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# Merger Arbitrage

a fundamental  
approach to  
event-driven investing

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FOREWORD BY MICHAEL ZAOUJ

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# Merger Arbitrage

*A Fundamental Approach to  
Event-Driven Investing*

**Lionel Melka**

**Amit Shabi**



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To our beloved children: Tia, Ilai, Raphaël and Gabriel

# Foreword

In my professional life I have learned to respect the power and influence of merger arbitrage in the transaction process. Good fortune gave me the opportunity to do so in very different ways: as an investment banker in charge of M&A deals; as an investor in event-driven funds; and most recently as a director of a public company under offer. If you are contemplating being involved in financial markets in any of these capacities, you must read this book.

During my many years at one of the greatest investment banks in history, Morgan Stanley, I had the privilege to execute several of the largest mergers, acquisitions, takeovers, and defenses on both sides of the Atlantic. My career there (from 1986 to 2008) spanned the two decades which saw the greatest M&A bull market in recent history. Activity charts mark the beginning of what became known as “merger mania” towards the end of 1983; one of the deals which started it was Pennzoil's offer to buy 20% of Getty Oil in December of that year. Ultimately all of Getty Oil was acquired by Texaco; the deal was large, complex and contested, a perfect combination for merger arbitrage which provided an early, yet spectacular, opportunity to deploy capital and to take calculated risk. For many of them, playing that situation paid off, and, although it was before my time on Wall Street, I knew it had been a defining moment.

The development of professional merger arbitrage logically accompanied the enormous wave of merger activity which followed, and soon the question “what are the arbitrageurs doing?” became central to understanding and sometimes predicting the outcome of takeovers. To put it simply, merger arbitrageurs analyze transaction risks in

public deals and put capital to work, increasingly in scale, by going long or short on financial instruments from different issuers in ways that reflect their risk assessment and ultimate convictions. The combined strength of such convictions and of the capital used to back them might result, for example, in a higher price for the security “in play” - e.g. the stock of a public company under offer. Nowhere would this be more relevant than in contested situations, whether as a result of a hostile bid or competitive offers for a company. To quote a business magazine article from the previous decade, “these are the situations M&A bankers live for”. The same could be said of merger arbitrageurs, although more plain-vanilla agreed transactions have long constituted the bulk of the activity for all.

This is clearly a risky business, but so is deal making. As a banker, you know the transactions you've worked on and which never saw the light of day - these are many in number. I always told my colleagues “there will be more reasons for a deal not to happen than for it to happen”. A dose of humility is healthy in the banking business, and not just because of the current climate. Investment bankers often felt that the toughest part of the job was to get to the announcement stage; yet this was only the beginning of the story for the market, of which merger arbitrage instantly became a key component. Risk is no longer about pursuing alternative strategies to the deal in question, or testing the CEO's and board's resolve in following it through; attention moves to market reaction, interloper action, regulatory delays, defensive moves, and other execution risks. This is the time for merger arbitrageurs to deploy their skills in assessing these risks, to mitigate them using the range of available securities and derivatives instruments, and to push for their preferred outcome. So for their transactions to

be successful, M&A bankers need to know and understand what the merger arbitrageurs are thinking at all times.

The authors of this book have chosen several notable transactions to illustrate these points with competence and clarity. I was involved in the Alcan-Pechiney deal as Alcan's banker, and encourage you to read the case study. It has many of the components of a textbook unsolicited offer: compelling strategic logic, as evidenced by prior discussions between the two companies; vigorous bidding and takeover defense strategies; powerful and positive market reactions for both stocks; and finely conducted negotiations which ultimately resulted in an agreement. I remember the question the board of Alcan asked me the first time I met with them in Montreal: "Can it be done?". The question essentially related to whether it was then possible to acquire a French company via a hostile offer. I replied without hesitation: "Yes it can". Certainly by 2003, European equity markets were driven by institutional shareholders - including merger arbitrageurs - whose objective is to maximize the value of their investment. It was increasingly hard for any target company to successfully reject an opportunity to get a premium without providing shareholders with a better option. Indeed, in my entire career, the "just say no" defense worked only once, in 1999, when Société Générale rebuffed BNP's offer, in an exceedingly complicated situation. Going back to Alcan/Pechiney, it was significant that we received the "Deal of the Year" award in 2003 from the "Club des Trente", an association of major French CFOs, as a mighty French industrial name had fallen to shareholders' power.

