GA-Courtenay Special Situations Fund

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Assessing The Activist Opportunity Type Within Merger Arbitrage

December 6th, 2024

"The typical stockholder is a most docile animal. They do what the board of directors tell them to do and rarely think of asserting their individual rights as owner of the business and employer of its paid officers.

The result is that the effective control of many, perhaps most, large corporations is exercised not by those who together own a majority of the stock but by a small group known as – 'the management'."

Ben Graham, Security Analysis, 1934[1]

"Ask yourself – why is somebody willing to pay $60 for Philips Petroleum, without corporate management, but only $35 with management? It is sort of simple – a corporation with management is worth half of its value without management."

Carl Icahn, speaking at a corporate law seminar in 1985[2]

"You see, a person who rises to the top of a big corporation and yet owns none of it is much more interested in control than they are in economics. Whereas the person that owns the business never has to fight for control, they are used to control. What they fight for is economics."

John Malone, quoted in Cable Cowboy by Mark Robichaux, 2005[3]

"When an active role is necessary to optimise the deployment of capital, you can be sure – we will not be standing in the wings."

Warren Buffett, writing in 1964[4]

Introduction

In the evolving landscape of investment strategies, combining merger arbitrage with an activist approach can deliver a powerful yet underappreciated path to accreting investment returns. This white paper examines how shareholder activism can address the corporate principal-agent problem in stock market takeovers while capturing performance advantages through the fund manager directly exerting influence on a takeover situation rather than relying solely on the mere discovery of mispriced securities.

> *"Information has no meaning unless it leads to action. Analysis has no meaning unless it is carried out for the purpose of action. Assets are dead assets unless there is the ability to energise them.*
>
> *Be courageous. And learn when not to conform."*
>
> Georges Doriot, Manufacturing Class Notes, Harvard Business School 1937-1966[5]

The paper's theoretical framework builds upon works by Berle and Means (1932)[6] and Ben Graham (1934)[7], showing how their early observations about the separation of ownership and control remain highly relevant in modern takeover situations.

Management and boards, acting as agents, may accept inadequate offer prices or tolerate preferential treatment for selected shareholders, effectively failing their fiduciary duty to maximise value for all owners. This misalignment creates opportunities for activist intervention in merger arbitrage situations. And, while traditional merger arbitrage focuses on capturing the spread between current market price and announced deal value, activist merger arbitrage seeks to influence upward the deal value outcome through various means – from public advocacy, to voting power, to financing competing bids.

The white paper also reveals that successful activism in merger arbitrage does not necessarily require the activist to oversee a large capital base, as thoughtful corporate governance advocacy in the form of either private or public communications or statements can influence outcomes even at modest capital deployment.

Our research draws on multiple case studies, from selected takeover interventions by Elliott Management, amongst others, to this fund's own experiences with Noront Resources and Western Areas, to demonstrate how activists can successfully advocate for improved deal terms through different approaches. These examples illustrate that when activists identify governance shortcomings within deal structures and possess the right competencies to address them, they can create significant value even when facing seemingly entrenched situations.

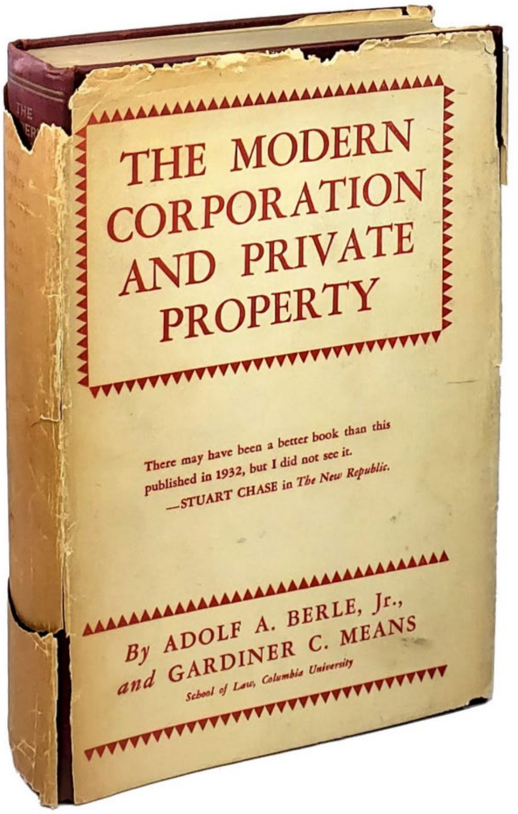
The white paper's comprehensive analysis of success factors for activist merger arbitrage – including within initial feasibility criteria, activist competency requirements, and bidder vulnerability characteristics – details a real-world blueprint for practitioners. We believe this structuring represents an important contribution to the literature on merger arbitrage activism.

Overall, the work presented targets a valuable input to the public domain understanding of how activist strategies can expand and enhance the merger arbitrage opportunity set. The targeted review of legal context, detailed case studies, and practical grouping of success factors provides a comprehensive analysis framework for protagonists deploying merger arbitrage, activism and corporate governance based strategies .

1. Shareholder activism and the corporate principal-agent problem

1.1 The corporate principal-agent problem and the incentive for shareholder activism

Figure 1: The corporate principal-agent problem was first formally recognised by Adolf Berle and Gardiner Means in their seminal 1932 work



> *"It is traditional that a corporation should be run for the benefit of its owners, the stockholders, and that to them should go any profits which are distributed. However a controlling management group may hold the power to divest a significant share of the profits into their own pockets.*
>
> *Under such conditions control may be held by the directors or titular managers who can employ the proxy machinery to become a self-perpetuating body, even though as a group they own but a small fraction of the stock outstanding.*
>
> *The outcome is that there is no longer any certainty that a corporation will in fact be run primarily in the interests of the stockholders. Instead, a large body of stockholders has been created who exercise virtually no control over the wealth which they or their predecessors in interest have contributed to the enterprise.*
>
> *It is the extensive separation of ownership and control, and the strengthening of the powers of control, that has raised this new situation calling for a decision as to whether legal pressure should be applied in an effort to enforce corporate operation primarily in the interests of the owners."*
>
> Adolf Berle and Gardiner Means,
> The Modern Corporation and Private Property, 1932[8]

To understand shareholder activism, we must first examine its core driver: the addressing of the corporate principal-agent problem, first identified by Adolf Berle and Gardiner Means in their 1932 work, *The Modern Corporation and Private Property*.

The principal-agent problem describes the challenge of ensuring agents (like corporate boards, or executive management) act in the best interests of principals (shareholders) rather than pursuing their own agenda. Berle and Means argued that modern corporate structures allowed directors to operate with minimal oversight, often advancing their own interests while shareholders—fragmented, small, and uninformed—remained powerless to intervene.

Ben Graham further examined this issue in his 1934 work *Security Analysis*, arguing that shareholders had not deliberately relinquished their rights but had instead allowed them to lapse through inaction. Graham emphasised that directors still maintained their legal obligation to serve owners' interests and suggested that shareholders needed only to re-assert their inherent rights of ownership.

> *"The typical stockholder is a most docile animal. They do what the board of directors tell them to do and rarely think of asserting their individual rights as owner of the business and employer of its paid officers.*
>
> *The result is that the effective control of many, perhaps most, large corporations is exercised not by those who together own a majority of the stock but by a small group known as – 'the management'."*

Ben Graham, Security Analysis, 1932[9]

The principal-agent problem mirrors a caretaker blocking the sale of an estate to protect their job, a situation cured only when the owner asserts their legal rights. In corporate situations, the owner asserting their rights is shareholder activism, and the process often has at its fulcrum shareholders pushing for greater control of the board through their votes during a special meeting, or so called proxy contest – a means for shareholders to vote to either re-orientate or replace incumbent management.

1.2 Shareholder activism – the enfranchisement by shareholders of their legal rights

As such, shareholder activism is the enfranchisement by shareholders of their legal rights. Activist practitioners have ranged from Carl Icahn to Warren Buffett[11], and are succeeded by today's new breed of activist investors including Bill Ackman, Jeff Smith and Paul Singer, who have rediscovered the power of the public media campaign, the proxy contest, and the tender offer.

> *"It is our contention that sizeable profits can be earned by taking large positions in undervalued stocks and then attempting to control the destinies of the companies in question by:*
>
> *a) trying to convince management to liquidate or sell the company to a 'white knight',*
> *b) waging a proxy contest,*
> *c) making a tender offer or*
> *d) selling our position back to the company."*

Carl Icahn, writing in his prospectus for activist capital raising, 1975[10]

Today's new breed of activists have moved in some cases to institutionalise shareholder activism, often attracting dedicated capital, and embracing innovations including from web-based campaigns to their rolling-in of their shareholdings into private equity deal structures.

Whilst each age brings differences in the opportunity set and therefore also the optimal activist strategy, the underlying structure of activist campaigns has remained on similar guide rails.

The activist typically begins by acquiring a significant stake in an undervalued company. The activist will highlight either privately to management, or publically, the gap between market price and intrinsic value while pressuring management for catalytic actions such as cost cutting or a sale of the company. If management resists, the activist may launch a public campaign, proxy contest or initiate their own tender offer, potentially even taking the company private at the undervalued price if no other bidders emerge.

Activism succeeds by exercising shareholders' concrete legal rights rather than relying on abstract notions of ownership. These shareholder rights are specific: voting in shareholder meetings, receiving proceeds from takeover offers, and collecting dividends. Activists leverage these rights by threatening to call special meetings of shareholders including during, or to precipitate, takeovers, or by demanding operational improvements that will increase dividends — converting these ownership rights into tangible value.

Activists gain additional leverage by drawing market attention to their assessment of the undervaluation or mismanagement of the company. These campaigns can attract other investors, including value investors, strategic buyers and private equity firms, and whose action may further influence the share price including through potential takeover outcomes. This creates a favourable dynamic: even if the activist's voting proposal at a special meeting fails, the campaign can still catalyse value over time, allowing the activist to profit from a range of potential developments thereon.

1.3 By including in their operating method a willingness to engage as an activist, the investor also expands their opportunity set, raising their probability of capturing the highly attractive opportunity

A further advantage of shareholder activism is that it expands the opportunity set of the investor, and as such shifts the activity of the investor from simply the *finding* of attractive investment opportunities to the *creation* of them. This raises the business-like advantage of shareholder activism and particularly in the current period in which traditional investing is challenged by both cyclically adjusted earnings or "CAPE" ratios sitting close to 40 year highs[12] and many market participants also increasingly having access to sophisticated computing tools to search for and identify undervalued securities. These dynamics handicap the achievability of identifying a high volume of mispriced securities, and as such raise the portfolio-level advantage of alternative forms of market strategy that can still robustly and consistently result in above average outcomes.

Figure 2: The Buffettian approach, sifting the world for mispriced securities, appears to be becoming more challenged in the modern era of high earnings multiples and sophisticated search computing tools

> *"Work hard at it, look and sift the world for a mispriced bet – and you can occasionally find one.*
>
> *Think of it as heavy odds against a game full of falsehoods and craziness and yet with an occasional mispriced something or other."*
>
> Charlie Munger,
> A Lesson on Elementary,
> Worldly Wisdom, 1995[13]

This perspective also reframes activism more modestly to fit its actual reality. Corporate activists are not necessarily claiming superior competency, but rather acknowledging that they must target an operating method that addresses the relative disadvantages that they would otherwise face compared to entrenched management, corporate insiders, private equity, or quantitative hedge funds deploying high speed computing algorithms.

As such the activist responds to reality by recognising that their optimal path should include a practical means by which accretion can be achieved through a series of additional opportunities that they themselves create.

