The Other M&A: Case Study in Merger Arbitrage

Investment banks are not the only one's cashing in on the increase in merger activity. Well known investor Warren Buffet and investment vehicles including Hedge Funds and Mutual funds employ a conservative trading strategy named "Merger Arbitrage" based on event driven activity. Merger arbitrage involves profiting from the spread created between two companies that are merging. If a deal is being done in cash a portfolio manager will only invest in the target company on the expectation that its' stock price will rise to the level of its buyer. However, if the deal is done for stock the portfolio manager will still purchase the stock of the target while simultaneously taking a short position on the buyer for protection. The idea is that the stock prices of the companies involved in the merger will converge as the completion date of the deal approaches.

DEAL TYPE	EXECUTION PLAN
Cash	**Purchase Stock of Target**
Stock	**Purchase Stock of Target** **Short Stock of the Buyer**

Now that we have an understanding of the concepts it's time to put them to the fire. I chose to focus on 3 transactions to see what the payout would be if I was running my very own "Select Merger Arbitrage Fund". I have chosen to focus on the price changes from the deal announcement date to the close of the deal date for Sprint's merger with Nextel and Capital One's acquisition of Hibernia. I have also taken a look at the progress of the Bank of America's mega acquisition of MBNA Corp.

Transaction #1

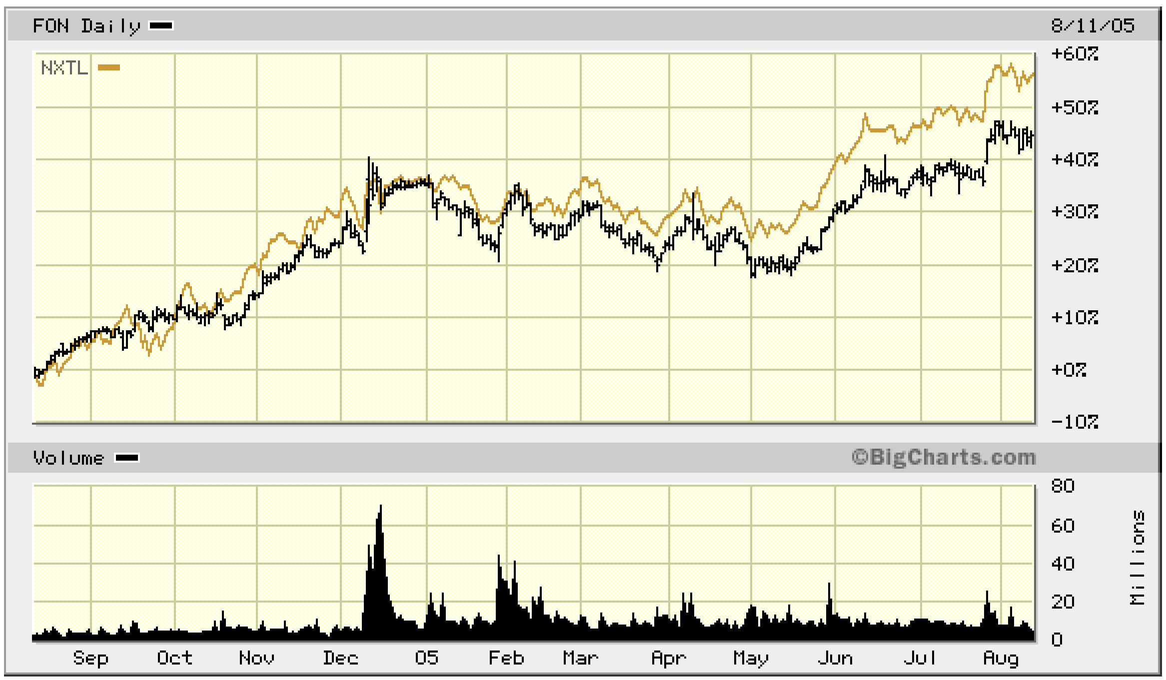
Sprint (**FON**: NYSE) and Nextel (**NXTL**: NASDAQ) announced their $35 billion dollar merger on December 15, 2004.

Deal Type: Mostly Stock

Expected Recommendation: Buy stock in Sprint and Nextel

On the day of the announcement Sprint shares closed at $24.02, while Nextel's shares closed at $30.01(*Average Price). Since the deal was structured to involve mostly stock, pundits of merger arbitrage would recommend purchasing the stock of the target company, Nextel while simultaneously shorting the stock of the buyer, Sprint. However, since this merger is widely viewed as the marriage of two equals I argue that arbitragers would have needed to add a page to the rule book and purchase the shares of both Sprint and Nextel. The merger closed on Friday, August 12th with Sprint shares up to $26.15 while Nextel shares closed at $33.32 for the final time. Since the merger Sprint Nextel have been trading under the former Sears symbol 'S'. Buying both stocks would have yielded an average return of **10%** over an **8 month period**.

		FON	% Increase		NXTL	% Increase
Close of Deal	**08/12/2005**	$26.15	**9%**		$33.32	**11%**
Announcement	**12/15/2004**	$24.02			$30.01*	
	$ Change	$2.13			$3.31	



Transaction #2

Capital One (**COF**: NYSE) and Hibernia (**HIB**: NYSE) announced their deal for $5.35 billion on March 5, 2005.

