SIMO Acquisition — Good or Bad?

Last quarter, we shared our opinion that the majority of our portfolio is very substantially undervalued, with re-rating catalysts imminent on the horizon within the next year or two at most. Less than a month later, on May 5th, our largest position, Silicon Motion, announced that it was accepting a takeover bid from MaxLinear, Inc., for about 52% higher than the price at the time we wrote those words. Admittedly, this was faster than even we had anticipated, as our discussion of catalysts was not predicting a takeover bid per se.

Although some would say that there is little to complain about a quick and easy 50%+ gain, the truth is that we are disappointed. We believe that Silicon Motion has far greater potential as a stand-alone company, and we believe that management has agreed to sell Silicon Motion for far too low a price. After deducting Silicon Motion's cash, MaxLinear is paying under 15 times earnings for a highly profitable, very fast-growing company with reduced competition going forward, quasi-monopoly positioning in some market segments, and very bright prospects ahead of it. The 50% premium being paid by MaxLinear is insufficient given the unduly depressed stock price that Silicon Motion was experiencing. We believe Silicon Motion's market multiple would have naturally corrected itself with the revenue, income, and market share growth they are experiencing this year and next.

Let's put it another way. MaxLinear is paying a 50% premium over the pre-deal share price. By the time the deal closes next year, it is extremely likely that Silicon Motion's earnings will be at least 50% higher than their pre-deal earnings, based on Silicon Motion's own revenue guidance, their strong market position, and their past business performance. That would mean that MaxLinear is paying a premium of one-year's growth, hardly an impressive premium. By the time the deal closes next year, MaxLinear will probably be paying less than 10 times earnings for Silicon Motion, an absolute steal!

The whole affair reminds us of a quote from the famous value investor, Bruce Berkowitz, who remarked in a 2008 interview, "Some of the stocks we hold are so cheap that we fear the companies will be taken over at too cheap a price." This is not a fear that we have thought deeply about in the past, but that is precisely what is happening to our position in Silicon Motion. So yes, some would say that you can't complain about a 50% gain, but we will complain nonetheless!

Will the Deal Close?

Although we personally stand against the deal, there is little doubt that it will almost certainly be consummated. MaxLinear shareholders may well be against the deal, as evidenced by MaxLinear shares dropping about 20% on the deal announcement, likely due to the leverage MaxLinear is taking to close the deal and its mixed record of past acquisitions. But MaxLinear shareholders do not to get to vote on the deal, so their stance is moot. Silicon Motion shareholders will likely approve the deal in the vote scheduled for August 31st, as the share price is still trading substantially below the deal price. And all necessary financing for the transaction is fully committed from Wells Fargo.

As for regulatory approval, there is basically zero overlap of product areas, so there is no regulatory risk from an anti-trust perspective. Indeed, US anti-trust approval has already been received, as the mandatory 60-day waiting period has expired without complaint from US regulators. The only regulatory process left before the acquisition can close is the need for Chinese approval for the deal. While China can be unpredictable and regulatory risk is not literally zero, we do believe it is highly unlikely for China to shoot down this deal, as there is very little pretense from an anti-trust or national security perspective for China to object. In addition, neither company is Chinese (MaxLinear, an American company, is buying Silicon Motion, a Taiwanese company), and the deal is relatively small. They have filed with the Chinese regulators in early July, and they expect to receive approval as early as October, although the process can be delayed to next year as well.

Merger Arbitrage

Despite the near-certainty of the deal going through for approximately $107 a share (depending on MaxLinear's precise share price at the date of closing), Silicon Motion's current share price substantially lags the deal price. On the day the deal was announced, the shares traded at a 14% discount to the deal price, and since then, the gap has widened substantially. For a while, the gap between Silicon Motion's share price and the deal price was north of 30%, and presently the gap is hovering a little above 25%.

