HEDGE FUNDS REVIEW

Merger arbitrage hedge funds poised for rich pickings in 2011

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There is strong consensus among merger arbitrage hedge fund managers that 2011 will be a banner year for the strategy.

Merger arbitrage funds returned a modest 4.3% on average in 2010, according to data provider Hedge Fund Research. However, the steady increase in dealmaking since last summer has got fund managers excited about prospects for the strategy in 2011.

Managers contacted by *Hedge Funds Review* unanimously agreed that M&A activity will heat up the months ahead, led by dealmaking in the healthcare and technology sectors. Finance, energy and consumer goods are also predicted to play an important role in M&A activity in 2011.

According to Paris-based M&A investment manager Bernheim, Dreyfus, "the value of worldwide M&A totalled $2.4 trillion during the full year 2010, a 23% increase from comparable 2009 levels and the strongest full-year period for M&A since 2008".

Bernheim, Dreyfus expects the trend to continue, predicting a particularly buoyant year in 2011 due to favourable conditions in credit markets.

With the spectre of regulatory changes looming, Bernheim, Dreyfus believes banks will unload "riskier business units, like those tied to derivatives and hedge funds. Other companies will be eager to jump in and enter the lucrative areas of financing and banking."

It also expects companies in health care services will "be on the prowl" due to increasing demand from ageing populations and healthcare legislation. Expiring patents should also create "the need to buy smaller biotech firms with new drug discoveries," it said.

Fabrice Seiman, portfolio manager of event-driven hedge fund Lutetia Patrimoine, agrees that 2011 will be a better year for merger arbitrage as the "level of cash on corporate balance sheets for larger US companies is absolutely tremendous".

As companies realise they have money to burn, Seiman believes the volume of M&A activity will increase 2011 with the US paving the way and the EU following in its wake.

Seiman agrees that much of this activity will be in technology and healthcare, although does not expect to see much deal-making in the finance sector.

According to Seiman technology should undergo a busy period as the industry is set to evolve due to the arrival of cloud computing and its constant need to reinvent itself.

Seiman also predicts M&A activity in the energy sector will outstrip technology in 2011 and expects more deals will be made in the consumer arena, particularly focusing on food and consumer goods.

He does not believe that 2011 will be a one-hit wonder for M&A, predicting that 2012 will also be "a great year" and that the storm of activity awaiting 2011 is likely to continue for several years to come.

This theory is based on his team of former investment bankers "personally witnessing typically long cycles in M&A activity followed by a few years of crisis," he said. Seiman believes these crisis years are now over for merger arbitrage hedge funds.

What he views as strange for the post-crisis environment is the level of hostile deals taking place. He estimates that hostile bids currently represent 25% of those made, up from normal levels of around 5%.

This is in part due to pressure on CEOs to spend the cash available on balance sheets. "The mood is no longer focused on restructuring like it was in 2008 and 2009. If you are a CEO, you have to do something," Seiman said.

Another unusual development in M&A activity has been political involvement in deal-making. Seiman refers to the Canadian government blocking the Australian mining company BHP Billiton from acquiring Canadian fertiliser group Potash.

Yet he believes that being wary of political risks can also be a good thing for merger arbitrage hedge fund managers, providing them with greater confidence in their investment decisions.

Steven Gerbel, founder of investment firm Chicago Capital Management, shares his peers' opinion that healthcare and technology are set to experience high levels of activity.

Like Bernheim, Dreyfus, Gerbel also foresees an increased number of mergers in the banking industry as companies "need to consolidate and clean up their balance sheets," he said.

Gerbel agrees with Seiman that high M&A activity will be a lasting trend and has been preparing Chicago Capital Management for battle for several months now.

"We have been waiting for this for a long time," he said.

"We have a lot of open desks we are looking to fill and have doubled staff in the last 12 months. We have updated, increased and improved our infrastructure as this spot in the M&A cycle won't come around again for another 15 years," he added.

Overall, "with the economy picking up and CEO sentiment improving, there will be a wave of high-quality strategic mergers in 2011," Gerbel declared.

For those looking for the deal of a lifetime, he believes this is the moment to do it. "If you've got a dream, costs of attempting to execute that dream are at an all-time low," he said.

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