Part I
The Arbitrage Process

The first part of this book describes the environment in which arbitrageurs work, as well as the major principles of merger arbitrage. Although they are often analyzed within the context of corporate financing, M&A are essentially tied to the financial markets and to changes therein, as the first chapter will show. In Chapter 2, we will study the financial mechanisms at work in the arbitrage process, as well as their different characteristics depending on the payment method of the transaction. The third chapter looks at the risk and return factors of merger arbitrage. The final chapter in Part I examines the historical performance of merger arbitrage and the different approaches adopted by specialist managers.

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1
The Role of the Market in Mergers and Acquisitions

In spite of the many laws governing mergers and acquisitions (M&A), it is always the market that has the final say. Takeover bids may have to comply with various national and international laws, but by accepting or rejecting the terms of these bids the market is the ultimate judge of whether they are successful. Whether they like it or not, the market can sometimes usurp even the decision-making bodies of the target company in this role as the ultimate judge. As you might expect, the market's role of arbitrator is governed strictly by securities regulations, whether during bull periods, such as the beginning of the 1990s, or during more difficult times for financial markets, such as we have seen since 2008.

The concept of "the market" has evolved considerably. It now comprises as many different operators as strategies, and recent changes have served only to make it more fragmented and diverse in terms of the operators it groups together. These market operators include investment funds (arbitrage funds, private-equity funds, etc.), family offices, wealth managers, asset management units of major financial institutions, and individual shareholders. Each operator follows its own investment process in order to achieve its own goals, whether it is managing its own money or someone else's. All this means that the market, now more than ever, is a complex sum of individual interests. The partial or total liquidation of many so-called alternative investment funds, in the wake of early redemption requests from investors following the recent financial crisis, is a prime example. Moreover, the increase in trading volumes on global stock exchanges means a much greater turnover of shareholders in the share capital of companies. Combined with the different behaviors of market operators and the wide range of financial instruments available, this makes takeover bids – and the factors that determine whether they will be successful – more complex.

Such diversity on the financial markets means there can be no broad-brush analysis of takeover bids. As well as the individual characteristics

of each operation, the reactions of the many parties involved and their respective dynamics need to be taken into consideration. The success, or otherwise, of takeover bids therefore depends fundamentally on the market. Over the last few decades, the market has undergone many changes that have affected M&A practice.

1.1 STRUCTURAL CHANGES TO THE FINANCIAL MARKETS

Over the last few decades, the global financial markets have experienced several major structural changes as they have risen on the back of the growth and globalization of listed companies. The total stock-market capitalization of all US and international companies listed on the New York Stock Exchange rose from $2,700 billion in 1990 to more than $13,300 billion in 2010. Over the same period, the S&P 500 climbed from 350 points to more than 1,350 – an increase of over 285%.

The first thing to point out is that market liquidity has increased considerably. Average annual trading volumes on the New York Stock Exchange rose from around $1,325 billion in 1990 to more than $11,600 billion in 2010. This significant increase in trading volumes, and therefore market liquidity, enables market operators to position themselves more easily, and above all more quickly, in the share capital of companies. Those wishing to launch a takeover bid can therefore quickly build up significant stakes in the share capital of target companies, whether before or after the bid is actually submitted.

There are many ways of building up blocks of shares, such as purchasing shares on the market, buying blocks of shares off market, and using derivatives. Whatever method is used, it is made easier by a more liquid market. Having said that, all these techniques are subject to strict regulatory control. There are two major determining factors: first, the notion of privileged information held by the potential instigator of the transaction (moreover, different jurisdictions interpret this issue in different ways – does a market operator preparing a takeover bid for a target company have privileged information?); and second, ownership threshold disclosure requirements. These issues are topical and often trigger debate, as shown by the recent creeping takeover of Porsche by its German competitor Volkswagen.

A second significant change to the markets is their integration with international capital flows. Nowadays, foreign capital always represents a large part of the volumes traded on all global financial markets. This

change has significant consequences and goes hand in hand with the first change we discussed earlier. It encourages ownership fragmentation and the circulation of capital – both of which are conducive to takeover bids. The greater openness of the markets also means that individual investment choices depend increasingly on economic and financial criteria. In the context of takeover bids, these criteria are particularly crucial in determining whether or not an investor tenders their shares.

There are many reasons for this change. First, EU regulation encourages the free circulation of capital. Second, advances in communication technology have brought about the development of new types of electronic trading platforms, which facilitate market access and allow for faster execution. Lastly, the harmonization of international accounting standards and better access to financial information have also contributed to better global integration of capital markets.

Countries have responded to the opening up of the international capital markets, but it remains to be seen what effect this response will have on M&A. Several countries have created investment structures aimed at protecting "sensitive" assets. There is, of course, nothing new about sovereign wealth funds (SWFs); the first, the Kuwait Investment Board, was set up in 1953. These funds now manage more than $3,000 billion, and their primary aim is to diversify their investments. Until now, they have been most active in taking minority stakes in large US or European groups that have built up a dominant position in their markets. There have been several recent examples of conflict between SWFs and the authorities in the country of the target company, such as the attempted takeover in 2006 of US oil company Unocal by state-controlled Chinese group CNOOC. It remains to be seen what effect will arise from these funds being in the share capital of M&A target companies. As they are largely a recent phenomenon, it will be interesting to see the stance adopted by these funds, especially if their presence in the share capital has come about through a concerted effort with the management team of the target company.

The third major change in the markets is the growing importance of hedge funds. The main aim of these funds is to deliver "absolute" returns, i.e. to generate positive performance whatever the conditions on the financial markets, as opposed to benchmark management where performance is compared to that of a reference index. Other specific characteristics of hedge funds include widespread and sometimes mass usage of leverage, short selling, derivatives, and fee systems that include performance fees. The hedge fund industry currently has $2,000 billion

of assets under management, which is fairly small compared with the asset pool of traditional, long-only mutual funds. Redemption requests from investors and many fund liquidations caused hedge fund assets under management to fall sharply during the recent financial crisis. Fundraising has been positive since 2010, however, with investors once again very keen on returns that are uncorrelated to the markets. Furthermore, we need to take into account the leverage used and the actual exposure of hedge funds, which in general is much greater than for other asset management players and therefore increases the amount of assets.

Hedge funds are something of a broad church in that they comprise many different investment strategies, asset classes (equities, bank debt, high-yield bonds, etc.), and financial instruments. And yet the names given to the different styles have become familiar: long/short, event driven, macro, convertible arbitrage, etc. With regard to takeover bids, "activist" funds specialize in acquiring significant stakes with a view to acting as a catalyst, or sometimes with the explicit aim of encouraging a bid, whether under their own steam or on behalf of a third party. The strategies employed by these funds are very similar to the conduct of individual activist investors such as Carl Icahn or T. Boone Pickens. Among other things, Mr Icahn was particularly active in the split of Motorola into Motorola Mobility (housing all the mobile phone activities) and Motorola Solutions (specializing in corporate telecoms services). This separation enabled the acquisition of Motorola Mobility by Google, which was on the lookout for patent buys to help its Android system compete better with Apple's iPhone. A large number of takeover bids are the result of moves by these activist investors or funds.

