SPECIAL REPORT

THE BIG SECRET ON WALL STREET

EXCLUSIVE PREVIEW OF:

THE *FIRST BOOK EVER PUBLISHED* ON THE FIELD OF SPECIAL SITUATIONS

Special Situations

IN STOCKS AND BONDS

THE AUTHORIZED EDITION

BY THE FATHER OF SPECIAL SITUATIONS INVESTING

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FROM THE DESK OF PORTER STANSBERRY

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Chapter 1: What Makes A “Special Situation”

“Special situations” are investments in stocks or bonds that are in the process of reflecting “corporate action” which occurs within the administrative scope of the corporation rather than at the business level of the company.

Just as there are many types of real estate investments and speculations, such as the ownership of commercial property, industrial plants, commercial buildings, residential apartment houses, privately owned homes, farm land and acreage, there are numerous types of investments in securities.

While ”special situations·’ are particularly attractive for investment because they are profitable and are based on safety of principal, they frequently contain a dash of “great hope and expectations” generally associated with securities which are purchased for their substantial profit possibilities. This intriguing characteristic is known as Romance, or Windfall. In “special situations” romance or windfall is the glamour that the investor obtains without costs. It is an added attraction, unique in ”special situations”, in that it can have but one effect and that is beneficial, whereas; in the conventional investment or speculation the romance may be a decisive and costly element in the investment.

The romance or windfall in a “special situation” lies in the little known, the undisclosed, or uncalculated factors which quite unexpectedly do come into being and create a substantially larger profit than had been estimated. Such unanticipated benefits may result from new found values in obscure assets, tax adjustments, acceleration of the consummation of the ”corporate action”, or new ideas injected into the proceedings of a situation.

The ease with which one may calculate or figure out a ” special situation” investment arises from the fact that preponderantly all of the information pertaining to the investment situation is readily available. Consequently, the investor can determine for himself the desirability of the investment. All that is needed is pencil, paper, curiosity and a desire to make money. The investments are primarily arithmetic and not a guess on the future.

A characteristic of “special situations” generally not inherent in other investments is the prior knowledge of the amount of the expected profit. Because the expected profit is known beforehand, the various cross currents which could effect that profit are anticipated and analyzed. This is done in part through such self asked queries as:

Is the particular situation limited to the calculated profit?

Does the situation have more than one corporate action which may benefit it?

Will the profit be a fixed amount established only at consummation of the corporate action?

Will the profit accumulate progressively and be reflected marketwise as the situation develops?

Can the situation be terminated with a profit before consummation of the corporate action?

Could protracted duration consume the entire profit? Could the duration work to the advantage of the investor?

The complexion of a "special situation" reflects the answers to the above questions, and thus determines the desirability of the situation as an investment for profit.

Corporate Action Makes A Special Situation

As a fundamental quality of a "special situation" is the minor risk (though profit potentials frequently exceed successful speculations) "special situations" appeal to the conservative as well as the speculative minded investors. This dual attractiveness exists because the profit does not arise from the quality of the investment, nor the security market activity, but, rather from the "corporate action" which is reflected in the securities involved.

"Corporate action" is the fundamental characteristic which distinguishes "special situations" from conventional investments. Therefore, it seems advisable at this point to make certain that the meaning of "corporate action" is mutually understood. To aid the investor in obtaining a clear picture of the type of activity referred to as "corporate action", we will divide a corporation into two identities.

The corporate identity wherein our interest lies differs in that this phase of a corporation's actions pertains to the very existence of the company as distinguished from its products. Our corporate identity is responsible for the fundamental purpose of the corporation being in business. It is concerned with the finances that represent the money invested in the company, i.e., the capital structure. This part of the corporation also directs the policies effecting the nature of the company and the administration of the corporation's functions as a unit.

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As the corporate action which creates a "special situation" has a limited existence, so the "special situation" investment terminates when the corporate action has been completed. This automatic ending is a decidedly favorable factor as it eliminates the guesswork on the part of the investor as to when to dispose of an investment. Thus it has a self-liquidating characteristic.

The other part of the corporation's life is concerned with the business for which the corporation was organized, such as the manufacture of a product. "Corporate actions" are not concerned with the profits or losses from operations of the business.

It follows then that a "corporate action" creating a "special situation" pertains to a specific corporate activity. Under this circumstance the investment would not be influenced importantly by prevailing economic conditions; nor would a "special situation" investment be dependent upon the movement of the security market in order to attain the profit objective. This latter condition prevails because it is "the corporate action" which creates the profit. Therefore, the completion of "the corporate action" would at the same time establish the profit.

