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# DEEP VALUE

Why Activist Investors and Other Contrarians Battle for Control of Losing Corporations

TOBIAS E. CARLISLE

WILEY

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*For my ladies luck, Nickole and Stella.*

# Contents

# Preface

> *"The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."*
>
> —Adam Smith, *The Wealth of Nations* (1776)

Deep value is investment triumph disguised as business disaster. It is a simple, but counterintuitive idea: Under the right conditions, *losing* stocks—those in crisis, with apparently failing businesses, and uncertain futures—offer unusually favorable investment prospects. This is a philosophy that runs counter to the received wisdom of the market. Many investors believe that a good business and a good investment are the same thing. Many value investors, inspired by Warren Buffett's example, believe that a good, undervalued business is the best investment. The research seems to offer a contradictory view. Though they appear intensely unappealing—perhaps *because* they appear so intensely unappealing—deeply undervalued companies offer very attractive returns. Often found in calamity, they have tanking market prices, receding earnings, and the equity looks like poison. At the extreme, they might be losing money and headed for liquidation. That's why they're cheap. As Benjamin Graham noted in *Security Analysis*, "If the profits had been increasing steadily it is obvious that the shares would not sell at so low a price. The objection to buying these issues lies in the probability, or at least the possibility, that earnings will decline or losses continue, and that the resources will be dissipated and the intrinsic value ultimately become less than the price paid." This book is an investigation of the evidence, and the conditions under which *losing* stocks become asymmetric opportunities, with limited downside and enormous upside.

At its heart, deep value investing is simply the methodical application of timeless principles proven by over 80 years of research and practice. The intellectual basis for it is Graham's *Security Analysis*, the foundational document for the school of investing now known as *value investing*. Through his genius and his experience, Graham understood intuitively what other researchers would demonstrate empirically over the eight decades since his book was first published: That stocks appear most attractive on a fundamental basis at the peak of their business cycle when they represent the worst risk-reward ratio, and least attractive at the bottom of the cycle when the opportunity is at its best. This has several implications for investors. First, the research, which we discuss in the book, shows that the magnitude of market price discount to intrinsic value—the *margin of safety* in value investing parlance—is more important than the rate of growth in earnings, or the return on invested capital, a measure of business quality. This seems contradictory to Buffett's exhortation to favor "wonderful companies at fair prices"—which generate sustainable, high returns on capital—over "fair companies at wonderful prices"—those that are cheap, but do not possess any economic advantage.

In the book, we examine why Buffett, who was Graham's most apt student, sometime employee, long-time friend, and intellectual heir, evolved his investment style away from Graham's under the influence of his friend and business partner, Charlie Munger. We examine why Munger prompted Buffett to seek out the wonderful company, one that could compound growth while throwing off cash to shareholders. We analyze the textbook example of such a business to understand what makes it "wonderful," and then test the theory to see whether buying stocks that meet Buffett's criteria leads to consistent, market-beating performance over the long term. Do Buffett's wonderful companies outperform without Buffett's genius for qualitative business analysis, and, if so, what is the real cause? We know that a wonderful company will earn an average return if the market price reflects its fair value. To outperform, the price must be discounted—the wider the discount, or margin of safety, the better the return—or the business must be more wonderful than the market believes. Wonderful company investors must therefore determine both whether a superior business can sustain its unusual profitability, and the extent to which the stock price already anticipates its ability to do so. This is a difficult undertaking because, as we'll see, it is the rare company that does so. And we don't well understand what allows it to do so. In most cases competition works on high quality businesses to push their returns back to average, and some even become loss makers. What appears to be an unusually strong business tends to be one enjoying unusually favorable conditions, right at the pinnacle of its business cycle.