The final change to the financial markets is that the different markets are becoming increasingly integrated. The connections between the equity and derivative markets and the markets for other products have become much stronger in recent years, partly because hedge funds use all of these financial instruments at the same time.

LVMH's acquisition of a 21.4% stake in Hermès once again provides a good example of how derivative products (in this case, equity swaps) can be used to build blocks of control. It also shows the role that regulation needs to play in market transparency. In most cases, the use of derivatives is not regulated. Since 2009, however, regulation has gradually evolved in its attempts to encourage more transparency by making more information available to market operators, particularly

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on the existence of such derivative products. Furthermore, intermediaries have developed new ways of financing call and put options. These strategies involve less exposure and greater leverage. Their development has therefore enabled certain highly specialized operators – such as arbitrage, activist, and sovereign funds – to play a greater role in the markets. We can see that all of these financial innovations, brought about by greater market integration, require changes to regulation and have undeniably transformed the markets themselves.

1.2 CHANGES TO M&A PRACTICE

The transformations we have just discussed, which have altered the environment of the financial markets and how they operate, have also affected how takeover bids are conducted. The first thing to note is that the increase in the size of mergers and acquisitions is closely linked to the increase on the financial markets. Since the mid-1990s, M&A volumes have been around 10% of stock-market capitalization on average in a given market. In recent years, as well as the increase in the size of M&A, there have been significant changes to takeover bids and the way they are conducted.

The first change involves the greater role of cash in M&A transactions. Before the dotcom bubble burst in 2000, cash-only deals represented around 35% of all M&A. Since 2005, this figure has climbed steeply to between 60% and 70%. There are several reasons for the rise of cash deals at the expense of all-share and mixed offers:

- Since 2000, large international groups have shaken up their cost structures to generate more cash and therefore improve their liquidity. Since 2005, the trend has been to use this cash, and one of the main uses has been the acquisition of target companies with a view to improving growth prospects.
- The increased role of cash goes hand in hand with fewer share offers, which can be seen as more risky because they depend partly on the share price of the buying company. Some observers believe the number of share transactions has fallen because they are less attractive than all-cash deals to shareholders of the target company. Moreover, all- or part-share offers can create unwanted downward pressure on the buyer's share price as the result of large sell positions being built up.
- The third reason – which we will come back to later – is the emergence and growing importance of private-equity funds in M&A transactions

up to the summer of 2007. Extraordinarily favorable lending conditions saw a sharp rise in the number of leveraged buyouts (LBOs), which involve large amounts of debt. Finally, any credit squeeze would surely see a return to more share offers at the expense of all-cash deals.

A second change has been the increase in hostile transactions. In 2000, this type of operation represented only around 2% of global M&A. Over the last few years, this figure has risen to approximately 15%. Hostile bids are generally a sign that managers of the buying company are confident about the prospects for their business, about macroeconomic stability, and that the transaction is strategically sound. Such bids are less likely to arise in uncertain climates like the present one, which is marred by fears over eurozone debt and global growth. The presence of activist investors, such as the ones we discussed earlier, in the share capital of target companies can encourage a hostile bid, too.

The emergence of LBO funds has also brought about a big change on the financial markets. Starting in 2005, extremely favorable lending conditions and low interest rates encouraged the appearance of these funds and allowed them to play a more important role in the financial markets. They were able to raise considerable sums of money and make full use of debt for most of their transactions. In 2006 and 2007, LBO funds were behind as many as 25% of global M&A. Historically, these funds came about largely for the purposes of financing management buyouts, with a view to maximizing profits and cash flow. They typically have a medium-term investment horizon (three to five years; sometimes more) and target returns that are attractive and partly uncorrelated to the financial markets.

A return to more "normal" credit conditions in recent years, and indeed tougher conditions in the form of the credit crunch, has had a big impact on this kind of transaction and on private equity as a whole. Private equity will remain, however, a key player on the markets and an initiator of takeovers owing in particular to its immense investment power. At the same time, the ways in which these investment funds intervene have changed slightly. These days, some private-equity firms tend to acquire minority stakes and then help managers to take operational decisions (e.g. Blackstone in Leica Camera). Majority transactions now involve lower levels of leverage.

Lastly, M&A are increasingly instigated by groups from emerging nations. Since 2000, the financial markets of emerging nations have

changed dramatically. They are playing an increasing role in international transactions, both as a source and a destination of capital. Between 2000 and 2007, stock-market capitalizations in China, India, Russia, and the Middle East increased tenfold to reach around $5,000 billion.

1.3 MARKET EVALUATION OF M&A

Before actually making an offer, the bidder must take into account the often different objectives of the parties involved. The two determining factors are the bid price and how the offer is structured. The price needs to be attractive to shareholders of the target company, and the offer must be structured in such a way that respects the many constraints placed upon the bidder.

1.3.1 The price offered to shareholders of the target company

The bid price is the most important factor:

- it must include a control premium over the various reference share prices (volume-weighted averages taken over different periods; the peak price from the 12 months preceding the offer date is often the best indicator of a company's standalone value);
- it must be greater than the entry price paid by the target company's historic shareholders, hence the need to research as thoroughly as possible the shareholder structure and the entry price paid by the various shareholders;
- it must be analyzed against the price targets set by sell-side analysts and against how much growth potential the board and managers of the target company think the share price has;
- it should be evaluated based on the likelihood and amount of a counteroffer from a rival bidder (and therefore on the synergies attainable by this competitor).

From the buyer's point of view, they need to be able to justify the price by the possible synergies and by the added value that the target company's activities will create for their shareholders.

1.3.2 Structure – the key to evaluating an offer

Offers can be made either in cash or in shares of the buyer, or a mixture of the two.

An all-cash offer is generally considered to be more attractive to shareholders of the target company because they know exactly how much they will be getting. Share offers are unpredictable because the value of the buyer's shares is subject to market fluctuations. Having said that, share offers can be fiscally advantageous because they are generally subject to deferred taxation. Moreover, share offers mean shareholders retain an interest in the performance of the newly merged entity (although there is nothing to stop these shareholders using the money they receive in a cash bid to reinvest in the buyer).

For the bidder, the choice between a cash and a paper offer is determined largely by five factors:

- the cost and availability of financing;
- their financing constraints, debt ratios, and credit rating;
- their share price (issuing shares is often seen as a sign that a company's management team overvalues its shares);
- the accretive/dilutive effect on earnings per share (EPS) (unless the price-to-earnings ratio is very high, cash payment is generally more favorable);
- aspects relating to shareholder structure and dilution of control.

Whether the offer is announced before or during market opening hours, reactions from the different market operators are seen immediately and can be very revealing as to their assessment of the bid.

Attention should be paid to several factors, including the reaction of the share price not only of the target company but also of the bidding company. Indeed, the latter is even more important where the offer is for a similar-sized company or is made entirely or partly in shares. The different reactions provide a first impression of whether or not the market thinks the offer will be successful.

