DENALI INVESTORS, LLC

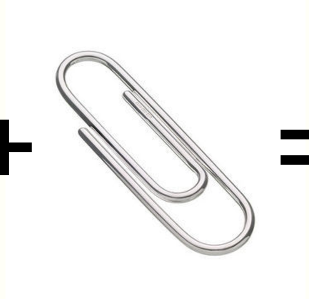
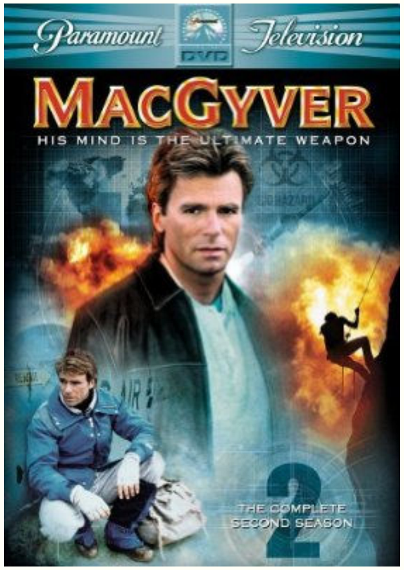
COLUMBIA BUSINESS SCHOOL – FALL 2009

SPECIAL SITUATIONS INVESTING

Simple Framework

Survival Investing

Survival = Value + Spec Sits + Options

 +  +  = 

Investing = "Art + Craft + Science"

Respect Micro + Macro + Cycles

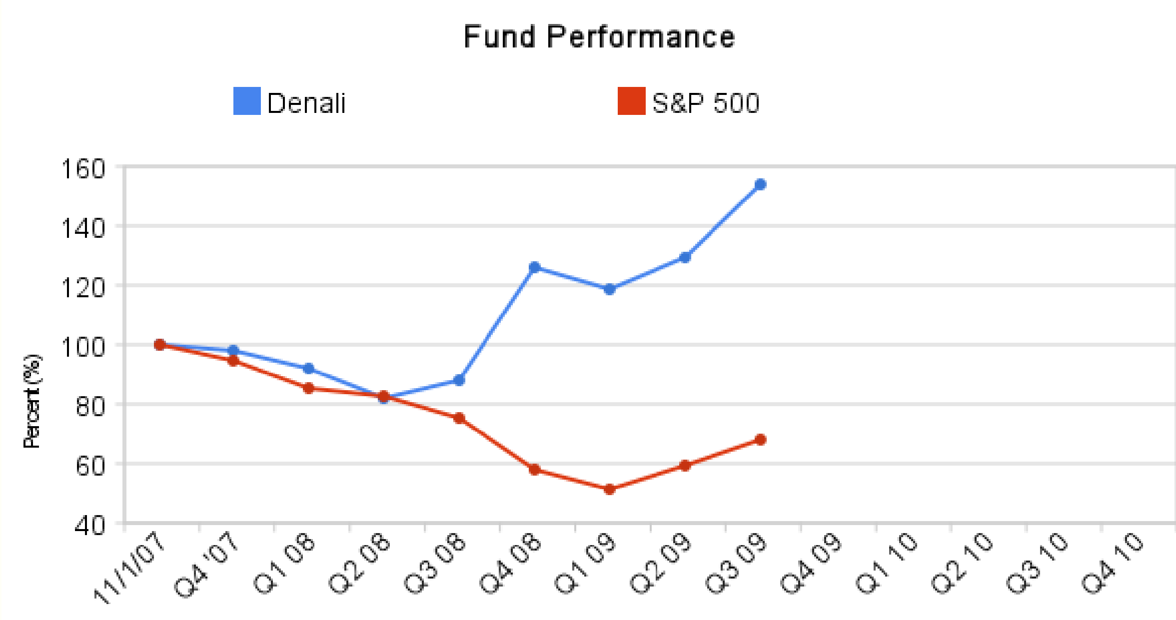
“Generals” + “Workouts”

Generals	Workouts
▪ Undervalued stocks	▪ **Non-recurring; Catalyst**
▪ Neglected	▪ Internal/External
▪ Long time horizon	▪ Mergers
▪ Favorable risk/reward	▪ Tender Offers
	▪ Spin-offs
▪ Shorts	▪ Capital Structure Arbitrage
▪ Flawed business, management	▪ Reorganizations
▪ Unrealistic expectations	▪ Liquidations
▪ Negative catalysts	▪ Bankruptcies

Flexible search for opportunities…

WWBD?

