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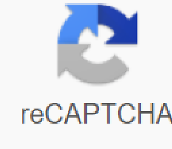
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N Interviews with Bonnie Smith and Fred Green and deals, deals and more deals. Like all arbs, Honchos Westchester Capital has been in the hog sky over the past few years as the desire to merge has become overwhelming, both on Wall Street and in many corporate boardrooms. The bull market generously provided funds, and nothing seemed to bother regulators to sleep. Until recently. Does the founder of several well-known mega-deals on shoals of ego and/or antitrust laws mean something fundamental has changed in the market that the risk is back in arbitration? Bonnie and Fred, whose New York firm Valhalla invests about $600 million (in private partnerships, a merger fund and an offshore fund) in arbitration deals, argue that the risk never left. But they also noticed a new focus, or philosophical tilt in Washington - which, along with the nuts and bolts of some current deals, they chatted about when we called last week. Westchester Picks: Bonnie, you and Fred have lowered their profiles since our last WA Smith: Yes, we closed the merger fund to new investors in June '96. It's getting really big. We started '96 with about $245 million in assets, and when we closed it in June, we had about $450 million of money coming in too fast for us to invest and we didn't want to do anything that would reduce the fund's productivity. Our primary responsibility was to our existing shareholders. We were afraid if it would continue to grow at such a rapid pace that our performance would be compromised. In principle, since then the fund has had just modest growth, and we like it much better. We continue to receive money from current investors and from financial planners who have accounts in some brokerage firms such as Charles Schwab and Fidelity who can continue to invest their clients' money. The question is: And are you still generating boring, just double-digit gains? Green: We are very consistent. This is what we are trying to achieve with the Merger Fund; about 10%-15% a year in good markets and bad ones, while taking significantly less risk than ordinary money managers. Measured by this criterion, we have done well - about 12% a year for the last five years. We had 21 straight profitable quarters. Very few equity funds can say that. We also manage private partnerships and an offshore fund, which we run a little more aggressively. Our return targets are slightly higher. But basically we do the same thing by investing in all our accounts: strictly merging arbitration. Smith: Fred means aggressively that we use more leverage. We remain very reluctant to take risks in these accounts. But leverage increases their performance by a few percentage points. Green: There are many different ways to do arbitration. Some approaches are riskier than others. We are position ourselves low end of the risk spectrum. The question is: Does that mean, among other things, that you are not investing in rumors? Smith: That's right. We will not invest until the public announcement. This doesn't have to be a final agreement, although it's usually what it is. Green: We also don't put a ranch on any one arbitration situation. We are in 60 different mergers and acquisitions now. From time to time we will be wrong. We don't want the bug to destroy the entire portfolio. That's why diversification is very important. We also do not make directed bets. We do not change the hedging ratio for shares merger to get its bullish bias because we are optimistic in the market. In the bull market, of course, this means that we leave a lot of money on the table. But I suspect we won't always be in the bull market. Smith: At times it's frustrating, but our very low-risk approach and our refusal to accept market rates is what sets us apart. Some arbs won't put on a full hedging, or won't put on at all if they think the equity of the equity-acquisition company is going up. The question: However, both the stock market and merger activities have gone through the roof. Why is your income lagging behind? Smith: Our favorite question! Green: Over the years, there has been no great connection between the total number of trades announced in any given period and our performance. What is much more important to us is whether arbitration spreads are attractive or unattractive. Also important is the percentage of transactions in which we invest, which are successfully completed. Obviously, we are happy to have more deals from which to choose, the less. So it's a net positive to see the activity of the MSA at record levels. But it's much more. The question is: In fact, not all actions attract less experienced participants? Smith: It definitely brings more people to the market, which can have a negative effect. It's supply and demand. If too much money is chasing deals, suddenly spreads narrow. It happens. The high level of MSA activity also brings in some hot money, run by managers who don't necessarily have the conviction to stay deals, based on their own research findings. That's where we sometimes beam. We are not afraid of market movements or think that the antitrust lawsuit against one company will affect every other merger in our portfolio. We use opportunities when other players are scared of their positions to increase ours. The question is: Do you still depend mainly on your own research? Smith: We are proud of our analysis. We are very intensively researching. And we do most of it ourselves. So once we reach our own conclusions, we are not easily affected by rumors or what is happening in the market. We don't care about who sells and who Sure. Sometimes rumours of a deal create great opportunities for us. The question is: But sometimes they're right. Green: You must remember that we were exclusively on merger arbitration for 18 years; We