The spread is the gap between the share price of the target company and the value of the offer once the bid has been made public. The size of the spread provides us with an idea of whether the bid is likely to be successful. If the market believes there are likely to be higher counterbids, the share price of the target company will be higher than the offer price, meaning the spread is negative. Conversely, if the market does not expect counterbids and is skeptical about the offer being successful – if there are doubts about financing or regulatory approval, for example – the spread will be very large, with the share price of the target company well below the offer price. If a bid is on track and the transaction is likely to be completed, the spread tends to gradually narrow as

the closing date approaches – i.e. the share price of the target company and the offer price converge.

Arbitrage funds make their investments once the bid has been made public, based on their view of the likelihood of success of the bid. We will come back to that later in the book.

In the event of an all- or part-share offer, it is important to keep an eye on how the share price of the bidder reacts to the announcement. After all, the final offer amount depends on the buyer's share price. If the bidder's share price falls, the offer premium is reduced and the bid becomes less attractive to the shareholders of the target company. This can indicate that the market has a lack of faith in the bid and its chances of success. Conversely, a rise in the bidder's share price makes the offer more attractive to the shareholders of the target company. We will take a closer look at this phenomenon in the case study on Alcan's bid for Pechiney, which follows this chapter.

In the event of an all-cash offer, the bidder's share price has no impact on the offer made to the shareholders of the target company, but it does give an indication of how supportive the bidder's shareholders are of the acquisition and should not, therefore, be ignored.

So, we have seen that the markets play an essential role of arbitrator in takeover bids. They judge the quality of the offer made by the bidding company and assess how capable the target company is of resisting this offer.

Having said that, the diversity of the parties involved and their individual objectives and interests make the situation much more complex in reality. The evolving nature of the parties involved, their methods and structures has also brought about changes in M&A practice.

1.4 TYPES OF SYNERGIES AND WAVES OF M&A

1.4.1 Justification for transactions

Buyers commonly justify M&A by claiming that the resulting synergies will create value. These synergies can be grouped together as a series of objectives.

1.4.1.1 Better efficiency

The main aim of any M&A operation is to maximize value for shareholders.

Economies of scale are generally the reason most often given for a business combination. This means a lower average unit cost of production for the quantity of products manufactured. A merger seems to be an effective way of achieving this and spreading fixed costs over a greater number of manufactured units.

The Boston Consulting Group (BCG) determined a few years ago that the unit cost price drops by 20% when cumulative production volumes double. An acquisition is therefore a quick way of enjoying economies of scale, for example in terms of research and development costs (pharmaceuticals) or distribution costs (e.g. Pernod-Ricard's purchase of Allied Domecq in the spirits sector, or the Kraft/Cadbury confectionery deal).

The size of the merged companies also brings improvements in efficiency and gives the buyer the chance to reach the critical mass it needs as part of its development.

Cost synergies can also be brought about through streamlining in the form of sharing nonspecific resources that are present in both companies.

This rationalization, which reduces costs through economies of scope, may involve one or more areas of business. It helps to avoid overlapping and makes the organization more coherent by offering cost-saving opportunities in the form of:

- grouping together sales forces and distribution networks;
- rationalizing certain services or functions;
- optimizing production sites by closing the less profitable ones or allocating resources more effectively;
- centralizing company departments and divisions;
- improving the distribution of human resources and, in some cases, cutting jobs.

1.4.1.2 Obtaining market power

One of the reasons for M&A is the desire to have enough economic power to strengthen the company at the expense of other market operators. This market power can then be used for offensive strategies.

Buyers use M&A to increase their domination or influence over the market, a strategy which is strongly linked to the company's ability to subtly affect the competition by, for example, reducing production volumes in order to increase prices or imposing certain restrictions on its rivals.

The increase in raw-material procurement volumes that arises from the combination gives the new entity an advantage in negotiating

contracts with its suppliers (e.g. Carrefour/Promodès). More specifically, it can negotiate lower prices, quicker delivery times, and longer payment terms.

1.4.1.3 Acquiring specific resources

This is important because a company sometimes needs to get hold of new resources, whether these come in the form of expertise or assets, quickly in order to remain competitive.

Such a situation can lead the management of a company to opt for a merger, which is the only choice available if the resources needed are not available on the market.

Buying companies look for resources such as specific expertise (e.g. Google's acquisition of YouTube) and reputable brands (e.g. the purchase of Volvo by Chinese group Geely).

Mergers can be explained by the desire to buy resources that are already available on the market. The transfer of resources from the acquired company to the buyer could involve technology resources or teams with a particular area of expertise.

In such a transaction, the target company is essentially a "resource provider" aiming to add to or improve the capabilities of the buying company.

1.4.1.4 Benefiting from the intellectual property of the target company

Intellectual property can give a company a competitive advantage and is perhaps one of the best reasons for an acquisition. It can include patents, registered trademarks, manufacturing processes, complex databases, and research and development laboratories with a strong track record in product development. Sanofi's acquisition of Genzyme is a perfect example.

1.4.1.5 Hindering the progress of a troublesome competitor

A merger can be an effective way of seeing off the threat of major rivals. It can be a defense mechanism in several situations, with results of varying impact, such as:

- neutralizing a competitor by strengthening market power – this strategy, which has a temporary and direct effect, can be seen in the case of internationalization;

- eliminating a competitor – this strategy, which has a long-term and direct effect, enables the buyer to eliminate a rival that is threatening its market leadership;
- submitting a counterbid – this strategy, which has a long-term and indirect effect, prevents rival firms from merging and enables the company to take control of the target entity of its biggest competitor. The hostile double all-share bid made by BNP in 1999 for Société Générale and Paribas, which were planning to merge, is a good example.

1.4.1.6 Blocking new entrants to a sector

If a company wants to prevent external threats, it can attempt to dissuade potential new entrants to a sector. This kind of threat is even more serious if the costs involved in getting access to the sector are not especially high for potential entrants. A merger can be a vital way of responding to the danger posed by new competitors.

A company can make entry into the sector more difficult by merging with one of its rivals, suppliers, or distributors. This enables it to raise the cost of entry into a sector to such an extent that penetrating the market becomes either too risky or not profitable enough.

By acquiring a potential rival, this kind of merger can also, of course, transform an element of risk into an opportunity for growth. Such a strategy is particularly useful where technology is a strategic resource with clear and sustainable benefits.

1.4.2 Waves of M&A

As shown in Figure 1.1, the M&A market has two main characteristics: an underlying trend of steady growth and a cyclical nature in the form of waves.