Deal stories, and their lessons, could be the subject of another book. But ensuring that you become a successful investment banker is not the only reason you should be familiar with the content of this book. Merger arbitrage provides investors, in the great tradition of other forms of

securities arbitrage, with a highly effective way to invest capital. As this book will explain, arbitrage plays a significant role in providing liquidity and ensuring the good functioning of securities markets. Investing in so-called event-driven funds has therefore become a permanent feature of asset management. Many portfolios include allocations to such funds, which are in principle uncorrelated to macroeconomic trends – or indeed the value of securities such as bonds or stocks going up or down. Because the returns produced are based on arbitrage opportunities, such funds provide an attractive diversification from other types of investments. Some of the smartest people I have met on Wall Street run such funds.

Understanding the role of merger arbitrage is also critical for boards. As I write this, GDF-Suez has made an offer for the 30% it does not own in International Power, a company listed on the London Stock Exchange. I am a director of International Power and, for the first time, I was going to live through the deal experience from a board seat: how exciting for someone who has spent most of his life advising boards in such situations! I had not forgotten the grueling rhythm of meetings imposed on the directors of Gucci during the “handbag war” with LVMH (I was Gucci's banker), to the point where we joked “today there is a board meeting, so it must be Sunday”. Interestingly, the agreement between GDF-Suez and International Power provided that, for a period of time following the original business combination, all six independent directors must approve any offer for buying out the minorities; here we had the power to just say no. After due consideration, we rejected GDF-Suez' first offer at 390p; our investment banks provided us with relevant analyses and market views to support such a stance, and the stock price actually settled above the offer price. The message from shareholders was clear, yet it must have been challenging for merger arbitrageurs to factor our right

to veto into their risk analyses. That additional element of uncertainty must have weighed on many people's decision to intervene: unlike in standard takeovers, the bidder could not bypass the board and take its proposal directly to the shareholders. In the end, we obtained a price of 418p, whereas the market price had stabilized at around 404p (I was involved in the negotiations). By the time you read this, shareholders will have voted on the transaction.

Finally, I would like to say that this excellent book gave me yet another opportunity to learn, this time as a student of merger arbitrage theory. Nowadays, it is impossible to understand how capital markets function without mastering the analyses contained herein. Indeed, you will read how complex such analyses need to be in certain takeover situations - dare I say sometimes in direct proportion to the creativity displayed by those involved? I referred above to the very complicated situation created by BNP's dual offer for Société Générale and Paribas, which had previously agreed to merge, so that all three stocks' movements became interdependent. A five-month rollercoaster was stopped with BNP taking control of Paribas but missing out on Société Générale. Other situations where I led the defense were certainly difficult to analyze at times, such as when Elf, in a bold defense move against Total's hostile offer, launched a counterbid for Total itself. This was an unprecedented defense strategy in 1999, which observers quickly named "Pac-Man" after the popular video game. In this case, which stock do you buy and which one do you short? To end the battle, Total raised its price and Elf agreed to merge. In another famous situation mentioned earlier, what were merger arbitrageurs to do when Gucci issued stock overnight (as could be done then on the Amsterdam exchange), first as part of an employee share ownership plan and then to white squire PPR (at a premium to the market price, of course), to stop competitor LVMH from

taking creeping control of its capital? In a second stage which took place in 2004, PPR acquired the rest of Gucci, also at a premium. Merger arbitrageurs must have been surprised again in 2004 when Aventis announced it would issue “Plavix warrants” to holders of its shares should Sanofi (the maker of Plavix) succeed in its takeover plans, undoubtedly creating confusion in the marketplace and prompting a regulatory review of yet another innovative structure. Sanofi increased its offer, and Aventis agreed to merge. In 2006, merger arbitrageurs were taken aback when Arcelor, under a hostile offer from Mittal, agreed to sell a significant non-controlling stake to Severstal in exchange for assets and cash; Mittal had to raise its offer to see off the competition (and I received a bottle of champagne from a happy merger arbitrageur). Ultimately, in all these situations, merger arbitrageurs had to incorporate previously unseen complexities into their analyses; but ultimately, and without exception, these moves resulted in a superior outcome for shareholders, including merger arbitrageurs themselves.