have invested about 1500 mergers and acquisitions. I'd like to think we've learned something. The question is: What tells you that the deal will fly - or not? Green: Not getting on the laundry list, the most important question when we look at the proposed deal: What is the strategic rationale? What does the buyer hope to achieve by participating in the transaction? Why does the seller want to sell at this particular moment? And this buyer? We have seen deals that have been very well thought out, which have made great strategic sense, to survive a series of unexpected external shocks. Conversely, we have seen deals that have been less well thought out terminated in the face of relatively minor problems. It is also important to understand the regulatory process. Smith: If you can! Green: We have invested, over the years, in every industry, and understand the critical issues that affect transactions in any sector. The question is: But things are changing. Suddenly, instead of a smooth swim, some big MSA deals ran into big problems. Green: I don't think it's safe to generalize from the experience that ARVs have had with a few deals recently. Smith: There is no doubt that the Federal Trade Commission and the Department of Justice have recently shown that if they are concerned about the deal, they are willing to go to court. It hasn't happened in years. We were very surprised when the Office Depot/Staples deal was blocked - pretty much the entire Arb community was - the stock was trading virtually without a spread. Similarly, if you looked at the Northrop/Lockheed deal just a couple of days before they made the announcement that the Justice Department had fundamental concerns about the merger, it actually traded at zero spread. Spread, for your readers who are not familiar with arbitration, is the difference between the current price of the target company and the value we will eventually get when the transaction is completed. So if you have a $20 deal and it trades at 18, you have a $2 spread. Lockheed/Northrop traded with absolutely no distribution just a couple of days before the roof fell in. Smith: That doesn't mean they'll never let the defense merge again. Each transaction must be considered individually. But you will learn a little from each experience - good and bad. What we learned from the Office Depot/Staples deal was how important the customer response is these days. So it was a critical issue for us when we looked at Bergen Brunswig/Cardinal. The question is: Arb disaster did you avoid? Smith: Yes. While we probably all believed in our hearts that a deal could happen without any negative impact on the consumer, we were very nervous about it because of our Office Depot/ Experience. We had no position to go into announcing that the deal had been blocked. We originally some on. But after McKesson and AmeriSource announced their intention to merge, we did a lot more work on Bergen Brunswig/Cardinal and came out. I don't know what we learned from Northrop/Lockheed yet, other than that we were completely shocked. Green: I might add, so were the companies and so every antitrust lawyer we know! We believed that previous deals in the defence industry had provided a road map to address competition; that a combination of selective seizures and firewalls will do the trick. For some reason, the government has taken much tougher positions. It is possible that the negotiations may be reopened before the case goes to court, but we will not hold our breath. Smith: There has been a change of personnel to the Department of Defense. It is possible that with new people, you have some new ideas. But this deal was a big disappointment in arbitration land. The question is: One that you don't get around? Smith: We had a position in it that we're basically out of at the moment. Green: We put it on for a $10-$12 spread, saw it go to zero and then to $30. The important point here is not to learn the wrong lesson. Some of our colleagues may be tempted to completely avoid any deal that is causing antitrust concerns now. That would be a big mistake. Over the years, we have invested in many transactions that have been thoroughly tested by regulators, but which have ultimately been successfully completed. More recently, we have seen an expansion of spreads, especially in antitrust deals. This is an opportunity for us. The question is: Is there a new Maginot line in antitrust order, a line of deals do not dare to cross? Green: It's very difficult. But then again, there were a lot of deals that triggered a second request from the Justice Department or the FTC, meaning that companies had to provide data boxes to the government. These deals were dealt with very carefully and - with very few exceptions - got done. So antitrust issues just mean that arbs have more work to do. Green: Before the Northrop/Lockheed deal was blocked, we could always take comfort if the company's customers were in a relatively strong position. The deals that were most problematic - say the Office Depot/Staples deal - were problematic because customers were in a less strong position. In other words, the government has argued that office supermarkets represent a separate market for people who would like one-stop purchases for office supplies, and would have no alternative if a merger was allowed. The question is: Just a thousand other stores. Smith: Not to mention mail order catalogs and Internet.Green: Exactly. However, this was the government's thesis. She is that it exists to protect the consumer from anti-competitive practices by office supermarkets. According to the government, you had a small amount of suppliers and a diverse group of consumers, none of whom individually had market power. We've seen a lot of deals get done in the energy sector, on the other hand, which at first glance may seem somewhat problematic from an antitrust point of view. They went through this