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What Is A Merger Arbitrage? Definition And Examples

Updated: Dec. 05, 2023 | By: Ian Bezek

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Merger arbitrage is a strategy which allows investors to profit from upcoming corporate transactions by purchasing the takeover target's shares at a price lower than the proposed closing value.

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What Is Merger Arbitrage

Merger arbitrage is a strategy where investors seek to profit from the anticipated changes in stock prices when an upcoming corporate action such as a merger or acquisition closes.

Sophisticated investors are often drawn to merger arbitrage strategies because there is a clear catalyst, defined reward, and a fairly definitive timeline for when the value in the trade will be realized. When done correctly, merger arbitrage has the potential to achieve steady and fairly high returns while minimizing risk from general market fluctuations. In this way, merger arbitrage can be a strategy that offers potential alpha and diversification to a broader investment portfolio.

However, merger arbitrage isn't a free lunch. There are risks involved in seeking the rewards of a pending merger or acquisition.

Takeover Premiums

There are thousands of publicly-traded U.S. companies. Not surprisingly, a significant chunk of them are involved in mergers and acquisitions in any given year. According to legal research firm Lexology, a total of 167 deals were announced in the year 2022 where the target was a publicly-traded U.S. corporation.

Large corporations that want to acquire another company usually must offer a premium over the recent trading price. For instance, if company ABC trades at $24.50/share, it usually means that investors believe $24.50 is the approximate fair economic price given the firm's business prospects. If ABC received a takeover offer for $24.50/share, it likely wouldn't entice shareholders to give up their shares to another entity. Even an offer of $25 is likely insufficient to excite shareholders.

Often, to make a takeover offer attractive, an acquiring firm will offer a 20% premium, 40% premium, or sometimes even a 100% premium or more to entice shareholders to accept the offer. High premiums are common for hostile takeovers.

How Does Merger Arbitrage Work In A Cash Offer?

While an acquiring firm may offer shares of its own stock, or a combination of stock and cash, most commonly acquisition attempts include a cash offer. Say, for example, a software company is trading at $25/share and a bigger tech firm wishes to acquire it. The bigger tech firm might offer to pay $40/share to existing holders of the target company.

On the announcement of a takeover offer, or even just rumours of a takeover, the stock value might soar in value from $25 to somewhere near the takeover price, perhaps $38. Although it's possible, usually the stock of the target company won't immediately rise to the cash offer level.

There are several reasons why a company's stock price may not rise to the takeover offer upon the announced acquisition proposal:

- there's risk that majority shareholders/board of directors won't approve the deal
- there's risk that regulators may not approve the deal
- the market may doubt the ability of the acquirer to complete the deal (for example, if the acquirer doesn't have enough financing)
- there's risk the acquirer could walk away from the deal
- the official offer might require the target firm to meet certain difficult criteria to qualify for the takeover
- the time value of money (if the risk-free interest rate is 5%, and the merger is expected to be completed 6 months from now, investors will factor in a ~2.5% discount for this)

Due to these factors, stocks usually (but not always) trade under their deal price up until the deal closes, with that spread generally narrowing over time as the deal's closing date approaches.

This is where the merger arbitrage opportunity lives. The risks that the deal won't close at the stated offer price drive a valuation discount. Opportunistic investors may move in to take advantage of the discount, especially if they feel the market is overestimating the risks.

How Does Merger Arbitrage Work For In-Stock Offers?

Takeover offers that are in the form of stock (or at least partially in stock) as opposed to cash have an extra element at play. If the stock of the potential acquirer drops after the takeover offer announcement, and it often does, the true value of the offer may drop as well.

Let's assume that company XYZ trades for $80/share, and company ABC trades for $40/share. ABC might attempt to acquire company XYC by offering 2.5 shares of ABC for each share of XYZ outstanding, which are currently worth $100 (=2.5 x $40). This reflects a premium of 25% ($100 takeover value/$80 current XYZ share price).

However, if ABC's shareholders are pessimistic about the proposed deal, and ABC shares drop to $36.00, suddenly their offer is only worth $90/share (2.5 x $36) to XYZ shareholders.

All the risk elements of cash offers are usually in play for in-stock offers as well, such as the risk that the board or regulators don't approve the deal, the question of financing, and the time value of money. So in-stock acquisition offers usually also see a discount to the fair economic price, upon announcement, allowing opportunistic investors a chance to capture the spread.

Merger Arbitrage Example

Let's suppose that a hypothetical tech firm is offering one share of its own stock for each share of a software company that it is attempting to acquire. Let's further assume that the acquirer firm trades at $40 per share, and the target firm trades at $25 per share.

If the acquirer believes it's worth offering $40/share for the software company (which is currently trading at $25/share), they might consider offering a 1-for-1 share exchange. Let's say that the software company's stock rises to $37 upon announcement of the acquisition offer.

At this point, a sophisticated investor could buy the target company's stock at $37, short sell the acquiring firm's stock at $40, and in theory net a nearly risk-free $3 profit when the acquiring firm issues one share of its own stock for each share of the software company that it is purchasing. If the deal closes, the prices of the acquirer and acquired firm will converge, leaving the merger arbitrager with a clean profit. There are risks that can derail the trade, but if everything goes to plan, this tactic of owning the M&A target and short selling the acquirer can be a lucrative strategy.

Is Merger Arbitrage Truly Arbitrage?

Arbitrage is a transaction where investors can earn excess profit at no risk. A classic example would be buying gold at one price in London and selling it for a different price in Tokyo, taking advantage of a discrepancy in shipping costs, interest rates, localized demand, or other such variables between those markets.

