An Underappreciated Warren Buffett Investment Technique

Event Driven Investing
Event Driven Investments

Arbitrage

Work-Outs

Risk Arbitrage

They are all the same thing.
Event Driven Investments

- Pursuit of profits from *announced* corporate events

- Mergers, recapitalizations, spin-offs, liquidations, reorganizations, self tender offers, etc.

- Evaluation based on probability of event occurring, time, upside, downside

- We expect to profit regardless of the behaviour of the stock market in most circumstances
“These are securities whose financial results depend on corporate action rather than supply and demand factors created by buyers and sellers of securities. In other words, they are securities with a timetable where we can predict, within reasonable error limits, when we will get how much and what might upset the applecart. Corporate events such as mergers, liquidations, reorganizations, spin-offs, etc., lead to work-outs.”

Buffett Partnership Letter, January 24, 1962
Event Driven Investments

“The risk pertains not primarily to general market behavior (although that is sometimes tied in to a degree), but instead to something upsetting the applecart so that the expected development does not materialize. Such killjoys could include anti-trust or other negative government action, stockholder disapproval, withholding of tax rulings, etc. The gross profits in many workouts appear quite small.

[...] However, the predictability coupled with a short holding period produces quite decent annual rates of return. This category produces more steady absolute profits from year to year than generals do. In years of market decline, it piles up a big edge for us; during dull markets, it is a drag on performance.”

Buffett Partnership Letter, January 18, 1964
“In past reports we have told you that our insurance subsidiaries sometimes engage in arbitrage as an alternative to holding short-term cash equivalents. We prefer, of course, to make major long-term commitments, but we often have more cash than good ideas. At such times, arbitrage sometimes promises much greater returns than Treasury Bills and, equally important, cools any temptation we may have to relax our standards for long-term investments.”

Berkshire Hathaway 1988 Letter to Shareholders
“Since World War I the definition of arbitrage – or “risk arbitrage,” as it is now sometimes called – has expanded to include the pursuit of profits from an announced corporate event such as sale of the company, merger, recapitalization, reorganization, liquidation, self-tender, etc. In most cases the arbitrageur expects to profit regardless of the behavior of the stock market. The major risk he usually faces instead is that the announced event won’t happen.”

Berkshire Hathaway 1988 Letter to Shareholders
“To evaluate arbitrage situations you must answer four questions: (1) How likely is it that the promised event will indeed occur? (2) How long will your money be tied up? (3) What chance is there that something still better will transpire – a competing takeover bid, for example? And (4) What will happen if the event does not take place because of anti-trust action, financing glitches, etc.?”

Berkshire Hathaway 1988 Letter to Shareholders
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Case Study

Precision Castparts Corp.

Berkshire Hathaway Inc.
Event Driven Investments

Transaction Details

- Definitive agreement for Berkshire Hathaway (BRK) to acquire Precision Castparts (PCP) announced on 08/10/15
- $235 per share in cash
- Quarterly dividends maintained until closing
- No financing condition
- HSR act approval and other foreign competition clearances required (EU, Canada, China, France, Turkey, Ukraine)
- PCP shareholder approval
- Expected closing in Q1 2016
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Key Considerations

- BRK track record for closing transactions
- No financing condition
- Premium price to be received
- HSR Act approval received on 10/05/15
- Shareholder approval received on 11/19/15
- Remaining foreign competition approvals seemed routine
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Timeline

- **08/10**: Transaction announced
- **10/10**: Definitive Proxy Statement filed
- **11/19**: Shareholder approval
- **01/14**: Purchased shares
- **01/25**: Final regulatory approvals received
- **02/01**: Cash received

- **10/05**: HSR Act waiting period expired
- **11/09**: Purchased shares
- **12/15**: Canada Competition Act approval
- **01/20**: Purchased shares
- **01/29**: Transaction closes
Event Driven Investments

Return Analysis (per share)

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Received</td>
<td>235.00</td>
</tr>
<tr>
<td>Dividend Received</td>
<td>0.02</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>235.02</strong></td>
</tr>
<tr>
<td>Price Paid</td>
<td>231.20</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>3.82</td>
</tr>
<tr>
<td><strong>Annualized Rate of Return</strong></td>
<td><strong>11.17%</strong></td>
</tr>
</tbody>
</table>

Closing Date: 01/29/16
Weighted Average Holding Period: 54 days
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Case Study

Johnson & Johnson
Event Driven Investments

Transaction Details

- Definitive agreement for Johnson & Johnson (JNJ) to acquire Actelion Ltd. (ATLN) announced on 01/26/17
- $280 USD per share in cash plus one share in a new R&D company (Idorsia)
- Minimum Acceptance rate of 67% of total shares
- Competition clearances required from United States, European Commission, Japan, Russia, Israel and Turkey
- Material Adverse Event – 15% of EBIT or 10% of sales
- Expected closing in late Q2 2017 (06/15/17)
Event Driven Investments

Key Considerations

- No financing condition
- Premium price – CEO lock up agreement
- Well shopped before agreement
- Idorsia potential valuation
  - Value of early stage pipeline
  - JNJ – 16% interest @ 235 million CHF (c. 11.50 per share)
  - c. 8 CHF per share in cash
- Potential Uptravi issue - Will this trigger a Material Adverse Event?
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Timeline

- **01/26**: Transaction Announced
- **02/01**: Purchased Shares
- **03/27**: Purchased Shares
- **03/30**: Tender Offer declared successful
  - HSR Act, Japan & Israel regulatory approvals received
- **03/31**: End of Main Tender Offer Period
- **04/05**: General Meeting (Vote on Demerger successful)
- **04/21**: End of Additional Tender Offer Acceptance Period
- **06/15**: Expected closing and Idorsia listing
- **01/30**: Purchased shares
- **02/16**: Public Tender Offer Prospectus issued
- **03/30**: End of Additional Tender Offer Acceptance Period
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Expected Return Analysis (per share)

Cash Received: CHF 280.42
Idorsia Estimated Market Price: CHF 10.00
Price Paid: CHF 270.99
Gross Profit: CHF 19.43

Closing Date: 06/15/17
Weighted Average Holding Period: 108 days
Annualized Rate of Return: 24.23%
Event Driven Investments - Summary

Benefits

- Returns depend on transaction completion and not on movement in equity markets
- Most transactions are uncorrelated with each other
- Short completion times lead to cash availability
- Multi-strategy benefits – adds another page to our “investment playbook”
- Good information availability – Read the Documents!
Event Driven Investments - Summary

Risks

- Transactions can break for many reasons
  - Financing issues
  - Shareholder rejection
  - Regulatory concerns
  - Anti-trust approvals
  - Material Adverse Event

- Any single transaction is a binary event

- A good batting average is required
Question & Answer
Period