Come Together: Why Merger Arbitrage Strategies Deserve Renewed Attention

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Despite historically high market valuations, merger and acquisition activity remains subdued. Franklin Mutual Series CIO Christian Correa explains why corporate mergers have slowed, and why he thinks merger arbitrage strategies are worth paying attention to as activity in this area picks up.

Merger arbitrage opportunities tend to increase as equity valuations rise. As stock prices increase, corporate managers' confidence rises along with their willingness to do deals. Despite the significant rally in equity markets over the past year, merger and acquisition (M&A) activity has remained depressed when compared to deal volume during other periods of historically high stock prices. There are signs this anomaly is ending, however, creating a fresh opportunity for those seeking a way to diversify sources of risk, invest in uncorrelated asset classes and increase risk-adjusted returns.

A Beginning

Merger arbitrage is a lesser-known investment strategy among the general investing public. The strategy seeks to profit from announced corporate takeovers or mergers. Historically, merger arbitrage returns have been relatively uncorrelated with equity market returns and can potentially reduce the return volatility of an equity portfolio.

When a company tries to acquire another company, the acquiring company's bid will represent a premium for the target company's stock when compared with the share price prior to bid speculation. Acquirers pay this higher price, called a control premium, to encourage acceptance of the deal by the target company's shareholders. However, there is often a long period between the announcement of the proposed acquisition and its closing, and during this time the target's share price trades at a discount to the acquirer's bid price. The difference between where the target company's stock is trading once the deal has been announced and the value of the acquirer's bid price is called the spread.

There are several things that can affect the spread, including the likelihood the deal will get past regulatory and legal hurdles and the amount of time until the anticipated closure date of the merger or acquisition. As the closure date approaches and the deal makes it past various hurdles, the target company's stock price normally converges on the acquirer's bid price. The investor benefits from the increase in stock price plus any dividends that are paid by the target company prior to the closure of the acquisition.

Can't Buy Me Love

Although a vast majority of mergers and acquisitions successfully close, there is always a chance that one will not. The greater the potential issues, the wider the spread tends to be, and thus the greater potential profit for the merger arbitrage investor. There are four main reasons why a deal may end up in jeopardy.

- Regulatory issues. Examples of regulatory issues include governing organizations such as the Federal Communications Commission in the United States, or a public utility commission, objecting to the merger or acquisition on the grounds that it violates a law or other regulation.
- Material adverse events. These occur when the unexpected happens—an event the acquirer hasn't contemplated. An example would be a hurricane or an earthquake which disrupts the target's ability to run their business, thus damaging the company's ability to earn revenue and the value of its stock.
- Shareholder rejection. Usually, shareholders of the target company will vote on the proposed transaction. They may feel the bid price undervalues the stock and they will hold out for a higher bid. Conversely, the purchasing company's shareholders may feel management is proposing to pay too much for the target and vote the deal down.
- Financing conditions. In certain instances, an acquisition may be subject to the availability of financing, which increases uncertainty.

Ask Me Why

Clearly, it is most advantageous to find merger arbitrage opportunities that offer a wide spread, yet a low likelihood of deal collapse. In addition to the likelihood of the issues listed above, the relative complexity of a deal also effects the spread size. Higher complexity generally means a wider spread. This is where team structure comes into play as a key differentiator in merger arbitrage investing.

Our Mutual Series team contains equity, credit, and merger arbitrage analysts who work closely together to inform each other's processes and share knowledge and experience as it relates to regulatory bodies, capital markets and company management across a wide range of industries, geographies and situations. We believe this breadth and depth of knowledge makes us uniquely positioned to handle the complexity that underlies some of the best potential opportunities.