Figure 1.1 shows two aspects of the global M&A activity since 1980: the number of transactions and their overall value. The cyclical nature of this activity and the waves of transactions can be clearly observed. In the US, there are generally considered to have been six M&A waves:

- The first dates back to the 20-year period straddling the end of the 19th and the beginning of the 20th centuries, just after the industrial

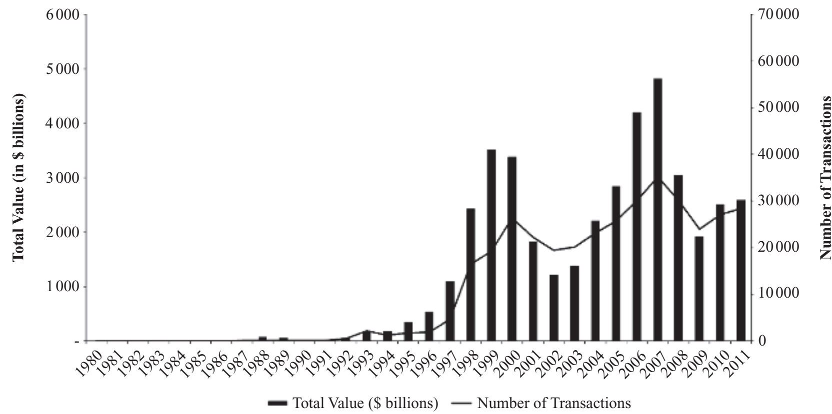

Figure 1.1 Global M&A activity in value and number of transactions since 1980
Source: Bloomberg

revolution in the US. It involved the creation of "majors" through the horizontal mergers of industry-leading conglomerates. Groups such as U.S. Steel and Standard Oil were created during this period. Research shows that the period saw more than 5,000 companies merged into just 300 conglomerates. The first wave was interrupted by the Panic of 1907 and prompted many responses from regulators. It was during this period that the first texts were written regulating the constitution of conglomerates, and these texts form the basis of the competition rules still in effect today.

- The second M&A wave was born out of the economic growth that followed the First World War. Horizontal transactions were less common because new antitrust rules gave government authorities the power to block anti-competitive deals. The second wave was therefore a large consolidation of existing groups by way of many vertical M&A. This movement gave rise to oligopolies but did not result in specific regulation. However, the 1929 Great Depression that brought an end to the second wave led to the creation of the Securities and Exchange Commission (SEC) and the adoption of the Exchange and Securities Acts, with a view to regulating the issue and exchange of shares.
- The third wave emerged at the start of the 1960s and lasted for a decade. The trend at the time was for companies to expand and diversify, with the peak period of 1967–1969 seeing more than 10,000 companies acquired. The stand-out feature of this movement was the

prevalence of hostile takeovers. Previously, offers required the publication of a proxy statement and then the approval both of the target company and of its shareholders. Now, bids took the form of tender offers with payment in cash. This meant the decision was taken directly by the shareholders of the target company, bypassing the opinion of the board of directors. The third wave was a considerable movement because companies had no anti-takeover defense mechanisms at the time. The still-young SEC passed the Williams Act in 1968 to regulate tender offers from start to finish. The recession and stock-market crash at the start of the 1970s did not put a complete stop to the third wave. A new type of transaction emerged, born out of the previous wave of initial public offerings and the subsequent stock-market downturn: delistings. Often initiated by a majority shareholder, these operations were mostly a display of authority. This caused regulators to clampdown on delistings, which saw small investors often rendered powerless and presented with a *fait accompli*. Well after the end of the third wave, the SEC passed a law forcing companies undergoing a delisting to publish their position on the equal treatment of shareholders with no affiliation to the buyer. The aftermath of the stock-market crash at the beginning of the 1970s put a definitive end to the third wave.

- The fourth wave was the wave of corporate raiders. It started at the end of the 1970s and came to a close with the savings and loans and high-yield bond market crisis. The proportion of hostile takeovers rose sharply during this period, mainly in the form of tender offers. An abundance of high-yield credit enabled the financing of large acquisitions by investment banks mandated by investors such as T. Boone Pickens. As a result of the previous M&A wave, companies were now equipped with anti-takeover defense mechanisms, making hostile bids more difficult. But favorable lending conditions meant bidders could offer huge control premiums, making hostile cash offers especially attractive to shareholders of target companies. This wave ended once such credit facilities had disappeared, namely after the 1989 crisis.
- The fifth and penultimate M&A wave came with the arrival of the dotcom bubble and extremely high stock-market levels. The period, which lasted from 1993 to 2000, was also one of "mega deals": six of the 10 largest ever deals took place in the final two years of the period. One of these deals, for example, was the $165 billion merger

of AOL and Time Warner in 2000. The regulatory response came in the wake of the Enron and WorldCom scandals.
- The sixth and final wave was dominated by private-equity funds. It lasted from 2003 until 2008 and will be discussed in more detail in Chapter 10 on LBOs.

There is nothing random about the cyclical nature of M&A; it is the result of interaction between many different economic forces. It can be explained, to varying degrees, by all of the following factors:

- Periods of innovation and technological change – these tend to bring about a wave of mergers between companies. As soon as a new technology appears (e.g. the internet or renewable energies), large numbers of companies are created. Some become market leaders, but others find it tougher, need to finance their development and end up being bought by the success stories. Microsoft's acquisition of Skype in May 2011 is an excellent example.
- Changes in scale or reference markets – companies now operate in a globalized framework that requires major investment and critical mass. The merger between British Airways and Iberia provides a good example of this.
- Changes to the regulatory environment – the majority of western countries have implemented a general regime of deregulation across many sectors (e.g. air travel, telecoms, banking, energy) over the last 20 years. This market liberalization caused a wave of privatizations and then reorganizations of certain sectors (e.g. J.P. Morgan's acquisition of Chase Manhattan in January 2011, and Imperial Tobacco's acquisition of fellow tobacco firm Altadis in 2008).
- A final factor is the structural evolution of the financial markets and the passage from a German model (dominated by bank financing and the weight of major shareholders) to an Anglo-Saxon one, where shareholders apply pressure on managers to improve competitiveness, financial results, and, therefore, the share price. In a context where the outlook for organic growth is fairly bleak (static populations and sluggish economic growth), companies are strongly swayed to sate their craving for growth by means of acquisition.

The phenomenon of waves of M&A has been the subject of extensive academic research, which has generally uncovered two possible

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explanations on top of the ones we have already seen (which, of course, are not mutually exclusive):

- M&A waves could perhaps be explained by the coexistence of under- and overvalued companies on a market at any given time. In this context, companies which are aware that they are overvalued look to buy undervalued firms in order to improve their value before investors pick up on the situation. It is a way of overvalued companies mitigating against a future sharp fall in value. This approach relies on the different information that different investors get from the market, and the same difference of information can be found between the buyer and the target company. In theory, the target firm, knowing it is undervalued, agrees to be bought in any case because it tends to overestimate potential synergies.
- The other possible reason is the behavioral aspect of finance. Several researchers have found that the psychology of a company's management team plays a crucial role when it comes to M&A, particularly the pride of an executive who buys a rival or another firm and finds himself at the head of an enlarged group. Research also suggests the existence of mass movements at the start of M&A waves, whereby managers are persuaded to embark on an acquisition because they do not want to be seen as the only inactive ones.

The following case study will provide examples of the things we have just discussed. Whether before or after the announcement of the acquisition of French industrial group Pechiney by Canada's Alcan (itself subsequently acquired by Rio Tinto), which began in September 1999, the market and its reactions played a fundamental role in how the operation panned out. We will start to look at M&A arbitrage in its own right in the next chapter.

CASE STUDY: The Alcan/Pechiney Deal

Three-Way Merger Aborted

In September 1999, Canadian aluminum giant Alcan signed a three-way merger agreement with Pechiney and Alusuisse Lonza Group AG (Algroup). The transaction was due to take the form of two independent share-swap offers by Alcan: one for Pechiney and one for Algroup. On November 22, 1999, Alcan shareholders approved the issue of new Alcan shares to be awarded to Pechiney and Algroup shareholders as part of the two offers.