2. Shareholder activism in merger arbitrage

2.1 Activism in merger arbitrage for performance orientation

Traditional merger arbitrage as the primary layer of a capital allocation strategy can resolve a number of the limitations of conventional investment approaches, including disassociation from the cycle of overpromotion then value disenfranchisement by issuers of securities, the delivery of binding returns, simplicity, and the objective assessment of prospective returns.

The advantages of merger arbitrage also include its properties allowing mitigation of unitholder adverse liquidity risk exposure as well as its delivery of de-correlated performance across a range of market conditions, and its shorter duration of trade construct which can output a higher consistency of annual returns than many other approaches.

We have reviewed these advantages more comprehensively in our September 2024 white paper, *Performance Orientation in Merger Arbitrage*[14].

An important additional aspect of merger arbitrage, however, is that it can also be orientated to strong performance. As Warren Buffett notes below, for the 62 year period 1926 to 1988, the combination of Ben Graham's and Buffett's returns from merger arbitrage averaged over 20% per annum.

> *"While at Graham-Newman, I made a study of its returns from merger arbitrage during the entire 1926-1956 lifespan of the company. Unleveraged returns averaged 20% per year.*
>
> *Starting in 1956, I applied Ben Graham's merger arbitrage principles, first at Buffett Partnership and then Berkshire. Though I've not made an exact calculation, I have done enough work to know that the 1956-1988 returns averaged well over 20%."*

Warren Buffett, Berkshire Hathaway shareholder letter 1988[15]

However, to optimise performance in merger arbitrage the fund manager must also capture the activist opportunity type including by possessing the correct analysis framework to successfully participate in activist campaigns led by others, as well as the understanding of the toolkit necessary to initiate campaigns of their own.

And, whilst activism in merger arbitrage was touched on in our prior white paper, in this document we explore it in greater detail, including both its overall premise in merger arbitrage and the more specific activist strategies that the merger arbitrageur can adopt, with case studies pertaining to each opportunity category.

2.2 The merger arbitrage activist addresses the corporate principal-agent problem in takeovers

In merger arbitrage, activists typically challenge management agent decision making when it appears to have aligned with a bidder to accept an inadequate offer price. This issue is compounded if one or a selection of other shareholders have additionally received preferential treatment, effectively turning them into additional agents.

The problem exists in the context of takeover regulations in most jurisdictions, which allow potential bidders privileged access to high resolution information for due diligence purposes, yet information that other prospective shareholders do not obtain. Corporate boards typically support this inequality, creating a structural disadvantage for regular shareholders.

This opens the route by which the corporate principal-agent problem can be exacerbated during a takeover. When the potential buyer first approaches with an indicative offer, they typically next privately negotiate with the target company board and management for access to higher resolution information for due diligence. These negotiations can include terms beyond standard non-disclosure agreements, such as 'golden parachutes' and future roles for target management post-acquisition, should the takeover prevail. Bidders may readily agree to these terms – the cost is low compared to the total acquisition price, and having management support eases post-merger integration.

This process can amplify principal-agent problems. Target company boards become incentivised to approve the takeover based on their personal post-deal benefits rather than their fiduciary duty to shareholders.

While shareholders still have the right to vote on takeover offers, this safeguard is often ineffective in modern markets. Many institutional investors, together with index funds, control the majority of voting rights, and may automatically follow board recommendations. Thus, true shareholder enfranchisement in many cases only occurs through activist intervention in merger arbitrage, which helps secure appropriate takeover premiums.

Without activist shareholders in many cases zero-premium takeovers might succeed. Control buyers who discover positive information during due diligence could also proceed with nil or low-premium offers, while those who find negative information could withdraw — delivering an additional structural handicap to public market investors.

2.3 The merger activist's advantage is twofold: their ability to drive change, and their unique opportunity to build a full position before announcing their intentions

While shareholder activism creates value by addressing the principal-agent problem, this alone does not explain why activists can meaningfully outperform other investors, since all shareholders in a targeted company should benefit from its activist-led value uplift.

The activist's performance advantage stems from their unique position regarding information. Unlike trading on external non-public information, which would violate insider trading laws, it is perfectly legal for activists to trade in advance of their own plans and intentions.

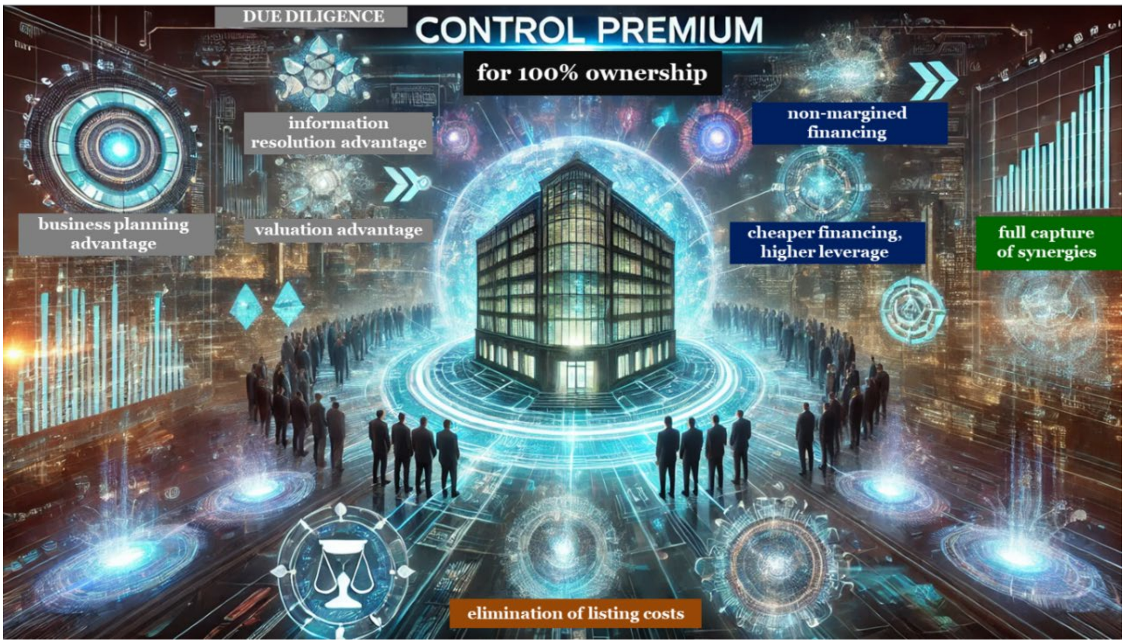
As such, when an activist develops a campaign strategy and then purchases shares accordingly, they are acting on self-generated material information that is not yet public — an approach breaching no laws yet which can give the activist a significant edge. Since only the activist knows their plans beforehand, they alone can build a scaled position at pre-announcement prices, opening the door to the significant performance advantage.

A case study of an archetype situation in activist merger arbitrage

The archetype activist situation in merger arbitrage commences when shareholders have been offered an inadequate takeover premium, and an activist subsequently leverages their voting power. By opposing the deal and publicly advocating for other shareholders to do the same, activists can force control buyers to offer a fair price that properly compensates for their information advantage. This is merger arbitrage activism.

Figure 3: The control premium exists because 100% ownership offers unique benefits to the acquirer: the ability to value and capture inside information advantages gained through due diligence, access to cheaper and unmargined financing, full capture of synergies, and elimination of listing costs.

Since shareholders must vote on each deal despite their information disadvantage, the premium serves as compensation for their handicap in information resolution.[16]



The 2017 takeover of Hitachi Kokusai by KKR provides an archetype case study of these dynamics. KKR's initial offer of JPY2,503 per share came after due diligence, giving them superior information access compared to public shareholders[17]. Notably, this offer was below Hitachi Kokusai's recently preceding trading price of JPY2,600, and as such offering no premium to compensate for KKR's access to cheaper and unmargined financing, full capture of synergies, elimination of listing costs, and the ability to buy the company with an information advantage – gained through KKR's due diligence – relative to public shareholders.

In response, acting as a merger arbitrage activist Elliott Management acquired an 8.6% stake (representing 17.8% of the free float) and publicly campaigned for a higher offer price[18]. Their activism pressured KKR to raise the takeover price to JPY3,132 per share—a 20% increase—at which point Elliott tendered their shares[19].

While Elliott's activism appeared successful initially, KKR's subsequent 15x return on their investment (revealed by the Wall Street Journal in 2024[20]) suggests that even the increased offer price significantly undervalued Hitachi Kokusai. This exceptional return demonstrates the full extent of the advantage that KKR realised from both their superior information access, ability to implement unmargined leverage financing, and other advantages, for a takeover which the Hitachi Kokusai shareholders in perfect hindsight potentially still unreasonably sanctioned by allowing the takeover to succeed at what was just a 20% premium.

Figure 4: KKR's initial offer for Hitachi Kokusai proposed no premium to shareholders despite KKR possessing due diligence information and financing advantages, and was subject to successful shareholder activism by Elliott Management whose actions resulted in KKR raising their takeover price by 20% in order to complete the acquisition[21]

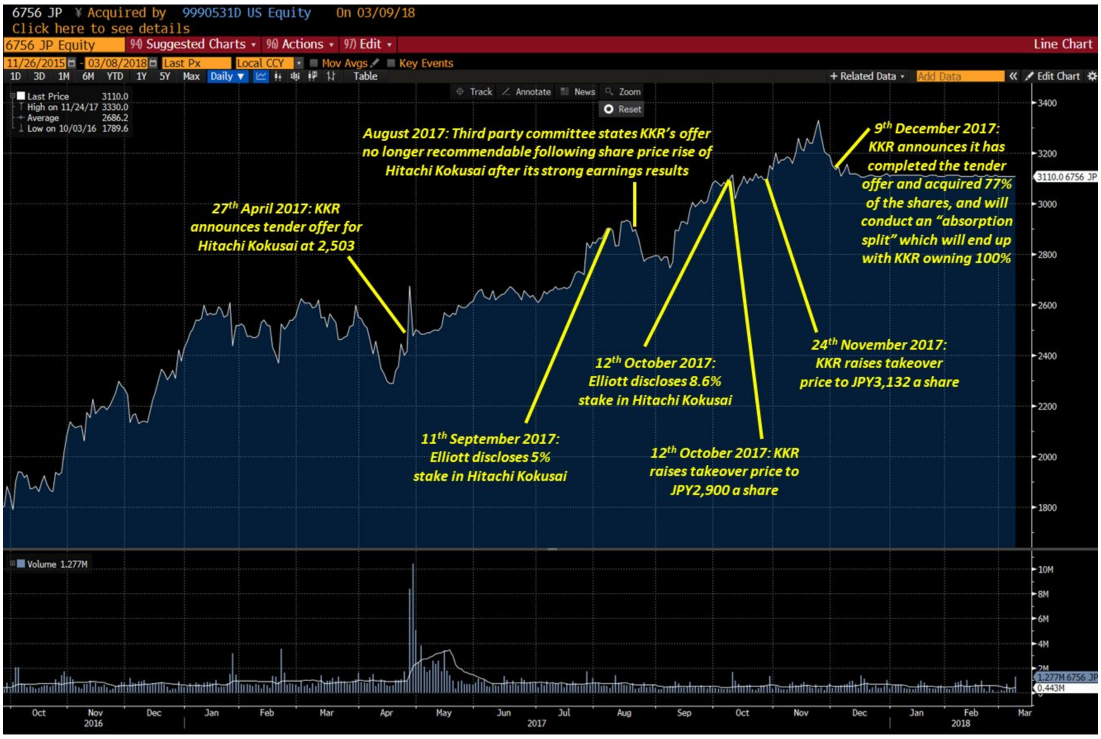


Figure 5: In 2024 it was disclosed KKR realised a 15x return on its investment in Hitachi Kokusai: Elliott arguably did not ask for a high enough takeover consideration before agreeing to tender[22]

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MARKETS & FINANCE

KKR Looks to Japan to Boost Its Growth

Nation is firm's key market in a region it sees as vital to its goal to double assets

By Luis Garcia

Around 40 years ago, **KKR** pioneered the buyout movement by carving out subsidiaries of U.S. conglomerates. Now the asset manager is finding similar opportunities in Japan.