No system can guarantee success…



Roll with the punches…

Case Study #1

What do you get when the following get together?

- An industry no one wants to touch
- Two industry leaders
- Sandbagging management
- A catalyst

Case Study #1

Cardinal Health's (ticker CAH) Spinoff of CareFusion (ticker CFN)

CAH	CFN
CardinalHealth	CareFusion

Thesis:

Buy ParentCo, and get SpinCo for very cheap

Deal Background

- Summer 2009 - CAH was trading at $30 - $31 per share
- CAH was still expected to close the spin in Q3 2009

Mr. Market says NO to healthcare for various reasons…

Cardinal Parent (CAH)

The new CAH is now organized into two segments.

The Pharmaceutical Segment, which accounts for 2/3 of profits, includes pharmaceutical distribution, manufacturer and specialty services, and nuclear and pharmacy services.

The Medical Segment, which accounts for 1/3 of profits, includes medical product distribution, lab product distribution, and infection prevention products.

Pharma Distribution is an industry in the final innings of consolidation in which the top three players (CAH, MCK, and ABC) have 90% market share.

Outlier in distribution economics…

CareFusion Spinoff (CFN)

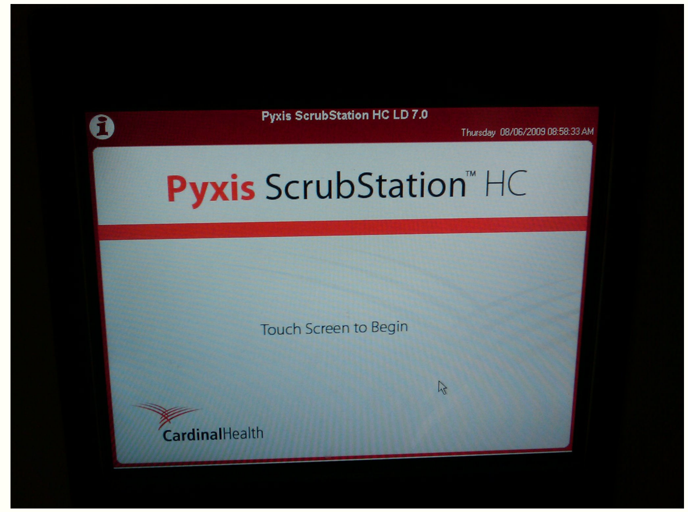
CFN is another industry leader with attractive metrics and margins and additional room for upside in fundamentals.

CFN offers product lines in the areas of IV infusion, medication and supply dispensing, respiratory care, infection prevention and surgical instruments – **a razor/razor blade model**.

The industry has a longer runway and is quite fragmented and under penetrated.

Demonstrated maintenance of pricing discipline and expressed desire to continue to grow organically.

CareFusion Spinoff (CFN)



Valuation – CAH Pre-Spin

JUL 2009	CAH (Pre-Spin)
Price:	$31
MC:	$11.7b
Debt:	$3.7b
Cash	$1.7b
Net Debt	$2.0b
EV	$13.7b
EBIT (TTM)	$2.1b
EBIT Multiple	6.5x

- Comps traded around 7x – 9x EBIT
- Market is afraid of healthcare reform uncertainties
- Work shows spinoff may unlock $5 - $10 per share value
- 1 CAH to 0.5 CFN share ratio
- CAH keeps 20% of CFN

Valuation – CAH Post-Spin

Comps traded around 7x – 9x EBIT (ABC and MCK)

CAH deserves slight premium (pricing, margins, customer base, etc.)

Private transactions took place above 10x - 20x EBIT.

CAH should kick out $1.5b in EBIT 09.

At 5x - 8x, that's $18 - $30 per share.

The CAH shares started trading on Sept 1st at $25 per share, or <u>6.7x EBIT</u>.

Valuation - CFN

CFN should kick out $540m in proforma EBIT 09.

Comps trade around 9x – 15x EBIT, 15x – 20x PE, and 2x – 3x book.

If valued in line with comps, that implies $18 - $40 per share (or $9 - $20 per CAH share).

