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Merger Arbitrages: Capturing The Competitive Bidding Situation

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Merger arbitrage opportunities, identified from mergers and acquisitions situations, can deliver asymmetrical outcomes with attractive annualised returns

In 1956, when a young Warren Buffett launched his first investment fund, his investor letters highlighted that around one half of his allocations were in "workout" situations, or in modern dialect, merger arbitrages. Today, an investor might therefore ask, if a merger arbitrage strategy was good enough for Buffett in 1956, how attractive are the merits of this strategy in the current markets?

The arbitrage opportunity set arises from corporate activity – mergers, but also sell-outs, reorganisations, or spin-offs – and offers allocators two crucial differentiations from non-arbitrage investments. Firstly, arbitrage situations in their base case have a fixed price outcome from the existence of a binding takeover offer. Secondly, these situations have a timetable. And, whilst the gross profits in arbitrage opportunities often appear quite small, their predictability coupled with a short holding period can produce attractive levels of annualised return, an outcome that also can be significantly accreted if new bidders emerge to "gazump" the initial binding offer.

From the perspective of an investor allocating to arbitrage constructs, these opportunities can also allow a more asymmetrical outcome than non-arbitrage investments. In certain equity market environments this is a particularly advantageous feature – particularly those periods where the market possesses risk of a market correction. It is notable in this regard that the S&P500 is currently trading at an above average earnings multiple. However, market correction risk may have recently become exacerbated by the co-incident emergence of factors that can also provide a headwind to corporate earnings: still high energy costs, a rising cost of interest, and a rising cost of wages. Therefore, a scenario has become possible of a contraction in the market's earnings multiple at the same time as a decline in the market's earnings number, and therefore the relative attraction of arbitrage opportunities has potentially increased.

However, is it straightforward to find arbitrage deployments for an investor today? The answer is that the number of arbitrages is a function of the total deal count of mergers and acquisitions or "M&A" activity. From an industrial perspective, M&A is conducted when the need exists to restructure companies for business advantage, for example, during periods of technological change. Another driver of M&A is low financing costs, which enhances the profit incentive of the takeover protagonist. In the markets today a reasonable level of arbitrage opportunities is observed, albeit not an above average level as can be seen in more favourable environments. However, the arbitrage practitioner can increase the number of opportunities reviewed by thorough screening for arbitrages across all global developed markets and at a broad range of market capitalisation.

The current inflationary environment may increase the frequency of one of the most profitable types of arbitrage opportunity – the competitive bidding situation

It is only a rare number of arbitrages, however, that will produce unusually attractive results, and this category is captured when an allocator succeeds in the early identification of the "competitive bidding situation" – when new interlopers compete with existing offerors in an escalating auction for a company. This scenario significantly increases the arbitrageur's profit with each successive bid.

In an inflationary environment, such as that which has characterised the recent period, there is rationale for the frequency of competitive bidding situations to increase. This is because for those asset classes where a steeper gradient of inflation is observed (for example mining resource deposits, or land and property holdings), net asset values can rise in some instances as to high as or even above the market capitalisation of the corporate equity that owns them. This then can result in some takeover situations being so prospectively profitable for an interloping takeover protagonist, that competing bidders become the most probable outcome. This means that a focused approach in arbitrage that is highly alert to signs of a competitive bidding emergence can still permit a rewarding path even when a cautious approach is taken with regard to overall equity index levels.

The attractiveness of competitive bidding arbitrages in an inflationary environment can be further enhanced because higher inflation also correlates with increased yields on government bonds, and increased yields on government bonds tends to correlate with lower PE ratios. Therefore, not only may a number of asset-rich securities possess real assets whose inflating value is beginning to exceed their market capitalisations, but in addition to this, the share prices of such securities may also de-rate because the market environment may become one of deflation in the PE multiple.

This means that the magnitude of share price change during a competitive bidding process can be that much larger because of a start point valuation that is that much lower (and the first bidder, not recognising yet that the process will become competitive, may start off with a bid at only a modest premium). This then can lead to a "golden period" opportunity for competitive bidding arbitrage allocations.

A particular attraction of this opportunity set is also that it allows a "conservative aggressive" approach to capital allocation. This is because an experienced practitioner, using agility to identify the situation early, can often make deployments to competitive arbitrages at a discount to an existing binding offer. As such, competitive bidding situations can offer both preservation of capital and a yield to maturity. More importantly, competitive bidding situations also offer meaningful equity-like returns on top, so long as they have been identified as also possessing an intrinsic value – likely to be reached by the end of the auction process – that is significantly higher than the value of the prevailing bid.