The New York-based asset manager said it sees the Asia-Pacific region as vital to its goal of doubling its assets under management from $553 billion at the end of December to more than $1 trillion in the next five years. The firm has chosen Japan as its main market in the region, partly because of the many opportunities it sees to buy businesses at bargain prices, KKR executives said last Wednesday during the firm's annual meeting with investors in New York.

The country accounted for 39% of the $47 billion the firm has invested across the Asia-Pacific region since 2005, followed by India and Australia with 17% each, the firm said.

"We generated more [private-equity returns] in this market than in many other places for a lot of reasons that probably aren't obvious," Joseph Bae, KKR's co-chief executive, said of Japan. "It's low valuations, big conglomerate structures with a lot of noncore businesses, massive room for operational improvement in these companies when we bought them, and a very low cost of capital."

A particularly profitable KKR deal in Japan was semiconductor-equipment maker **Kokusai Electric**, a former unit of Japanese conglomerate **Hitachi**. KKR took the business private in 2018 before relisting it in October through an initial public offering on the Tokyo stock exchange. KKR had earned 15 times its investment in the company as of early November, when Kokusai's stock was up about 35% from its IPO price and the firm still owned 40% of the businesses, KKR said at the time. Kokusai's stock has risen further since then.

39%
Portion of KKR's Asia-Pacific investment since 2005 that Japan comprises

KKR has at least 10 other Japanese businesses in its portfolio, including drugmaker **Bushu Pharmaceuticals**, supermarket chain Seiyu and tool manufacturer Koki Holdings, also a former Hitachi unit. Last year, KKR took private yet another Hitachi subsidiary, logistics company Hitachi Transport System, which the firm rebranded as Logisteed.

A change in the "mindset" of Japan's conglomerates is driving them to shed assets as they seek to streamline their operations, creating buyout opportunities for KKR, said Gaurav Trehan, a partner who co-leads the firm's Asia-Pacific operations.

"If you look at the Tokyo Stock Exchange, it has nearly 4,000 companies, 40% of [which] are trading below book value," Trehan said. "Some of these are very high-quality companies with global customers, but just haven't been managed as well."

KKR also benefits from a lack of competition for deals in Japan, co-CEO Bae said. He noted that alternative assets represent only 9% of the entire economy in Asia, compared with 26% in North America and 16% in Europe. "That 9% private-equity penetration in Asia is even lower in the Japanese market today," he said.

KKR is betting Japan also can boost other parts of its business, including insurance as well as infrastructure and real-estate investments. The firm roughly two years ago acquired KJR Management, a Japanese real-estate management company, from Mitsubishi and the asset-management unit of Swiss bank **UBS Group**. The deal increased KKR's real-estate assets under management by $54 billion, the firm said at the time.

Japan's roughly $3 trillion insurance market is the world's second largest, behind only that of the U.S., which is valued at about $4 trillion, according to Allan Levine, CEO of Global Atlantic, KKR's insurance business. The two markets share several trends, including "growing demand for retirement products, an aging population [and] interest rates that have been low for a sustained period of time that are finally rising," he said.

But the Japanese insurance market is much less developed. For example, while sales of annuities in the U.S. total about $300 billion a year, in Japan they amount to as much as $100 billion, Levine said.

2.4 Public statements as an impactful alternative to scaled positioning for activism in merger arbitrage

An additional advantage in favour of activism in merger arbitrage is that it can be executed with relatively modest capital in selected instances, making it also suitable for emerging fund managers.

This complements the additional advantages that fund managers overseeing a lower volume of assets can capture in merger arbitrage, including their ability to pursue opportunities in lower-capitalisation companies whilst also avoiding the traditional deficits of lower capitalisation investing outside of merger arbitrage (for example the lower ability of smaller capitalisation stocks to attract high quality management and their lack of forcing function to intrinsic value outside of takeover situations).

The power wielded by activists through use of well-planned public statements, or even the mere threat of them, can be substantial when the activist achieves credibility with other shareholders and even when the activist is absent significant capital backing in terms of their own funds.

Public statements by any activist can influence outcomes in takeovers particularly when they expose corporate governance issues, threatening reputational damage to both management and acquirers that outweighs the cost of the offer price being increased.

> *"Carl Icahn had 17 or 18 practice runs before he started on us..*
>
> *And so it was a very unsettling thing, it is a very time consuming thing, a very emotional thing, without a doubt, and at the same time you are trying to run a company –*
>
> *And so it is a difficult thing to go through."*

Ed Meyer, former president of Transworld Airlines, speaking in 1985[23]

As the former president of Transworld Airlines Ed Meyer observed following Carl Icahn's 1985 campaign, facing the activist was "*a very time consuming thing, a very emotional thing... a difficult thing to go through*."

The challenge for incumbent management or the acquirer of a company in facing activist-led campaigns motivates management or the acquirer to acquiesce to activist demands, and in cases even when the activist lacks a dominant stake, rather than risk a public confrontation in which light may be further shined on any corporate principal-agent problems inherent in the takeover's design.

A case study of the power of public statements, or the threat of public statements, in effecting change in takeovers

In 2021, this fund held a position in nickel miner Noront Resources, which had been subject to a series of competing, yet low valuation, takeover offers. Each low valuation offer had been recommended by the board of directors[24] indicating in our assessment the existence of the corporate principal-agent problem.

A further disenfranchisement of shareholders was then proposed – rather than the competitive bidding auction continuing, the two bidders formed a 50:50 joint venture which aimed to impose a price ceiling in the auction[25] for Noront Resources, a company in which this fund held just a 2.0% stake.

Our letter on November 19, 2021 to bidder Wyloo Metals, disclosed in Figure 7, argued against the joint venture, and also revealed our willingness to make public activist statements with the aim of drawing the interest of additional bidders to the undervaluation of Noront Resources.

The letter also contended that the fair value of Noront Resources was at least C$1.10 per share, a value 47% higher than the joint venture's proposed deal value at C$0.75 per share and the share price of Noront at the time[26]. On 22nd December Wyloo Metals increased their takeover offer for Noront Resources to match our fair value at C$1.10 per share[27], whilst the second bidder BHP Billiton withdrew from both the joint venture and the bidding process. Both outcomes were advocated for by our letter.

Figure 6: In 2021, this fund successfully advocated for a 47% increase in the takeover consideration for Noront Resources, from C$0.75 per share to C$1.10 per share[28]

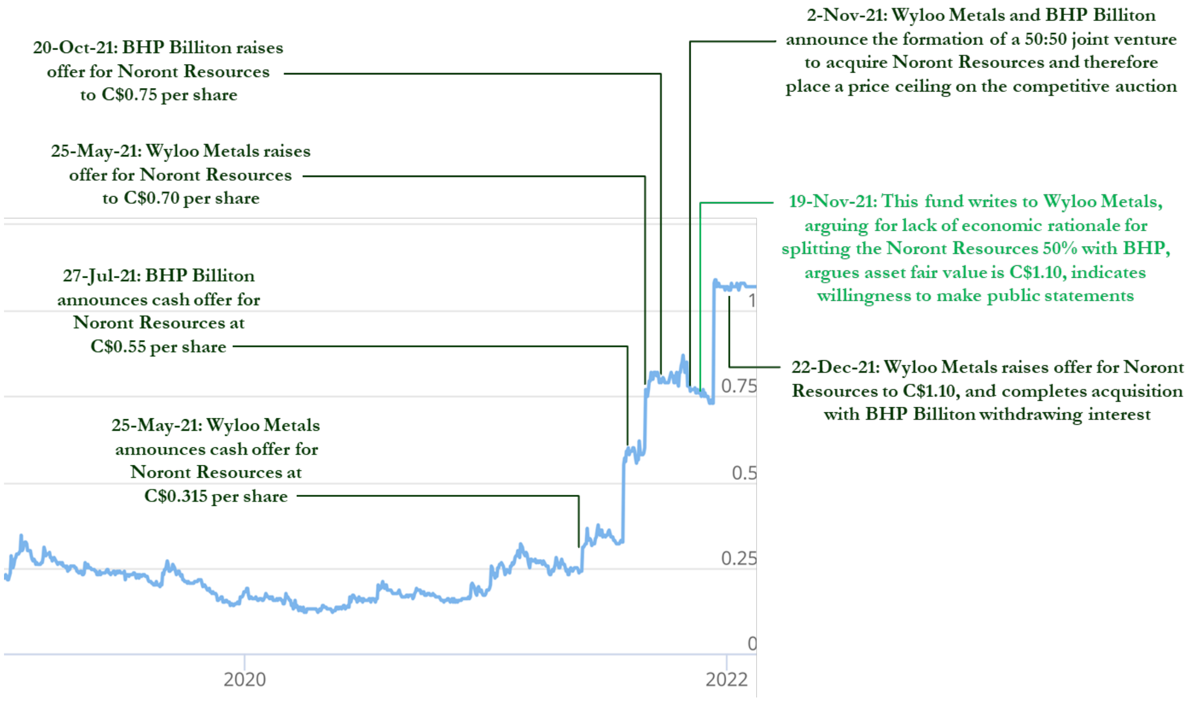
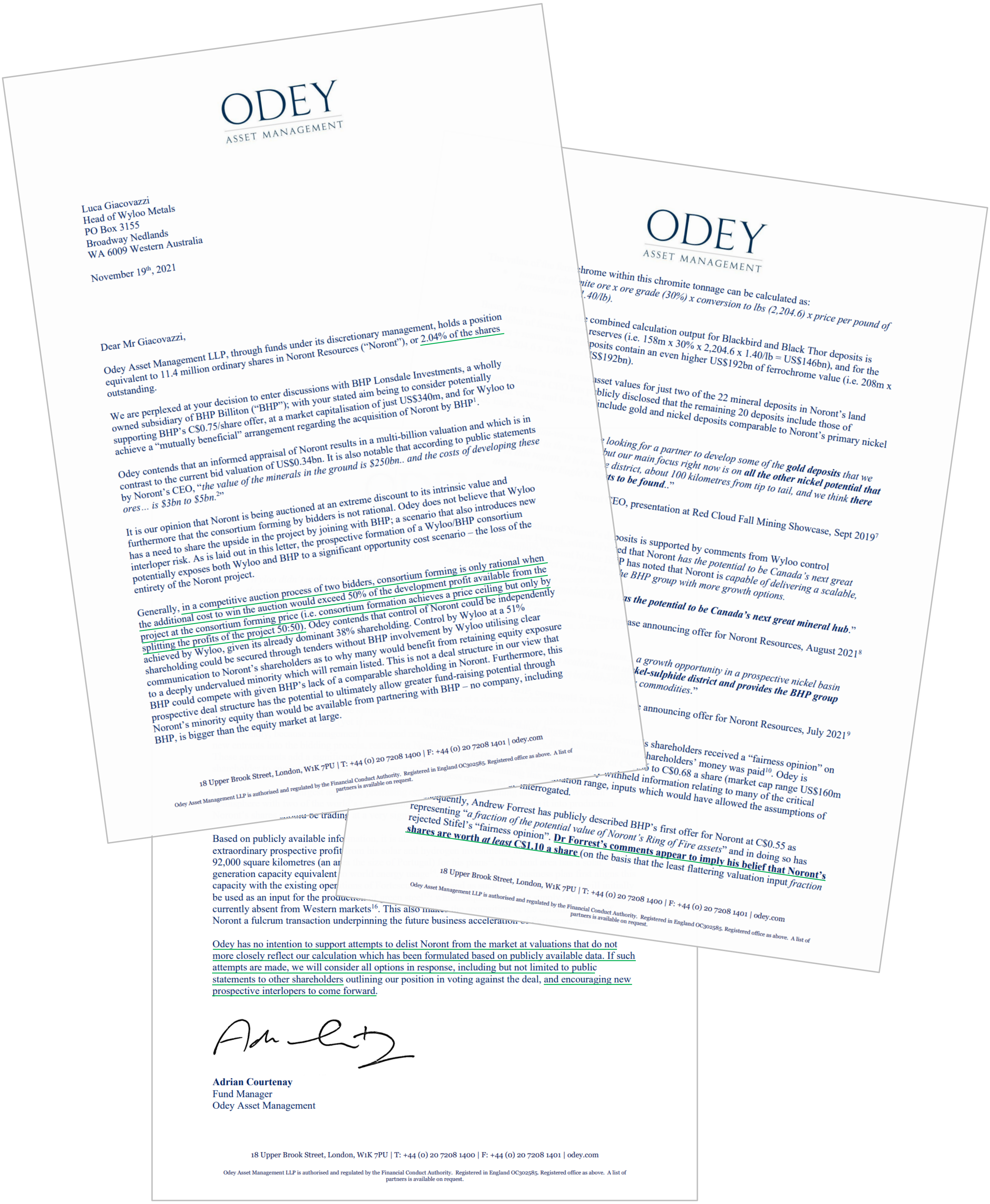