There is a fifth and final reason why you should read this book, even if you do not plan on becoming a better banker, investor, director or scholar of market efficiency theories: it could very well set you on the path to becoming a merger arbitrage professional.

Michael Zaoui

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# About the Authors

**Lionel Melka** started his career in 1998 with Lazard Frères, where he undertook numerous M&A advisory engagements for blue-chip clients (LVMH, Saint-Gobain, Casino, France Telecom, Thomson, Air Liquide, Kingfisher) in a large scope of situations: privatizations, friendly and hostile takeover bids, LBOs, asset disposals, and IPOs. He then joined the M&A Department of Calyon, where he worked on various advisory assignments in the TMT-Defense team and LCF Rothschild in 2005, where he led many M&A cross-border assignments in various industry sectors.

Lionel is also a teacher at the University of Paris Dauphine, one of the leading academic institutions in Europe, in the fields of corporate finance, asset allocation, and alternative investments.

**Amit Shabi** is an ex-commander of an analyst team in a military intelligence unit of the Israel Defense Forces. After completing three years of army service, he moved to Paris to pursue his studies and obtained a Master's degree in Finance from Sorbonne University.

Amit started his career in the asset management department of LCF Rothschild. After this experience in traditional asset management, he worked in the Capital Markets divisions of MAN Group and Cantor Fitzgerald selling sophisticated financial instruments to hedge funds and institutional investors.

In 2006, Lionel and Amit cofounded Bernheim, Dreyfus & Co., a Paris-based asset manager specialized in alternative investments. Since then, they have used a merger arbitrage strategy to manage the Diva Synergy funds.

# Introduction

It is Monday morning. Before the markets open, Salinas PLC announces a \$50-per-share takeover bid for Migjorn Inc. Shares in the target company closed at \$36 in New York on Friday. Trading will begin again at any moment. What price will Migjorn shares open at? Who will buy? Who will sell? Does that really matter in the grand scheme of things? And, perhaps most importantly, is there a way of making money from the situation?

Arbitrageurs spend their working days asking themselves these questions, analyzing operations and taking (or not, as the case may be) positions on the stock market. In friendly operations, they often act in the buyer's favor and facilitate the conclusion of the transaction. In hostile operations, they tend to be more of an arbitrator, in terms of the "fairness" of the final price, by rotating capital as soon as the takeover bid is announced.

Merger arbitrage is one of the event-driven alternative strategies applied by hedge funds, whereby they trade in the stocks of companies that find themselves at a particular stage in their life cycle. This could be a merger, a takeover bid, a restructuring or insolvency proceedings. Merger arbitrage was developed in the 1940s by Gus Levy at investment bank Goldman Sachs and enjoyed its heyday during the fourth big wave of mergers and acquisitions in the 1980s. Let us first give a brief reminder of what a hedge fund is and what merger arbitrage is.

Hedge funds are investment vehicles that aim to deliver absolute returns with no benchmark. They are generally free to invest in any asset class, and insofar as they do not raise money from the public, they are subject to very little regulation, if any. They can use leverage and sell short

(something we will come across several times in this book). Hedge fund managers, who invest significant sums in the funds, are paid according to their performance. They may be vilified by some, but they actually play a positive role by adding liquidity to the markets and helping the prices of the financial assets in which they trade to level off more quickly.

