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How to make money from takeovers

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Making money when companies are about to be taken over has long been the domain of powerful offshore hedge funds, but a growing number of local players are taking on the big boys and playing the deals in a bid to amplify returns.

As the broader sharemarket remains volatile, amid concerns the US economy is poised to fall into another recession and ongoing European debt woes, a range of investors across Asia have turned their attention to event-based investing, trying to pick short-term profits as opportunities arise.

Some of the world's best-known hedge funds from New York and Hong Kong have been busy playing Australian deals. John Paulson's Paulson & Co, for example, which famously profited from large bets against British banks during the credit crisis, was said to be an active player in Rio Tinto's recent acquisition of Riversdale Mining.

Likewise, investors have come to expect the likes of Centaurus Capital, or one of the investment banks' prime-broking desks, to pop up on the register of a takeover target. Traders say that others, such as Och Ziff, are known to sit just under the 5 per cent substantial level so they don't have to disclose their positions.

But there's also a small pocket of local investors chancing their arm in the M&A game. Event funds represented about 8 per cent of all hedge funds in Asia back in 2004, but that number is expected to be closer to 20 per cent today.

Merger and acquisition arbitrage is one of the most popular event-driven methods. It relies on buying shares in takeover targets once a deal is announced and holding the stock as it nears completion.

Most M&A deals are announced with control premiums as high as 50 per cent. The bidder must be prepared to pay a premium to convince shareholders to sell their shares, and it is within that premium that hedge funds move into action and try to make fast money.

Coal & Allied, for example, this week received a \$122 a share non-binding approach from Rio Tinto. The offer was at a 33 per cent premium to Coal & Allied's prior close of \$91. Coal & Allied shares jumped 29 per cent to \$116.20 on the day the bid was announced.

Likewise, software company iSOFT received a 17¢ a share offer from global giant Computer Sciences Corporation when its shares were trading at only 5¢ each. iSOFT shares rose from 5¢ to 15¢ on day one and slowly crept towards the 17¢ a share mark as the deal moved closer to completion.

Speed is the key to success for hedge funds. They must quickly assess how likely a deal is to complete once it is announced, and then decide whether they can make a profit that justifies the risk. If a fund thinks the deal is likely to go ahead, or that there could be an improved offer out there, it will buy into the shares on the way up as long-only investors take some profits, and re-allocate funds to other areas of their portfolio. It's a short term, high-risk play. But the returns, if played right, can be exceptional and produce the sorts of numbers that long-only equity funds only dream about in the current market.

Antonio Meroni, who runs Pengana's Asian Special Event Fund from Sydney along with Singapore-based colleague Vikas Kumra, says his strategy has returned about 13.4 per cent each year since it started in 2006. If you invested \$1000 with Meroni in December 2006, you would have about \$1700 today. If you had put that same \$1000 in the S&P/ASX200 Index, you would have about \$730 (plus any dividends received).

It sounds straightforward, and in theory it is. But the key to making money is getting the call right on whether a deal will complete.

"Due diligence is very, very critical in M&A trading," says Kumra. "Essentially, proper due diligence is what separates the men from the boys."

That due diligence includes the motives of the buyer (strategic or financial), the target's valuation based on a



Due diligence is very, very critical in M&A trading. Essentially, proper due diligence is what separates the men from the boys. **Photo: Rodger Cummins**

discounted cash-flow method, the target's shareholder register and an assessment of the deal's conditions, including regulatory hurdles.

The homework should snuff out the likelihood of a better offer, be it from the current bidder or a rival.

Despite the current market malaise, there are plenty of opportunities in the M&A universe. A Bloomberg survey of 21 takeover targets that had recently received offers showed only three were trading at levels above the offer prices. Among those trading below their offer price were high-profile targets Foster's Group, Macarthur Coal and Austar United. Austar was trading at a massive 75 per cent premium to its \$1.52 a share offer price earlier this week.

Kumra says it is important to study the nature of the buyer and their capacity to arrange funding for a higher offer, as well as putting a dollar amount on any synergies the buyer would receive from the transaction which could identify how far they are willing to go to secure the asset. He said the strategy paid handsome dividends on the Territory Resources deal, which is nearing completion.

The iron-ore miner received a 46¢ a share takeover offer from Exxaro, which was recommended by Territory's board. The offer looked juicy – it was pitched at a 64 per cent premium to the miner's last closing price – but some thought it had further to go.

Also circling was Territory's largest shareholder, Noble Group.

Kumra says Noble has been an aggressive bidder in Australia, and an improved offer was always likely. Noble subsidiary Jonesville lobbed a 50¢ a share bid soon after Exxaro's approach and has since secured more than 90 per cent of Territory's register. Once a bidder gets to 90 per cent they can compulsorily acquire the remaining shares.

"If you studied the nature of the buyer, Noble has demonstrated very aggressive behaviour in the M&A markets," Kumra says. "We felt they would become aggressive in protecting their interest and there was a very high probability that was being mispriced by the market."

Returns from M&A activity have made others stand up and take notice and have caught the attention of some local fund managers who are taking on the big boys.

Wilson Asset Management portfolio manager Chris Stott oversees his firm's active funds that make bets in the M&A game, as well as looking for other opportunities.

Stott lists iSOFT as one of their profitable calls, along with Healthscope. Healthscope was acquired by a private equity consortium last year after a bidding war with a rival private equity suitor.