because the government recognized that customers of these companies - large oil companies - can shrug off market power, will not tolerate unreasonable price increases by oilfield suppliers. The irony in the Northrop/Lockheed deal, of course, is that the government is the primary and in some cases the sole customer of its products. The Pentagon is absolutely able to excerise market power, and yet, for some reason, the government was not satisfied with this. Smith: That's why we're diversifying. We had a position at Office Depot/Staples last year, and even in that month that the deal fell apart, we managed to eke out a small gain. Enough other trades continued to move towards completion and spreads narrowed. The question: From the shells above Northrop/Lockheed, spreads should be wide. Smith: Yes. There are people who just realized: Gosh, maybe arbitration is a little more risky than we thought. Green: It was a tough quarter. The good news is that arbitration spreads have expanded significantly in recent weeks. So arbs that still stand can look forward to excellent returns over the rest of the year. The question is: Let's talk about some of the deals on offer where you like spreads. Green: Digital/Compaq is one of those deals that were initially perceived as a very high probability of a transaction. Some arbs who run highly leveraged operations put this one on the use of equity swaps. Then the spread, which soon after the deal was announced, narrowed to about $2, expanded to $4. They just have no tolerance for such pain and had to relax at the wrong time. The companies have received a second request under Hart-Scott-Rodino, so there is an antitrust issue here, but we doubt it is serious. For us it is still a highly likely deal, with a very attractive annual yield. The question is: You use at least some leverage. Green: But not excessive shoulder. Some armies will take so-called risky trades and use it 5- or 10-to-1 to create a higher interest rate. Sometimes they use stock swaps that take these positions, in fact, from their balance sheets. I don't think it provides much added value. One of the things we learned is that there is no such thing as a risk-free transaction. It's a pretty risky bet. Smith: In contrast, we look at leverage-based portfolios altogether. We don't that we love DEC/Compaq so we're going to use it 5-to-1. We look at our portfolio and say we would like to be 200% invested. We extend our leverage between all our transactions. What should come back from here under the Compaq/DEC deal? Smith: If it closes at the end of the end From today, the annual yield is 34%. Green: About $3 per share is an arbitration spread. The question is: Are you worried about whether the deal is for real money, or for stocks? Smith: It really doesn't matter to us. Today, when the market is at such a high level, stocks are the currency of choice. It takes a little more capital for us to invest in stocks for a stock deal because we need short stocks purchased. In a one-way transaction, entirely for cash, we don't need to tie as much of our capital as possible to have a hedged position in it. What's another stock-stock deal that you like? Smith: US Filter's offer for Culligan Water Technology. This is a deal with shares with a flexible exchange ratio. In some transactions, the company-acquiring company tells you a certain number of shares that you will receive, regardless of where its shares are traded. In some, they will say: We'll give you a value of $60, and vary that exchange ratio depending on where the shares are traded. The question: And then there are deals with even more confusing terms. Smith: Yes, and there are actually collars in it. Many of the terms have become more complex over the years. Now they have price collars and sometimes they can have four different break points where they go from fixed dollar value to fixed exchange ratio and back. Green: We believe that investment bankers have it in for arbs. The question is: Or try to justify their fees. Green: There is no doubt that in some deals they intentionally structured the deal to make it difficult for hedge arbs. The question is: Does it make sense? They need you. Smith: They don't like it when we cut stocks. Green: They worry that we are raising the cost of the acquisition company's capital by putting downward pressure on its share price through hedging, even if it is a temporary phenomenon. So we actually had some bargain pricing periods that involved randomly selecting a certain number of days over longer periods, so the armers can't be sure they're hedging on the average price during the pricing period. The question is: Sounds treacherous. Smith: That means we sometimes don't hit the average price right on our heads. Sometimes we do a little better, sometimes a little worse. But this is usually not the main factor. We have also found some brokers willing to deal with this uncertainty. Thus, we sometimes use custom derivatives only to hedge that pricing period risk and lock in the amount of profit. Green: Our goal is to be a clean merger of arbitrators and not worry about the stock market. We're fine if we leave on the table. We don't have to make all the last pennies in the deal. It is more important for us to protect our downside. Anyway, the Calligan deal should fly - the U.S. filter is clearly committed to consolidating the industry, and Culligan Man is happy with the deal. The question is: What other deals attract you? Green: Money Store / / Union. There has been so much negative press about sub-prime lenders that some investors are spooked about the group. Which caused some arbs to shy away from this deal. We're confident that First Union, which has been aggressively acquired in recent years, knows exactly what it's buying - and thinks it makes a lot of sense. One thing that separates the Money Store from some other subprime lenders is that it enjoys