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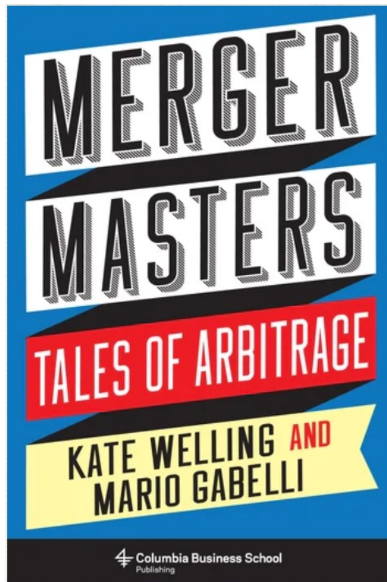

Title, Author: Merger Masters – Tales of Arbitrage, Kate Welling and Mario Gabelli
Published: 2018, Columbia Business School Publishing

Give a man a fish and you feed him for a day. Teach him how to arbitrage and you feed him forever.
(Warren Buffet, 1988 Annual Letter)

Rather than being a technical tome, this book articulates the rewards and challenges of risk arbitrage through stories. Divided into two parts, the first runs through seventeen leading practitioners with a chapter allocated to each. The second part is smaller and takes the perspective of three CEOs who have been on the receiving end of the arbitrage trade, climaxing with a dramatic telling of the drawn-out high profile, attempted hostile takeover of Air Gas Inc between 2009 and 2011.

Risk arbitrage is a strategy that emerged in the 1970s and subsequently proliferated during the decade of "merger mania" in the 1980s. In its plain vanilla form, it involves a transfer of risk from a long-term shareholder of a company that has been publicly targeted for a takeover to another investor who bears the risk of that deal falling through. For example:

- Naan PLC is trading at £50/share
- Samosa PLC intent on taking over Naan makes an open offer of £100/share
- Naan's share price rallies to £95 in reaction
- There is a £5 spread between what the shareholders will receive (£100) and the new price (£95)
- The long-term shareholder that has just enjoyed an unrealised gain of £45 may look to forego that extra £5 for the risk involved and lock in that profit.
- On the other side of that trade will be a risk arbitrage investor who will bear the risk of the deal collapsing for the short-term gain of £5.

The "arb" will often apply modest leverage to enhance returns but will also seek to insulate the position from adverse market movements until the deal has closed by shorting the acquirer company or the peer group. This at a portfolio level results in a return profile that intends to be *market neutral*.

Beyond plain vanilla merger arbitrage the opportunity set extends to distressed investing and activism. The challenge with such strategies is that one earns less for being right than what can be lost when wrong[1]. In the case of Naan PLC, if the deal falls through the downside is £45 compared to gaining £5 for being right. As such pricing risk and having a clear set of rules to mitigate losses was a running theme. If there is no strategic rationale for a merger, it is likely to collapse and conversely if it makes *too much sense* companies have often run into anti-trust issues. Furthermore, the area has been a victim of its own success:

"When I got into the merger-arbitrage business…It was a relatively uncrowded business…Likewise when I got into the corporate distressed business, it was the same ten or fifteen bankers and lawyers who were doing everything, and off the top of my head I knew of all the big distressed investors' office numbers, weekend numbers, spouse's names. Then suddenly, in both cases, there were legions of nameless investors doing these things. The question clearly was, how do you stay ahead of the curve?"[2].

The parallels with active management in general here are expanded on in a later chapter byJames Dinan:

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[1] Often more fancifully described as asymmetric concave payoffs
[2]John Bader, Halcyon Capital, Chapter 12 pg 153

"There's no information advantage anymore in risk arbitrage, there's only a judgment advantage … Arbitrageurs obviously need to have good quantitative skills, but you don't need ***great*** *quant skills. You do need great judgment though – and judgment is basically understanding human behaviour, the human condition. Because in arbitrage, the decisions are made by humans; arbitrage is driven by individuals. Every individual has a unique personality, so you almost always want to be a student of human of human psychology – but if you love investing and you love human psychology, risk arbitrage is an amazing business."*[3]

Part two focuses on the perspective of management teams of companies acquiring or being acquired. William Stiritz (a protagonist in Thorndike's book The Outsiders), argues that the transfer of power from CEOs to independent boards has hamstrung management teams' ability to think long term and Peter McCausland warns against descending into a one size fits all approach to corporate governance and shareholder activism. Paul Montrone cites Peter Drucker's 5 *deadly business sins* which includes *worshipping at the altar of high margins*, and rails against the Street's shift away from qualitative research towards a reliance on models. For instance instead of valuing a company on its own merits, it gets lumped with its peer group multiple, benefitting the weaker operators in the industry. He argues that in today's environment the only rationale for being a public company is if it can command a high multiple to allow it to benefit from a lower cost of capital.

Like many parts of the investment world the book elucidates how institutionalisation has dried up many traditional sources of outperformance. It's the greater abundance of skill that has made it harder to outperform. Nevertheless, there are winners and losers on two sides of a trade and book provides an enjoyable and informative read replete with examples across a number of successful practitioners on the important of disciplined processes to analyse risk and build up valuation skill irrelevant of whether one is in the arbitrage game or not.

Amul Pandya
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[3] James Dinan, York Capital Management, Chapter 14, pg 179