We believe this gap is wholly unjustified, as the deal is nearly certain to go through, offering close to a guarantee of a 25–30% gain in six to nine months. Indeed, we have noticed that in many areas of the market, the gap between share prices and announced deals have widened dramatically in recent months, even when our analysis of the deal particulars does not warrant a large discount. We believe the market is leaving twenties, and in some cases even hundreds, lying on the street. For various reasons, the dedicated merger arbitrage funds are not succeeding in closing the gaps, leaving ample opportunity for us to profit from the market's shortsightedness.

Indeed, we have bought more Silicon Motion shares after the acquisition announcement, as we do not believe in leaving twenties lying on the street. Although merger arbitrage is a bit afield from our usual investing strategy, ultimately, we are tasked to use our research, analysis, and long-term thinking to make money for the Fund and our investors. Right now, merger arbitrage is offering some excellent opportunities for fantastic risk/reward investments in specific, specialized situations, and it would be foolish to ignore our analysis and pass on these opportunities. We expect to return to this theme in future letters as well.

This deal in particular is very attractive to us. Usually, when betting on an announced merger, however much money you stand to make when the deal goes through, there is some level of risk of the deal falling through and the stock dropping sharply. And if you can't possibly imagine how the deal could fall through in a specific instance, that is a failure of your imagination! In Silicon Motion's case, however, we would be thrilled if the deal fell through, as we feel the stock is ultimately worth much more long-term on a stand-alone basis than what the MaxLinear deal is offering. So, from our perspective, the situation is win, win a lot; lose, win even more.

To Hedge or Not to Hedge?

Any merger arbitrage needs to take into account whether the purchase is being paid in stock or with cash. In our case, the majority of the deal consideration is in cash, $93.54 a share, with an additional .338 shares of MaxLinear stock per share of Silicon Motion, worth about an additional $13.50 at the time of this writing, for a total consideration of about $107 a share. This will fluctuate slightly as MaxLinear shares trade up and down in the market, but even if MaxLinear went to zero (which obviously is not going to happen), the cash portion of the deal guarantees *at least* $93.54 at deal closing. Realistically, even in an absolute worst-case scenario, it is hard to imagine less than $100 a share at deal closing.

The standard way to arbitrage a merger deal when made with stock is to buy shares of the company being acquired and sell short shares of the acquiring company, so as to lock in the deal gap whichever way the acquiring company's shares continue to trade. So, in our case, the standard way to arbitrage this merger deal would be to sell short 338 shares of MaxLinear for every 1,000 shares of Silicon Motion purchased, locking in the deal gap of 25%, whether MaxLinear trades up or down. However, doing so increases the risk, because if the deal falls through for whatever reason, however slim we judge that possibility to be, we can then lose on both sides of the trade. If the deal falls through, Silicon Motion's stock will drop and MaxLinear's stock could well rise (to counteract the drop it experienced when they announced the deal).

On the other hand, if we don't hedge the deal by selling MaxLinear short, we possibly reduce our upside, but lower our risk. If we don't sell MaxLinear short and MaxLinear shares drift downwards, we will make less than the anticipated 25% profit when the deal closes (but not less than about 18% in a worst-case scenario). By not hedging, however, our risk is lower if the deal falls through, because if the deal falls through, we end up as proud holders of Silicon Motion stock, which we are confident will do very well over the long term. As of now, we have chosen *not* to hedge our Silicon Motion position by selling MaxLinear stock short.

Summary

We did not expect to be writing again about Silicon Motion so soon after our last discussion of its prospects (see our 2021 Q3 letter and the follow-up in our 2021 Q4 Portfolio Update), but unexpected events have cropped up. While 50% gains are usually nice, we see a gray cloud in the silver lining, as we believe Silicon Motion is being bought out for substantially below its true value. Nevertheless, the market has given us a golden opportunity to profit from the remaining gap between Silicon Motion's current share price and the deal price, with the likelihood of profiting in the area of 25% in about six to nine months. We have taken advantage and purchased more Silicon Motion under these circumstances. We consider the deal very unlikely to fall through, and in the unlikely event that it does, we believe we will do even better over the medium to long term, presenting what is truly a situation of heads we win, tails we win even more.