CFN deserves a value at the middle of the ranges.

CFN-wi started trading on Sept 1st at $20 per share.

At the company given assumption of $16 per share, that implies <u>only 6 -7x EBIT and 0.8x book</u>.

Other Factors/Forces

- Must respect legislative and regulatory risk
- Hospital spending patterns
- Forgotten margins
- Spinoffs costs roll off

Spinoff Checklist

- ✓ Valuation
- ✓ Capital structure
- ✓ Quality business
- ✓ Institutional ownership
- ✓ Management incentives/ownership
- ✓ Fundamentals

Ways to Place an Investment

Pre-spin

Play the break up value

- Via equity or options
- Many possible scenarios, so consider '**<u>long strangle</u>**' position (very attractive…)

Post-spin

Buy CAH on the cheap

Buy CFN on the cheap

- Via equity or options (time arbitrage/LEAPs)

Options/Catalysts create very attractive risk/reward…

Position Pre-Spin

Long strangle position breakdown and review…

Leg 1: KCFLG – DEC 09 35 Calls at $1.20
Leg 2: KCFXE – DEC 09 25 Puts at $0.50
Total position cost = $1.70 (KCFLG + KCFXE)

Each option contract adjusted to deliver 100 CAH shares and 50 CFN shares

Structure allows for sizing of position because it is safer (risk and return relationship is negative)

Valuation – CAH & CFN

Initial work indicated \$5 - \$10 of value unlocked per share as a result of the spinoff…

JUL 2009	CAH (Pre-Spin)
Price:	\$31
MC:	\$11.7b
Net Debt	\$2.0b
EV	\$13.7b
EBIT (TTM)	\$2.1b
EBIT Multiple	6.5x

OCT 2009	CAH	CFN
Price:	**\$29**	**\$22**
MC:	\$10.4b	\$5.0b
Net Debt:	\$1.1b	\$0.8b
EV:	\$11.5b	\$5.8b
EV/EBIT (ttm)	**7.7x**	**10.7x**
PB	1.4x	0.9x

Pricing has moved more for CAH than CFN and upper range of expected value creation (\$5 - \$10) has been reached…

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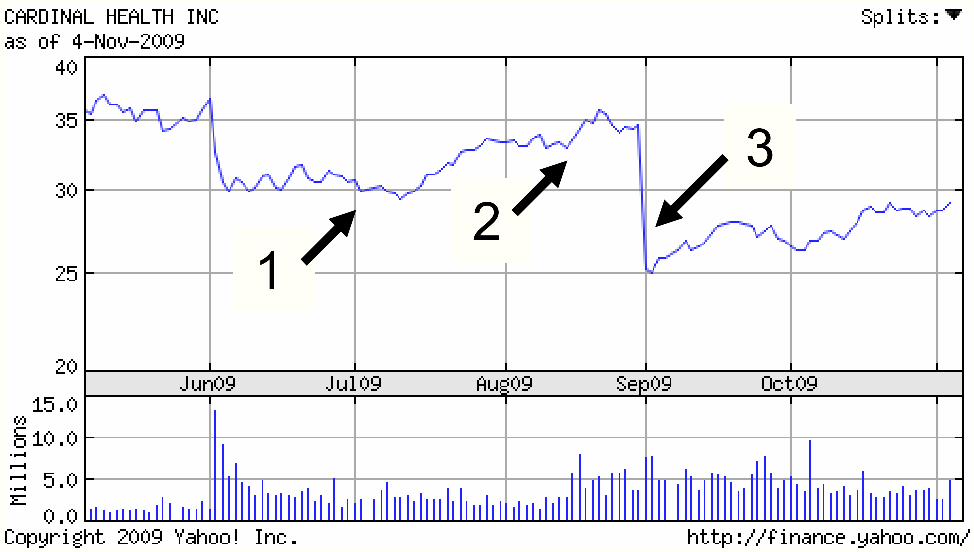
So What Happened?