We have noted that the corporate actions which create "special situation" investments do not pertain to the business operations of the company (which are related to the profit and/or loss from the commercial operations). Nevertheless, the profits from the "special situation" investment are contained in the intrinsic value of the corporation's securities, which is reflected in the greater worth or price. Such appreciation in the value of a security is known as capital gains.

The investor's objective in a "special situation" investment is to make money. "Special situations" differ from the conventional investment objective of the individual which is to afford a return (income) for the use of the money, whereas special situations result in capital gains.

"Special situation" investors are not primarily interested in a continuing income as compensation for the money invested.

Instead, the "special situation" investor finds it profitable to think and act in terms of dollar increases (or decreases) in the principal used in a transaction. The money invested is the capital and the profits are recognized as "capital gains" or capital appreciation.

Having broadly defined the nature of "special situation" investments it would appear helpful at this point to discuss a bit of the substance of these investments with a view to better understanding the "how" and "why" of this type of profitable investment medium.

"Special situations" are a unique type of investment and have specific common basic characteristics or elements. The absence of one of the basic elements would eliminate a candidate security from the "special situation" category.

Basic Requirements Of A Special Situation

There are four fundamental elements which should be present in a “special situation” investment. The first and most important is that the investor’s interest should be aroused because of a “corporate action” that is occurring. The next element is contained in the security (stock or bond) being available in the market at prices less than its expected worth, This is known as “undervalue”. Following in importance is the availability of facts so that the investment can be calculated, i.e., figured mathematically and judged on its merits. The fourth element is the investment’s minimum risk status.

A “special situation·’ then, contains a specific “corporate action”, it is “undervalued”, it is “calculable”, and the “risk” can be reduced to a “minimum”.

The understanding of the significance of the four basic elements is the key to successful “special situation” investment procedure. This chapter presents a broad but simple explanation of each of the basic elements which must be present for a security to qualify as a “special situation” investment.

A “special situation” investment does not exist because a security is cheap in relation to comparable securities. It becomes an investment medium only when the attractiveness has been created by a corporate action, which, in turn, is the key to “special situations”.

Therefore, then, the investor knows that when searching for a “special situation” investment he should look for “corporate action”.

What Corporate Actions Lead To Special Situations

As the mining prospector knows his geological formations, so the security investor responds to the field in which “special situations” germinate. There are currently about ten categories in which “special situation” investments are found today. These are: **Mergers, Acquisitions, Liquidations, Tenders, Reorganizations, Divestments, Spin-offs, Appraisals, Tax Contingencies, and Over-Subscriptions**.

The most prolific area for “special situations” is in the field of **MERGERS** and **ACQUISITIONS**. Herein, the combining of two or more corporations and/ or the purchase of a company by another brings to light “special situation” investment opportunit1es almost daily.

LIQUIDATION... which is the act of winding up the affairs of a corporation, is a most profitable field. Much publicity is given this type of activity and thus the investor finds this category readily available for his use.

TENDERS, which are vehicles for offering securities, are well known to the investor, through offers to purchase securities by the issuing or acquiring corporation.

REORGANIZATIONS and/or **RECAPITALIZATIONS** offer varied opportunities for profit in view of the numerous corporate activities associated with such development.

DIVESTMENT OF SECURITY HOLDINGS as a result of governmental decree offered many opportunities for profit during the Public Utility Holding Company period of divestment, and no doubt similar situations will continue to present profitable opportunities in the future.

Closely associated with this tatter activity is the "**SPIN-OFF**", which is a newcomer to the "special situation" field. Herein a corporation distributes its holdings of a subsidiary company to its stockholders.

Request for **APPRAISAL** and the opportunities presented by tax contingencies are technical fields where the investor willing to "seek" will find numerous opportunities for "special situation" investment.

The newest "corporate action" field is found in the opportunities present when a corporation offers shares to its stockholders with the additional privilege of subscribing to shares remaining at the expiration of the subscription offer. This activity is known as "**OVER SUBSCRIPTION**".

Each of the sources of "special situations·' is discussed in detail in the following chapters.

Summarizing, we find that the present lucrative areas of "special situation" investment are: **Mergers, Acquisitions, Liquidations, Tenders, Reorganizations, Divestments, Spin-offs, Appraisals, Tax Contingencies, and Over-subscriptions.** Undoubtedly other fields will develop as ideas are created.

