Porsche, Volkswagen and CSX Case Study

Total Return Swaps in CSX Case

In a total return swap, one party will receive any return on the asset over the life of the swap, plus any income generated by the asset while the other party pays a fixed rate on the swap. Total return swaps allow the party receiving the total return to gain exposure and benefit from a reference asset without actually having to own it.

TCI entered into total return swaps relating to approximately 14 percent of the outstanding common stock of CSX Corporation in 2006 and 2007 and also purchased approximately 4.2 percent of CSX’s outstanding common stock. TCI acquired exposure to CSX’s common stock through these swaps. Throughout this period, TCI met with several funds, including the 3G Funds, to discuss TCI’s investment in CSX. On December 12, 2007, TCI sent a notice to CSX of TCI’s intention to nominate directors to the CSX board. Concurrent with the delivery of the notice, TCI entered into a letter agreement with the 3G Funds to coordinate the purchase and sale of CSX shares and derivative securities related to CSX shares and to propose actions and transactions to CSX.

Risks and Benefits of obtaining synthetic shares in CSX

The benefit that TCI and 3G got from taking a huge position in CSX was that in the end, it helped TCI and 3G gain the seats in the board and replace two CSX-backed directors with dissident nominees.

In the 3G and TCI case, the hedge funds were exposed to the risk of volatility of the CSX returns because what 3G and TCI receive from investment bank is totally determined by the return of the CSX’s common share. So they are exposed to the CSX’s equity risk. Another potential risk to be considered is regulatory risk because 3G and TCI had a large undisclosed position through total return swaps (12.6%).

Regulatory position on disclosure of synthetic positions
There are arguments both in favor and against the disclosure of synthetic share exposures. The argument in favor of disclosure is that it puts a company on notice about the accumulation of significant positions, which could be used either as a springboard for a potential take-over bid or to exert influence over the direction and the management of the company and that it helps investors make fully informed investment decisions. On the other side, those in favor of non disclosure argue that a synthetic holding of shares provides only the economic incidents of ownership and that without a specific agreement to the contrary between the parties to the swap, the long party to a swap has no real influence or power over the shares, and therefore the company, by virtue of its synthetic position.

On the basis of the analysis conducted on these two cases, it is believed that the ideal regulation regarding disclosure of synthetic shares should be that any accumulation of significant shares should be disclosed to the shareholders because such positions can lead to shareholders losing control on the company's management and hence is not in their best interest.

**Short Squeeze**

A short squeeze is a situation in which a heavily shorted stock increases in price. It is generally triggered by positive news that suggests a turnaround in stock price. The short sellers have to close out their positions to minimize their losses and hence there is too much demand and not enough supply of the stock, which further pushes the price upward.

**Cash Settled Options in Porsche-Volkswagen Case**

Cash settled or cash-based options are option contracts whereby settlement is done via the payment of cash equal to the difference between the market value and the contractual value of the underlying at the time of exercise or expiration. This is opposed to physically settled options in which actual physical delivery of the underlying security is required.

On 26th October, Porsche stated that, it held 42.6% of the VW ordinary shares and in addition 31.5% in cash-settled options relating to VW ordinary shares. Upon settlement of
these options Porsche will receive in cash the difference between the then actual Volkswagen share price and the underlying strike price in cash.

**Potential Risks of Porsche’s CEO’s decisions**
The major risks faced by Porsche in this case are that firstly, since the price of the Volkswagen share increased too high, it is difficult for Porsche to take-over the company. The gain over investment banks is not enough to compensate for the increase in share price. Secondly, Porsche’s publicly denying the fact that they had a significant position in VW and non-disclosure of the fact that they were exposed to 75% of VW’s stock would be considered unethical and deceptive and is bound to be condemned by both the markets and the regulators. Lastly, the options that Porsche entered into were created in such a way that the upside was limited and if things didn’t go as planned, the gains from the options might not have been enough to cover the potential losses.
The major benefit Porsche gained from entering the cash settled options was that Porsche only had to pay the minimal initial option premium and could enjoy much larger gains from the change in price of the underlying.
In the end, the risks somewhat paid off as Porsche was able to gain from the cash settled options it had entered on VW’s stock.

**Pairs Trading**
Pairs trading refers to an investment strategy which involves the simultaneous purchase and sale of two highly correlated instruments. The bet hedge funds were making in this case was that Porsche’s share price would move in correlation with VW’s share price. The short squeeze caused after Porsche’s disclosure led to huge losses for most of these hedge funds.