As purely defined, merger arbitrage isn't exactly a form of classic arbitrage. That's because the profit in merger arb comes from buying an asset and exposure to the risk that the merger doesn't close. True arbitrage is defined as riskless profits.

How To Calculate Merger Arbitrage Spread

For a cash deal, it is simple enough to calculate the merger arbitrage spread. Simply take the price at which a company is being purchased, and then subtract out the current price of the target company. The difference is the profit spread that can be realized if and when the deal closes at the agreed-upon price. Then to calculate the % opportunity, divide the spread by the price of the target firm.

Potential Profit Spread = Cash Offer Amount – Current Share Price Level (target)

% Opportunity = Potential Profit Spread / Current Share Price Level (target)

Merger arbitrage investors will then often convert the potential profit to an annualized rate. So if there's a 4% potential profit spread, and the deal is expected to close in 3 months, that would point to an annualized rate of more than 16% (after compounding).

For a stock transaction, the investor should find the value of the stock of the acquirer, multiply that by the amount of shares being issued per share of the target company, and then subtract out the current price of the target company to find the potential profit for the merger arbitrage transaction.

Potential Profit Spread = (Acquirer's stock price X Share Exchange Ratio) – Current Share Price Level (target)

% Opportunity = Potential Profit Spread / Current Share Price Level (target)

Example:

Company ABC, with a share price of $90/share, is offering a share exchange ratio of 0.5 in an attempt to acquire company XYZ, which currently trades at $43 per share after the acquisition proposal announcement.

Potential Profit Spread = ($90 x 0.5) – $43 = $2.00 per share

% Opportunity = $2.00 / $43.00 = 4.65%

Remember that the price of the acquiring company's stock can fluctuate significantly, and thus endanger the potential profit on a deal. For example, if the acquiring firm misses earnings and its share price gaps down, for example, that could eliminate the potential profit from a merger arb deal and/or possibly cause the target firm's share price to drop as well.

Other Merger Arbitrage Considerations

It's also important to account for smaller factors when calculating potential returns on investment for a merger arbitrage transaction. Companies may still pay dividends while they are in the process of being acquired, which can change the deal math to some degree. Also, for deals where people are short selling the stock of the acquiring company, don't forget to include borrowing costs for that short sale transaction. As merger arb is a fairly popular strategy, sometimes these short sales can become crowded and thus face a higher borrowing cost.

Real-Life Merger Arbitrage Example

Hedge funds and other sophisticated institutions have been engaging in merger arbitrage strategies for decades now. There are countless examples of deals, both lucrative and not-so-successful, to look at over the years.

For a recent example from 2023 of a large, controversial, and ultimately profitable merger arb deal, let's consider **Microsoft's** (MSFT) purchase of **Activision Blizzard**. Microsoft has long been involved in the gaming industry through its Xbox and games publishing operations. It has built on this in recent years through offerings such as its Games Pass subscription service. Activision Blizzard, for its part, is a large games developer making a variety of popular games such as *Call of Duty* and *World of Warcraft*.

Microsoft decided that Activision Blizzard was available at a reasonable valuation and would add nicely to its own gaming efforts. So, in January 2022, it offered $68.7 billion for Activision Blizzard, which amounted to approximately $95/share. Activision shares had been trading for about $65 each prior to the Microsoft offer. They leaped to $85 on the announcement of the Microsoft offer, representing a $20/share gain for prior holders of the stock, but leaving $10 on the table for merger arbitragers to collect between the new $85 market price and Microsoft's $95 offer.

However, it wouldn't be a quick or simple profit for the arbitrage community. Antitrust regulators in both the United States and Europe sought to block the deal, claiming that it would give Microsoft too much market power in the industry. In addition, there were some operational issues at Activision Blizzard which made people worry about what the stock price of the company would be if Microsoft walked away from the deal. By November 2022, Activision Blizzard shares dipped from ~$85 to as low as $72 despite the outstanding $95 Microsoft bid to acquire the company.

In July 2023, however, the deal made it through the regulatory hurdles and shares finally jumped to $90, leaving just a $5 spread to the deal's closing price. Shares gradually drifted upward from that point on toward the eventual transaction price, and in October 2023, the deal finally closed as planned. Note, however, that it was more than 18 months from the deal announcement to closing, and that there was a real risk of regulators blocking the transaction. This deal shows both the lucrative upside of a successful deal, along with the potential risks both of delays and of the deal potentially breaking if something were to go wrong.

Merger Arbitrage ETFs

For investors who want to leave merger arbitrage attempts to the experts but would still like to gain some exposure, there are dedicated exchange-traded funds (ETFs) devoted to merger arbitrage. The **IQ Merger Arbitrage ETF** (MNA) and **AltShares Merger Arbitrage ETF** (ARB) are two such examples. However, in general, performance has been fairly lackluster in recent years and they have modest assets under management (AUM) numbers.

In general, merger arb is a specialty strategy that may require domain expertise and skilled trading and execution to achieve best results. ETFs have proven to do a great job of matching the returns of passive indexes with minimal fees or slippage, but it may be harder for them to succeed in more niche fields that require higher levels of trading activity such as merger arbitrage.

Bottom Line

Many hedge funds and other sophisticated investors have long obtained steady and attractive returns from merger arbitrage. For investors who can analyze risk well and have a good perspective on upcoming deals, merger arbitrage can add alpha to a portfolio while diversifying one's overall holdings.

That said, merger arb is a specialty strategy and one which comes with tail risks. While most deals close, some will inevitably fail to play out as expected, which can lead to sudden losses. As with any sophisticated trading or investment strategy, investors should use prudence when considering any specific merger arb deal for their portfolio.

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