Figure 7: The proposed 50:50 joint venture between competing bidders Wyloo Metals and BHP Billiton in our appraisal lacked economic rational in favour of Wyloo; this fund indicated our willingness to make public our argument and successfully advocated for a 47% increase in offer price to C$1.10[29]



ODEY
ASSET MANAGEMENT

Luca Giacovazzi
Head of Wyloo Metals
PO Box 3155
Broadway Nedlands
WA 6009 Western Australia

November 19th, 2021

Dear Mr Giacovazzi,

Odey Asset Management LLP, through funds under its discretionary management, holds a position equivalent to 11.4 million ordinary shares in Noront Resources ("Noront"), or 2.04% of the shares outstanding.

We are perplexed at your decision to enter discussions with BHP Lonsdale Investments, a wholly owned subsidiary of BHP Billiton ("BHP"); with your stated aim being to consider potentially supporting BHP's C$0.75/share offer, at a market capitalisation of just US$340m, and for Wyloo to achieve a "mutually beneficial" arrangement regarding the acquisition of Noront by BHP[1].

Odey contends that an informed appraisal of Noront results in a multi-billion valuation and which is in contrast to the current bid valuation of US$0.34bn. It is also notable that according to public statements by Noront's CEO, *"the value of the minerals in the ground is $250bn.. and the costs of developing these ores… is $3bn to $5bn."*[2]

It is our opinion that Noront is being auctioned at an extreme discount to its intrinsic value and furthermore that the consortium forming by bidders is not rational. Odey does not believe that Wyloo has a need to share the upside in the project by joining with BHP; a scenario that also introduces new interloper risk. As is laid out in this letter, the prospective formation of a Wyloo/BHP consortium potentially exposes both Wyloo and BHP to a significant opportunity cost scenario – the loss of the entirety of the Noront project.

Generally, in a competitive auction process of two bidders, consortium forming is only rational when the additional cost to win the auction would exceed 50% of the development profit available from the project at the consortium forming price (i.e. consortium formation achieves a price ceiling but only by splitting the profits of the project 50:50). Odey contends that control of Noront could be independently achieved by Wyloo, given its already dominant 38% shareholding. Control by Wyloo at a 51% shareholding could be secured through tenders without BHP involvement by Wyloo utilising clear communication to Noront's shareholders as to why many would benefit from retaining equity exposure to a deeply undervalued minority which will remain listed. This is not a deal structure in our view that BHP could compete with given BHP's lack of a comparable shareholding in Noront. Furthermore, this prospective deal structure has the potential to ultimately allow greater fund-raising potential through Noront's minority equity than would be available from partnering with BHP – no company, including BHP, is bigger than the equity market at large.

18 Upper Brook Street, London, W1K 7PU | T: +44 (0) 20 7208 1400 | F: +44 (0) 20 7208 1401 | odey.com

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ODEY
ASSET MANAGEMENT

…hrome within this chromite tonnage can be calculated as:
…nite ore x ore grade (30%) x conversion to lbs (2,204.6) x price per pound of …1.40/lb).

…combined calculation output for Blackbird and Black Thor deposits is …reserves (i.e. 158m x 30% x 2,204.6 x 1.40/lb = US$146bn), and for the …posits contain an even higher US$192bn of ferrochrome value (i.e. 208m x …S$192bn).

…asset values for just two of the 22 mineral deposits in Noront's land …blicly disclosed that the remaining 20 deposits include those of …include gold and nickel deposits comparable to Noront's primary nickel

*…looking for a partner to develop some of the **gold deposits** that we …but our main focus right now is on **all the other nickel potential that** …e district, about 100 kilometres from tip to tail, and we think **there** …**ts to be found**.."*

…EO, presentation at Red Cloud Fall Mining Showcase, Sept 2019[7]

…posits is supported by comments from Wyloo control …ed that Noront *has the potential to be Canada's next great* …P has noted that Noront is *capable of delivering a scalable,* …*he BHP group with more growth options.*

…s the potential to be Canada's next great mineral hub."

…ase announcing offer for Noront Resources, August 2021[8]

*…a growth opportunity in a prospective nickel basin …**kel-sulphide district and provides the BHP group** …commodities."*

…announcing offer for Noront Resources, July 2021[9]

…s shareholders received a "fairness opinion" on …hareholders' money was paid[10]. Odey is …to C$0.68 a share (market cap range US$160m …withheld information relating to many of the critical …ation range, inputs which would have allowed the assumptions of …interrogated.

…equently, Andrew Forrest has publicly described BHP's first offer for Noront at C$0.55 as representing *"a fraction of the potential value of Noront's Ring of Fire assets"* and in doing so has rejected Stifel's "fairness opinion". **Dr Forrest's comments appear to imply his belief that Noront's shares are worth at least C$1.10 a share** (on the basis that the least flattering valuation input *fraction*

18 Upper Brook Street, London, W1K 7PU | T: +44 (0) 20 7208 1400 | F: +44 (0) 20 7208 1401 | odey.com

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…be tradin…

Based on publicly available info… extraordinary prospective profit… 92,000 square kilometres (an ar… generation capacity equivalent… capacity with the existing oper… be used as an input for the produc… currently absent from Western markets[16]. This also ma… Noront a fulcrum transaction underpinning the future business acceleration o…

Odey has no intention to support attempts to delist Noront from the market at valuations that do not more closely reflect our calculation which has been formulated based on publicly available data. If such attempts are made, we will consider all options in response, including but not limited to public statements to other shareholders outlining our position in voting against the deal, and encouraging new prospective interlopers to come forward.

Adrian Courtenay
Fund Manager
Odey Asset Management

18 Upper Brook Street, London, W1K 7PU | T: +44 (0) 20 7208 1400 | F: +44 (0) 20 7208 1401 | odey.com

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2.5 When the activist has acquired sufficient voting power to directly influence deal outcomes, activism in merger arbitrage can offer superior certainty than other merger arbitrage opportunities

Whilst merger arbitrageurs can achieve attractive underlying returns through comprehensive opportunity discovery and leverage deployment, and through efficient capture of special situations such as competitive bidding opportunities, a proportion of the highest-yielding opportunities will still involve antitrust risk.

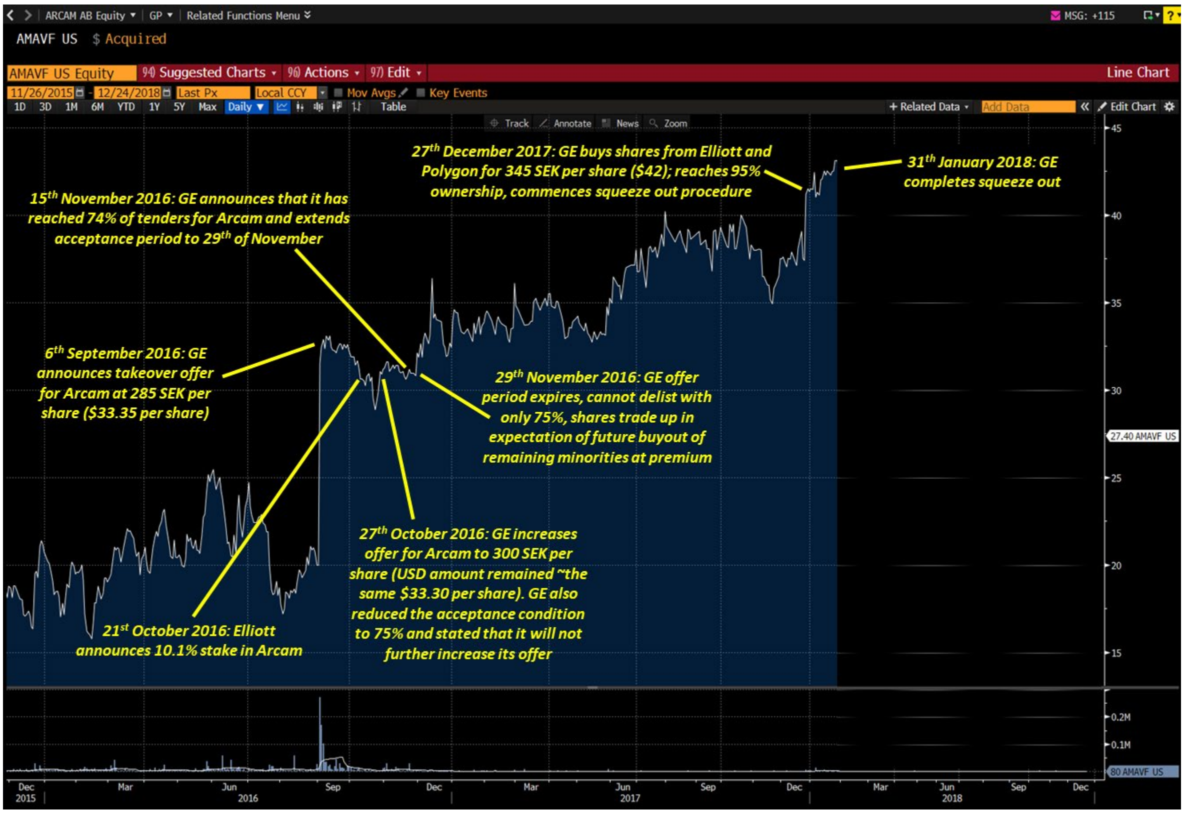
For optimal antitrust assessment, our contention is that legal theory expertise must be combined with insights into the variance in human decision-making outcomes at regulators. We advocate for merger arbitrageurs to build proprietary antitrust history systems, which analyse decades of antitrust and enforcement histories with sector-specific context, to help assess new deal clearance risk more accurately by considering both legal framework and the variance in human decision making at regulators through history in each specific sector market definition[30].