The problem for investors is not only that high growth and unusual profitability don't persist. Exacerbating the problem in many cases is that the market overestimates the business's potential, bidding the price of its stock too high relative to its potential. The stock of high quality companies is driven so high that long-term returns are impaired *even assuming the high rates of growth and profitability persist*. The corollary is also true: A company with an apparently poor business will generate an excellent return if the market price underestimates its fair value *even assuming the low growth or profitability persists*. These findings reveal an axiomatic truth about investing: investors aren't rewarded for picking winners; they're rewarded for uncovering mispricings—divergences between the price of a security and its intrinsic value. It is mispricings that create market-beating opportunities. And the place to look for mispricings is in disaster, among the unloved, the ignored, the neglected, the shunned, and the feared—the losers. This is the focus of the book.

If we want rapid earnings growth, and the accompanying stock price appreciation, the place to look for it is counterintuitive. It is more likely to be found in undervalued stocks enduring significant earnings compression and plunging market prices. How can this be so? The reason is a pervasive, enduring phenomenon known as *mean reversion*. It can be observed in fundamental business performance, security prices, stock markets, and economies. It returns high-growth stocks to earth, and pushes down exceptional returns on investment, while lifting moribund industries, and breathing new life into dying businesses. Though Graham described the exact mechanism by which mean reversion returned undervalued stocks to intrinsic value as "one of the mysteries of our business," the micro-economic theory is well understood. High growth and high returns invite new entrants who compete away profitability, leading to stagnation, while losses and poor returns cause competitors to exit, leading to a period of high growth and profitability for those business that remain.

Though it is ubiquitous, we don't intuitively recognize the conditions for mean reversion. Time and again investors, including value investors, ignore it and consequently reduce returns. We can show that a portfolio of deeply undervalued stocks will, on average, generate better returns, and suffer fewer down years, than the market. But rather than focus on the experience of the class of deeply undervalued stocks, we are distracted by the headlines. We overreact. We're focus on the short-term impact of the crisis. We fixate on the fact that any individual stock appears more likely to suffer a permanent loss of capital. The reason is that even those of us who identify as value investors suffer from cognitive biases, and make behavioral errors. They are easy to make because the incorrect decision—rejecting the undervalued stock—feels right, while the correct decision—buying stocks with anemic, declining earnings—feels wrong. The research shows that our untrained instinct is to naïvely extrapolate out a trend—whether it be in fundamentals like revenues, earnings, or cash flows, or in stock prices. And when we extrapolate the fundamental performance of stocks with declining earnings, we conclude that the intrinsic value must become less than the price paid. These biases—ignorance of the base case and, by extension, mean reversion—are key contributors to the ongoing returns to deep value investment.

In the book we also examine how the public stock market, by making possible an involuntary exchange of management control, creates a means for disciplining underperforming managers, and improving poorly performing businesses. Where high-return businesses attract competitors, low-return businesses attract outside managers. Through acquisition, or activism, these external managers—typically financial buyers like private equity firms, activist investors, and liquidators—compete for control of corporate resources with underexploited potential in the *market for corporate control*. The *principal-agent conflict*—caused by the separation of ownership and management in publicly traded companies—leads management to put its own interests ahead of the shareholders. Activists seek to resolve this conflict by pressuring boards to remove underperforming managers, stop value-destroying mergers and acquisitions, optimize capital structures, or press for a sale of the company, and earn a return doing so. They are thus incentivized to foment catalysts in otherwise neglected stocks, and are an important participant in the market for deeply undervalued, underperforming stocks.

As a portfolio, deeply undervalued companies with the conditions in place for activism offer asymmetric, market-beating returns. Activists exploit this property by taking large minority stakes in these stocks and then agitating for change. What better platform than a well-publicized proxy fight and tender offer to highlight mismanagement and underexploited intrinsic value, and induce either a voluntary restructuring or takeover by a bigger player in the same industry? Activist investing can be understood as a form of arbitrage. Activists invest in poorly performing, undervalued firms with underexploited intrinsic value. By remedying the deficiency or moving the company's intrinsic value closer to its full potential, and eliminating the market price discount in the process, they capture a premium that represents both the improvement in the intrinsic value and the removal of the market price discount. We scrutinize the returns to activism to determine the extent to which they are due to an improvement in intrinsic value, or simply the returns to picking deeply undervalued stocks. Finally, we examine valuation metrics used to identify the characteristics that typically attract activists—undervaluation, large cash holdings, and low payout ratios. These metrics favor companies with so-called *lazy* balance sheets and hidden or unfulfilled potential due to inappropriate capitalization. Activists target these undervalued, cash-rich companies, seeking to improve the intrinsic value and close the market price discount by reducing excess cash through increased payout ratios. We analyze the returns to these metrics and apply them to two real world examples of activism. The power of these metrics is that they identify good candidates for activist attention, and if no activist emerges to improve the unexploited intrinsic value, other corrective forces act on the market price to generate excellent returns in the meantime.