On March 13, 2000, after several months of negotiations with European and US competition authorities, the three companies informed the European Commission that they had withdrawn their notification of the operation concerning Pechiney and abandoned the merger with the French company. The project was abandoned because the European regulator rejected the undertakings proposed by the three companies in response to competition concerns it had identified.

According to the European Commission, the new group would have had dominant positions in certain European markets, notably flat-rolled aluminum products used in the production of beverage and food cans and certain packaging products. The regulator did not consider satisfactory the undertakings proposed by the companies to resolve this issue of a dominant position. The Commission therefore published a press release on March 14, 2000, in which it identified the different problems raised by the proposed merger of the companies and explained its reasons for rejecting the undertakings they proposed.

On the same day, however, the European Commission gave its approval to the share-swap deal between Alcan and Algroup, subject to certain disposals. The combination between the two companies took place on October 17, 2000, with Alcan buying 99% of Algroup's shares. The remaining shares were acquired by Alcan in 2001, prompting the delisting of Algroup from the Swiss stock exchange.

Despite this sequence of events, Alcan had not given up hope of merging with Pechiney.

The First Approach

On October 7, 2002, Travis Engen, the chairman and CEO of Alcan who was still determined to add the French firm to his group despite the setback three years earlier, met in Paris with his counterpart at Pechiney, Jean-Pierre Rodier, for informal talks on whether the two companies might consider another attempt at a combination. The two parties were clearly convinced of the potential of such a deal and decided to continue discussions.

At the end of October, however, Pechiney announced that it had agreed in principle to buy the flat-rolled aluminum products business of Anglo-Dutch group Corus, which represented 14% of its total turnover at the time. This deal was driven by Corus' desire to focus on its core steel business and Pechiney's desire to re-establish itself as the world's third-largest aluminum producer, a position it had lost to Norway's Norsk Hydro. However, Pechiney's acquisition of the Corus business posed a regulatory problem for the potential merger with Alcan – just like in 1999.

Alcan and Pechiney executives held another meeting soon after, where the French firm explained that its priority was to proceed with the Corus acquisition and that, for the moment, it did not want to continue merger talks with the Canadian group. There was, however, another twist in the tale.

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On March 11, 2003, Corus announced that the supervisory board of Corus Nederland NV, its aluminum subsidiary, had rejected the proposed sale to Pechiney of its flat-rolled products and shaping activities. On this occasion, Pechiney's expansion plans had been thwarted because the Corus supervisory board was afraid that the deal would have had a negative impact on jobs owing to the considerable losses posted by the aluminum business of the Anglo-Dutch steel group.

Following the abandonment of the Corus acquisition, Mr Engen and Mr Rodier got together again to discuss the possibility of a merger between their respective groups. In the wake of discussions with their respective boards of directors, Pechiney executives informed their Canadian counterparts that the time was not right to discuss such an operation. Alcan and its board of directors continued to look at the possibility of a merger during this time.

On July 3, 2003, Mr Engen's PA organized a telephone conversation with Mr Rodier for the following morning. That same day, Reuters reported rumors of possible takeover bids for Pechiney by both Alcan and Norsk Hydro. Pechiney's share price rose from €32 to €33.70, with trading volumes above average levels.

During his conversation with Mr Rodier the following day, Mr Engen raised the issue of Pechiney's rising share price and assured his French counterpart that Alcan was not involved, either directly or indirectly, in buying Pechiney shares on the market. He asked Mr Rodier to organize a meeting that same day in Paris, and the meeting took place – at Mr Rodier's request – at the offices of Pechiney's lawyers.

During the meeting, Mr Engen presented to Mr Rodier the economic and commercial advantages of a merger between Alcan and Pechiney, the changes that had occurred in both groups and in the aluminum and packaging industry as a whole since the aborted merger in 1999, and Alcan's new approach to the potential competition issues arising from the transaction. Mr Engen said he wanted to establish the headquarters for the combined packaging business in Paris and to examine the economic and commercial reasons for also having the aeronautical and engineered products activities based in the French capital. He also discussed how Alcan would protect Pechiney's French employees, establish its R&D headquarters in France with a view to setting up a center for new reservoir technology, and commit to a meritocratic system for selecting the management team of the new Alcan group. Mr Engen also insisted on reaching an agreement before July 7, 2003 in light of the recent progress of Pechiney's share price, stock-market speculation (this concern related to legal requirements and other market disclosure restraints), and the need for Alcan to protect its own interests.

Mr Rodier said he was not in a position to give a formal response to Mr Engen, but he did raise several difficulties that Pechiney had faced in the wake of the failed operation in 1999.

He indicated to Mr Engen that Pechiney would not respond favorably to any transaction that would be subject to competition regulatory authorizations.

Mr Engen then presented the terms of the initial bid that he envisaged submitting on behalf of Alcan. Mr Rodier said he would have to take into consideration his obligations to his shareholders, employees, and customers in determining whether the offer was the best solution for Pechiney and all its stakeholders. He requested a few weeks to think over the offer. Mr Engen raised the issue of market disclosure constraints and asked if they could continue their conversation the next day. Mr Rodier agreed to meet him on Saturday afternoon.

On July 5, the two protagonists met in the offices of Publicis (Alcan's communications agency) in Paris. Mr Engen explained his understanding of the European Commission's regulatory timetable, of the timetable for takeover bids in France, and of the processes and timeframes available to the management and the board of Pechiney to review the terms of an offer. Mr Engen and Mr Rodier discussed a timetable for a possible bid from Alcan, and the Canadian group's executive again expressed his concerns about the possible need to make public the discussions between the two groups in light of the market speculation. He also stressed the importance of the investigation by the competition authorities getting under way as soon as possible in order to clarify the necessary undertakings and resolve the problems envisaged by Alcan and Pechiney in light of their experiences in 1999. Mr Rodier revealed that he had begun informal talks with the board of directors at Pechiney. He also said that the three key factors in evaluating any offer would be: price; the opinion of senior executives on the bidder; and matters relating to competition law.

Discussions continued, and then Mr Engen informed Mr Rodier that Alcan may issue a press release on the Monday morning (July 7), but he stressed that a final decision had not been taken.

On July 6, during talks with members of Alcan's executive committee, Mr Engen gave his views on the terms and conditions of the initial offer and revealed he had decided to announce and submit the offer the following day.

The Hostile Takeover Bid

On July 7, 2003, Alcan filed its initial offer with the French Financial Markets Council (*Conseil des Marchés Financiers*, CMF), the French Stock Exchange Operations Commission (*Commission des Opérations de Bourse*, COB), and the US Securities and Exchange Commission (SEC).

It was a "mix and match" offer, with a cash element (capped), a paper element (capped), and a mixed element (not capped). This meant shareholders could choose the element they preferred and give Alcan an indication of the final cash/shares mix.

The terms of the offer were as follows:

- The offer values each Pechiney share at €41 (on the basis of the closing price of Alcan's shares as at July 3, 2003 and the US$/€ exchange rate of 1.15).