Significance Of "Duration"

A paramount decision confronting most investors is to know when to purchase an investment and how long to remain as an investor. After having discovered a "special situation" in one of the ten categories, it is essential to get an idea of the length of time that will be required to complete the "corporate action". This phase is known as the duration period. It is an extremely important element as profits in "special situations" are to a major degree determined by the length of time one's capital is being used. This is so since the main return upon the capital placed in a "special situation" is in the form of capital gains. The effect of duration can be seen readily if we realize that the capital gain or profit amortized over the duration is subject to the law of diminishing returns if the length of time the investment is held is protracted. A simple arithmetical example shows that a 20% return which takes two years to fulfillment is considerably better than a 20% return allocated over four years.

In the first instance the return would be at the rate of 10% per annum, while in the latter case the return would be only 5% on an annual basis. However, the dollar profit or capital gain would be the same in both instances. The length of time or longevity of a "special situation" investment is of particular significance since income frequently is not obtained, nor is it of prime importance in a "special situation" investment. Thus, under the present tax law it is more advantageous to have long term (over six months) periods, than to receive a current yield in the form of capital gains.

The duration period is significant because the rate of return (which is the percentage yield on the capital invested) or profits on the investment are calculated or figured out upon the basis of annual return. The importance of this factor (duration) can be seen in the fact that the duration element frequently is subject to conjecture despite a definite date objective. Nevertheless, investors often arbitrarily double the indicated duration period in their calculation of the situation.

Uncertainties in duration arise from the character structure of an investment. Conspicuous contingencies causing duration delays are legal and tax differences. While some "special situations" come into being because of legal and tax disputes other situations may be impaired if such contingencies develop unexpectedly. The decision as to whether to participate in a "special situation" investment or not frequently is determined by the state of the duration factor.

The following illustration discloses the importance of duration:

A calculated or mathematically figured appreciation of 40% in an investment over a two year period would be dissipated if the situation became protracted. This would occur in a case wherein a fixed value is estimated to be obtained when the corporate action is completed. Each year's delay would depreciate the annual rate of return so that only 10% would be realized if consummation required four years, while further extension could wipe out the profit or reduce it to a point where the situation would be totally unattractive.

A further example of the importance of duration can be seen in the instance wherein a capital appreciation of 40% is indicated based on a two year time factor. This is equal to 20% gain on an annual basis. That investment would not be as inviting as a similar situation offering a 10% basis with six months to go or at a 5% basis with only three months in which to be completed. While the percentage of profit on an annual basis is the same in each case, i.e., 20% on the money invested, the margin for possible upset of the duration is considerably smaller in the latter instance than in the first and second. Too frequently "duration" has changed the complexion of many attractive special situation candidates, both favorably and unfavorably.

It is at this point that timing enters the situation. The question of when to buy

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and why the purchase should be made at a specific time is always difficult in conventional investing. However, in ”special situations” much of the uncertainty as to when to buy is removed by the status of the situation under consideration. In the first place, to merit consideration as a “special situation” investment, the expected “corporate action” should be beyond the vague, nebulous, or wishful hoping stage. The corporate action should be sufficiently advanced towards consummation so that its occurrence can be expected within some definite period.

The existence of that condition clarifies the question of timing to the extent that a degree of sureness exists as to the existence of a profit and a corporate action. Thus, as the ”special situation” does exist, it is then a matter of calculation (pencil and paper figuring) as to whether it meets the individual investor’s profit requirements. If the profit is too small percentage-wise, that is in relation to the amount of money required for the investment, then the situation would not be purchased and the creation of a transaction in that situation would be put off until the percentage return on the investment was satisfactory or the situation passed by completely. Generally the time when to buy is determined by the amount of profit indicated. Thus the decision as to when to buy is decided by the situation itself.

Determining The Four Basic Requirements

An investor’s first meeting with a new “special situation” investment generally is at the point of origin where the investment can be classified in one of the ten categories of sources, noted previously. If the corporate action and duration period appears reasonable and satisfactory, then the investor’s next step will bring to light the profit potential which is our second element, known as ”undervalue” and sometimes referred to as “discount”.

“Undervalued” or “discount”, means that a stock or bond is available at a price which is less than its expected worth at the time of completion of the ”corporate action”. The difference between the market price of a security and an expected higher value to be obtained through a corporate action is known as the ”discount”. A stock that is estimated to be worth or has a tangible value of $20.00 per share and is priced in the market at $15.00 per share, would be considered to be selling at a discount of $5.00 per share. This is equivalent to 25% of the $20.00 value (5 /20 = 25%). Thus the stock at $15.00 would be available at a discount of 25% from its estimated or tangible value.

The security is then considered undervalued to the extent that the tangible or calculated value is related to the corporate action responsible for investment interest in the situation. A corporation in liquidation (to use an example) may have assets worth $10.00 per share while the shares are available in the market at $9.00 per share. Thus the situation would be undervalued to the extent of 10%. When the liquidation has been completed it is expected that the shareholder will have received $10. 00 for each of his shares.

