Executive Summary

M&A is a well-researched and broad topic, with one branch of research focusing on the analysis of M&A from the shareholder or investor perspective. Investors of target companies can profit from M&A in the short term (Martynova & Renneboog, 2008), as target company shareholders often receive a premium on the stock's current price when a deal is announced and subsequently closed (Varaiya, 1987). Several institutional investors follow a merger arbitrage strategy, trying to identify M&A deals that will likely realize the arbitrage spread (Jetley & Ji, 2010). The arbitrage spread is the difference between the market price after the announcement of the deal and the offer price, which is created due to the uncertainty of the eventual closing of the deal (Jindra & Walkling, 2004). A question that arises when discussing such strategies is how merger arbitrage investors can identify and distinguish promising deals from unfavorable ones.

The fundamental goal of this thesis was to derive a merger arbitrage-based investment strategy by using deal-specific factors influencing the likelihood of deal success to locate deals that are likely to be successful with the intention of realizing the merger arbitrage spread.

As a first step, a literature review of the field of M&A was conducted to receive insights into the behavior of the market for corporate control, the main reasons why companies engage in M&A, and what investors might expect from a proposed merger or acquisition. Furthermore, relevant research regarding deal success probabilities was analyzed. Results from several studies find deal-specific factors that seem to predict deal success (e.g., Brown & Raymond, 1986; Caiazza & Pozzolo, 2016; Tanna et. al., 2021). The factors used for the strategies are:

- Deal Attitude: Was the transaction friendly or hostile?
- Deal Consideration: Was the transaction financed with cash or stock?
- Deal Geography: Are the companies' headquarters located in the same country?
- Deal Rationale: Was the transaction motivated by diversification or industry focus?
- Deal Closing Probability: Does the market imply an above- or below-average transaction success probability?

As a second step, the deal-specific factors were utilized to construct two different investment strategies. One strategy bought the target stock if a certain number of deal-specific factors were favorable while excluding deals not reaching the desired number of factors (upper threshold). The second strategy additionally sold the target stock short if a certain number

of deal-specific factors were unfavorable (lower threshold). Furthermore, the two fundamental strategies were expanded using three different holding periods and three upper and lower threshold levels. Also, a long-only strategy (LON) investing in all 160 transactions was tested as a baseline strategy against which the constructed strategies could be compared, resulting in a total of 21 strategies that were tested throughout the thesis. For external comparison, the S&P 500 index and the S&P Merger Arbitrage index were used.

As a third step, the constructed strategies were applied to a dataset of 160 M&A deals. As for the dataset, the investment universe comprised transactions that occurred between 2010 and 2022 and included targets that were, at the time of the transaction announcement, constituents of the S&P 500. Annualized returns were calculated for all transactions to calculate mean annualized returns for the respective strategies.

On a descriptive basis, the returns for the strategies seemed to differ. For example, the LES strategies showed higher losses due to the loss potential of short selling. However, the results of the inductive comparison between strategies showed no significant differences between the average returns of the constructed long-exclusion (LEX) and long-exclusion-short (LES) strategies and the LON baseline strategies. Furthermore, the tests between different threshold levels also did not yield significant differences. This implies that the chosen deal-specific factors could not identify more profitable M&A transactions. One explanation could be a missing connection between deal success probabilities and the magnitude of the arbitrage spread. Only because a transaction is likely to succeed, it does not necessarily make the deal profitable for merger arbitrage investors. Further research could be conducted using the same or a similar methodology with an adjusted or more extensive set of deal-specific characteristics, different holding periods, or a different data sample.

Literature

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