immediate concern, as mentioned above, is that the presence of escrow accounts be known, for they are often devised and overlooked by the investment community. Let us assume, for example, that each X will receive one Y upon consummation of the merger, but that there is an escrow of 10 percent of the Y stock. To the arbitrageur, the exchange ratio automatically become one X equals nine-tenths Y, and the remaining tenth is forgotten. The investor who has counted on a share-for-share exchange, and who accordingly takes a long and short position in X and Y, finds himself short one-tenth Y per X upon consummation. If Y is higher than it was when the position was taken, all the efforts may well have been for naught. Even if Y is lower, the original spread works out to be less than was originally envisioned.

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