Having established the prerequisites of “corporate action” and “undervalue”, we next want to know whether the situation can be calculated, That is the third basic element. This factor determines the desirability of the situation from the monetary approach. Herein, the investor mathematically figures the amount of expected profit. If it satisfies his objective (investors’ objectives differ) then he will proceed with the investigation. Due consideration must then be given to all the facts which influence the probabilities of consummating the “corporate action”.

Adequate attention should be given to the tangible as well as the intangible factors. Such obstacles as opposition to the expected corporate action, legal and tax contingencies and the amount of possible loss if the situation does not work out satisfactorily are weighed and given a place in the calculations.

Favorable influences effecting the amount of profit and the duration are also carefully investigated. A fixed date for distribution of funds, for example, is helpful if verified, as it limits the duration period of the investment to a specified length of time, while knowledge of the true value of the assets of a corporation in liquidation give assurance to the safety of the situation.

During the life of a “special situation” it is expected that the calculated worth will remain comparatively constant. This condition would exist because the underlying assets are based on sound values, and not subject to broad fluctuations.

An example of the calculation procedure is readily seen in the recent sale of Briggs Manufacturing Corporation’s assets to the Chrysler Corporation. Herein the mathematical figuring and assumptions regarding the non-mathematical factors were weighed and given relative importance, the results of the calculations suggested the attractiveness of the situation.

Briefly stated the facts of the Briggs case are:

Briggs shares were priced around 36-1/4 on the New York Stock Exchange in Dec. 1953. The sale of Briggs’ properties equaled $32.25 per share which amount was to be distributed to the shareholders some time within the year. The unsold or remaining assets had an estimated value of $9.50 per share; based on earning power of $1.50 per share. Thus the combined values totaled $41.75 per share. The discount from the indicated worth of $41.75 was 12.9% while the expected profit on the investment of $36.25 amounted to $5.50 per share equal to 15% on the money invested. This was a satisfactory return in view of the probable duration which appeared to be less than one year (complete details of this case are presented. See exhibit B in Chapter II)

Subsequent developments supported the calculations. Dividends of $0.50 per share were distributed to stockholders during the first part of 1954. The shares responded to the basic favorable conditions of the situation by advancing to

41-5/8 by September 1954. Thus the combined market price of the stock and the distributions totaled 42-1/8, exceeding the expected value of 41-3/4 in less than one year's time. (The distribution of $32.25 was made in the latter part of 1954.)

An element which endears the investors to "special situations" is the fourth requisite, known as "minimum risk". The high level of safety of the principal invested flavors "special situations" with a quality generally found only in the most riskless of investments. It is indeed comforting to own a security and have the feeling of confidence which is contained in a "special situation" as to the amount of profit and possible loss that could occur.

Because all the pertinent data in a "special situation" is available and because the mathematical computations can be relied upon, the monetary risks involved can be reduced to a calculated minimum. In this respect many "special situations" are as safe as high grade, triple 1 "AAA" loans or bonds. Where the investment rating is high the amount of money loaned or risked is comparatively small in relation to the borrowers' gross capital, while his earning power is substantially in excess of the amount of interest to be met. The "AAA" borrower would obtain the use of the money at the lowest rate of interest as the risk assumed by the lender would be minor in respect to nonpayment of the interest and principal.

To give a security minimum risk classification merely requires making use of the known facts and giving proper values to each item of information. "Special situation" investments come into being where the known facts disclose all the essential material and thus show the potential loss to be minor in relation to the probability of successful completion. Consequently, through the process of selection and elimination we can discard those securities which contain unverified facts and excessive speculative possibilities. Facts and valuations are the subject matter of subsequent chapters.

Knowing all the facts and desiring to estimate the amount of possible loss, the procedure is to calculate first the amount of loss that would be incurred in the event the "corporate action" failed to materialize. The estimated loss in a "special situation" should be related to the amount of capital to be invested. If the calculated loss amounts to a substantial sum in relation to the capital required, then the transaction would not be considered a true "special situation".

A "special situation" showing a capital gain of 10% on an annual basis should have a probability of nine to one in favor of success. While the percentage gain could be considerably higher in numerous instances, the risk probability should not increase in the same ratio. Should that occur, then the situation would be a speculation rather than a "special situation" investment.