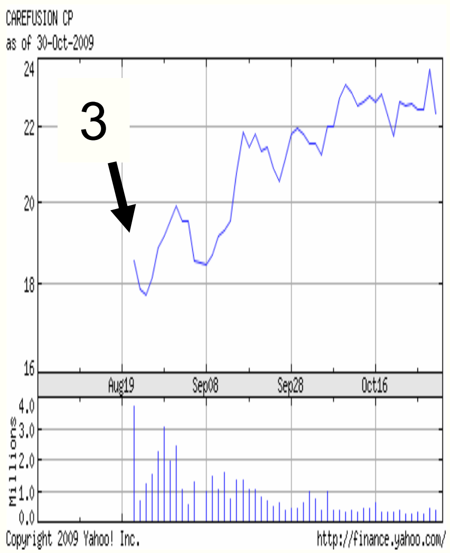
- Pre-spin investment
- Outcome agnostic
- Greenlight files soon after
- Last week Barron's article



Events

Catalysts

Insurance at work



OUTCOME

KCFLG: $1.20 to $8.50 [+$7.20]

KCFXE: $0.50 to $0.00 [-$0.50]

Net Gain/(Loss) = +$6.80

* Figures per contract

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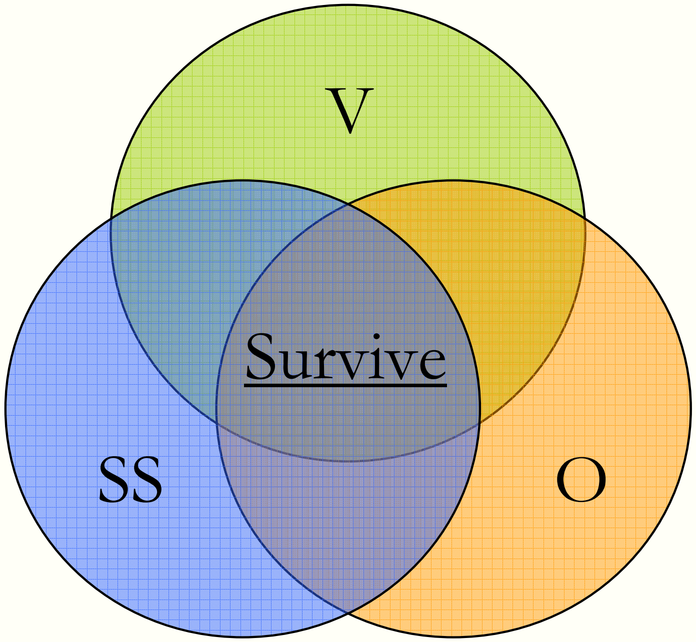
Review

Intersection of <u>Value</u> + <u>Spec Sits</u> + <u>Options</u>…

- Spinoffs
- Inefficiency built into the system
- Valuation
- Options / Hedges
- "The Ratio"
- Downside protection!



Brains vs. Bull Market – plenty of credit given to market (Thanks and praise to Bernanke? Tread lightly…)

<u>Process</u> vs. <u>Probability</u> vs. <u>Outcome</u> (Favorable this time)

Case Study #2

What happens when the following get together?

- Old School Management (Git'er done!)
- Need to Consolidate
- Peaking/Collapsing Fundamentals
- Peaking/Collapsing Stock Prices
- Big Deal Fees

Answer: GW / PDS

- An Election Merger

GW

GREYWOLF

PDS

Precision Drilling Trust

Deal Background

Precision Drilling (PDS) buys Grey Wolf (GW)

- GW and PDS announced a merger in Aug 2008
- Tail end of an **energy boom**.
- The election merger consideration for each GW share was either 1) $9.02 in cash per share, or 2) 0.4225 share of PDS. Election subject to proration.
- By December 2008, in combination with the market market, GW traded down from $9 per share to about $6 per share. PDS from $20 - 25 to $6 - 7 per share.

An opportunity hiding in plain sight…

Possible Outcomes

Outcome Band includes:

- The deal closes (PDS buys GW)
- The deal breaks (PDS does not buy GW)
- GW shareholder makes cash election
- GW shareholder makes share election
- GW shareholder makes no election (defaults to share election)
- Something in between…

Ways to Place an Investment

The Approach…

“Short” GW & hedge PDS

- Counterintuitive (typical to long target / short acquirer)
- Tactics are critical
- Standard merger arb analysis on GW alone is limited
- Insurance/hedge “cost”
- Combination increases safety
- “The Ratio” – 1/10 risk/reward ratio

Heads I Win, Tails I Don't Lose

Combining the GW short and PDS hedge:

Investment boils down to – heads I win (likely a lot), tails I break even.

