Relative Value Strategies for Equities

Introduction

Relative Value strategies in equities are all those strategies that seek to minimize their systematic risk exposures while retaining exposure to certain idiosyncratic factors. We decided to analyze those strategies because their non-directional nature can be interesting in the current environment characterized by high geopolitical tensions and inflationary risks.

Relative Value strategies in equities can be classified in three macro-categories: 1) long-short strategies, 2) arbitrage strategies, 3) event-driven strategies. In the following table, we display the Sharpe Ratios of these strategies and those of the market over a period ranging from 2000 to 2021. We notice that all these strategies were able to beat the market in risk-adjusted terms. In particular, long-short and event-driven hedge funds have a similar risk-return profile, with returns comparable to those of the market but with a lower volatility. On the other side, arbitrage hedge funds achieved lower returns than market, but with a far lower volatility, resulting in the highest Sharpe Ratio.

Sharpe Ratios (2000-2021)				
	Arbitrage Hedge Fund Returns	Long Short Hedge Fund Returns	Event Driven Hedge Fund Returns	Market
Mean Annual Excess Returns	5.26%	7.16%	7.38%	6.96%
Annualized Standard Deviation	3.10%	7.48%	7.15%	15.67%
Sharpe Ratio	**1.70**	**0.96**	**1.03**	**0.44**

We now analyze these strategies and propose a trade idea on a company in liquidation.

Long-Short Strategies

Most hedge funds' strategies in equities are long-short, these strategies seek to remove market risk combining long and short positions on stocks and retain only the exposure to idiosyncratic risk. Managers will often implement these strategies with a substantial degree of leverage achieved reinvesting the proceeds coming from the short-leg in the long-leg. Essentially, these strategies are betting that the stocks gone long will outperform those shorted, regardless of the market's performance.

There are several criteria used to select "overvalued" and "undervalued" stocks, the main ones are statistical and fundamental methods. We analyzed statistical methods in a recent article looking at pairs trading strategies with two techniques: the distance and cointegration methods. With respect to fundamental methods, they generally involve sorting companies based on accounting metrics (including the Price/Earnings, Price/Book-Value, Enterprise Value/EBITDA ratios) and then going long companies with low metrics and short those with high ones.

In the following table, we display the results of a regression of the excess returns of long-short hedge funds on the Fama-French 5 factors.

Long-Short Hedge Funds Excess Returns					
	Coefficient	Standard Error	T-Stat	P-Value	Semi-Partial R-Squared
Intercept	**0.36**	**0.07**	**5.20**	**0.00**	
MKT-RF	0.36	0.02	21.33	0.00	**42.4%**
SMB	0.17	0.03	6.61	0.00	**4.1%**
HML	0.01	0.03	0.25	0.80	**0.0%**
RMW	-0.02	0.03	-0.55	0.58	**0.0%**
CMA	-0.04	0.04	-1.00	0.32	**0.1%**
R-Squared	75.9%				

Looking at the results, we can see that the market factor retains some explanatory power, with a semi-partial r-squared at 40%, while the other factors are not much useful in explaining returns, except for the size factor. The statistically significant and positive intercept confirms the ability of these hedge funds to produce positive and uncorrelated excess returns.

Arbitrage Strategies

Arbitrage strategies exploit market inefficiencies buying and selling stocks in particular situations, with very low risk. A common arbitrage strategy involves the purchase and sale of the same company's stock quoted in different markets at different prices. The manager will purchase the "undervalued" stock, going short the "overvalued" one. Merger arbitrages are very common too, they will involve investing in merger situations; these strategies require an assessment of the success probability of the merger/acquisition better than that of the market. If the actual probability is deemed higher than the one being priced in markets, the manager will purchase the stock of the target company, shorting that of the acquirer; if the manager deems the acquisition will not take place, the opposite strategy will be followed.

Those strategies, among the relative value ones, are characterized by a particularly low volatility of returns, leading to high Sharpe Ratios as displayed previously, and are almost purely market neutral as they bet on very specific situations. In the following table, we show the results of a regression of arbitrage hedge funds excess returns on the Fama-French 5 factors.

Arbitrage Hedge-Funds Excess Returns					
	Coefficient	Standard Error	T-Stat	P-Value	Semi-Partial R-Squared
Intercept	**0.34**	**0.04**	**7.69**	**0.00**	
MKT-RF	0.12	0.01	11.38	0.00	**28.8%**
SMB	0.05	0.02	2.90	0.00	**1.9%**
HML	-0.01	0.02	-0.79	0.43	**0.1%**
RMW	0.02	0.02	0.83	0.41	**0.2%**
CMA	0.02	0.03	0.82	0.41	**0.1%**
R-Squared	42.4%				

As expected, the regression highlights that returns of these strategies are poorly explained by the 5 factors, with an r-squared of just 40%; we can also highlight the low semi-partial r-squared of market returns, close to 30%. On the other side, the intercept is positive and highly significant, accounting for a large component of positive non-correlated excess returns.