Merger arbitrage aims to make a profit on the difference between the market price of a stock and the price put forward in a takeover bid. The price at which the shares of a target company settle after an operation has been announced is an implicit indicator of whether arbitrageurs feel the transaction will go ahead. Where there is competition (a situation often instigated by the target company's management), the market price is usually higher than the bid price. In general, offer execution risks and uncertainties surrounding the ability of the bidder to complete the transaction are more likely to get an arbitrageur's attention. In these cases, the market price will tend to be less than the bid price, generating a difference known as the spread.

This spread varies depending on how likely the transaction is to fail. There are risks related to:

- the financing of the transaction;
- the intervention of government bodies and other regulatory authorities (such as competition regulators);
- the shareholder vote (or reaching approval thresholds for takeovers);
- the implementation of legal clauses featuring in the merger agreement.

If these conditions precedent are met, the spread will gradually narrow as the transaction completion date approaches.

All these risks can appear after an M&A transaction has been announced, and they must therefore be evaluated by arbitrageurs. In order to capitalize on the control premium

usually offered by a buyer, some investors try to buy shares in potential target companies even before a deal is announced. These pre-event strategies are founded on several decisions that relate to risks of varying importance.

The most risky strategy is to take positions on the basis of pure speculation, a practice adopted by Ivan Boesky, who was the inspiration for the Gordon Gekko character in Oliver Stone's film *Wall Street*. At the other end of the scale, there are arbitrageurs who wait until the buyer and the target company have signed a definitive agreement. Others make their move somewhere in the middle: upon the entry of an activist investor, a mere approach, advanced discussions, or a conditional offer. In this book, we will look only at deals that have been formally announced, as these represent the majority of situations targeted by arbitrageurs.

Whatever your opinion of the financial markets (an instrument of economic efficiency and resource allocation, or a sounding box for short-term and copycat behavior), it is these markets that decide the fate of major mergers and acquisitions. This notion of "market" has, however, become increasingly diverse and fragmented. The presence of new types of investor (US/UK mutual funds, arbitrage funds, activist funds, sovereign wealth funds, etc.), each with their own incentives and constraints, makes it increasingly difficult to analyze investment decisions. The M&A market has also undergone major changes: the outbreak of hostile bids; the rise of private-equity firms; the emergence of buyers from emerging nations; and the growing impact of ratings agencies and government bodies (particularly competition authorities). All these mechanisms, changes, and issues are at the heart of this book.

The book is split into three parts. In the first part, we examine the basis of merger arbitrage. Chapter 1 looks at the key role of the market in takeover bids. It also assesses the major changes in the financial markets over recent

years and their impact on M&A. Chapter 2 uses recent examples to describe the different types of transaction that provide investment opportunities for arbitrageurs. In Chapter 3, we look at the various M&A risk and return factors, such as the risk of the deal failing, the timetable, and bidding wars. Chapter 4 focuses on the historical profitability of merger arbitrage, the different approaches used by fund managers and the results of academic studies on the subject.

In the second part of the book, we look in more detail at the risks of an M&A transaction failing, which is the key factor in an investment process. Chapter 5 deals with financing risk, Chapter 6 with competition issues, Chapter 7 with the legal aspects of merger agreements and Chapter 8 with other risks, such as administrative and political risks.

The third part of the book examines specificities of M&A transactions. Chapter 9 deals with hostile takeovers and Chapter 10 with leveraged buyouts.

We will examine many recent examples and case studies in order to show how the various theories and notions are put into practice. These include Dow Chemicals' purchase of Rohm & Haas to illustrate financing risk and Oracle's takeover of Sun to demonstrate competition risk. Sanofi's purchase of Genzyme will reveal the dynamics of a hostile takeover, while the takeover of Del Monte Foods by a KKR-led consortium will illustrate the particular characteristics of a leveraged buyout.

# Part I

## The Arbitrage Process

The first part of this book describes the environment in which arbitrageurs work, as well as the major principles of merger arbitrage. Although they are often analyzed within the context of corporate financing, M&A are essentially tied to the financial markets and to changes therein, as the first chapter will show. In Chapter 2, we will study the financial mechanisms at work in the arbitrage process, as well as their different characteristics depending on the payment method of the transaction. The third chapter looks at the risk and return factors of merger arbitrage. The final chapter in Part I examines the historical performance of merger arbitrage and the different approaches adopted by specialist managers.