Agile allocation to arbitrage situations that are enticing competitive bidders can offer all three of: preservation of capital, yield, and equity-like returns at the same time

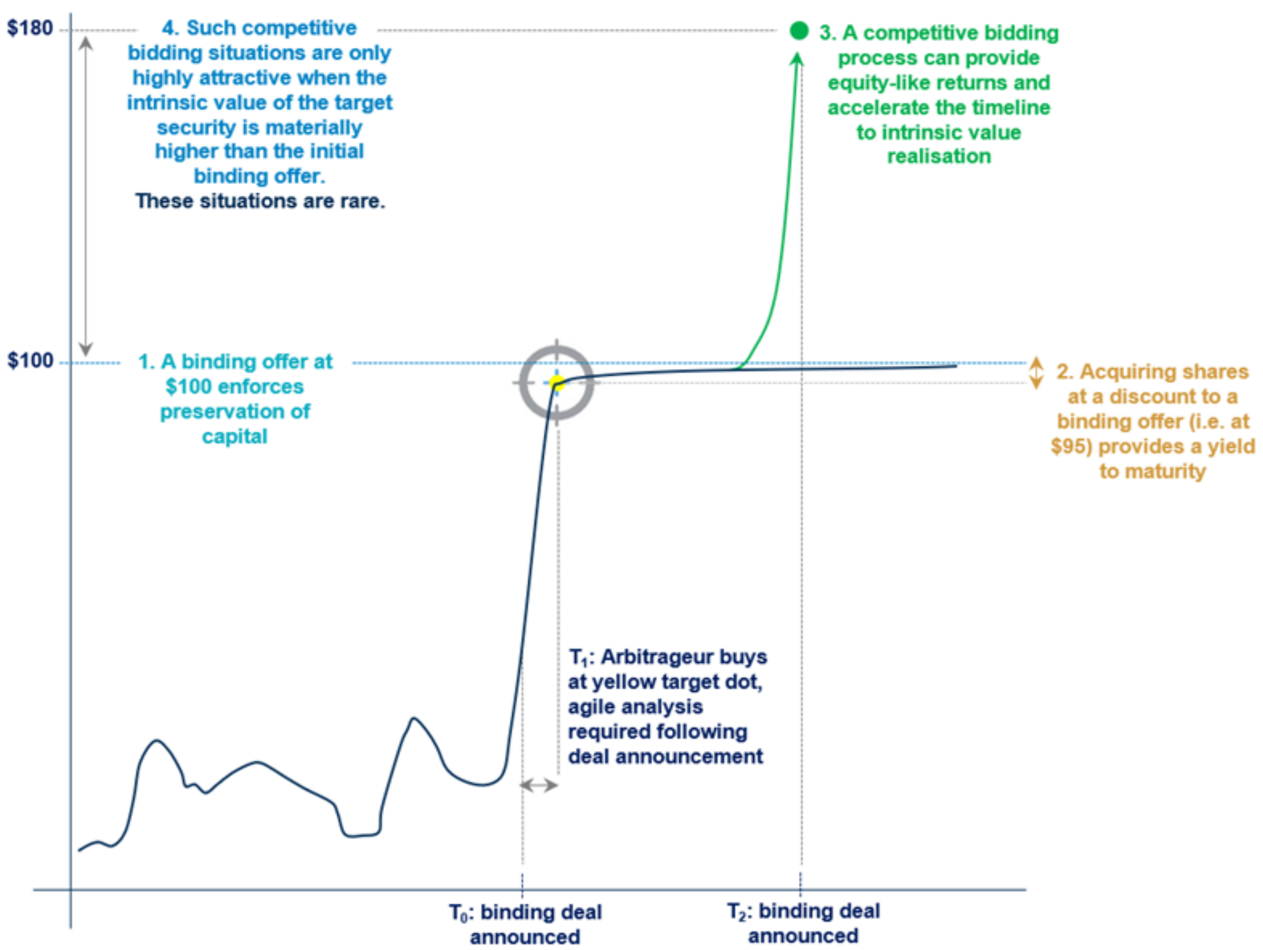
Allocation to constructs with these three coincident qualities of competitive bidding situations: preservation of capital, yield, and equity-like returns at the same time, is a fortuitous mix. Convertible bonds, which are the only standardised instruments offering all three of these attributes, are by comparison rarely priced inefficiently in the securities markets due to the homogeneous nature of their valuation inputs attracting quantitative funds into this market area. And strip away the fixed income element from a convertible bond (because it is fully priced already), and the resulting equity exposure does not offer preservation of capital. Or strip away the equity option from a convertible bond, and the fixed income element remaining does not offer equity-like returns.

A key challenge to identifying competitive bidding situations is, however, that the practitioner must leverage their fundamental value skillset in a short duration timeline to determine whether the auction target remains deeply undervalued. This requirement is crucial because takeover situations by their nature normally already include some premium, and so to find the uncommon situation where there is already some premium, yet which also remains deeply undervalued, is an often-demanding task.

However, thereon is achieved a final pleasing advantage: the concept of acceleration to intrinsic value – because each situation is timeline-driven. Timeline acceleration to intrinsic value, in situations at deep discount to intrinsic value, is a highly attractive performance accretion to an investment strategy and absent from most other investment approaches.

These dynamics within the arbitrage opportunity set, correctly anticipated and captured, and particularly in the area of competitive bidding situations, offer highly attractive return opportunities. More importantly, they also offer the defensive qualities that Warren Buffett became well known for, and that continue to be prudently optimal in the high earnings multiple equity markets today which investors must navigate correspondingly.

Figure 1: Agile allocation to arbitrage situations that are enticing competitive bidders can offer all three of: preservation of capital, yield, and equity-like returns at the same time



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