When deciding whether to buy into a situation, Stott says the first point of call is to ensure the potential return covers the risk. "When we assess it, the annualised return has to be above what we get on our cash, for starters," Stott says.

Annualised return is the key. Just because a company's shares are trading at 16¢ and the offer price is at 17¢ does not mean the return is insufficient. It is important to consider the timeframe. If that 1¢ gain happens over the course of one month, the annualised return becomes far more attractive.

If it passes the return test, Wilson's team assesses the two parties involved in the deal, before getting on the phone to broker analysts to get a feel for what the wider market thinks of the target and the specific deal.

Once a position has been established, M&A investors treat their investments like a bond. If the yield becomes too small given the calculated risk, they trim the position or sell out completely.

But Stott says one of the most important factors is liquidity.

"You want to be able to get out if things go wrong," he says.

When a deal gets called off or "breaks", as the hedge funds say, M&A players often dump stock, causing the share price to fall sharply – sometimes even to levels below what the stock was paying before the bid was launched.

Austar shares recently dropped from \$1.29 to \$1.05 when the Australian Competition and Consumer Commission raised competition issues in its approach from Foxtel and its shareholders.

Foxtel is 50 per cent owned by Telstra, while Rupert Murdoch's News Corp and James Packer's Consolidated Media Holdings, own 25 per cent each. The ACCC was worried that the deal would produce "a substantial lessening" of competition in several areas.

Austar shares have since fallen further, closing yesterday at 90.5¢.

Aurora Funds Management chief investment officer John Corr says it has been a relatively tough six to 12

months in M&A arbitrage for hedge funds.

Corr says deals are less likely to complete since the global financial crisis thanks to regulators, shareholders and company boards.

“We think post GFC there’s going to be lot more regulation, a lot more concentration concerns and in a market that has had big falls, some shareholders still have a belief they should be getting close to previous highs when someone wants to take out a company,” Corr says.

“We have still made some money but some deals are failing, which is what you find in a market that has fallen and well off its highs.”

As well as Austar’s apparent deal break, hedge funds have been caught out by Redflex and Indophil Resources in the past year.

Redflex shares dropped 32.4 per cent when shareholders rejected a takeover bid from Macquarie Group and The Carlyle Group, while Indophil Resources shed 50 per cent last year when its takeover offer broke.

Corr blames a widening gap between shareholder expectations and buyer interest. The gap would not have been helped by the recent sell-off and has some market pundits tipping a quieter period for M&A in the coming months.

Wilson’s Stott says playing events was easier throughout 2009 and 2010, when companies recapitalised balance sheets and some confidence returned to the boardroom.

“All the companies had re-capitalised their balance sheets; there was a heightened level of M&A activity,” Stott says.

“It was a good period for M&A activity but it’s dried off, given uncertainty in the economy globally. Balance sheets are in great shape but there is too much uncertainty for people to go out and pull the trigger.”

But the recent fall in confidence has not necessarily been enough for shareholders to accept any offer that comes their way.

Likewise, boards such as Macarthur Coal have been holding out for a better offer. “Some actions by shareholders and directors are not always what most people would consider logical,” Corr says.

He says there is not much investors can do to avoid being hit when a deal breaks, other than continually doing research and monitoring the situation.

“If you are scared in these situations, we recommend keeping position size relatively small,” he says. “Once you are in position and news turns bad, it will tend to run pretty quickly.”

Over at Wilson, Stott keeps a 10 per cent stop loss on all of his deals, which means a sell order is automatically triggered if the stock drops more than 10 per cent.

But deal breaks can be a positive for hedge funds that are masters of short selling.

Pengana’s fund did just that in Austar. Kumra says he worried that shares across the media sector had fallen by about 20 per cent in the time that Austar received its offer until the ACCC announcement, while Austar shares had gained about 20 per cent.

“We’ve not seen many deal breaks,” Kumra says.

“Most of the deals we have been involved in have successfully completed. Austar is probably the one that stands out where we took a non-consensus view.”

Playing the field

Takeover targets and their premium or discount to offer price

Target	Deal size (\$m)	Offer price (\$)	Trading price (\$)	Premium (%)
Bannerman Resources	134	0.61	0.35	74.9
Austar United	2577	1.52	0.96	57.5
Amadeus Energy	80	0.33	0.22	46.7
Catalpa Resources	373	1.77	1.4	26.0
Kresta Holdings	40	0.32	0.26	25.0
Auzex Resources	62	0.42	0.37	13.0
Gold One	428	0.55	0.5	10.0
Sundance Resources	1125	0.50	0.46	8.7
ConnectEast	2449	0.55	0.51	7.8
Eastern Star Gas	599	0.78	0.74	5.9
NSX	23	0.23	0.22	4.4
FerrAus	120	0.94	0.9	4.2
Territory Resources	113	0.50	0.49	3.1
Foster's Group	11441	4.90	4.79	2.3
Macarthur Coal	3518	15.5	15.21	1.9
DKN Financial	94	0.80	0.79	1.3
Valad Property Group	207	1.80	1.78	1.1
Cellestis	343	3.80	3.77	0.8
Centrebet	149	2.00	2.04	-2.0
Conquest Mining	264	0.42	0.44	-5.3
Crescent Gold	48	0.05	0.07	-21.7

18 of 21
targets are
trading at
a discount
to their
takeover
offer

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