

## **Bargain hunters see profit in panic**

Whitney Tilson

Published: December 16, 2008

Value investors spend a great deal of time searching for what investing legend John Templeton used to describe as “points of maximum pessimism”.

That is when the prevailing but myopic outlook for a country, sector or individual company becomes so negative that shares can fall to fire-sale levels. Buying closer to those points of peak fear is a crucial factor that separates great investors from the pack.

While I’m certainly no optimist about the near-term economic prospects for US companies as their customers cut their spending, in some cases dramatically, I do believe the level of panic that has overtaken the market has created buying opportunities for investors who can see light at the end of the very dark tunnel.

This in no way means a bull market is at hand but, as Howard Marks, the venerable chairman of Oaktree Capital Management, put it recently: “It does mean the negatives are on the table, optimism is thoroughly lacking, and the greater long-term risk probably lies in not investing.”

One need look no further than the shares of Warren Buffett’s [Berkshire Hathaway](#) for an indication of the lunacy that has gripped the market in recent months. In November, Berkshire’s B shares fell nearly 40 per cent in two weeks – to an intraday low of \$74,100 – and its credit default swap spreads widened to junk levels based primarily on absurd rumours the company faced huge losses and possibly a liquidity squeeze.

The “culprit”, in the market’s estimation, was a series of put-option contracts expiring 15 to 20 years from when they were written, for which Berkshire has received upfront premium payments of \$4.85bn. Should the indices (the S&P 500, plus three foreign indices) trade at the expiration of the puts below the levels at which they traded when the puts were written, Berkshire would have to make up the difference. The maximum exposure, in the ridiculous extreme all the indices went to zero, would be \$37bn.

So, given the tanking of the market in the past year, the writing of these derivative contracts was a horrible idea, right? Not so fast. We don’t know the strike prices of the put options, but let’s assume the worst case that these indices are today down by 40 per cent on average from the strike prices. That’s a bad start, but the puts have an average remaining life of 13.5 years, so if the indices rebound by 67 per cent over that period, a mere 3.9 per cent annually, the puts will expire worthless and Berkshire will pocket the entire \$4.85bn premium.

We don't know the details of how the puts are structured, but let's assume the payouts are on a straight-line basis, such that if the indices were down 50 per cent 13.5 years from now – another 17 per cent from today's levels – then Berkshire would have to pay \$18.5bn (half of the \$37bn maximum). That would be a painful loss, but one Berkshire could easily afford – the company's earning power exceeds \$10bn a year and, as of the end of October, its net worth exceeded \$111bn, both figures that will be much higher more than a decade from now.

It's also important to understand that the loss in this doomsday scenario would not be \$18.5bn minus \$4.85bn, because Mr Buffett can invest the \$4.85bn for the entire period. If he earns a mere 7 per cent return for 13.5 years, that \$4.85bn becomes \$12.1bn. In this case, Berkshire's break-even point on this investment would be a 33 per cent decline in the indices from the point at which the puts were written. That means the indices would only have to increase less than 1 per cent annually over the next 13.5 years to reach this level from today's point of down 40 per cent.

From present depressed levels, it's likely the major indices will compound at a minimum of 4 per cent annually, in which case Berkshire won't have to pay out anything on these contracts. And even if there is a loss, given the huge premium and Mr Buffett's ability to invest it, it's even more unlikely that this will be a losing investment.

As a more sane appraisal of Berkshire's risk from these derivative contracts has prevailed, the shares have rebounded to around \$105,000, roughly 30 per cent below what I believe they are conservatively worth (valuing the company's investments at current market and then placing a 12-times multiple on the normalised pre-tax operating profits of the company).

More remarkable – and indicative of just how detached from reality the market can become – is that shares of one of the most respected and largest companies in the country can fall 40 per cent and then rise 40 per cent in just four weeks.

One might look at the carnage in the market and conclude that, while Berkshire might be cheap, there are many far cheaper stocks. We would agree. Berkshire is probably the least cheap stock in our portfolio, but we own it because it's so safe. Most of the rest of our portfolio is in extraordinarily beaten-down stocks or special situations, a good example of which is Huntsman.

[Huntsman](#) is a chemical company that makes things such as polyurethanes and pigments. It is a good company, a market leader in nearly all its product categories, but has a fair amount of debt, though no pending maturities that concern us.

Last year there was a bidding war for the company that was won with a bid of \$28 a share by buy-out firm Apollo, which intended to merge Huntsman into a company it controlled, Hexion Specialty Chemicals. Then the markets and the financing world changed and Apollo tried to get out of the deal, resulting in Huntsman's stock collapsing to around \$3 and Huntsman suing Apollo and its banks to force them to consummate the deal.

On Sunday, Huntsman settled with Apollo for \$750m, and Apollo agreed to buy \$250m in 10-year convertible notes from Huntsman – a total of \$1bn in cash.

We view this settlement as very favourable for Huntsman, but the stock was cut in half on Monday, in part we believe because investors misunderstand the dynamics of what's happening. The key piece of information the market appears to be missing is that Apollo "agreed to fully cooperate in connection with Huntsman's litigation against" Credit Suisse and Deutsche Bank, which had promised to fund the deal and then reneged.

The suit, which "claims the banks conspired with Apollo and tortiously interfered with Huntsman's prior merger agreement with Basell, as well as with the later merger agreement with Hexion", is going to court in February in Texas – not a jurisdiction where deep-pocketed firms want to have this kind of case tried.

We think Huntsman has an extremely strong case against the banks, especially now Apollo is co-operating, and could force the banks to pay \$2bn-\$3bn to settle – a huge sum for Huntsman, which only has a market cap of around \$700m. Moreover, Apollo is highly incentivised to be helpful, since it will receive 20 per cent of any award over \$500m.

This is a fascinating situation for investors ready to do the research and comfortable with legal complexities.

In his recent column ("[Buy American. I am.](#)") in The New York Times, Mr Buffett said: "I don't like to opine on the stock market, and again I emphasise that I have no idea what the market will do in the short term. Nevertheless, I'll follow the lead of a restaurant that opened in an empty bank building and then advertised: 'Put your mouth where your money was.' Today my money and my mouth both say equities."

Mr Buffett's call carries particular weight because he rarely comments on the general level of stock prices.

His summation of the situation in 1979, in an article for Forbes, strikes me as similarly appropriate today: "Managers currently opting for lower equity ratios either have a highly negative opinion of future American business results or expect to be nimble enough to dance back into stocks at even lower levels. There may well be some period in the near future when financial markets are demoralised and much better buys are available in equities; that possibility exists at all times. But you can be sure that at such time the future will seem neither predictable nor pleasant. Those now awaiting a 'better time' for equity investing are highly likely to maintain that posture well into the next bull market."

*Whitney Tilson is a money manager who co-edits Value Investor Insight and co-founded the Value Investing Congress. E-mail: [feedback@tilsonfunds.com](mailto:feedback@tilsonfunds.com)*