APPLIED FUNDAMENTAL RESEARCH

Reconsidering the Catalyst in Event Driven Investing

A Practitioner's Viewpoint by Ted Wagenknecht, Portfolio Manager, AFR

March 27, 2015

There has always been a healthy debate among event-driven investors as to what in fact constitutes the catalytic event that defines the strategy. For many, the moniker "event driven" can only, and should only, be used by practitioners who rely upon a "hard" catalyst to collapse a given discount between market price and determined value. At AFR, we believe this focus on an event as defined by a single hard catalyst leaves much of a potential investment's return to be captured by others (namely those who provide the action that creates the hard catalyst), or cuts short the ultimate investment return that can be achieved subsequent to a catalytic event. We pursue a different formula for event driven success: a focus on identifying investment opportunities wherein not one *single* event, but a *series* of positive events work in sequence to collapse the discount between market price and intrinsic value – and in many cases, expand upon and *grow* ultimate intrinsic value over time.

True hard catalysts typically originate from the domain of credit-focused investors and arbitrageurs: maturities of debt instruments, refinancings, repricings due to amendment negotiations, bankruptcies, restructurings, emergence from restructurings, exchange offers, mergers, buy-outs or other tender offers, or spin-offs, to name a few.

Event Driven strategies that look to capitalize on these hard catalysts more often than not realize any price improvement on their position caused by the specific event, close out their position, and allocate capital to the next attractive hard catalyst that can be identified.

At best, this strategy achieves a return that represents the discount that was initially present between a security "pre-event" and its "post-event" value. But what about the return that is available within a given capital structure subsequent to the defined hard catalyst? Does a matured or refinanced debt obligation result in a lower cost of capital, more flexible balance sheet, or longer "runway" that can in turn benefit the equity securities in the same capital structure? Does an exchange offer de-lever a balance sheet to the subsequent benefit of other creditors or equity holders, allowing them to generate greater risk-adjusted returns subsequent to this hard catalyst? Can a spin-off generate significant returns to holders even after the initial price movement once such an event has been announced or completed?

A study of returns generated from the period before a hard catalyst to immediately after such hard catalyst event took place would likely not be meaningful as any averages implied would be subject to specific points of entry and exit. We suggest instead that prospective allocators considering event driven strategies that pursue either a single "hard" catalyst or an AFR-type return outcome assess for themselves the likely difference in ultimate return from two theoretical scenarios outlined in Exhibit #1 below:

Exhibit #1

X corp Simplified Financial Statement

Timing	*0*	*12 Months*	*24 Months*
	Pre-Refin	**Post-Refin**	**Post-Refin+Inv**
Revenues	500.0	500.0	505.0
Costs	450.0	450.0	452.5
EBIT	50.0	50.0	52.5
Interest	30.0	22.5	22.5
EBT	20.0	27.5	30.0
Tax @ 30%	6.0	8.3	9.0
Net Income	14.0	19.3	21.0
xPE Multiple	10.0	10.0	10.0
Equity Value	140.0	192.5	210.0
Debt	300.0	300.0	300.0
Int. Rate	10.0%	7.5%	7.5%
Debt/EBIT	6.0x	6.0x	5.7x
TEV/EBIT	8.8x	9.9x	9.7x
IRR to Equity		37.5%	22.5%
Multiple of Investment		1.38x	1.50x
Return to Bond from purchase at 95%		15.8%	
Multiple of Investment		1.16x	
Multiple of Inv. Difference		0.22x	0.34x

Scenario #1: Hard Catalyst fund purchases an 10% unsecured bond of X corp. 12 months before maturity at 95 cents on the dollar for a potential 1-year return of 15.8%. At the end of 12 months the company finances the maturity of the bond at par with a 7.5% secured bond due in 10 years, generating a return to Hard Catalyst fund of 15.8%, or 1.158x investment.

Scenario #2: AFR recognizes that the likely refinancing of the maturing unsecured bond with a secured bond will yield an interest rate of 7.5%, and buys the equity of X corp. AFR believes that this lower cost of capital will generate a one-year IRR to the equity of X corp. of 37.5%. Further, AFR believes that X corp. can invest the $5mln of interest savings in a project that generates an EBIT margin of 50%. 12 months following the refinancing, X corp. is realizing the benefits of its investment of its incremental cash flow, yielding $1.7mln more of net income, which at a constant P/E multiple generates a two-year IRR to AFR of 22.5%, or 1.5x investment.

In the example above, a definitionally “hard” catalyst in the form of a debt maturity yields a satisfactory return (15.8%) to the Hard Catalyst fund. But by looking at this debt maturity as the beginning of a *series* of events that could increase the equity value of X corp., AFR is able to generate a 50% return on its investment over two years in X corp’s equity (although it would be more likely than not that AFR, as part of its cross-capital structure mandate would invest some portion of its capital in *both* the bond likely to be matured *and* the equity securities that benefit from both the refinancing of the company's bond and its subsequent investment opportunities in new projects).

The scenario above highlights the fundamental difference between event-driven investing that relies upon a "hard" catalyst, and the type of event-driven investing that is characteristic of AFR's approach. To us, there is very little difference between the "hard" catalyst that would drive the price of X corp's bond towards par value, and the subsequent "soft-catalyst" benefits that X corp. would derive from a lower cost of capital and in turn its ability to re-invest a portion of its increased cash flow in new projects that generate returns that further increase its enterprise value (all risk factors related to equity versus debt securities being considered).

So-called "Soft" catalysts are often more difficult to identify than simple "hard" catalysts, and require deep diligence on a targeted business that provides the investor an understanding of the various business prospects available to a company, and, perhaps more importantly, how management will react in the face of these prospects under various general business conditions. So-called "soft" catalysts can take a multitude of forms: improvement in underlying industry characteristics, the advancement of a company's competitive position within its industry, new projects, balance sheet changes, changes in customer or supplier power, to name only a few.

This view leads to what we at AFR believe is a fundamental truism of event-driven investing- that a) a number of "events" both "hard" (in this case the maturity of a security), and "soft" (in this case, the resulting cost of capital savings and the ability to invest in favorable new projects) must be considered when formulating an investment thesis, and b) that more often than not, these "soft" catalysts, especially when there are many that can be achieved by a particular company in sequence, often provide a potential investment outcome that is vastly superior to the traditional hard catalyst-driven outcome. AFR's proprietary SURROUND diligence process aims to identify these types of catalysts, and interpret how they may be combined to drive not only the collapse of a given discount between market price and intrinsic value, but the expansion of intrinsic value as well.

It is therefore imperative that a true event-driven investor look beyond the obvious "hard" catalyst to the ultimate impact of, or ramifications of, a number of "soft catalysts" that can not only collapse the discount offered between the market price of a given security and its intrinsic value, but in many instances expand that intrinsic value (as in the case shown above), creating the opportunity to generate truly exceptional returns on invested capital without the need to constantly recycle capital into new "cigar butt" opportunities.

About Applied Fundamental Research

Applied Fundamental Research, LLC (AFR) is a privately held investment management firm founded in 2013 and based in Cambridge, Massachusetts. The firm seeks to compound capital on behalf of high net worth individuals and families, endowments and foundations, and institutional partners in a risk-averse manner. AFR utilizes a defined research methodology to benefit from identifying, analyzing and valuing fundamentally mispriced equity and credit opportunities for its investment partners. Learn more at www.appliedfr.com

Contact: David Carson, Director of Business Development at (617) 401-9989 or dc@appliedfr.com