Table CS1.1 Alcan's offer implied premium

	Pechiney share price** (€)	Implied premium*** (%)
July 2, 2003	32.00	28.1
1-month average*	29.59	38.6
3-month average*	26.78	53.1
12-month average*	30.73	33.4

* Volume-weighted average of closing prices
** Ordinary share
*** On the basis of the closing price of Alcan shares as at July 3, 2003 and the US$/€ exchange rate of 1.15
Source: Analysts' presentation

- Main offer: For every five Pechiney shares €123 in cash plus three Alcan shares (0.6 Alcan shares + €24.6 in cash per Pechiney share).
- Alternative offers:
  - All cash: €41 per Pechiney share
  - All stock: three Alcan shares for two Pechiney shares
  - Total offer mix: 60% cash and 40% in shares.
- Other components
  - For each Pechiney OCEANE: €81.7 in cash
  - For 50 Pechiney Bonus Allocation Rights: €123 in cash and three Alcan shares.

On the day the offer was filed, Alcan's bid included a significant control premium over the Pechiney share price, as shown in Table CS1.1.

The operation would allow Alcan to consolidate its position among the world's leading aluminum and packaging firms and to benefit from economies of scale, increased financial and technology resources, and the greater ability of the new group to reach customers across the globe. The new group would also be better diversified in the low-cost primary aluminum production segment, enabling it to increase profits and manufacture more aluminum products thanks to local sites in many countries across the world, and would enjoy a market-leading position in flexible packaging. The addition of Pechiney would provide the new Alcan group with better R&D capabilities as well as better industrial process and product development capabilities across all business segments. See Figure CS1.1.

Upon the bid announcement, Pechiney's share price was marginally above the offer price and closed at €42 on July 7, 2003. This indicated that arbitrageurs expected an improved offer.

Pechiney's Defense Strategy

On the same day that the offer was submitted, Pechiney issued a press release saying that it had negative implications for the company, its employees and its

Unique Business Opportunity

Greater Range of Strategic Options
and Value Maximizing Opportunities

- Increases presence in core markets
- Broadens technology leadership – core smelting technology
- Benefits customers
- World leader in low-cost primary aluminum
- Enhances aluminum fabrication portfolio – e.g., aerospace
- Creates US$6 billion packaging leader

Figure CS1.1 Alcan's rationale for Pechiney takeover
Source: Analysts' presentation

shareholders, and that Alcan's offer price did not reflect Pechiney's strategic value:

> Pechiney is aware of the unsolicited takeover bid launched by the Alcan group for control of its share capital. There was no consultation between the two groups prior to this decision.
>
> Pechiney is shocked by the hostile nature of the approach.
>
> Pechiney hereby gives notice that the offer is subject to conditions precedent pertaining notably to authorization from the competition authorities. It is therefore very uncertain whether the operation will go ahead, which is damaging for the company, its staff and its shareholders.
>
> Pechiney's leadership in technology and policy of constant growth has consolidated its undisputed market leadership in primary aluminum, enabled it to forge strong positions in the aerospace and automotive industries, and confirmed its market-leader status in packaging. In light of the above, the takeover bid very significantly undervalues the economic and strategic value of the Pechiney Group.
>
> Pechiney's Board of Directors will meet soon to examine the offer in relation to Pechiney's strategic value, from a business perspective and in terms of creating value for its shareholders.

Two days later, Pechiney issued a press release confirming that its board had rejected the initial offer from Alcan during a meeting held the previous day.

Responding to a question from a reporter the same day, Mr Engen said he would seek another meeting with Mr Rodier.

On July 16, the CMF declared Alcan's initial offer to be admissible.

A week later, Pechiney published its provisional results for the second quarter of 2003 and announced it would begin a road show to respond to Alcan's initial

offer. Mr Rodier and Pechiney's advisory banks began to hold meetings with investors in Paris, London, New York, and Boston at the end of July.

Pechiney's defense strategy was built around several things:

Standalone strategy

This involved executives meeting with the company's major shareholders and trying to convince them that Alcan's offer price did not reflect the intrinsic value of the company. Pechiney attempted to carry out this strategy, but it had several flaws:

- The French company's management was in no real position to promote a standalone strategy given: (i) the failure of the three-way merger in 1999; (ii) the fiasco of the Corus deal; (iii) a struggling share price; (iv) the company's image as a "fallen angel".
- Pechiney's mooted sale in the summer of its packaging unit, designed to return some cash to shareholders in anticipation of better times ahead, was met with disappointing bids.

The search for a white knight

This involved looking for a third party to come in with a friendly bid at a higher price. With that in mind, Mr Rodier went on the offensive in the press, telling the *Financial Times* that "any offer would be better than Alcan's" and claiming that "several other groups" had already phoned him. The French company's CEO also claimed to have the support of shareholders representing "40% of the share capital," who, he said, "were unanimous in finding the offer [from Alcan] to be ridiculously low."

It appeared, however, that contacts established by Pechiney's advisory banks had not brought about anything concrete. After all, the aluminum sector was already fairly concentrated and there were not many potential buyers around.

Play the jobs card and mobilize employees

This involved mobilizing the trade unions and/or public authorities in order to persuade Alcan to drop its bid. Pechiney's CGT union representatives were the most outspoken against the takeover bid, describing it as part of "the process of concentration of capital that has extended to many industries worldwide and of which we have seen the harmful effects on the day-to-day life of employees and national industries." Alcan had largely defused this threat, however, by making it clear that it did not intend to reduce the number of staff or production sites in France beyond the existing restructuring plans of Pechiney.

Faced with the failure of these various defense strategies, the Pechiney board was rapidly forced to exchange its recommendation for an improved offer price.

Alcan's Attack Strategy and the Issue of Synergies

Since Alcan chose to make a mixed cash and paper offer for Pechiney rather than an all-cash one, it was essential that the Canadian firm's share price did not fall when the bid was announced or in the subsequent days. Such a fall would have devalued the stock offered in exchange and therefore reduced the value of the offer, making it less likely to be accepted by Pechiney shareholders.

Quantifying the synergies that had been announced took on huge importance because it was the assessment of the quality of the business plan and the potential synergies that would determine how the market, and the Alcan shareholders in particular, embraced the deal.

Communication on the synergies had two contradictory objectives:

- announce a large and credible amount of synergies in order to reassure Alcan shareholders that the merger would create value;
- do not announce excessive synergies for fear of letting Pechiney shareholders think that they were entitled to a share of a very large pie and therefore ask for more money.

In the end, Alcan's management team announced annual cost savings of approximately $250 million before tax. By way of comparison, Alcan had achieved annual synergies of around $200 million through the successful integration of Algroup.

The synergies envisaged by Alcan's offer represented around 3.8% of Pechiney's 2002 turnover, excluding revenue from its international commerce business. Again by way of comparison, the synergies achieved through the integration of Algroup represented approximately 3.9% of Algroup's 1998 turnover.

The predicted cost savings were supposed to come from the following areas (see also Figure CS1.2):

- SG&A (31%): lower head-office costs and costs for trading and shared-activity support services.
- Manufacturing (15%): lower production costs from improved production sites and productivity gains.
- Logistics and purchasing (26%): lower raw-material costs, operational costs and financing costs through improved project management, greater purchasing volumes and an extended chain of suppliers.
- Research and development (12%): lower costs through shared research equipment and technical and IT services.
- Corporate (16%): maximizing profits from investments for shareholders by optimizing the investment program for Alcan and Pechiney.

