# Trends & Ideas

PRIVATE CLIENT SOLUTIONS

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# Ways to Play a Merger

Over the past ten years, roughly $560 bln in merger and acquisition (M&A) deals have been closed by Canadian companies targeting public companies listed on US or Canadian exchanges. In 2016 alone, $124 bln in deals closed, making it a record year. Most of the deals were *closed* in the energy space with the announcement of the acquisitions occurring just prior to the recent collapse in the commodity. We emphasize the word "closed" as not all announced deals are completed. And therein lies the risk for investors deploying a merger arbitrage strategy. To successfully implement this strategy, we believe investors require a unique understanding of the announced deal and the regulatory process, which often makes this strategy difficult to implement for retail clients. In this piece, we illustrate how investors, usually hedge fund managers, employ this strategy and also explore the risks involved.

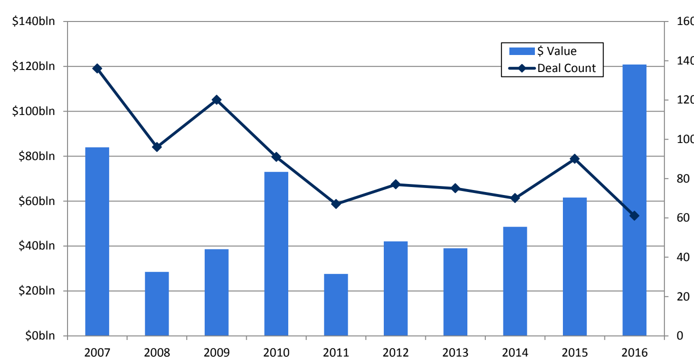
## What is Merger (or risk) Arbitrage?

Some may have noticed that following the announcement of an acquisition, the target company (or entity being taken over) rarely trades at the announced takeout price. When the target company trades below the offer price, we call that a merger arbitrage opportunity. While there exist multiple methods to undertake a merger arbitrage strategy through options or other securities (bonds, preferred shares, etc.), in this piece we focus on equities.

## Long-Only Strategy

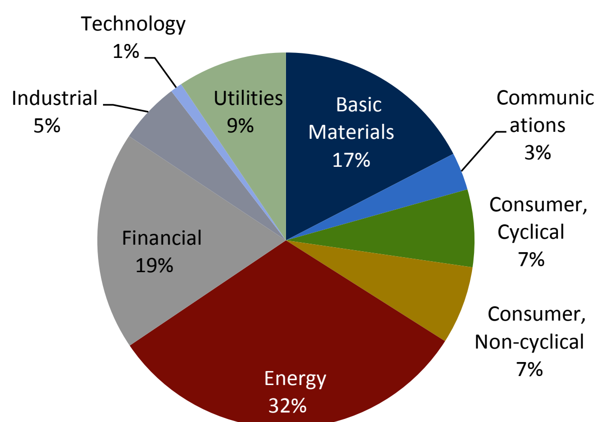
In an all-cash deal, an investor would buy the target company and simply wait until the deal closes. While not an arbitrage strategy per se ("arbitrage" requires simultaneous buying and selling), one would simply take a position in the target and wait for a cash payment. For instance, Company A ("A" for acquirer) announces they are acquiring Company T ("T" for target), which is trading at $5, for $10 a share in an all-cash deal. However, instead of Company T advancing to $10, it trades at $8. That $2 discrepancy is due to the uncertainty of the deal going through, which presents an arbitrage opportunity for those willing (and able) to take the risk. Here, investors could buy Company T shares at $8 and pocket the $2 difference if the deal closes (and we write "if" because, as we mention further below, there is always a risk of the deal not going through). In some cases, the target company's stock price may rise above the all-cash offer, which may indicate that the market expects a higher bid from a third party. After Amazon.com (AMZN-US) announced their intent to acquire Whole Foods (WFM-US) last Friday, WFM's share price increased above the announced 27% takeout premium, reaching 31%, $43.22, around 3:02 p.m. ET. By the end of the trading day, WFM closed higher than the offer price of $42, at $42.68, indicating belief that another bidder may be in town (stock trading at $42.96 at time of publication).

**2016 Marked a Record in the M&A Space**




Source: Bloomberg, Raymond James

**Over 50% of Transactions Over the Past 10 Years were Completed in the Financial and Energy Sectors**




Source: Bloomberg, Raymond James



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## Long-Short Arb

With an all-stock transaction, if Company A, trading at $100, announces they are acquiring Company T, trading at $5, for 0.1 shares of Company A in an all-stock deal, this equates to an acquisition price of $10 ($100*0.1), or a 100% premium to Company T's current price. However, instead of Company T advancing to $10, it trades at $8, a similar situation to the all-cash deal. In this scenario, buying Company T's stock alone may not cut it. Typically, when acquisitions are announced, the acquiring company's stock declines, while the target company stock rises to the announced transaction price, or at least close to it. Since this is an all-stock deal, the target shareholders will be receiving shares in the acquiring company. To eliminate the risk of the acquiring company's price declining, one could buy stock in Company T and simultaneously short shares in Company A. As a reminder, selling shares of Company A short entails borrowing Company A shares from a broker and then selling these in the market. During a merger arbitrage, an arbitrageur (as an investor employing this strategy is called) will not be buying Company A shares to close out the position, but receiving those shares once the deal is complete.