However, whilst building legal theory expertise and antitrust history systems to this level adds value, focusing on activist strategies can often still produce superior results than trying to predict the most uncertain of complex antitrust outcomes.

In merger arbitrage activism, the activist gains maximum negotiation leverage when they acquire enough voting power to directly influence deal outcomes without reliance on other shareholders. If the activist has acquired sufficient voting power to influence deal outcomes in this manner, the power imbalance shifts. The activist can withhold their shares until price expectations are met. This approach can then deliver high certainty in outcomes.

A case study of the sizing of the activist's shareholding alone being sufficient to dictate outcomes

Figure 8: Following GE's offer for Arcam which required 90% acceptance, Elliot established a 10.1% position and successfully advocated for a raised offer in order for the takeover to succeed[34]



GE launched its takeover bid for Arcam in 2015 at SEK285 per share, which the Arcam board recommended[31]. However, GE needed to acquire 90% of Arcam's shares to delist the company[32]. Elliott Management saw an opportunity and acquired a 10.1% stake, positioning itself to veto the delisting unless GE increased its offer[33].

The delisting was important for GE to realise several benefits: accessing cheaper financing options, fully implementing inter-company synergies, eliminating listing costs, and exercising complete control combined with their information asymmetry advantage. These benefits could only be fully achieved with 100% ownership. GE was also a significantly larger company than Arcam, and as such a raised price by GE for Arcam stood to have little detrimental impact on the overall earnings of GE[35].

Elliott's position was also strategically sound, offering minimal downside risk. They could either sell their shares later at the initial takeover price or force GE to raise its bid to achieve the 90% threshold needed for delisting. This created an asymmetric opportunity for Elliott with limited risk and attractive upside potential.

Elliott's strategy proved successful: three months after the initial offer, GE increased its bid by 21% to secure Elliott's shares and complete the delisting[36].

3. Additional case studies of the activist opportunity type in merger arbitrage

3.1 When the merger arbitrageur targets activism through public statements

A case study of the takeover of Altran in 2020

The 2019 takeover of Altran Technologies by Capgemini provides a further example demonstrating how public statements can be used as part of merger arbitrage activism, even when the activist shareholder lacks a stake sufficient to dictate outcomes in its own right.

Capgemini initially secured board approval for a €14.00 per share takeover offer and simultaneously purchased an 11.4% stake from Apax Partners at the same price[37]. To complete the deal, Capgemini needed to acquire 50% in total of Altran's outstanding shares, meaning they needed to secure a further 43% of the remaining free float.

Elliott Management then entered the picture, purchasing a 15% stake and opposing the deal terms[39]. This strategic move increased Capgemini's tender ratio requirement to 52% of the remaining shares, complicating the takeover process.

However, the upping of the required ratio to 52% did not hand to Elliott the outright ability to dictate the outcome of the takeover. Elliott's subsequent strategy hinged on, by necessity, rallying other shareholders through a public campaign to demand better deal terms. The campaign included multiple public statements and a dedicated website (fairvalueforaltran.com), featuring detailed presentations arguing for a higher valuation[40].

Elliott's campaign also pointed to the corporate principal-agent problem – Elliott's statements put forward that Altran exhibited corporate governance deficits, including that Apax Partners had tied the CEO's compensation to a specific sale price[41].

Figure 9: Although Elliott lacked a blocking stake in Altran, their public advocacy campaign successfully pressured Capgemini to raise its initial €14.00 per share takeover offer[38]

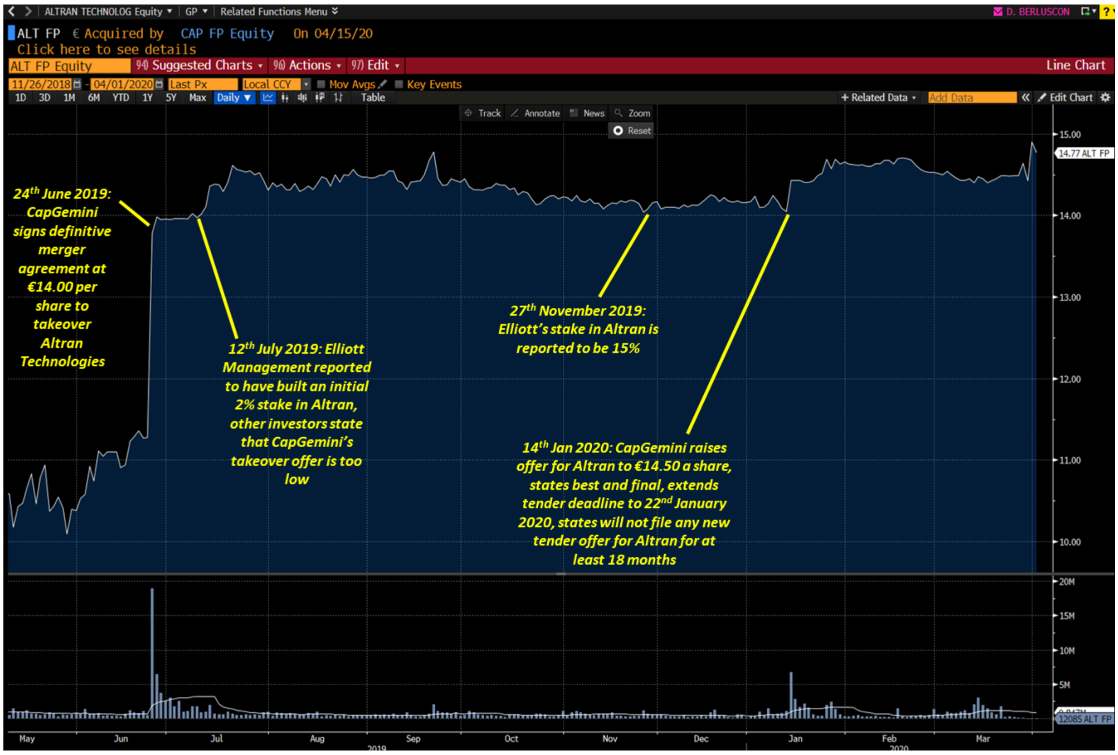


Figure 10: Unable to force a higher bid through its ownership stake alone, Elliott launched a public campaign in 2020 to pressure Capgemini to increase its Altran offer[42]

Elliott Publishes Letter on Capgemini's Offer for Altran

Elliott believes Offer price is now even less adequate, and shares its rationale for its current intention to not tender

Full materials available at www.FairValueforAltran.com

January 08, 2020 02:30 AM Eastern Standard Time

PARIS & LONDON--(BUSINESS WIRE)--Funds advised by Elliott Advisors (UK) Limited (together "Elliott"), that collectively hold an economic interest in Altran Technologies SA ("Altran" or the "Company") representing nearly 14% of the share capital, today published a letter outlining their concerns with Capgemini SE's ("Capgemini") offer for Altran ("the Offer").

Elliott believes that recent developments have underscored its current intention to not tender into an Offer that fails to recognise Altran's true value.[1] Elliott's open letter to shareholders includes the following key points:

- **Capgemini's Offer Is Inadequate.** The current Offer is the result of a suboptimal process driven by a series of corporate governance shortcomings. We consider that the Offer price of €14.00 per share does not reflect Altran's true value and implies that shareholders are expected to forgo nearly all the upside potential of this combination.
- **Offer is Now Worse: The Implied Premium Is Shrinking.** The equity market has gone up in value since the Offer was announced in June, yet the Offer price has remained unchanged. Based on analysts' consensus break price, ***the premium offered to shareholders today is only 7%***, which is significantly below the 38% offered in comparable precedent transactions.[2] Furthermore, key shareholders and market participants have expressed increasingly negative sentiment towards the Offer price.[3]
- **More Pathways to Realise Value; Fewer Reasons to Tender Now.** In Elliott's view, there is no compelling case for tendering now given (1) the potential mid-term upside in shares of an independent Altran if the Offer fails compared to the currently inadequate Offer price,[4] and (2) if the Offer succeeds, the incremental potential upside that could accrue to minority shareholders alongside Capgemini resulting from the synergy potential of the combination. Furthermore, should the Offer succeed, Capgemini's commitments to reopen or refile the Offer after the Paris Court of Appeals decision in March in principle create the potential for additional optionality for remaining Altran shareholders.

Elliott continues to urge Capgemini to properly recognise the true value of this transformative combination. Elliott is convinced that a fair price would result in a win-win scenario for both Altran and Capgemini shareholders, and prevent further uncertainty and integration delay. In the meantime, Elliott believes all Altran shareholders should be well-informed of the options available to them, particularly in light of Capgemini's binding commitments should the Offer succeed.

Elliott's letter, along with additional analysis and perspectives, are available to view and download at www.FairValueforAltran.com. Interested parties are encouraged to visit the website to receive additional information and sign up for future updates.

Elliott's seven-month campaign ultimately yielded only modest results, securing a 3.6% price increase from Capgemini, which Elliott accepted[43].

The campaign's limited success may be attributed to two factors: the initial acceptance of the takeover price by Apax Partners (despite their reputation for maximising value) was a form of signal that the original consideration was at least reasonably fair, and Capgemini's need for only 52% of the remaining shares also existed as a factor lowering Elliott's power as activist.

3.2 When the merger arbitrageur engages in activism through corporate governance advocacy

3.2 a) Modern corporate governance adheres to a fundamental principle: all shareholders should be treated equally

Modern corporate governance adheres to a fundamental principle: all shareholders should be treated equally, with no preferential treatment for the select few. An example is the prohibition of greenmail – a portmanteau of 'blackmail' and 'greenback' – where company management pays a premium to buy back shares from an activist investor. Warren Buffett decried this practice as 'odious and repugnant' in his 1984 Chairman's Letter.

Buffett decried the practice of greenmail in his 1984 letter..

In these transactions, two parties achieve their personal ends by exploitation of an innocent and unconsulted third party.

The players are: (1) the "shareholder" extortionist who, even before the ink on his stock certificate dries, delivers his "your-money-or-your-life" messages to corporate management; 2) corporate management who quickly seek peace at any price – as long as the price is paid by someone else; and 3) the third party shareholders whose money is used by 2) to make 1) go away.

As the dust settles, the mugging, transient shareholder gives his speech on "free enterprise", the muggee management gives its speech on "the bests interests of the company", and the innocent shareholders standing by mutely fund the payoff.

Warren Buffett, Berkshire Hathaway letter 1984[45]

..a period during which it was common

"And so the investment banker said, 'Come on outside Carl. And so I come outside with him, he said – look the board don't like you at all. If you start buying more stock – we are going to dilute the hell out of you.'

'Now, on the other side of the coin, you haven't had the stock too long we'll give you a $10m profit to walk away.'

So he looks at me and says – you want some time to think about it? I said 'no, I'll take the $10 million!' "

Carl Icahn, speaking in 1985[44]

In the 1980s, prominent investors including Carl Icahn, T. Boone Pickens, and James Goldsmith successfully employed greenmail strategies, forcing companies such as Texaco, Quaker State Oil, and St. Regis to repurchase shares at premium prices[46].

However, the frequency of greenmail declined sharply after the 1990s due to the IRS's 1987 implementation of a 50% excise tax on greenmail[47], widespread adoption of poison pill defences, and state-level prohibitions[48].

3.2 b) In instances, modern takeovers however continue to target the unequal treatment of shareholders, and this presents the opportunity for successful activist engagement

Today's more modern corporate governance standards are written with the aim of preventing unequal treatment of shareholders, dictating that boards of public companies should seek to serve all shareholders equally.

