New Year Idea #2: HRG Spectrum Brands Merger $HRG $SPB

In general, I've tried to use this blog to focus on deeper dive / in depth looks at companies and situations.

But, as my Christmas present to you, this week I'm going to "present" (pun intended) three (note: I was planning four, but decided not to present one due to a combination of extreme illiquidity and wanting to dive a bit deeper into the third) of my favorite special situations in a bit of a shallower manner; instead of a full deep dive, I'll just provide a situation overview with a little background and some risks. Why chose these three situations as a Christmas present? My reasoning is that there is a decent chance that all three of them will "not be with us" (i.e. will have played out) by this time next year, so if I don't "gift" them to you this Christmas I'll never have the chance to! I'm also going to post the ideas in a bit of an order: the first post will be the most liquid, the least quirky, and the least likely to play out in the next year, while the last post will be the least liquid, the most quirky, and the most likely to play out next year. If you missed it, you can find my first idea, DVMT (disclosure: long), here. (Update: Idea #3, YUME, is now posted).

So let's turn to my second idea: HRG (disclosure: long).

HRG has a long history which I won't dive into (this Barron's article hits a good piece of it, and this Mittleman letter covers a bit more). Today, the company is controlled by Leucadia and, after selling its insurance company, consists of basically one asset: a controlling ~60% stake in Spectrum Brands (SPB). HRG has been undergoing a strategic alternatives process for over a year now, and if you read between the lines of both their actions and what Leucadia publicly says about them, it seems pretty clear the goal is to wind up HRG. The simplest way to do so has always been for SPB to "buy" HRG in a share for share swap. Doing so would be a win/win for everyone: SPB shareholders remove the overhang of a controlling shareholder while HRG could collapse their NAV discount (HRG does a nice job of laying out their NAV discount in their Q4'17 earnings supplement here; you can update pretty easily by plugging in an updated SPB share price); in addition, there were likely some tax benefits to be had by merging the two companies. The big question was always what price SPB should pay to swap out HRG: should they just offer NAV for HRG? Should they offer a premium for HRG given HRG controlled SPB and control generally garners a premium? Or, as a large SPB shareholder posited, should SPB acquire HRG at a huge discount because HRG's SPB stake was completely illiquid?

The story got a lot more interesting on December 19th when HRG filed a 13-D requesting several directors be added to the SPB board and publicly providing terms on which they were willing to merge HRG and SPB. SPB responded by saying they had been negotiating with HRG and thought they were close to coming up with a mutually agreeable deal, and that the new HRG offer was far from that deal.

So that's where we sit today: SPB thought they were in late stages of negotiating one deal, and HRG comes out with a completely different deal publicly.

I think that situation creates really interesting upside for HRG. At today's share price of ~$17.50, HRG is trading for a slight discount to their NAV. That makes almost no sense to me. Why? Well, given the public exchange, we know now SPB's bid is basically valuing HRG at NAV while HRG is offering NAV + ~$1/share (I am simplifying both bids a bit, but that's how I read them). With HRG priced a bit below NAV, the market is currently valuing HRG as if it will almost certainly take SPB's bid.

Is that right? I don't think so. I think HRG's public negotiating tactics are brilliant and that a final deal is much more likely to be closer to HRG's price than SPB's. Here's why: SPB's stock was up ~6% on the announcement of HRG's offer. So SPB's board now knows that public shareholders, on the whole, want the deal / think a deal is value accretive. HRG also included the demand for more directors in their offer; adding more directors would allow HRG to effectively take control of SPB's board. In other words, by going public with their offer, HRG has put SPB's special committee in a tight place: the committee knows shareholders want a deal (as evidenced by the big increase in SPB's price), and the committee knows that if they don't strike a deal quickly HRG will begin exerting control on SPB and could wait to strike a more favorable deal once they've sunk their claws deeper into SPB.

So I think SPB's in a bit of a tight spot. And, logically, I think paying a bit above NAV makes tons of sense from an SPB standpoint: control generally gets a 20-30% premium in the public markets, so to lift a controlling stake at a slight premium (and get tax assets to boot!) is a really solid deal for SPB.

Could things go wrong for HRG? Sure. Deal talks could break down, and the ultimate price HRG shareholders receive is highly dependent on SPB's stock price since it'll likely be a share for share deal. But SPB looks pretty cheap compared to their peers, and, even after the recent move on HRG's public offer, I would guess definitively resolving the HRG overhang results in a bit of a bump for SPB shares. All told, I would guess SPB takes out HRG sometime in the first half of 2018, and HRG shareholders ultimately get ~$20/share in a combination of cash and SPB shares (heavily, heavily weighted to SPB shares).