The book is intended to be a practical guide that canvasses the academic and industry research into theories of intrinsic value, management's influence on value, and the impact of attempts to unseat management on both market price and value. Each chapter tells a different story about a characteristic of deep value investing, seeking to illustrate a genuinely counterintuitive insight. Through these stories, it explores several ideas demonstrating that deeply undervalued stocks provide an enormous tail wind to investors, generating outsized returns whether they are subject to activist attention or not. We begin with former arbitrageur and option trader Carl Icahn. An avowed Graham-and-Dodd investor, Icahn understood early the advantage of owning equities as apparently appetizing as poison. He took Benjamin Graham's investment philosophy and used it to pursue deeply undervalued positions offering asymmetric returns where he could control his own destiny. More than any other, Icahn's evolution as an investor mirrors the evolution of activism. In the following chapters we step through the looking glass to examine the theories of deep value and activist investing from Graham to Buffett to Icahn and beyond.

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CHAPTER 1

# The Icahn Manifesto

## Corporate Raider to Activist Investor

*"Had we but world enough, and time,*
*This coyness, Lady, were no crime. . .*
—Andrew Marvell, *To His Coy Mistress* (c. 1650)

**bouleversement** *bool-vair-suh-MAWN*\\, *noun:*
*Complete overthrow; a reversal; an overturning; convulsion; turmoil.*
—Comes from French, from Old French *bouleverser*, "to overturn," from *boule*, "ball" (from Latin *bulla*) + *verser*, "to overturn" (from Latin *versare*, from *vertere*, "to turn").

Over the fall of 1975, Carl Icahn and his right-hand man, Alfred Kingsley, hashed out a new investment strategy in the cramped offices of Icahn & Company. Located at 25 Broadway, a few steps away from the future site of the *Charging Bull*, the iconic 7,000-pound bronze sculpture erected by Arturo Di Modica following the 1987 stock market crash, Icahn & Company was then a small, but successful, discount option brokerage with a specialty in arbitrage. Kingsley, a graduate of the Wharton School with a master's degree in tax from New York University, had joined Icahn in 1968. Immediately impressed by his ability to quickly grasp complex transactions, Icahn had asked Kingsley what he knew about arbitrage. "Not a thing," Kingsley had replied.[1] Soon Kingsley was spending most of his days arbitraging the securities of conglomerates like Litton Industries, LTV, and IT&T. Arbitrage is the practice of simultaneously buying and selling an asset that trades in two or more markets at different prices. In the classic version, the arbitrageur buys at the lower price and sells at the higher price, and in doing so realizes a riskless profit representing the ordinarily small difference between the two. Icahn had Kingsley engaged in a variation known as convertible arbitrage, simultaneously trading a stock and its convertible securities, which, for liquidity or market psychology reasons, were sometimes mispriced relative to the stock. Litton, LTV, IT&T, and the other conglomerates had issued an alphabet soup of common stock, preferred stock, options, warrants, bonds, and convertible debt. As an options broker, Icahn used his superior market knowledge to capitalize on inefficiencies between, say, the prices of the common stock and the warrants, or the common stock and the convertible debt. The attraction of convertible arbitrage was that it was market-neutral, which meant that Icahn & Company's clients were not subject to the risk of a steep decline in the market.