Event Driven Strategies

Event-driven strategies try to exploit mispricing driven by corporate events such as restructuring, liquidation, spin-offs, change in management and others. Betting on such idiosyncratic events, they seek to achieve a neutral exposure to market risk. Nevertheless, they offer a risk-return profile closer to that of long-short strategies than arbitrages.

Below, we show the results of a regression of excess returns of event-driven hedge funds on the Fama-French 5 factors.

Event-Driven Hedge Funds Excess Returns					
	Coefficient	**Standard Error**	**T-Stat**	**P-Value**	**Semi-Partial R-Squared**
Intercept	**0.36**	**0.07**	**4.93**	**0.00**	
MKT-RF	0.33	0.02	18.56	0.00	**38.9%**
SMB	0.18	0.03	6.80	0.00	**5.2%**
HML	0.09	0.03	3.14	0.00	**1.1%**
RMW	0.03	0.03	0.91	0.36	**0.1%**
CMA	-0.05	0.04	-1.23	0.22	**0.2%**
R-Squared	70.7%				

The results confirm that these funds have an exposure to market risk like that of long-short ones, with a semi-partial r-squared of the market's excess returns slightly below 40%, and with a size factor that has some explanatory power. Finally, as expected, the strategy has a statistically significant and positive intercept.

Our Trade Idea for the current environment

We propose a trade idea on a company which is currently in liquidation. We believe this can be an interesting opportunity in the current environment characterized by uncertainty due to high inflation, and geopolitical tensions sparked by the Russian invasion of Ukraine. In fact, returns of companies in liquidation are mostly driven by idiosyncratic factors related to the size and timing of distributions to shareholders.

We propose taking a long position on the stock of Dolphin Capital Investors, a UK listed company owning a portfolio of real estate properties in the Mediterranean Area with a market capitalization of just € 40m and a Net Asset Value of about € 150m. In what follows we will briefly explain the story of this company and we will analyze its real estate portfolio to estimate its NAV and to understand when the liquidations will likely take place.

The company went public in 2005 and raised about € 1bn from investors, it then purchased several seafront sites in the Mediterranean, Caribbean and LATAM area where it could develop high-end residential resorts. However, several investments were not as successful as the management hoped, consequently, activist investors become involved with the company; they purchased a large stake in 2016 and approved at the EGM the liquidation of Dolphin. Since 2016, several assets were sold, and the proceeds were used to repay debt accumulated over the years. However, the liquidation was slower than expected, and, in the meantime, the sponsor and managers extracted large fees from the company. Covid-19 further worsened the situation, slowing the pace of the liquidations. For these reasons, the discount to NAV of the company progressively increased reaching the current levels of about 70-80%.

In mid 2021, this led to the removal of past directors and to the appointment of new experienced professional which would lead the liquidation. They approved in September 2021 the new Investment Management Arrangements which significantly reduced sponsor fees and director's compensation, aligning the interests of the investors and those of the management team. Some notable characteristics of the new IMAs are the following:

- Removal of fixed management fees (which ranged between € 5-20m per year).
- Recognition of an incentive fee that will be paid to the management after distributions to shareholders total € 40m. The fee corresponds to 15% of distributions in excess of € 40m.
- Recognition of a bonus fee of € 1m for each € 5m distributed after € 80m, which can be of maximum € 5m.
- Retainment of a significant portion of management fees until all assets are sold to disincentive the liquidation of only the best assets.

In addition to this, the pay of the new directors was more than halved with respect to that of the previous one. The new IMAs are very important in our opinion because they align the interests of the management and those of the shareholders.

In the following table we display the main owners of Dolphin's shares. After the approval of the new IMAs, several activist investors increased their stake, as a result, nowadays just 11 funds and individuals own more than 70% of the company; in our opinion this ensures that distributions will be timely and imposes a big oversight on management, reducing the scope for opportunistic behavior.

Owner	Percentage of issued Share Capital held %
JO Hambro Capital Mgt Ltd	10.95%
Fortress Investment Group	9.94%
Dolphin Capital Holdings	9.73%
683 Capita Mgt LLC	9.20%
Peter Gyllenhammar	7.74%
Forager Funds Mgt	7.09%
Progressive Capital Partners Ltd	5.58%
Lars Bader	4.68%
Oak Hill Advisors	4.41%
Oceanwood	4.28%
Discover Investment Company	3.32%

As of today, the company has still on its balance sheet several real estate properties in the Mediterranean area while having paid off most of its debts. In the following table we display the properties owned and the company's estimate of their gross value, as of the 30th of June.