# 1

## The Role of the Market in Mergers and Acquisitions

In spite of the many laws governing mergers and acquisitions (M&A), it is always the market that has the final say. Takeover bids may have to comply with various national and international laws, but by accepting or rejecting the terms of these bids the market is the ultimate judge of whether they are successful. Whether they like it or not, the market can sometimes usurp even the decision-making bodies of the target company in this role as the ultimate judge. As you might expect, the market's role of arbitrator is governed strictly by securities regulations, whether during bull periods, such as the beginning of the 1990s, or during more difficult times for financial markets, such as we have seen since 2008.

The concept of “the market” has evolved considerably. It now comprises as many different operators as strategies, and recent changes have served only to make it more fragmented and diverse in terms of the operators it groups together. These market operators include investment funds (arbitrage funds, private-equity funds, etc.), family offices, wealth managers, asset management units of major financial institutions, and individual shareholders. Each operator follows its own investment process in order to achieve its own goals, whether it is managing its own money or someone else's. All this means that the market, now more than ever, is a complex sum of individual interests. The partial or total liquidation of many so-called

alternative investment funds, in the wake of early redemption requests from investors following the recent financial crisis, is a prime example. Moreover, the increase in trading volumes on global stock exchanges means a much greater turnover of shareholders in the share capital of companies. Combined with the different behaviors of market operators and the wide range of financial instruments available, this makes takeover bids - and the factors that determine whether they will be successful - more complex.

Such diversity on the financial markets means there can be no broad-brush analysis of takeover bids. As well as the individual characteristics of each operation, the reactions of the many parties involved and their respective dynamics need to be taken into consideration. The success, or otherwise, of takeover bids therefore depends fundamentally on the market. Over the last few decades, the market has undergone many changes that have affected M&A practice.

## 1.1 STRUCTURAL CHANGES TO THE FINANCIAL MARKETS

Over the last few decades, the global financial markets have experienced several major structural changes as they have risen on the back of the growth and globalization of listed companies. The total stock-market capitalization of all US and international companies listed on the New York Stock Exchange rose from \$2,700 billion in 1990 to more than \$13,300 billion in 2010. Over the same period, the S&P 500 climbed from 350 points to more than 1,350 - an increase of over 285%.

The first thing to point out is that market liquidity has increased considerably. Average annual trading volumes on

the New York Stock Exchange rose from around \$1,325 billion in 1990 to more than \$11,600 billion in 2010. This significant increase in trading volumes, and therefore market liquidity, enables market operators to position themselves more easily, and above all more quickly, in the share capital of companies. Those wishing to launch a takeover bid can therefore quickly build up significant stakes in the share capital of target companies, whether before or after the bid is actually submitted.

There are many ways of building up blocks of shares, such as purchasing shares on the market, buying blocks of shares off market, and using derivatives. Whatever method is used, it is made easier by a more liquid market. Having said that, all these techniques are subject to strict regulatory control. There are two major determining factors: first, the notion of privileged information held by the potential instigator of the transaction (moreover, different jurisdictions interpret this issue in different ways - does a market operator preparing a takeover bid for a target company have privileged information?); and second, ownership threshold disclosure requirements. These issues are topical and often trigger debate, as shown by the recent creeping takeover of Porsche by its German competitor Volkswagen.

A second significant change to the markets is their integration with international capital flows. Nowadays, foreign capital always represents a large part of the volumes traded on all global financial markets. This change has significant consequences and goes hand in hand with the first change we discussed earlier. It encourages ownership fragmentation and the circulation of capital - both of which are conducive to takeover bids. The greater openness of the markets also means that individual investment choices depend increasingly on economic and financial criteria. In the context of takeover bids, these criteria are particularly

crucial in determining whether or not an investor tenders their shares.