Icahn and Kingsley shortly progressed to arbitraging closed-end mutual funds and the securities in the underlying portfolio. A closed-end mutual fund is *closed* because it has a fixed number of shares or units on issue. Unlike open-end funds, management cannot issue or buy back new shares or units to meet investor demand. For this reason, a closed-end fund can trade at a significant discount or, less commonly, a premium to its net asset value. Icahn and Kingsley bought the units of the closed-end funds trading at the widest discount from their underlying asset value, and then hedged out the market risk by shorting the securities that made up the mutual fund's portfolio. Like the convertible arbitrage strategy, the closed-end fund arbitrage was indifferent to the direction of the market, generating profits as the gap between the unit price and the underlying value narrowed. It was not, however, classic riskless arbitrage.

As it was possible for a gap to open up between the price of the mutual fund unit and the underlying value of the portfolio, it was also possible for that gap to widen. When it did so, an investor who had bought the units of the fund and sold short the underlying portfolio endured short-term, unrealized losses until the market closed the gap. In the worst-case scenario, the investor could be forced to realize those losses if the gap continued to widen and he or she couldn't hold the positions, which could occur if he or she failed to meet a margin call or was required to cover the short position. Unwilling to rely on the market to close the gap, Icahn and Kingsley would often take matters into their own hands. Once they had established their position, they contacted the manager and lobbied to have the fund liquidated. The manager either acquiesced, and Icahn and Kingsley closed out the position for a gain, or the mere prospect of the manager liquidating caused the gap to wholly or partially close. The strategy generated good returns, but the universe of heavily discounted closed-end funds was small. Icahn and Kingsley saw the potentially far larger universe of prospects emerging in public companies with undervalued assets. This was the new investment strategy they were shaping at 25 Broadway in 1975.

Already moribund after a decade of stagflation, an oil crisis, and a failing U.S. economy, Wall Street was sent reeling from the knockout punch delivered by the 1974 stock market crash, the worst since the Great Depression. Out of the bear market punctuating the end of the Go-Go 1960s, the stock market had rallied to a new all-time high in early 1973. From there it was brutally smashed down to a trough in October 1974 that was some 45 percent below the January 1973 peak. (The market would repeat this wrenching up and down cycle until November 1982, at which point it traded where it had in 1966, fully 16 years before.) Stocks that had become cheap in 1973 had proceeded to fall to dust in 1974. Bonds, ravaged by runaway inflation, were described by wags as "certificates of confiscation."[2] Investors were still shell shocked in 1975. Even if they could be persuaded that they were getting a bargain, most seemed unwilling to re-enter the market, believing that undervalued stocks could start dropping again at any moment. If they would take a call from their broker, they simply wanted "the hell out of the market."[3]

Although few could sense it, a quiet revolution was about to get under way. Icahn and Kingsley had seen what many others had missed—a decade of turmoil on the stock market had created a rare opportunity. After trading sideways for nine years, rampant inflation had yielded a swathe of undervalued stocks with assets carried on the books at a huge discount to their true worth. Recent experience had taught most investors that even deeply discounted stocks could continue falling with the market, but Icahn and Kingsley were uniquely positioned to see that they didn't need to rely on the whim of the market to close the gap between price and intrinsic value. Kingsley later recalled:[4]

> *We asked ourselves, "If we can be activists in an undervalued closed-end mutual fund, why can't we be activists in a corporation with undervalued assets?"*

As they had with the closed-end mutual funds, Icahn and Kingsley would seek to control the destiny of public companies. Their impact on America's corporations would be profound.