a very strong national franchise, which is very valuable to the First Union - one of the reasons why they want to make this deal. The question: Most sub-prime lenders have richly earned their bad reviews. It's not as if they were gang-like for no reason. Green: No questions asked. I want to say that the First Union at the moment cannot ignore these issues. They know the profit on the sale of accounting is controversial. What some of the economic assumptions that subprime lenders were making regarding payments may have been unrealistic. Competition is heating up. But in our view, the First Union wants to make this deal for solid strategic reasons. The question is: Have we really seen the KKR deal on your list? Green: We are gluttonous for punishment. Smith: Some LBOs we now call strategic LBOs because there is a business goal for them. It's not the eighties where they'd buy them, fix them and spit them out. This deal really makes sense. First, you have KKR and Hicks Muse teaming up, which is probably unprecedented. Together they want to own the largest theater network in the country. KKR in October bought Act III. It's a financial transaction because it's a borrowed buyout. But with strategic foundations. Regal's management is very highly regarded and they want to run all the shows for them. They buy management along with the company here. The question is: What else is the appeal? Green: The Telemundo/Apollo Group affair kind of fell through the cracks. There aren't many arbs to play it in size, for whatever reason. There are some regulatory issues. Univision is the dominant provider of Hispanic programs in the U.S., and has filed a petition to deny the Federal Communications Commission. They raised a number of questions, hoping to block the deal - or at least seriously delay it. The question is: Do you doubt that this will prevail? Green: We have kept the FCC attorney's look at their filing and we don't see it as a deal breaker, although there is a problem there. The FCC should see straight through the Univision argument. Telemundo, through its 13 stations and affiliates that serve 53 markets, broadcasts about 85% of the Spanish-language market. Univision is clearly concerned that this new organization created to buy Telemundo by Apollo and two strategic partners with deep pockets - Sony Pictures Entertainment and Liberty Media - a much stronger competitor in programming. So they they they all kinds of red flags in the FCC. But we suspect the commission will see their case for what they are. Smith: Somehow, when it's a competitor that raises these issues, regulators are usually very knowledgeable about who is making a complain. Univision has been the only game in town for quite a while. They are very concerned about this acquisition because Sony is one of the players. He has a very good stash of programs that he could just duplicate in Spanish and feed at the stations. One of the complaints about Univision was that many of its programming is rather callous rather than interesting. The question: You mentioned the oil patch earlier. Green: Weatherford Enterra and EVI is one we like. Both are service companies, mainly involved in the exploration of equipment. Smith: Despite the fall in crude oil prices - and any company involved in oil exploration until the last few days, when they rallied around the news of OPEC-Mexico's supply-limit cooperation - the big oil companies didn't cut their exploration budgets. There is a great demand for equipment. So we don't see the current crude pricing environment breaking this deal. The question is: Are you also presumably hedging market risk? Smith: Yes. This is a direct deal on shares. So for every Weatherford share we bought, we lowered 0.95 EVI shares - because that's a fixed exchange ratio. So whether the stock go up or down doesn't concern us. We have taken market risk. The question is: Isn't there an oil price on which the deal no longer makes sense? Green: This deal makes sense whether oil is at $14 or $18 a barrel. There is a real demand for companies that can provide one-off purchases to large oil companies that would prefer not to deal with a huge number of suppliers. Thus, oil-nosed and equipment companies are teaming up to offer what the majors want. The question is: Tell us about another deal. Green: John Alden Financial/Fortis. What makes it unusual is that Fortis is not only a foreign acquired, but is legally located in two countries like the Netherlands and Belgium. This is a real cross-border company. Smith: John Alden hired an investment banker last August - Credit Suisse First Boston, in fact - to find them a suitable partner. And Fortis is very interested in increasing their U.S. exposure. So it's a good fit. The question is: Ready, clearly. But why do they fit well? Green: Fortis already has significant insurance operations in the States and they are looking to buy more assets here. In addition, the price is correct. And in the 18 years that we've been doing merger arbitration, we've made a lot of successful investments in deals involving foreign buyers. For very few these deals turned out to be good for us. Obviously, British Telecom has not stayed the course regarding the MCI. They can live to regret regret But we are generally happy to play deals with foreign buyers. Smith: We love deals that have a geographical justification for penetration. We've seen, over and over again, companies identify a market in which they want to be bigger and then conclude that it's much cheaper and easier to buy a presence than to try to build it themselves. This is a quick fix to what they identified as a problem. This is what John Alden will do for Fortis. The question is: Thank you, Bonnie and Fred. Fred. paradise lost book 1 summary pdf download. paradise lost summary pdf download. paradise lost book 9 summary pdf download

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