Deal Type: 45% Cash & 55% Stock

Expected Recommendation: Buy stock in the target company, Hibernia

On Friday, March 4th, before the acquisition announcement, Capital One shares closed at $78.08, while Hibernia shares closed at $26.57. On the day of the announcement Hibernia shares jumped 21% to $32.24. While there is some inherent risk concerning whether or not a deal will close paying attention to the regulatory environment and shareholder sentiment will help an investor identify any show stoppers. On Wednesday, August 3rd shareholders gave approval for the Capital One acquisition. Shares of Hibernia fell 5 cents to $33.95, while shares of Capital One dipped 39 cents to $83.07 during intraday trading. It is clear that the strategy of buying the target company, Hibernia, in this case would have returned **28%** return over a **5 month period**. Since the acquisition was not "all cash" a merger arbitrager would not have shorted Capital One for protection. In this case the execution plans above apply. Let's see if the same holds true for the final example.

		HIB	% Increase		COF	% Increase
Close of Deal Announcement	08/03/2005	$ 33.95	28%		$ 83.07	6%
	03/05/2005	$ 26.57			$ 78.08	
	$ Change	7.38			4.99	

Transaction #3 (In Progress)

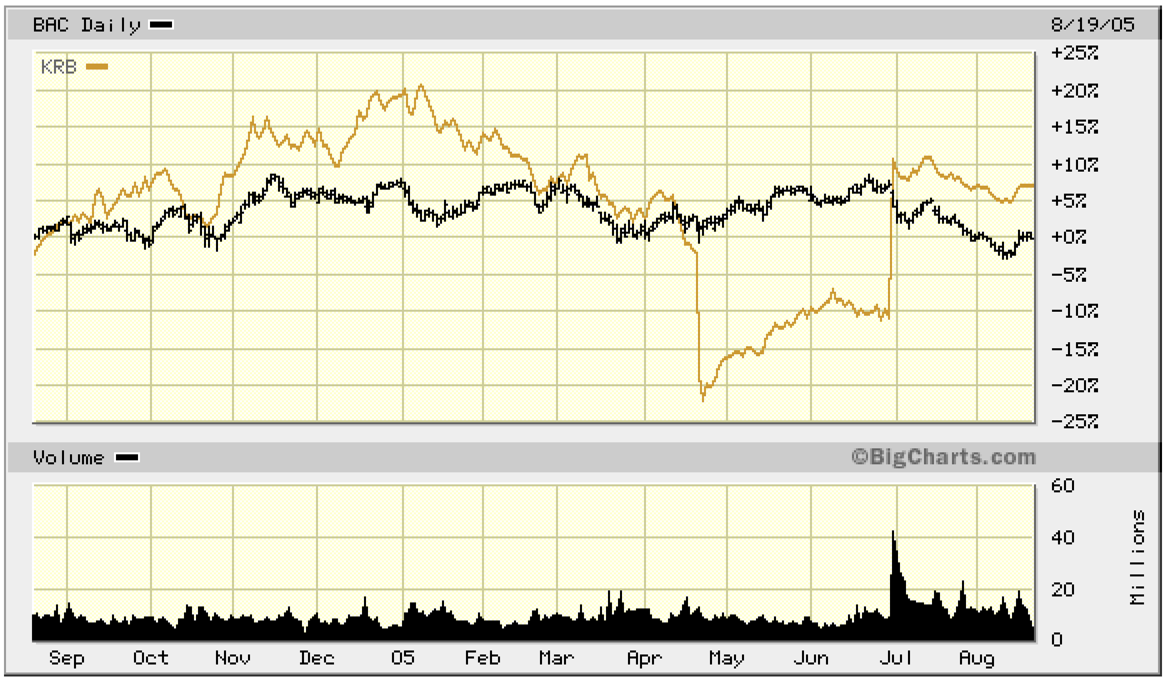
Bank of America (**BAC**: NYSE) announced plans to acquire MBNA Corp (**KRB**: NASDAQ) for $35 billion on June 30, 2005.

Deal Type: Cash & Stock

Recommendation: Purchase Shares in Bank of American and MBNA Corp

On the day of the announcement BAC shares closed at $45.61 while shares of MBNA closed at $26.16. Since the deal is comprised of cash and stock I would advise an arbitrager to purchase stock in both companies and hang on for the ride. As of yesterday, August 18, 2005 Bank of America closed at $43.80 while MBNA closed at $25.32. The deal is expected to be approved by the forth quarter. Investors will have to stay tuned to see if my strategy holds water. Based on the returns seen from the Sprint and Capital One deals the current negative returns will not stay negative for long.

		BAC	% Increase		KRB	% Increase
Prices as of :	**8/18/2005**	$43.80	**-4%**		$25.32	**-3%**
Announcement	**6/30/2005**	$45.61			$26.16	
	$ Change	($1.81)			($0.84)	



Conclusion

The best way to stay on top of a merger arbitrage opportunity is to pay attention to the:

1. Regulatory environment - Will the deal be approved?
2. Interest rate environment - Where are interest rates headed?
3. Benefits derived from the deal - What will the market position of the combined company look like?

Merger Arbitrage is low on risk which means that investors are not likely to receive eye popping results like being on the inside of the recent Baidu IPO, but for investors seeking steady returns this is a great place to look for parking your dollars and cents.

Sources:

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