## ICAHN'S WALL STREET REFORMATION

Icahn's progression from arbitrageur and liquidator of closed-end funds to full-blown corporate raider started in 1976 with a distillation of the strategy into an investment memorandum distributed to prospective investors:[5]

> *It is our opinion that the elements in today's economic environment have combined in a unique way to create large profit-making*

> *opportunities with relatively little risk. [T]he real or liquidating value of many American companies has increased markedly in the last few years; however, interestingly, this has not at all been reflected in the market value of their common stocks. Thus, we are faced with a unique set of circumstances that, if dealt with correctly can lead to large profits, as follows: [T]he management of these asset-rich target companies generally own very little stock themselves and, therefore, usually have no interest in being acquired. They jealously guard their prerogatives by building 'Chinese walls' around their enterprises that hopefully will repel the invasion of domestic and foreign dollars. Although these 'walls' are penetrable, most domestic companies and almost all foreign companies are loath to launch an 'unfriendly' takeover attempt against a target company. However, whenever a fight for control is initiated, it generally leads to windfall profits for shareholders. Often the target company, if seriously threatened, will seek another, more friendly enterprise, generally known as a 'white knight' to make a higher bid, thereby starting a bidding war. Another gambit occasionally used by the target company is to attempt to purchase the acquirers' stock or, if all else fails, the target may offer to liquidate.*
>
> *It is our contention that sizeable profits can be earned by taking large positions in 'undervalued' stocks and then attempting to control the destinies of the companies in question by:*
>
> *a) trying to convince management to liquidate or sell the company to a 'white knight'; b) waging a proxy contest; c) making a tender offer and/or; d) selling back our position to the company.*

The "Icahn Manifesto"—as Icahn's biographer Mark Stevens coined it—was Icahn's solution to the old corporate principal-agency dilemma identified by Adolf Berle and Gardiner Means in their seminal 1932 work, *The Modern Corporation and Private Property*.[6] The principal-agency problem speaks to the difficulty of one party (the principal) to motivate another (the agent) to put the interests of the principal ahead of the agent's own interests. Berle and Means argued that the modern corporation shielded the agents (the boards of directors) from oversight by the principals (the shareholders) with the result that the directors tended to run the companies for their own ends, riding roughshod over the shareholders who were too small, dispersed, and ill-informed to fight back. According to Berle and Means:[7]

> *It is traditional that a corporation should be run for the benefit of its owners, the stockholders, and that to them should go any profits which are distributed. We now know, however, that a controlling*

*group may hold the power to divert profits into their own pockets. There is no longer any certainty that a corporation will in fact be run primarily in the interests of the stockholders. The extensive separation of ownership and control, and the strengthening of the powers of control, raise a new situation calling for a decision whether social and legal pressure should be applied in an effort to insure corporate operation primarily in the interests of the owners or whether such pressure shall be applied in the interests of some other or wider group.*

Berle and Means gave as an example the American Telephone and Telegraph Company (AT&T), which they said had assets of $5 billion, 454,000 employees, and 567,694 shareholders, the largest of whom owned less than one percent of the company's stock:[8]

*Under such conditions control may be held by the directors or titular managers who can employ the proxy machinery to become a self-perpetuating body, even though as a group they own but a small fraction of the stock outstanding. In each of these types, majority control, minority control, and management control, the separation of ownership from control has become effective—a large body of security holders has been created who exercise virtually no control over the wealth which they or their predecessors in interest have contributed to the enterprise. In the case of management control, the ownership interest held by the controlling group amounts to but a very small fraction of the total ownership.*

Icahn cut straight to the heart of the matter, likening the problem to a caretaker on an estate who refuses to allow the owner to sell the property because the caretaker might lose his job.[9] His manifesto proposed to restore shareholders to their lawful position by asserting the rights of ownership. If management wouldn't heed his exhortations as a shareholder, he would push for control of the board through a proxy contest—a means for shareholders to vote out incumbent management and replace them with new directors. In a proxy contest, competing slates of directors argue why they are better suited to run the company and enhance shareholder value. If he didn't succeed through the proxy contest, he could launch a tender offer or sell his position back to the company in a practice known as *greenmail.* A neologism possibly created from the words *blackmail* and *greenback*, greenmail is a now-unlawful practice in which the management of a targeted company pays a ransom to a raider by buying back the stock of the raider at a premium to the market price. Warren Buffett, who said of greenmail that