Given that Alcan's share price did not fall when the bid was announced, and that it actually rose during the subsequent weeks owing to the combined effect of rising aluminum prices and good financial results published by the company,

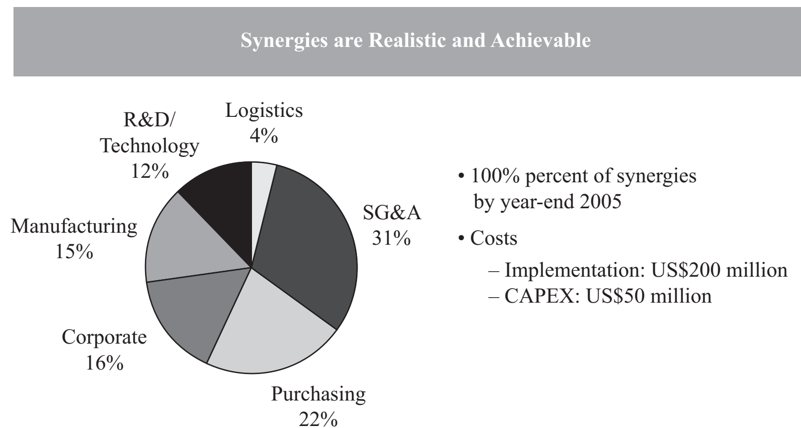

Figure CS1.2 Alcan's estimated cost synergies
Source: Analysts' presentation

the value of the mixed offer kept on increasing, rendering Pechiney's defense increasingly futile. For Alcan, it was simply a case of waiting for Pechiney to back down and collecting its prize. The turnover of capital in favor of arbitrageurs, who by definition favor a "good" offer price, would do the rest.

To give you an idea of the mood at the time, here is an extract from an interview given by Travis Engen on August 20, 2003:

> *Pechiney's share price has risen well above the cash offer of €41 since the Alcan bid was launched. Why do you think that is?*
>
> It is interesting to note that Pechiney's share price is simply mirroring Alcan's, which has risen sharply since the bid was announced, particularly after we published our second-quarter results. At current share prices, the paper offer (3 Alcan shares for 2 Pechiney shares) is equivalent to €48 per Pechiney share – a price that the Pechiney stock is moving towards. The mixed (paper and cash) offer values Pechiney shares at €44, while the cash offer remains at €41.
>
> *Pechiney said your offer was "manifestly insufficient". Will you be increasing it?*
>
> Pechiney's share price is low because there is little visibility of the group's prospects. Alcan's shares have also fallen in recent years owing to the difficult climate, but not as sharply as Pechiney's. After the failure of APA [the attempted three-way merger between Alcan, Pechiney and Alusuisse], we have continued to grow, notably through the integration of Algroup, while Pechiney has not managed to capitalize on opportunities for growth. We are now giving Pechiney shareholders the chance to create a major group – something we were unable to do three years ago. If we increased our offer, we would be jeopardizing our future financial room for maneuver. In fact, the acquisition of Pechiney will increase our debt levels and

it will take us one or two years to bring them back down to a normal level. If we increase our offer, we will need more time to recover our financial resources. Pechiney shareholders who want to cash in after the operation will still be able to sell their Alcan shares, which will be listed in Paris.

Negotiations and Announcement of a Non-hostile Operation

In mid-August 2003, Mr Engen phoned Mr Rodier to request a meeting so the two men could discuss their opinions and reach an agreement on the terms of a revised offer that the Pechiney board of directors would be likely to recommend. A meeting was scheduled for the end of the month in Geneva.

In the meantime, Alcan announced that it had formally filed its bid with the European Commission and proposed certain undertakings to resolve some competition issues regarding the European markets for certain flat-rolled products, aluminum aerosol cans, and aluminum cartridges. Following the filing and the proposed undertakings, the European Commission's initial investigation period (commonly known as Phase 1) was completed at the end of September 2003.

At the meeting in Geneva, the management teams of Alcan and Pechiney discussed problems raised in relation to the European competition authorities' approval procedure, and Mr Rodier said the fundamental issue for Pechiney with regard to Alcan's offer was the price. He put forward several arguments for the price being substantially higher, while Mr Engen set out the pertinent factors used to determine the price that Alcan was willing to pay. Mr Engen said that although the support of the Pechiney board could reduce regulatory uncertainty, a price above €50 (i.e. in the range suggested by Mr Rodier) would exceed Alcan's estimation of the fair value of the French company. Mr Rodier suggested that the Canadian group be made aware of certain financial factors that it may want to consider.

Immediately after the Geneva talks, Alcan's advisory banks – Lazard and Morgan Stanley – met in Paris with the advisory banks of Pechiney: BNP Paribas, Goldman Sachs, JPMorgan and Rothschild. Pechiney's banks once again raised arguments relating to the valuation of the French group and how its accounts would be impacted by several recently announced operations. In the days that followed, the two groups' respective banks talked over possible changes that might cause the Pechiney board to recommend the offer. On August 28, 2003, the two sets of bankers met again to provide details on possible changes to the financial terms of the offer. Among these changes was making the bid a simple mixed cash and shares offer, valued at a maximum of €47 per share. Alcan would also have the choice of paying all or some of the paper element in cash. Later that day, the Pechiney banks informed their Alcan counterparts that the French firm considered the offer to be too low.

Negotiations resumed the following day, with Alcan's advisory banks seeking assurances that any revised offer would be considered promptly by the Pechiney

board. If this were the case, they explained, it was highly likely that an agreement could be reached over the weekend.

On August 29, 2003, Alcan filed the Hart–Scott–Rodino notification with the US authorities, triggering a 30-day waiting period under US competition laws which would expire on September 29.

Early in the evening on August 30, 2003, Mr Rodier called Mr Engen to inform his Alcan counterpart that he had tried to organize a Pechiney board meeting for Sunday, August 31 with a view to discussing Alcan's bid.

During the subsequent meeting between the parties, a possible increase in the offer price was mooted for the first time, provided that at least 95% of Pechiney shares were tendered into the offer. Still with no assurance as to the response of the Pechiney board, the different parties began to put together their offer for presentation to the French group's board.

After the meeting, Alcan submitted a confidential written offer at the request of Pechiney. The offer was subject to acceptance by the Pechiney board, which was scheduled to meet later that day. The financial terms of the offer were similar to those described above, with an extra euro to be added if 95% of Pechiney shares were tendered into the offer. The offer also raised certain employment issues. A meeting was organized between Mr Engen and some Pechiney directors so the Alcan CEO could present his vision of the business logic behind the operation as well as the reasons for the offer. Later that evening, Pechiney's advisory banks requested a signed copy of the Alcan offer, which had been provided to the Pechiney board before its meeting.

Even later that night, Mr Engen and the Alcan banks were informed that the Pechiney board had rejected Alcan's offer and that the French firm intended to make public the next day both the offer and its decision to reject it.

