WealthCE

Event Driven

Event driven hedge fund strategies seek to profit from major business situations. Funds place themselves in positions to gain profits based on confirmed or rumored events. This can be directional plays or arbitrage driven plays. The positions taken are based on the likeliness that situations will occur, chances of varying outcomes, price direction implied by events, and investor reactions to all of the above.

Managers generate alpha from their ability to accurately identify profitable situations and the paths that will occur as a result. This typically requires substantial experience with the industry or business sector where the event is occurring. It also may require substantial experience with the potential event itself. Even if they are experienced, accurately anticipating major events is difficult. Managers often get predictions wrong, or may incorrectly time their investment. If a fund manager invests in a poorly predicted event, or invests at a poorly predicted time, they may suffer low returns or a loss.

The varying types of events include, but aren't limited to, the following: Acquisitions, Bankruptcies, Hostile Takeovers, Leveraged Buyouts, Management Buyouts, Mergers, Reorganizations, and Restructurings. There is a benefit to investing in these events: they are not completely market correlated. All of these can and regularly occur in both bull and bear markets, even if they increase or decrease in frequency according to the market. As an example: bankruptcies increase in occurrence in bear markets, but bankruptcies and restructurings aimed at avoiding them still happen in bull markets. If a desired situation cannot be found, it's not necessarily a problem. Managers of a fund, or a group of funds coordinating together, can create certain events by purchasing debts or shares and forcing their hand as a stakeholder in a firm. They may create events which modify the firm after their purchase. The target should be a good deal and maintain the ability position to fulfill the fund's objective.

Hedge Funds can create events by starting a cash pool to initiate their own buyouts, by borrowing to initiate their own leveraged buyouts, or by loaning money to fund external parties' leveraged or managed buyouts. Loaning money to others for buyouts is known as Bridge Lending, which assists others in creating events.

A leveraged buyout occurs when an outside group borrows large amounts of money to buy a firm or company. A managed buyout occurs when internal management teams borrow money to buy their firm from shareholders. Both buyout categories use the target firms current assets and future income as collateral. A leveraged buyout may also impact another firm's share price, depending on how much of their own assets are used to purchase the target acquisition versus the amount of borrowed money. A managed buyout is an internal takeover, and involves the company managed as well as the lenders.

An attempt to take over a company by an outside firm or fund may rapidly turn hostile. A hostile takeover occurs when funds or rival corporations try to acquire or merge another firm without management agreement or approval. Acquiring firms pose their offers directly to shareholders while the target firm's management objects to the sale. If the acquirer purchases enough shares, they gain control over the firm's board. At this point they gain the power to replace chief or senior executives and management. Replacing hostile management with friendly management will provide the acquirers with complete control of the firm.

There are many potential ways to prevent or disrupt a hostile takeover. Note that a nation's regulations may limit possible actions. Company management can attempt to convince preferred friendly parties to buy the firm, hoping they will offer higher prices than the hostile purchaser. This may incite a bidding war. Manipulation of a corporation's share classes or share types may also avoid takeovers. Share classes may prevent acquirers from having enough voting power to replace management even if they acquire a majority of shares. If friendly parties maintain voting power majority due to shares with higher voting rights, the board of directors is safe, along with executive management. Management and friendly shareholders can transform preferred shares or convertible bonds to common shares, raising the total amount of shares required for control. They can also activate stock options or share purchase plans to acquire more common shares. Any action that will legally increase the share's price will also increase the cost of purchasing the firm, helping to prevent the attack.

If a merged company is held after a cash deal is complete, there are new issues hedge funds must handle. The debt of a corporation merged into another business will become a responsibility of the combined firm. Since the problems of existing firms become the problems for a merged firm, prime targets for merger or acquisition have low debt, low risk, low expenses, and low financial needs. They alternatively have a substantial strategic advantage for the acquiring party or merger initiator. Obviously, such firms are unlikely to accept a merger or acquisition without a substantial cash premium offered for their shares or highly beneficial share swap. Firms pursuing event based strategies must remain aware of the impact of merges or acquisitions on firm financials, especially if they choose to hold the firm's assets after the merger.