- The near-term catalyst creates value – the merger will either close or break.
- <u>**The Outcome Does Not Matter**</u>: the potential for 100% upside exists on a close or break.

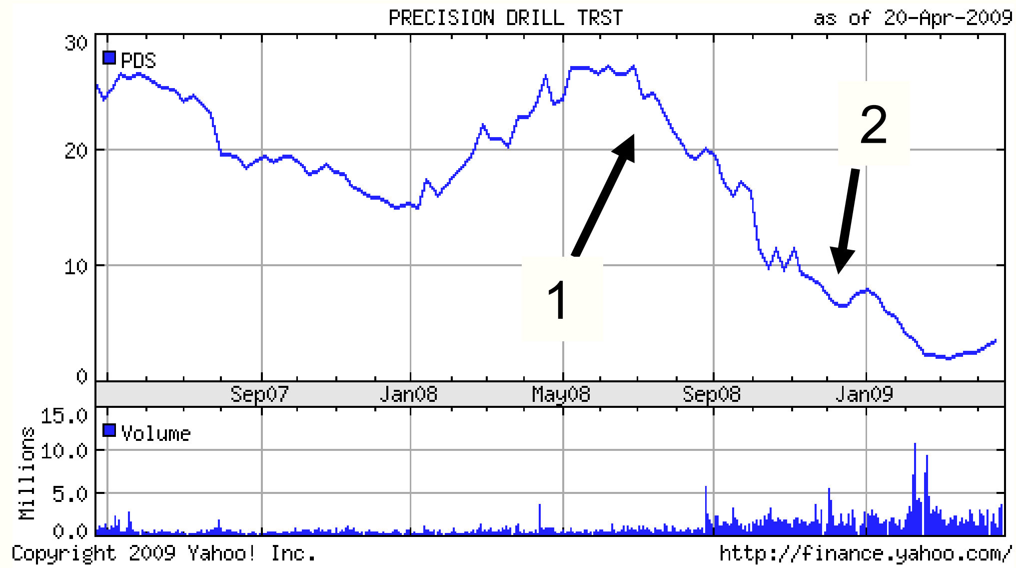
So What Happened?

- Deal closed Dec 19th
- Hiding in plain sight

Events

Catalysts

Insurance active



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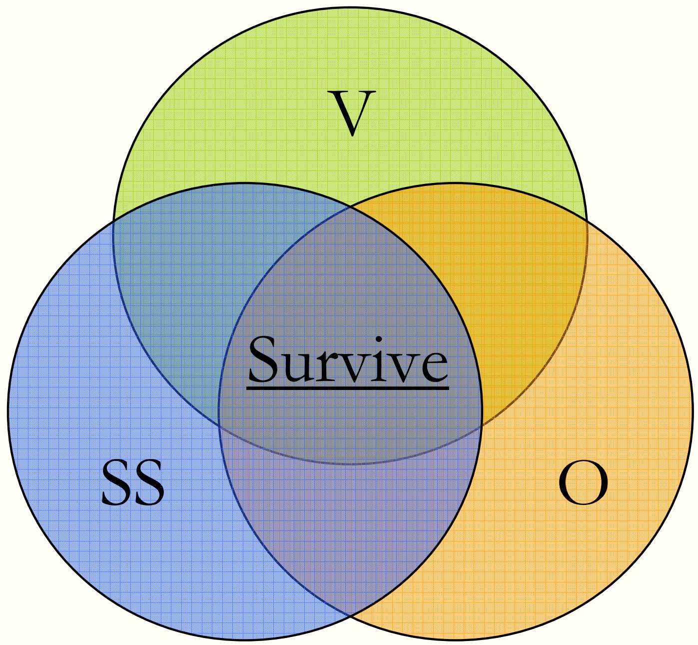
Review

- Special situation
- Optionality… that's free
- Hedging (Insurance)
- "The Ratio"
- Market agnostic