Our fundamental approach to merger arbitrage investing considers the bid price, the spread and the likelihood the deal may be rejected by either the target or acquiring company's shareholders, trigger an antitrust investigation, or even begin an auction-like scenario where other companies move in with more competitive bids and steal the target away from the original acquirer. It is not uncommon for deals to have a cross-border element, or involve different types of competing buyers, including private equity sponsors and strategic buyers, which increases the complexity around approval processes and financing needs. The key is to identify deals where we believe the market has mispriced the stock of the underlying companies relative to what we see as the risk/reward tradeoffs of the deal. This is how we believe our team structure adds value.

Another way a merger arbitrage strategy adds value is that it can help reduce total portfolio volatility. The uncorrelated nature of the investment stems from the fact that once the proposed acquisition is announced, the value of the target company's stock moves in accordance with the progress toward deal completion. It no longer moves in tandem with the overall market. This temporary negation of the stock's beta allows merger arbitrage portfolios to act as a diversifying element within an equity portfolio.

In addition, an all-cash deal provides a cap on the price of the target company in an environment where markets are rallying, and a floor under the price of the target company in times when prices are falling. In a stock deal, the setup provides reduced stock market volatility as the long position in the target is offset by a short position in the acquirer. In an environment when so many stocks seem to be rallying, this reduced volatility can seem trivial. However, any investor who has been around long enough knows rallies cannot last forever.

What Goes On

Let's look at an example.

Company DEF announces a bid to buy Company ABC to expand its product range and gain synergies from integrating the business. Prior to the announcement, ABC's stock was trading at $95/share. DEF, whose stock is currently trading at $60/share, agrees to give ABC's shareholders two DEF shares for every ABC share they hold, or approximately $120. The difference between the $120 bid price and the $95 pre-announcement trading price is the control premium. After the deal is announced, ABC's stock should begin to trade closer to the $120 bid price. However, the price of ABC will not actually reach the $120 bid price because of the risk the deal will fail. ABC shares might trade closer to $115.

The merger arbitrage analyst analyzes the deal, thinks it has a high chance of completion, so he or she enters a long (buy) position in ABC at $115/share, while simultaneously going short (sell position) two shares of DEF at $60 each, or $120 in total proceeds. As the closing date of the acquisition approaches, ABC's price converges on the $120/share acquisition price. When the deal closes, ABC shareholders are given two DEF shares for every ABC share they hold. The merger arbitrage analyst delivers these two DEF shares against their short DEF position, capturing a $5/share profit equal to the difference between $120 in proceeds and the $115 spent to buy the ABC share. This profit will be captured if the deal closes, regardless of where the market or share prices of ABC and DEF go in the meantime.

I Want to Tell You

There are several reasons why now is a good time for merger arbitrage investing. Until recently, the number of opportunities available in the market has been depressed as M&A activity has been historically low when compared to deal volume during other periods of high stock prices. We believe this was the result of ambiguities stemming from the US-China trade war and regulatory uncertainties.

With equity markets near all-time highs, low financing costs, a new US administration in power and anticipation of better trade relations on the horizon, these trends appear to be reversing, and companies seem keenly interested in re-engaging in M&A. More deals mean more opportunities for merger arbitrage investments. Despite the increasing number of deals, spreads remain wide. Why is this?

- Generalist investors often do not want to hold target companies in a rising market. A mostly-cash merger arbitrage deal put a cap on how much the price of a target company can appreciate. Holding target companies will cause a portfolio to lag its benchmark because they do not appreciate at the same rate as the rest of the companies in the sector. If beating a specific benchmark index is a goal, an investor may avoid investing in target companies.
- Large deals offer large spreads. The size of a target can cause a wide spread. While mega-cap companies are usually widely followed and can exhibit extreme market efficiency, their market cap can be too large to digest during a takeover, leading to wider spreads.

Wider spreads mean greater return potential. An increasing number of opportunities, combined with spreads that remain attractive, is providing renewed vigor in the merger arbitrage space. In an environment when it seems as though correlation, and uncertainty, is high, our team hopes investors will see the potential benefits of this uncorrelated, underutilized investment strategy.

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