When these standards are breached this offers activist investors leverage in takeover situations: if the activist can demonstrate that certain shareholders are receiving preferential compensation, they gain a concrete and often legally backed argument for deal restructuring beyond merely citing subjective valuations. And as per our examples prior, this strategy enables effective activism even when the activist possesses relatively modest capital resources.

While overtly discriminatory takeover structures remain rare, what is observed in selected instances in the modern era is a deal design which, through more subtle means, still aims for unequal shareholder treatment.

A case study of the takeover of Western Areas in 2022

A recent example of this fund identifying a deal structure which in our view targeted the unequal treatment of shareholders was the takeover of Australian nickel miner Western Areas in 2022[49]. Following our activism, a successful upward revision in deal terms was announced by the bidder. Our activism combined expertise in the Australia Corporations Act and a public statement, disclosed in Figure 12, to successfully advocate for a raised deal price. The outcome was achieved despite our shareholding of just 1% in the target company[50].

Our advocacy pointed to the fact that the deal structure offered the largest shareholder of the company an inducement: preferential access to a joint venture with the bidder and whose value implied a 67% increase in takeover consideration was being offered to that one shareholder[51]. As such, we argued, the deal structure breached the Australia Corporations Act and our public statement encouraged other shareholders to make their views clear to the board of the company. Following our statement, the bidder for Western Areas raised the deal value by 15%[52].

Figure 11: Despite just 1% ownership, our activist engagement in the Western Areas takeover in 2022 successfully resulted in a raised takeover offer[53]

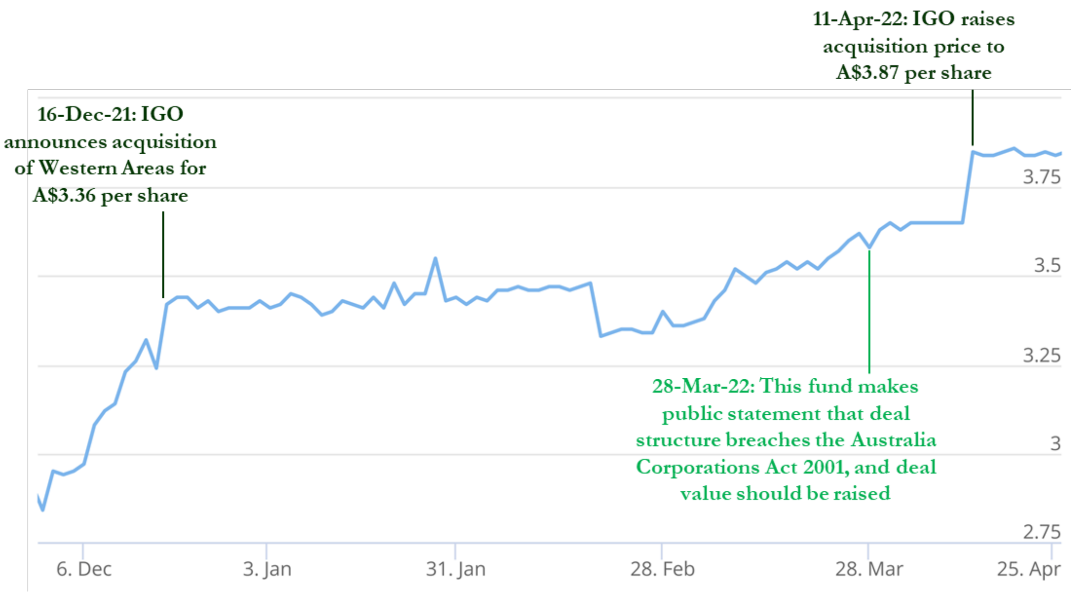


Figure 12: The Western Areas deal structure, our public statement contended, included an inducement offered to a 9.8% shareholder, a breach of the Australia Corporations Act 2001. The result was a raised deal value in favour of the outcome we advocated for[54].

Odey Asset Management calls on IGO Ltd to either raise the Western Areas takeover deal value to match the uplift offered, through a Joint Venture participation, to 9.8% shareholder Wyloo Metals, or to disband the Joint Venture which appears to Odey to be in breach of The Australia Corporations Act 2001

March 28, 2022 06:30 ET| Source: Odey Asset Management Follow

IGO's recently proposed Joint Venture with Western Areas 9.8% shareholder Wyloo appears to Odey to breach Section 623 of The Australia Corporations Act 2001 which prohibits a bidder, during a takeover period, from offering a benefit to a shareholder if the benefit is likely to induce the shareholder to accept an offer and the benefit is not offered to all shareholders.

To cure the breach of Section 623, Odey believes that all Western Areas shareholders should be offered compensation equalling that offered by IGO's proposed Joint Venture with Western Areas 9.8% shareholder Wyloo, which, based on assumptions previously disclosed by IGO, appears to be at least a 67% increase in deal value consideration, or the Joint Venture should be disbanded.

The Western Areas auction process should be conducted in a manner which is full and fair. IGO's offer, at just 1.6% of the gross value of the resources of Western Areas as at March 25, 2022[12], remains in Odey's view at a significant discount to reasoned appraisals of value of what is a best-in-class, highly strategic, and vast, development stage pure play nickel asset.

LONDON, March 28, 2022 (GLOBE NEWSWIRE) --

On December 16, 2021, IGO Ltd (IGO.AX) ("**IGO**") announced a takeover offer, structured by scheme of arrangement, for Western Areas (WSA.AX), an upstream development stage nickel miner[1]. The shareholders of Western Areas include Wyloo Metals ("**Wyloo**") which owns a 9.8% stake[2] and Odey Asset Management LLP ("**Odey**"), which owns a 1.0% stake[3]. Subsequently, on February 17, 2022, IGO published a press release stating that, subject to a feasibility study, a 70:30 joint venture would be formed respectively with Wyloo to construct and operate a downstream nickel processing facility (the "**Joint Venture**").[4]

Section 623 of The Australia Corporations Act 2001 (the "**2001 Act**") prohibits a bidder, during a takeover period, from offering a benefit to a shareholder if the benefit is likely to induce the shareholder to accept an offer and the benefit is not offered to all shareholders[5]. In this case, the 30% participation in the Joint Venture that has been offered exclusively to Wyloo appears to be implied at a value of, at least, A$71 million[6], or a 67% increase in offer consideration relative to Wyloo's A$106 million stake in Western Areas. This offer to Wyloo is therefore clearly, *a benefit*.

Odey notes that the economic feasibility and value of a *downstream* nickel processing asset is conditional on the co-incident volume of *upstream* nickel resources possessed. The value of Wyloo's 30% participation in the Joint Venture, an IGO-controlled *downstream* nickel processing asset, is therefore conditional on the success of the IGO takeover of Western Areas, a vast *upstream* nickel asset (Western Areas will increase the volume of IGO's nickel resources by 455%[7]).

As such, Odey believes that the benefit being offered to Wyloo has properties *likely to induce* Wyloo, by financial incentive, *to accept the offer* for Western Areas. This has also been demonstrated by Wyloo's actions: co-incident with the IGO and Wyloo statement announcing the Joint Venture, Wyloo committed to vote its shares in Western Areas in favour of the IGO proposal[8], one third of which had been purchased at a premium to the deal value[9].

To cure the breaches detailed, and in line with IGO's legal requirement under the 2001 Act, Odey believes that all shareholders of Western Areas should be offered a pro-rated share of the business entity encompassing the feasibility study, followed by the 30% Joint Venture participation, that has been offered to Wyloo. Alternatively, an independent expert can be appointed to determine the value of this business opportunity that has been offered to Wyloo. The value offered to all shareholders for IGO's proposed takeover of Western Areas must then be raised by this same percentage in cash.

A third alternative would be that, in light of the fact that the current deal structure appears in breach of the 2001 Act, IGO and Wyloo disband the announced Joint Venture entirely.

The Western Areas auction process should be conducted in a manner which is full and fair, and indeed, the provisions of the 2001 Act, which appear to have been breached, are designed to protect minority shareholders against discriminatory outcomes. Odey also encourages other Western Areas shareholders to make their views clear to both Western Areas, and to IGO, regarding the information in this press release.

It is furthermore notable that IGO's acquisition proposal, at just 1.6% of the gross value of the nickel resources of Western Areas as at March 25, 2022[10], also appears to be at a significant discount to reasoned appraisals of value of what is a best-in-class, highly strategic, and vast[11], development stage pure play nickel asset. Upon IGO and Wyloo disbanding the Joint Venture, not only will IGO's current acquisition proposal still remain, but further, in Odey's view, there is a good probability that a competitive auction process can then be incrementally achieved for Western Areas.

A competitive auction process for Western Areas under the provisions of the 2001 Act would demand that any protagonism from Wyloo was exclusively in the role of a competing bidder (a role that Wyloo has acted in for other, similarly sized, development stage nickel assets)[12]. Odey believes such an auction process also has a strong probability of attracting new interest from other scaled mining companies[13] and from forward thinking battery manufacturers and automakers looking to advantageously secure their future commodity needs. This contention is made particularly in the context of recent nickel price developments which have starkly demonstrated the price impact of changes in nickel demand.

Alternatively, the minority shareholders of Western Areas, subsequent to the disbanding of the Joint Venture and then including Wyloo acting also as an independent minority, can engage with IGO to ensure any takeover proposal from IGO only succeeds at a price much closer to fair value.

Adrian Courtenay
Fund Manager
Odey Asset Management

3.2 c) A roll-in equity benefit offered to one shareholder results in unequal treatment of remaining shareholders, and therefore also presents the opportunity for activist engagement

Preferential treatment also occurs when a selected shareholder is offered the option to roll-in their security ownership into the acquiring private equity vehicle, allowing this roll-in shareholder to benefit from advantages unavailable to others. These benefits include access to cheaper and unmargined financing, full capture of synergies, elimination of listing costs, and the fact that the election for roll-in equity has only occurred after an information resolution advantage over other shareholders has been gained following the bidders due diligence process.

Our earlier case study of Hitachi Kokusai showed a partial reveal of the potential value of such roll-in equity: while Elliott secured a 20% cash price increase for public shareholders, bidder KKR still achieved a 15-fold return on their investment for which, had a roll-in equity option been offered, its electors would also have participated in.

A case study of the Nielsen takeover in 2022 provides an additional quantification of the value of roll-in equity

A second quantification as to the value uplift from roll-in equity is presented by the 2022 takeover of Nielsen Holdings. Brookfield's consortium offered $25.40 per share[55], yet shareholder WindAcre opposed the terms and increased its stake from 10% to 27% to gain negotiation leverage[56]. Though Brookfield's offer was later raised to $28.00[57], WindAcre continued to oppose, demanding $40.00 per share plus options in the privatised company[58].

The dispute was ultimately resolved when WindAcre was offered the option to roll their equity into the acquiring consortium[59] — and their acceptance of this structure appears to imply their valuation of roll-in equity as at least equal to their prior $40.00 demand. This outcome illustrates how roll-in rights can represent substantial additional value, in this case implied at a 43% premium over the $28.00 cash consideration offered to other shareholders.

Figure 13: The takeover by a Brookfield consortium of Nielsen failed to achieve the support of core shareholder WindAcre unless a $40 per share consideration was offered, however, when WindAcre was offered roll-in equity, they agreed despite remaining shareholders only receiving a deal price at $28.00[60]

A case study of the inclusion of a roll-in equity option within the proposed takeover of Loungers Plc, 2024

In our view, shareholders who will receive roll-in equity in a takeover should lose their voting rights on the deal's approval, as their interests have become aligned to the bidder rather than with remaining shareholders.

However, some deals circumvent this by offering the roll-in as an *option to all shareholders*, while structuring it in a way that makes it *practically accessible* only to selected shareholders.