We have presented the basic elements of "special situations" leaving those vital components of dividends and interest on stocks and bond untouched. This factor has been by-passed because dividends and interest seldom if at all exercise a dominant reason for entering into a "special situation" investment. However, the existence of dividends and interest may influence the quality of the situation and hence become a pertinent determining factor. Where dividends or interest are sufficient to pay for the cost of the capital invested, the investor would be more inclined to look upon the situation with greater interest.

The value of dividend payments on shares or interest payments on bonds, as a qualitative factor is minor in a "special situation". The importance of income is reduced to the amount it contributes or detracts from the potential profit. This is considerably different than the significance placed on dividend and interest in the conventional long term investment where the stability of income may be the deciding factor for acquiring the investment.

Finding A Special Situation

We have discussed the various elements which when contained in one investment create a "special situation" in a stock or bond. Besides locating a special situation investment and classifying it for easy analysis, it may be helpful to verify the pertinent facts. The sources of information which may disclose, add to, or verify related information of a situation are numerous and varied. All sources of course can not be used at any one time. However, knowledge of the existence of a possible source of information may have valuable influence when working with a "special situation".

The prime sources for information concerning corporate action are of course the large city newspapers and the financial publications, while industry trade journals frequently contain data that is not contained in the press. A most comprehensive source of information is the corporation itself through its various publications such as annual reports, proxy statements and prospectuses, plus personal discussions with the management. It can be profitable to read the footnotes of corporation reports as these releases frequently contain information which gives clues to values of properties or securities. An example of this condition is present in the Annual Reports of National Department Stores, where income received from properties is the only item that gives an indication as to the value of some properties which are carried on the books at almost meaningless values.

Prospectuses and notices of annual meetings generally contain advice relating to such corporate activities as mergers, acquisitions, and inter-related officers and directors. Corporation and Securities & Exchange Commission releases also may contain the names of holders of large amounts of the corporation's securities.

The library facilities of Banks, the Exchanges, the Securities and Exchange Commission, and public libraries may have many of the financial reports that can be referred to for valuable corporate information,

A unique characteristic of "Wall Street" is the accessibility of information among investors and analysts who participate in "special situation" investments. A sort of esprit de corps for mutual exchange of information that is not found in other industries or professions is present in "Wall Street". It is also a good point to listen to and investigate all rumors. Notwithstanding the general opinion to the contrary, there more frequently than otherwise is more truth than fabrication in most hearsay stories relating to mergers, acquisition and liquidations.

The Appendix contains a comprehensive compilation and description of many sources for financial information relating to "special situations".

Each one of these sources has its value when it can be used in determining the probability of consummation of a "corporate action". Stock holdings of management give a clue to the degree of control the officers have and disclose the likelihood of completion of proposed corporate actions. The importance and application of the other items is apparent as knowledge of details of interrelated directorates, options, loan restrictions, and other financial matters are easily recognized.

"Special situation" investments by their very existence eliminate guessing. As noted previously, all the information one needs can be obtained. We have seen that the "special situation" can be figured on a dollar or money basis. An additional but not essential helpful aid would be a "sense for dollars" similar to that extrasensory perception for news that is inherent in the reporter with his "nose for news" or the gardener's fabled "green thumb". From this point on the investor is ready to partake of this profitable investment field.

Unlike other types of investments, "special situations" must be sought. They do not present themselves with a label in the manner a stock is classified as preferred or a bond is designated as first mortgage. Therefore it would be helpful if the investor learned to identify special situations" the speedy way, by selecting from the ten categories or sources which is the fertile ground for "special situations" growth.

To a degree, locating "special situation" investments contain the fascinating deductive thinking combined with investigatory plodding used in detective work. The clues are there; this book blueprints their nesting places. The type of security of which a "special situation" is made is of the general run of stocks and bonds traded on the various exchanges or the unlisted markets of the United States. The procedure for participation, that is, purchase and sale, is the same as other security transactions which an investor generally arranges through his broker. There are no secret markets or securities involved in "special situation" investments.

The following chapters will take the investor on a step by step procedure of each of the presently known categories of "special situations". We will work through the examples by discussing the conformists and nonconformists to the basic rules. We will show where the four basic elements, namely, "corporate action", "undervalue", “calculation”, and “minimum risk”, exist in each specific example. We will also trace the use of the different types of source material and show the methods of application of the data. When concluded the investor not only will know “special situations” but he will be able to refer to the examples and use them as guides for his own activities. In the majority of instances the procedure and examples used are the exact steps and cases used by the author in working with “special situation” investments.

Summarizing, we find that the type of security investment discussed herein offers profits of varying degrees with safety of principal. These factors obtain because the facts needed to create such conditions are available. Thus the investment can be analyzed and calculated to a degree which assures the existence of a profit.