### All-Cash Vs. All-Stock: The Winning Scenario

| All-Cash Transaction | Company A | acquiring | Company T | Comment |
|---|---|---|---|---|
| Target Firm Current Price | $ 8.00 | | | Long 1 share of Company T |
| Offer Price | $ 10.00 | | | |
| Spread | $ 2.00 | | | Make a profit of $2 after the deal closes |
| Expected Close | 12/22/2017 | | | 6 months from Today (affects annualized return) |
| | | | | |
| **Total Return** | **25.0%** | | | |
| **Annualized Return** | **50.0%** | | | The shorter the expected close date, the higher the annualized return |

| All-Stock Transaction | Company A | acquiring | Company T | Comment |
|---|---|---|---|---|
| Target Firm Current Price | $ 8.00 | | | Long 1 share of Company T |
| Acquiring Firm Current Price | $ 100.00 | | | Short 0.1 shares |
| Amount of Stock Offered | 0.1 | | | Fraction of acquirer's shares to be exchanged for each target share (can be less than or greater than 1) |
| Effective Offer Price | $ 10.00 | | | Exchange ratio of 0.1 shares of Company A for 1 share of Company T, or $100 * 0.1 |
| Spread | $ 2.00 | | | Make a profit of $2 after the deal closes. |
| Expected Close | 12/22/2018 | | | 18 months from Today (affects annualized return) |
| | | Gain/Loss | Return | |
| Acquirer Price at Close | $ 95.00 | $ 0.50 | 0.5% | Regardless of Company A's price at close, the spread will be fixed at $2.00 |
| Target Price at Close | $ 9.50 | $ 1.50 | 18.8% | Since Company A closes at $95, Company T receives $9.5. |
| **Total Return** | **25.0%** | | | |
| **Annualized Return** | **16.7%** | | | The longer the expected close date, the lower the annualized return |

Source: Raymond James

**Here is how it would work (hypothetically):**

- Once deal is announced:
  - Buy 1,000 shares of Company T at $8
  - Sell short 100 (or 0.1 * 1,000) shares of Company A at $100
- Upon closing:
  - The owner of 1,000 share of Company T would receive 100 shares of Company A (exchange ratio of 0.1 shares of Company A for 1 share of Company T)
- The arbitrageur would be left with:
  - No shares: They receive 100 shares of company A and use these to close their short position
  - A profit of $2 per Company T share they own

## Sounds easy, doesn't it?

However, this is far from a riskless $2 gain. For starters, the deal may actually not go through because of regulatory issues, inability to finance the transaction, a key change to either company, something that comes up in the due-diligence process, failing to obtain shareholder approval or even a misunderstanding between owners. As such, the arbitrageur would have to determine what they expect the probability of success to be. If the deal does not go through, Company T's price could go back to the price it was trading at pre-announcement, $5 (or less), resulting in possibly over a $3 loss; concurrently, Company A's price may surge, creating an infinite loss for a short seller. Now if the deal does happen, the time between the announcement and completion may generally take anywhere from one to 18 months, which adds another layer of risk. An arbitrageur would essentially have to assess the time it would take for the deal to close and decide if they are willing to wait, say up to 18 months, for a $2 gain. So an arbitrageur will be putting up $8 for a $2 gain (~25% return). On the flip side, if the deal does not go through, the arbitrageur loses 100% of their invested capital or more.

### All-Cash Vs. All-Stock: The Losing Scenario

| All-Cash Transaction | Company A acquiring Company T | | | Comment |
|---|---|---|---|---|
| **Target Firm Current Price** | $ 8.00 | | | Long 1 share of Company T |
| **Pre-announcement price** | $ 5.00 | | | Stock may drop even lower than the pre-announcement price. |
| **Spread** | $ (3.00) | | | Crystalized loss after the deal breaks. |
| **Deal Break** | 12/22/2017 | | | 6 months from Today (affects annualized return) |
| **Total Return** | -37.5% | | | |
| **Annualized Return** | -75.0% | | | |

| All-Stock Transaction | Company A acquiring Company T | Gain/Loss | Return | Comment |
|---|---|---|---|---|
| **Target Firm Current Price** | $ 8.00 | | | Long 1 share of Company T |
| **Acquiring Firm Current Price** | $ 100.00 | | | Short 0.1 shares |
| **Amount of Stock Offered** | 0.1 | | | Fraction of acquirer's shares to be exchanged for each target share (can be less than or greater than 1) |
| **Pre-announcement price** | $ 5.00 | | | Stock may drop even lower than the pre-announcement price. |
| **Spread** | $ (3.00) | | | |
| **Deal Break** | 12/22/2018 | | | 18 months from Today (affects annualized return) |
| **Acquirer Price at Close** | $ 105.00 | $ (5.00) | -5.0% | Here, the shorted position increases to $105 from $100, resulting in a loss for a short-seller. After the deal breaks, the short-seller would have to buy back Company A shares at market price. |
| **Target Price at Close** | $ 5.00 | $ (3.00) | -37.5% | Stock may drop even lower than the pre-announcement price. |
| **Total Return** | -100.0% | | | The arbitrageur may lose all of their invested capital, or more, if the short position rises further or the long position drops below the pre-announcement price. |
| **Annualized Return** | -66.7% | | | |

Source: Raymond James

## In Conclusion

We reiterate that this strategy is very risky and note that there is a reason why such speculation is left to event-driven hedge funds. These funds have the resources available to follow such deals, including securities lawyers, industry experts and advice from antitrust counsels, resources which for the most part are not available to the average market participant. While there are vehicles in the market available to play such strategies, we do not feel comfortable recommending such products to retail clients.

# Important Investor Disclosures

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