This is typically achieved by the bidder specifying the structure of the roll-in securities as is illiquid and non-transferable until the point at which the bidder thereon approves a sale of the company in the future. From a realistic perspective, such restrictions make these securities unsuitable for index funds, mutual funds, and individual investors[61].

In practice, only company founders, management, and their equity sponsors, in other words the "agent shareholders" can participate – exposing the principal-agent problem inherent in these deal designs.

By making the roll-in technically available to all shareholders yet practically feasible for only a few, this deal architecture enables agent-shareholders to retain their votes whilst effectively disenfranchising other shareholders.

At the time of writing, Fortress (private equity) has announced plans to acquire Loungers Plc at 310p per share, not meaningfully above the company's 2022 trading price of 300p and below most broker valuations[62].

Fortress has also secured binding commitments from 42% of shareholders, specifically from Lion Capital (private equity) and the company's founders, and these remain binding even if a competing bid emerges[64].

Whilst the takeover is structured as a scheme of arrangement requiring 75% approval, Fortress has reserved the right to switch to an offer[65] requiring only 50% acceptance, meaning they need just 8% additional support, or 13% of the remaining float, effectively neutralising opposition.

Figure 14: While shareholders protest Loungers Plc's takeover valuation, the 42% irrevocables and potential 50% acceptance threshold leaves dissidents with little leverage. The thoughtful merger arbitrage activist should shift focus from price to the board's governance obligations[63].

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FINANCIAL WEBSITE OF THE YEAR

Loungers shareholder 'furious' at £338m deal

By LAURA AVETISYAN
UPDATED: 11:20, 30 November 2024

More shareholders have come out to oppose the takeover of a cafe-bar chain by US private equity.

Fund manager Downing, which has a 1.5 per cent stake in Loungers, said it was 'absolutely furious' about the proposed deal. And Gresham House said it would use its near-4 per cent stake to 'vote against this transaction'.

The comments came after Slater Investments, which owns more than 10 per cent of Loungers, and Axa Investment Management, with over 4 per cent, said they were opposed to the takeover.

But Canaccord Genuity Asset Management, which holds a 1.7 per cent stake in Loungers, became the latest shareholder to back the deal.

That takes confirmed support for the takeover to 41.9 per cent. Loungers, which owns the Cosy Club and Brightside brands and has 280 sites, this week agreed to a £338million takeover by Majestic Wine owner Fortress Investment Group.

But Judith Mackenzie, a partner at Downing, said: 'We are furious about this.' She said the attempt to buy Loungers was 'opportunistic'.

The Loungers deal also includes an unlisted share alternative allowing shareholders the option to roll into the new Fortress vehicle. However, this option is in practice mostly limited to Lion Capital and the company founders, as other investors typically will not be able to hold the non-listed and non-transferable equity that the roll-in right allows[66]. As such, the structure from a practical perspective offers preferential treatment to selected "agent shareholders" in exchange for their vote.

Slater Investment Management, the largest independent shareholder of Loungers, has publicly opposed the deal on the basis of low valuation. However, we argue that it is only by focusing on the principal-agent problem, and its corporate governance implication, within such a deal structure that other shareholders will be most effectively convinced in aggregate to push back on the terms of deals such as this.

In this case, the achievement of 42% irrevocables within the deal structure simplistically signals Lion Capital and the company's management as accepting the pricing of the takeover. If the simple signal is the that the price is fair, why should other shareholders object? It is only when remaining shareholder attention is instead re-focused on the roll-in equity incentivising Lion Capital and management to acquire the remaining shares at as low a price as possible that the corporate principal-agent conflict is revealed, and particularly in the context that Lion Capital and management remain enfranchised to vote their own shares in favour of their proposed, and debt financed, agent-advantaged deal outcome.

More positively, the lack of readily ascertainable route by which shareholders can address such deals often results in the takeover target's shares pricing at a discount to the existing binding offer, allowing new shareholders with activist expertise – and acting on their own activist plans of self-generated material information that isn't yet public – to acquire a meaningful stake at attractive pricing.

3.3 When the merger arbitrageur engages in activism through voting power

The highest determinism in activist outcomes ultimately results from the voting rights that the activist's own share ownership provides. This avoids a reliance on convincing other shareholders to vote alongside the activist, and therefore also avoids the failure scenario if other shareholders remain unconvinced.

The voting power impact from an activist's own shareholding will be maximised when the merger arbitrage activist can deploy a large volume of capital into share purchases and becomes the decisive voting entity for those takeovers that require high levels of shareholder approval. Merger arbitrageurs willing to pursue activist strategies can in this manner leverage their growing assets over time to gain increasing competitive advantage in such opportunities.

3.3 a) Activism in merger arbitrage through voting power: when the tender threshold for de-listing is 90%

A case study of the takeover of Swedish Match, 2022

In Scandinavian markets, a 90% shareholding by the bidder is required for delisting, with no alternative takeover structures available to lower this requirement[67]. This means an activist holding of just 10% can effectively determine the success or failure of a takeover bid.

Scandinavian situations, due to these particularities of their takeover regulations, as such become particularly attractive from the point of view of shareholder activism when the initial takeover premium is also modest, limiting activist downside risk and upside optionality, and when the bidder has capacity to increase their offer.

The opportunity is further accreted when the bidder is also a large strategic acquirer relative to the target company, and for whom a higher purchase amount would have minimal earnings dilution impact and whose strategic considerations translate into a high motivation to complete the acquisition.

Figure 15: In 2022, Elliott Management gained effective veto power over Philip Morris's acquisition of Swedish Match by acquiring a 10.5% stake.

Given the 90% delisting threshold and the strategic importance of the deal, Philip Morris was compelled to raise its offer price[70].

The 2022 acquisition of Swedish Match[68] exemplified such a target for merger arbitrage activist Elliott Management. For acquirer Philip Morris, the $16bn deal offered strategic entry into smokeless tobacco, with the takeover consideration representing only 10% of their $160bn market value—meaning even a significant price increase would have a limited financial impact on Philip Morris[69].

After Philip Morris announced their bid, Elliott acquired a 10.5% stake in Swedish Match[71], handing to Elliott an effective veto on the deal given the 90% delisting threshold.

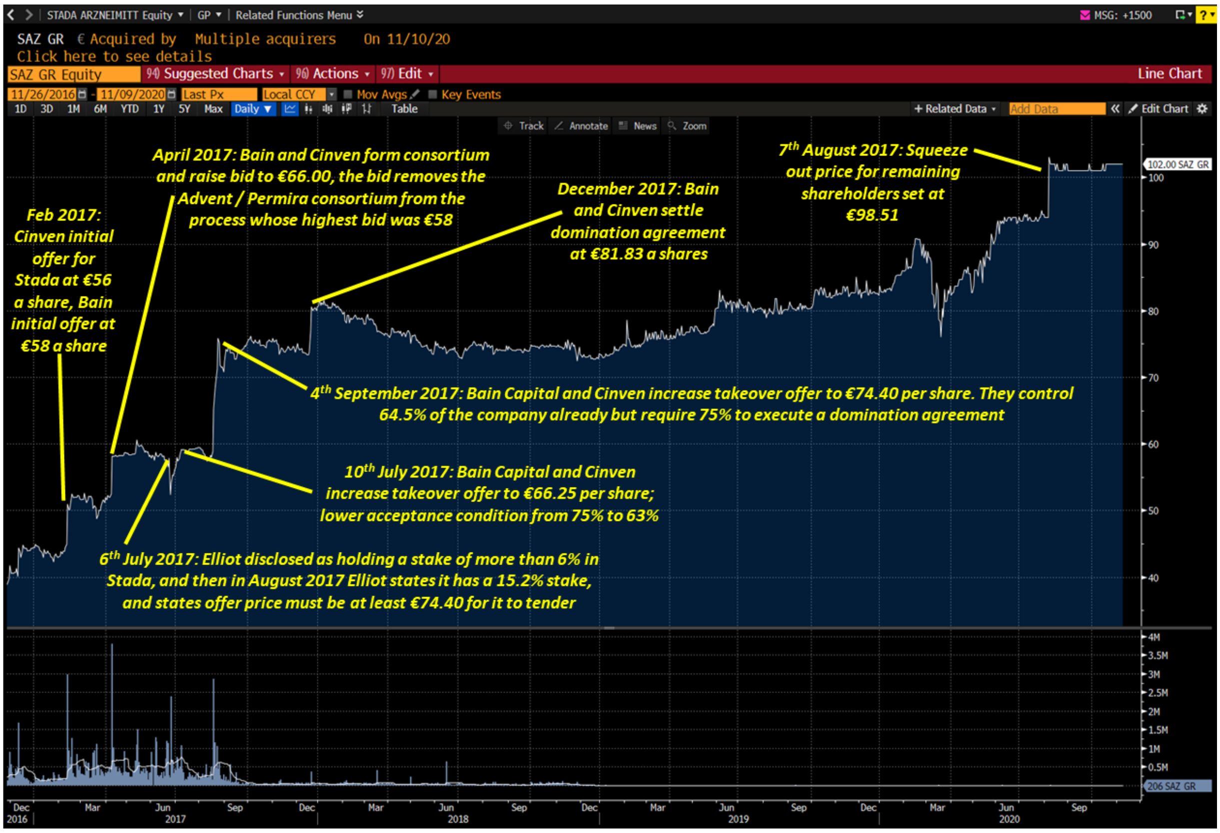
Elliott with this shareholding successfully forced Philip Morris to increase their offer by 13% to secure the acquisition[72].

A case study of the takeover of Stada Arzneimittel, 2017

In German markets, while a 90% threshold is needed for a delisting, acquirers can alternatively pursue a domination agreement at 75% ownership[73]. This agreement gives the acquirer binding control over management decisions at the target company[74]. The domination agreement also empowers greater financial flexibility for the acquirer, enabling them to justify a higher initial purchase price by thereon reducing their financing costs[75].

The 2017 Stada Arzneimittel takeover demonstrated how activists can leverage domination agreement requirements. After Bain and Cinven's initial €56 per share offer was raised to €66, Elliott Management disclosed a 6% stake in the company. In response, the private equity bidders tactically lowered their acceptance threshold to 63% – enough to secure majority ownership but insufficient for the domination agreement sufficient for binding control of operations and the optimisation of financing[76].

Figure 16: For their Stada Arzneimittel takeover in 2017, Bain and Cinven needed 75% shareholder approval to secure a domination agreement for company control. Elliott Management built a 15.2% stake and advocated for a higher price, ultimately forcing the acquirers to increase their offer[79].



Elliott responded by increasing its stake to 15.2%, controlling enough shares to significantly lower the probability of the bidders reaching the 75% threshold needed for a domination agreement[77]. To reinforce its negotiation position, Elliott, while publicly advocating for a higher price, also encouraged other shareholders to withhold their tenders[78].

Elliott's strategy succeeded when Bain and Cinven ultimately raised their offer to €81.83 per share, securing both Elliott's tender and the domination agreement[80].