On September 1, Pechiney issued a press release stating that although Alcan's offer was an improved one, it still fell short of the true strategic value of the company. The press release also specified that the Pechiney board had noted that Alcan's offer remained subject to approval from the European competition authorities under Phase 1. On the same day, Alcan issued its own press release indicating that since its offer had not been accepted by the Pechiney board, this offer was to be considered withdrawn and the talks with Pechiney were over.

However, talks between the two CEOs and the advisory banks resumed in the days that followed.

In addition, on September 5, the French finance minister announced that Alcan had informed him of undertakings it was willing to make should it acquire Pechiney, and that he had given his approval to the transaction. These undertakings concerned defense contracts and their corresponding commitments, the future of Pechiney's existing industrial sites in France, and the location for the headquarters of certain business segments.

On September 8, Pechiney's advisory banks requested another meeting, in which they presented a revised version of the terms of Alcan's offer from

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August 31, albeit without indicating a price. On the same day, Pechiney's bankers also indicated that Mr Rodier and another Pechiney director wished to meet with Mr Engen to present a proposition from the French company. Mr Engen accepted the request.

Three days later, Mr Rodier and Onno Ruding, vice-president and director of Citibank and also a director of Pechiney, met with Mr Engen and Alcan's chief legal officer, David McAusland, in Zurich to discuss potential changes to the terms of the Alcan offer that were likely to be proposed to the Pechiney board.

These talks were followed up by meetings in Paris on September 11 and 12 between Alcan's management team and the legal and financial advisory teams of both parties. On September 12, Mr Engen and Mr Rodier exchanged a letter accompanied by terms of the revised offer which had been approved that day by the Pechiney board. The revised terms of the offer were as follows:

- a simple mixed offer – no ancillary cash or paper offers;
  - cash – €24.60 per Pechiney share
  - Alcan shares – €22.90 in Alcan shares per Pechiney share; each Alcan share would be valued at the highest of (x) €27.40 or (y) the volume-weighted average of the Alcan share price on the New York Stock Exchange over 10 trading sessions picked at random from the 30-day trading period ending five trading days before the closing date of the offer.

The Pechiney Board Recommends the New Alcan Offer

> The Pechiney Board of Directors met on September 12, 2003 to examine Alcan's new offer regarding its takeover bid for Pechiney.
>
> The new offer is a maximum of €48.50 in cash and shares, comprising €47.50 per share plus an extra euro per share if take-up is at least 95%.
>
> After having studied the terms of the new Alcan offer carefully, and in light of the long-standing business logic of a combination between Pechiney and Alcan and of the various merits of such a combination versus those of a stand-alone growth strategy, which it considers to be a viable option, the Board has concluded that this new offer represents the best available valuation for Pechiney shareholders.
>
> The Board is pleased that the combination will allow Pechiney employees to participate in the creation of a global leader in aluminum and packaging.
>
> The Board has therefore decided to recommend to its shareholders that they accept this new offer, which it considers to be in the best interests of the company's shareholders, employees and customers.
>
> The Board notes that this offer remains subject to prior Phase 1 approval from the European Union and US competition authorities and that Alcan will submit its new offer by Tuesday, September 16, 2003.

On September 15, 2003, Morgan Stanley and Lazard, acting for Alcan, filed the increased mixed offer with the CMF.

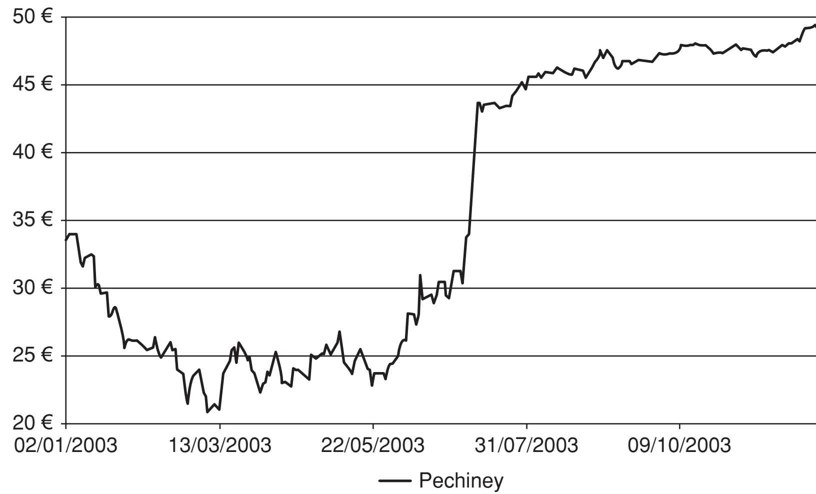

Figure CS1.3 Pechiney stock price evolution
Source: Bloomberg

Alcan's adviser at Morgan Stanley was Michael Zaoui (who wrote this book's foreword). Pechiney's adviser at Goldman Sachs was Yoël Zaoui, Michael's younger brother. Legend has it that the two men started negotiating at a holiday home rented by their respective families and their parents on the island of Ibiza.

Figure CS1.3 shows the Pechiney share price throughout the takeover episode.

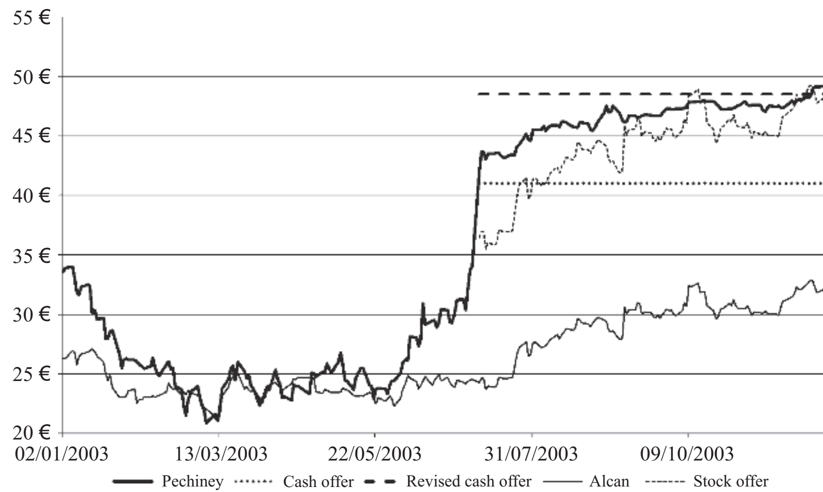

Figure CS1.4 Pechiney/Alcan: changes in stock prices and offer values
Source: Bloomberg

We can clearly see the sharp rise after the various takeover rumors were reported in the press in the days preceding the official offer from Alcan. We can also see that throughout the negotiations which took place after the launch of the initial bid, the share price of the target company went only one way – up. Figure CS1.4 explains this.

We can see that the increase in the Pechiney share price after the launch of the Alcan bid resulted not only from the rise in Alcan's share price given the positive reception to the transaction from the market, which we discussed earlier, but also from the structure of the mixed offer.

Figure CS1.4 also clearly shows the gradual convergence of the Pechiney share price to the Alcan offer price. This is known as the arbitrage spread convergence and it is the subject of the remainder of this book.