Heads I win, tails I don't lose…

Remember Columbo

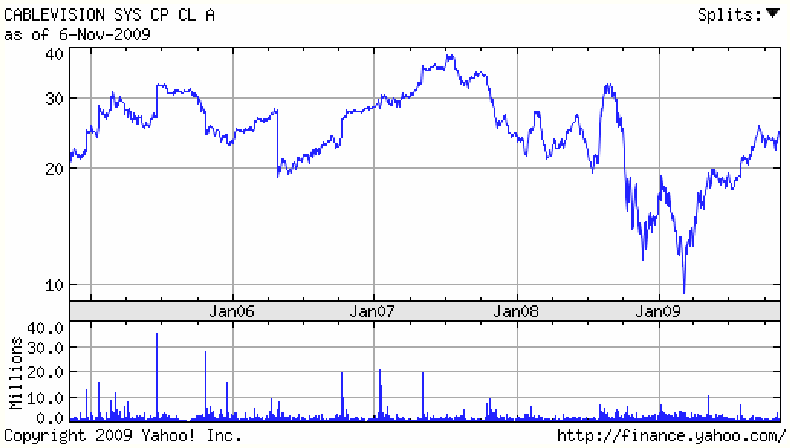
"**Columbo** is a scruffy-looking cop who is often underestimated by his fellow officers and by the murderer *du jour*. Despite his **appearance** and **superficial absentmindedness**, he solves all of his cases and manages to come up with the evidence needed for indictment, thanks to his <u>**eye for detail**</u> and the <u>**meticulous and committed approach he brings to his work**</u>."*

"Just one more thing..."

* Source: Wikipedia

Live Situation #1

Cablevision (CVC)
Spinoff of
Madison Square Garden (MSG)



- Splitting up the empire (know Jim Dolan…)
- Spinoff timing of Dec 2009
- Transfer of $190m cash to MSG
- No one owns CVC for MSG
- Plans for CVC pure play?

Variant Thesis: Be careful on this one…

Live Situation #1

Factors to Consider

CVC:

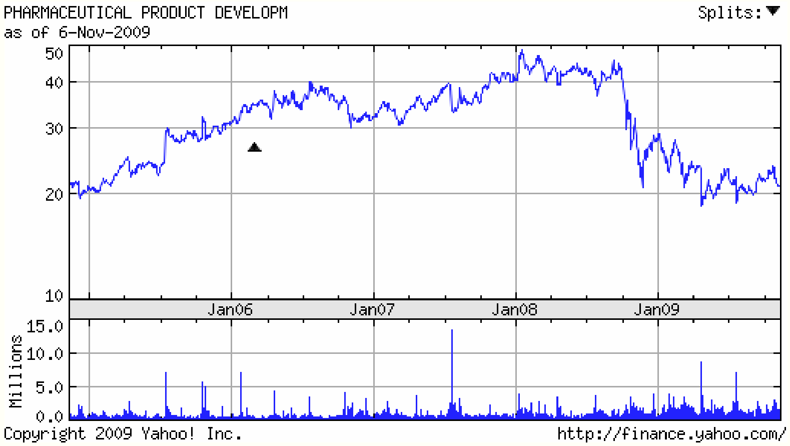
- Valuation (compare by RGU, per Sub)
- Fundamentals
- Leverage
- Capex

MSG:

- Concentration in NYC
- Discretionary dollar spend
- Capex (MSG renovation)

Live Situation #2

Pharmaceutical Product
Development, Inc. (PPDI)
Spinoff of
Compound Partnering
Business (Ticker TBD)



- A decade in the making…
- Spinoff timing is for middle of 2010 (lots of time to think)
- Transfer of $100m cash to SpinCo
- Everyone seems to hate the SpinCo

Variant Thesis: [GoodCo + BadCo] – BadCo = BetterCo

Live Situation #2

Factors to Consider

PPDI:

- Fundamentals
- Customer concentration (pharma R&D spend)
- Need for M&A (signs of gambling re Celtic investment)
- Cashflow and Capex

SpinCo:

- Fundamentals
- Follow the management
- Cashflow?
- Precedents are instructive (FACT and MYRX)

Looking Forward

- Capital structure arbitrage
- Merger arbitrage
- Corporate liquidations
- Tender offers (self & third party)
- **Upcoming bankruptcy wave**

Denali Investors

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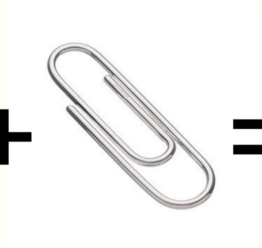
Thank You

Congrats to Class of 2010!

 +  +  =