3.4 When the merger arbitrageur engages in activism through financing counterbidders

A case study of the takeover of ShopKo Stores, 2005

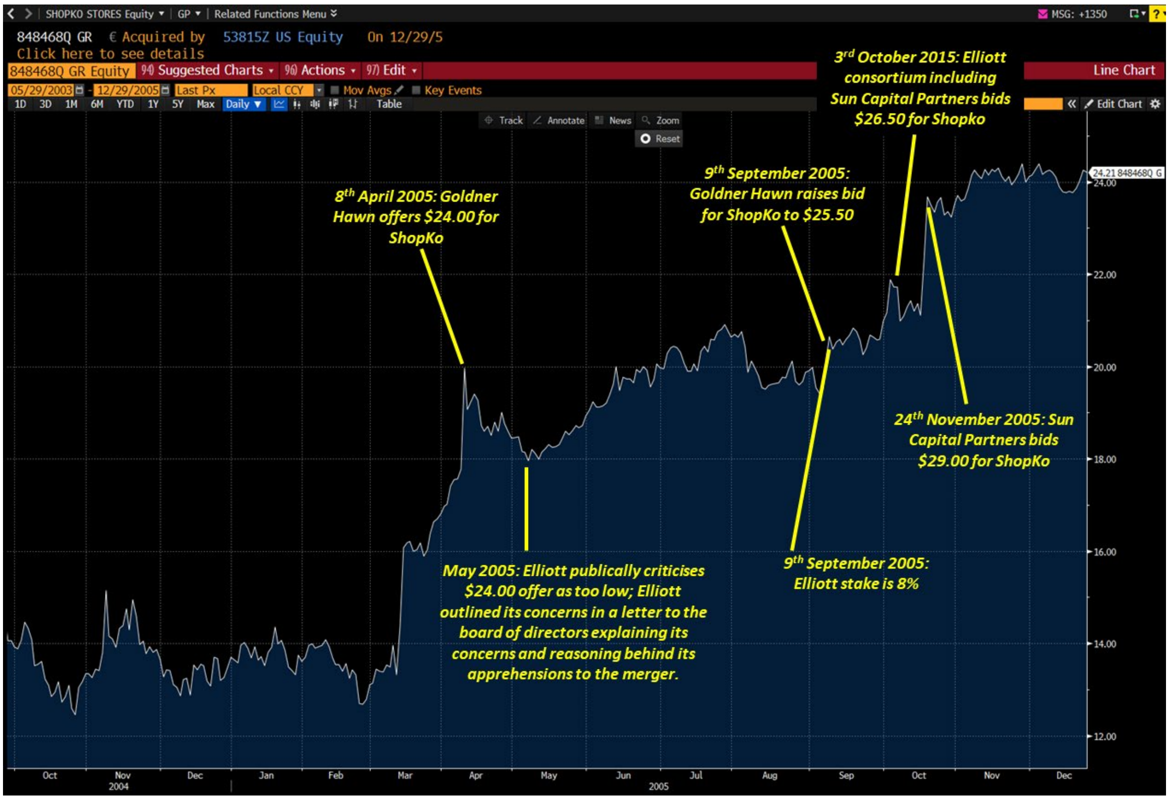
Finally, arguably the most sophisticated form of merger arbitrage activism involves the activist not only building a stake in the target company but also providing capital to private equity groups to support competing bids. The 2005 ShopKo Stores takeover illustrated this approach.

When Goldner Hawn (private equity) initially offered $24.00 per share[81], Elliott Management acquired an 8% stake and publicly opposed the price[82].

While the Elliott stake alone wasn't enough to block the 50% acceptance threshold of the US deal, Goldner Hawn still raised their offer to $25.50 to in an attempt to mitigate Elliott's concerns[83].

Still unsatisfied, Elliott then joined forces with Sun Capital Partners, with Elliott both as an existing investor in ShopKo and member of the Sun Capital Partners bidding consortium, to launch a competing $26.50 bid[84]. This ultimately forced both Goldner Hawn and the Sun Capital Partners consortium to raise their offer to $29.00 — 21% above the initial Goldner Hawn bid. Ultimately the ShopKo acquisition was completed by the Sun Capital Partners consortium[85].

Figure 17: In the takeover of ShopKo Stores in 2005, Elliott objected to the initial $24.00 offer price and provided financing to a Sun Capital Partners-led counter-bidding consortium. Both bidding entities then raised their price to $29.00, with Sun Capital Partners ultimately victorious[86].



Conclusion

The activist opportunity type within merger arbitrage represents an important enhancement to traditional merger arbitrage strategies, offering both the potential for higher returns and increased certainty in selected situations. As our analysis has demonstrated, the successful integration of activist techniques into merger arbitrage requires not only understanding of legal and regulatory frameworks but also the ability to identify situations where activism can effectively influence outcomes.

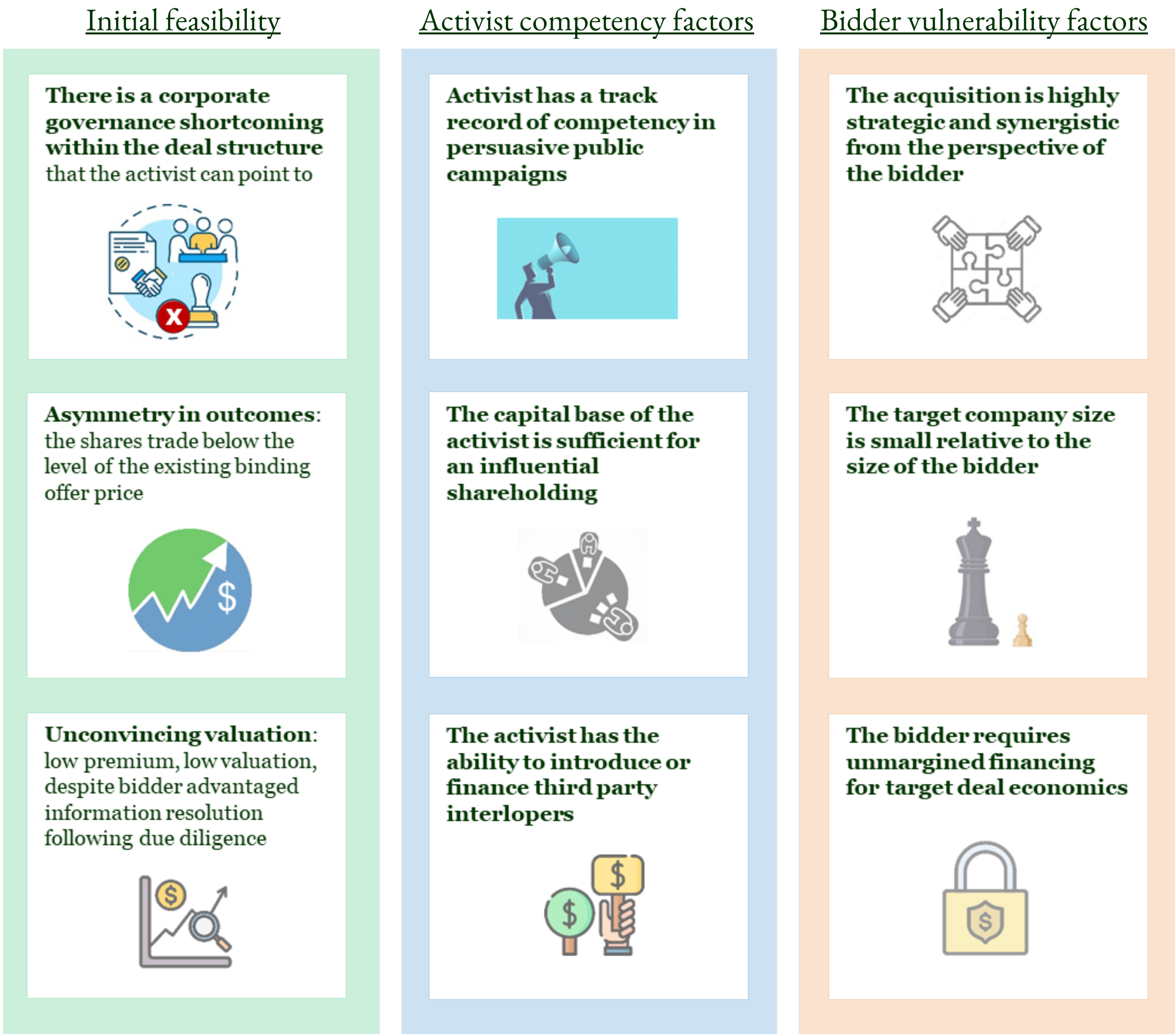
The case studies reviewed have underscored the key success factors for activism in merger arbitrage, which we can summarise into three categories.

First, the merger arbitrage opportunity must be initially feasible for activism. Characteristics should include that there is a readily ascertainable corporate governance shortcoming within the deal structure that the activist can point to. For the purposes of robust capital allocation, the opportunity should also be priced at a level allowing asymmetry in outcomes, with the shares trading below the level of the existing offer price. A further necessity is that the target equity remains priced at an undemanding valuation, likely due to a low premium having been offered and resulting in unconvincing valuation metrics which do not appropriately reward public shareholders for the information resolution advantage that the bidder possesses following their due diligence period.

For situations meeting these criteria of initial feasibility, it is the activist themselves that must then possess the competency factors that suit the situation in question. An activist will be more effective in persuasion – both in terms of influencing the voting behaviour of other shareholders, and in making a rational argument directed toward the bidder relating to fair value outcomes – when the activist themselves has a track record of successfully engaging in such campaigns. Any public campaign by the activist should also focus on corporate governance principles – as shareholders in the company have a fiduciary duty to act in favour of strong governance – the G in “ESG” – and focusing on these principles raises the probability of aggregating support from the wider shareholder base. The activist must also possess a capital base sufficient to fund share buying sufficient for at least a modest influence. And furthermore, an added advantage is gained when the activist possesses a demonstrated ability to influence third party interlopers to enter the bidding for the target company, either through persuasion or by the activist’s own ability to contribute to the financing structure of the prospective interloping party.

Finally, the probability of raised profit outcomes through activism in merger arbitrage is increased when the bidder themselves possesses certain vulnerability factors. These include that succeeding in the takeover is a highly strategic goal for the bidder, and as such the bidder will be more likely to be willing to agree to higher price outcomes in order to meet their strategic goals. An additional advantage in favour of the activist occurs when the target company size is small relative to the size of the bidder – in this scenario a raised price by the bidder will have little detrimental impact on the overall economics of the bidder and as such is more likely to be tolerated. Finally, the negotiation leverage of the activist is increased when the bidder has a business model – such as, but not limited to, private equity bidders – that derives a significant amount of its value by securing unmargined financing on the target company post acquisition. The requirement for this uplift disincentivises the bidder from lowering their tender threshold to permit the acquisition of a control stake yet without a delisting (which requires the higher tender threshold). Retaining the high tender threshold greater enfranchises the dissident proportionate voting power of those shareholders who join the activist in objecting to the deal terms.

Figure 18: The characteristics of the merger arbitrage opportunity suited to shareholder activism[87]



An important additional principle revealed by our analysis is that persuasion through public statements can have decisive impact in activist situations, and as such it is not the case – potentially contrary to conventional wisdom – that the ability to engage in activism in merger arbitrage situations is limited to large funds.

While certain activist strategies do require significant shareholdings, others – particularly those based on thoughtful corporate governance advocacy and persuasive public statements – can be successfully deployed by smaller funds. This democratisation of activist techniques suggests an expanding opportunity set for merger arbitrageurs of various sizes who are willing to develop the necessary expertise and capabilities.

Looking ahead, we expect the importance of activism in merger arbitrage to grow. The increasing scarcity of traditionally mispriced investment opportunities in financial markets enhances the competitive advantage captured by the merger arbitrage activist, by their creation of value through intervention rather than discovery.

The sophistication of deal structures continues to elevate, and this combined with varying shareholder protection regimes across jurisdictions, should continue to result in an attractive frequency of opportunities for activist intervention. For those merger arbitrageurs who succeed in effectively integrating activist strategies into their approach while maintaining their range of foundational expertise across merger arbitrage, we believe a path exists to achieve exceptional outcomes.

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