Category	Location	Investment	Land site (hectares)	Equity interest held by Dolphin	Aggregate Investment Cost (€ million)	Dolphin's estimate of gross asset value (€ million)
Core	Greece	One&Only at Kea Island Resort	65	33%	€ 10.0	
Core	Greece	Kilada Hills Golf and Country Resort	224	85%	€ 90.0	
Land Only	Greece	Scorpio Bay Resort	172	100%	€ 15.0	
Land Only	Greece	Lavender Bay Resort	310	100%	€ 27.0	
Land Only	Greece	Plaka Bay Resort	442	100%	€ 13.0	
Land Only	Cyprus	Apollo Heights Resort	447	100%	€ 31.0	
Land Only	Croatia	Livka Bay Resort	63	100%	€ 33.0	
		TOTAL	**1,723**		**€ 219.0**	**€ 161.0**
Other	Cyprus	Aristo	474	47.90%	€ 186.0	€ 42.7
Other	N/A	Itacaré Investment	n/a	13%	€ 1.0	€ -
		GRAND TOTAL	**2,197**		**€ 406.0**	**€ 203.7**

We split properties in three categories:

1. Core: high-end residential resorts under construction
2. Land Only: parcels of land in attractive locations, with permits to realize residential resorts
3. Other: equity stakes in other companies

Within the Core segment, the company owns two residential resorts: 1) the Kilada Resort, 2) the Kea Island Resort. Their construction will be completed by the beginning of 2023, and both resorts will include private homes, hotels, and residences.

Construction activities in the Kilada resort are divided in two parts:

- Phase 1: realization of 260 private residences which are almost complete.
- Phase 2: realization of a 100 rooms hotel and 88 additional villas.

To assess the value of Kilada's phase 1 residences, we looked at transactions already completed by the company and used prices per square meters achieved in these transactions to value the remaining resorts. So far, 24 residences have been sold for € 10m, and we expect the remaining 236 ones to be worth approximately € 100m.

The company has obtained the rights to realize Phase 2, but does not plan to do so, and wants to sell the relative construction site to potential investors. We valued the Phase 2 at € 10m, which appears very conservative to us given that the company has already sold limited parcels of lands within Phase 2 at € 1.5m.

Construction cost for phase 1 have been entirely covered, consequently, we obtained the company's proceeds from Kilada considering the percentage of the SPV owned, and accounting for the reimbursement of preferred shareholders that are part of the SPV.

With respect to the Kea Island resort, this involved the realization of 20 private homes and 55 resort villas. Sales have already started, and we valued remaining properties based on prices achieved in past sales. Units sold are 13 for € 45m, and we expect the remaining 62 ones to be worth approximately € 66m.

Construction activities have been almost completed and entirely paid for, consequently, to obtain the company's proceeds we just had to take into account the percentage of the relative SPV owned.

Land Only projects are clearly the most difficult to value. For all of them the company has obtained the rights to realize residential resorts of various size but does not plan to carry on construction activities and is now looking forward to selling the land. We valued those projects at 50% of the purchase price of the land; then, to obtain the proceeds to the company we netted the financial obligations of the relative SPVs. We consider this approach as very conservative given that the company has already sold some Land Only projects in 2019-2020 at prices close to book value.

Other projects include a 48% stake in Aristo, the largest residential developer in Cyprus. Dolphin purchased its stake for € 186m and in 2016 it sold the stake to the majority shareholder for € 43m. However, the transaction was not concluded due to non-compliance by the majority shareholder. Consequently, Dolphin is now trying to extract as much value from Aristo as possible with a divestment of the stake and collecting in the meantime dividends from the company. We decided to value the stake at € 43m, considering that this is already pricing an 80% discount to the original purchase price.

We sum up the results of our valuation in the following table.

Category	Location	Investment	Our estimate of gross asset value (€ million)	
Core	Greece	One&Only at Kea Island Resort	€	21.64
Core	Greece	Kilada Hills Golf and Country Resort	€	92.08
Land Only	Greece	Scorpio Bay Resort	€	7.50
Land Only	Greece	Lavender Bay Resort	€	13.50
Land Only	Greece	Plaka Bay Resort	€	6.50
Land Only	Cyprus	Apollo Heights Resort	€	15.50
Land Only	Croatia	Livka Bay Resort	€	11.40
		TOTAL	**€**	**168.12**
Other	Cyprus	Aristo	€	42.70
Other	N/A	Itacaré Investment	€	-
		GRAND TOTAL	**€**	**210.82**

We obtain a gross asset value slightly above € 210m. To finally obtain the liquidation proceeds, we net all liabilities of the company that currently stand at € 75m (out of this only € 21m are financial obligations). The management plans to end the liquidation by 2024, so we take into account all operating expenses that will be incurred up to that time. Their estimation is straightforward as they have been constant during the company's life. We then net the directors compensation and the incentive fees from the new IMAs. Results are shown in the following table.

		(€ thousands)
Gross Asset Value	**€**	**210,823.72**
Total Liabilities	€	72,985.00
Total Operating Expenses up to Liquidation	€	12,000.00
Net Asset Value at liquidation	**€**	**125,838.72**
Incentive fee	€	12,125.81
Bonus fee	€	5,000.00
Distributions to Shareholders	**€**	**108,712.91**
PV of Distributions	€	89,845.38
Current Equity Value	**€**	**41,462.07**
Upside Potential		**117%**

The final liquidation value is approximately € 110m; we then assume liquidations will take place at the beginning of 2024 (this assumption is conservative considering that liquidations from the core assets will probably take place already in 2022), and we set a cost of capital of 10%. In conclusion, we obtain an upside potential of 117% from the current market cap of € 40m.

TAGS: Relative Value, Long-Short Strategies, Arbitrage Strategies, Event Driven Strategies, Equities, Liquidation, Dolphin Capital Investors