There are many reasons for this change. First, EU regulation encourages the free circulation of capital. Second, advances in communication technology have brought about the development of new types of electronic trading platforms, which facilitate market access and allow for faster execution. Lastly, the harmonization of international accounting standards and better access to financial information have also contributed to better global integration of capital markets.

Countries have responded to the opening up of the international capital markets, but it remains to be seen what effect this response will have on M&A. Several countries have created investment structures aimed at protecting “sensitive” assets. There is, of course, nothing new about sovereign wealth funds (SWFs); the first, the Kuwait Investment Board, was set up in 1953. These funds now manage more than \$3,000 billion, and their primary aim is to diversify their investments. Until now, they have been most active in taking minority stakes in large US or European groups that have built up a dominant position in their markets. There have been several recent examples of conflict between SWFs and the authorities in the country of the target company, such as the attempted takeover in 2006 of US oil company Unocal by state-controlled Chinese group CNOOC. It remains to be seen what effect will arise from these funds being in the share capital of M&A target companies. As they are largely a recent phenomenon, it will be interesting to see the stance adopted by these funds, especially if their presence in the share capital has come about through a concerted effort with the management team of the target company.

The third major change in the markets is the growing importance of hedge funds. The main aim of these funds is

to deliver “absolute” returns, i.e. to generate positive performance whatever the conditions on the financial markets, as opposed to benchmark management where performance is compared to that of a reference index. Other specific characteristics of hedge funds include widespread and sometimes mass usage of leverage, short selling, derivatives, and fee systems that include performance fees. The hedge fund industry currently has \$2,000 billion of assets under management, which is fairly small compared with the asset pool of traditional, long-only mutual funds. Redemption requests from investors and many fund liquidations caused hedge fund assets under management to fall sharply during the recent financial crisis. Fundraising has been positive since 2010, however, with investors once again very keen on returns that are uncorrelated to the markets. Furthermore, we need to take into account the leverage used and the actual exposure of hedge funds, which in general is much greater than for other asset management players and therefore increases the amount of assets.

Hedge funds are something of a broad church in that they comprise many different investment strategies, asset classes (equities, bank debt, high-yield bonds, etc.), and financial instruments. And yet the names given to the different styles have become familiar: long/short, event driven, macro, convertible arbitrage, etc. With regard to takeover bids, “activist” funds specialize in acquiring significant stakes with a view to acting as a catalyst, or sometimes with the explicit aim of encouraging a bid, whether under their own steam or on behalf of a third party. The strategies employed by these funds are very similar to the conduct of individual activist investors such as Carl Icahn or T. Boone Pickens. Among other things, Mr Icahn was particularly active in the split of Motorola into Motorola Mobility (housing all the mobile phone activities) and

Motorola Solutions (specializing in corporate telecoms services). This separation enabled the acquisition of Motorola Mobility by Google, which was on the lookout for patent buys to help its Android system compete better with Apple's iPhone. A large number of takeover bids are the result of moves by these activist investors or funds.

The final change to the financial markets is that the different markets are becoming increasingly integrated. The connections between the equity and derivative markets and the markets for other products have become much stronger in recent years, partly because hedge funds use all of these financial instruments at the same time.

LVMH's acquisition of a 21.4% stake in Hermès once again provides a good example of how derivative products (in this case, equity swaps) can be used to build blocks of control. It also shows the role that regulation needs to play in market transparency. In most cases, the use of derivatives is not regulated. Since 2009, however, regulation has gradually evolved in its attempts to encourage more transparency by making more information available to market operators, particularly on the existence of such derivative products. Furthermore, intermediaries have developed new ways of financing call and put options. These strategies involve less exposure and greater leverage. Their development has therefore enabled certain highly specialized operators – such as arbitrage, activist, and sovereign funds – to play a greater role in the markets. We can see that all of these financial innovations, brought about by greater market integration, require changes to regulation and have undeniably transformed the markets themselves.

## 1.2 CHANGES TO M&A PRACTICE

The transformations we have just discussed, which have altered the environment of the financial markets and how