The gap says it all

Roger Montgomery looks at why a takeover bid and a stock's market price can be so different

IN A MARKET THAT HAS FALLEN nearly 20% since Christmas and much more since its highs in April, you'd be forgiven for thinking there's no way to make a dollar.

Perhaps surprisingly there are, however, a number of ways investors can generate positive returns and I am not talking about the higher-risk short selling and option-writing strategies exploited by some of the world's most successful investors. I am referring instead to another approach we employ called arbitrage. More specifically, I am talking about something that's called "post-announcement arbitrage".

Now before I get started, I must explain that there are no free lunches and there is always risk. Post-announcement arbitrage is one space where, generally, markets are pretty efficient. By that I mean the lowest-risk opportunities usually offer the lowest potential returns.

Post-announcement arbitrage seeks to profit, after a takeover announcement has been made for a company, from the difference between the market price of that company's shares and the offer price made for those shares.

When a takeover announcement is first made, it is sometimes the case that the share price races above the offer made by the suitor. This happens when, quite suddenly, sleeping analysts realise that the company is in play and another, even higher bid might be possible. In other cases, the price may jump but to a level short of the bid price being made.

But take Sundance Resources (ASX: SDL; quality score A4). Sundance is developing iron ore projects in the Congo and Camaroon and has received a 57c a share all-cash offer for 100% of the company by its largest shareholder, Hanlong Mining, owned by China's Sichuan Hanlong Group. The Sundance board has approved the bid. The shares, however, are trading around 43c. So why is there a post-announcement arbitrage opportunity of 32.6% available?

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If you look at the SABMiller bid for Foster's, there is a mere 2.25% arbitrage opportunity. That bid, however, is virtually certain to proceed as proposed. Remember, the lowest-risk opportunities offer the lowest returns.

The large difference in price for Sundance is because there is often risk that a deal isn't completed. In this case, there is some scepticism about a Chinese bid for an Australian company being successful or even being completed – particularly as there have also been allegations about senior executives using inside knowledge to trade in Bannerman Resources (and Sundance). This would be an embarrassment to the Chinese and their regulator could drop the bid altogether or hand it to another company.

Also, if the scheme of arrangement for Sundance is approved by the courts in February, shareholders subsequently approve the deal in April and Australian regulatory approval is also obtained by April, the implementation date would be May.

And as is the case with many bids, there are other conditions. Hanlong requires mining permits from the governments of the Republic of Cameroon and the Republic of Congo. Hanlong also requires funding and the offer is subject to Foreign Investment Review Board approval and approval from China's National Development and Reform Commission.

Finally the takeover could be terminated if another party acquires more than 12% of Sundance shares or if an independent expert says the offer is not fair.

So you can see that there are hurdles to overcome before the deal is done. That's why there appears to be a free 200-day, 32.6% arbitrage opportunity available. I would expect that as each hurdle is surmounted, the spread between the market price and the offer price will decline.

Sichuan Hanlong Group is a private Chinese company with operations spanning mining, energy, real estate, pharmaceuticals, industrial chemicals and technology. Hanlong already owns majority stakes in two Australian companies – 57% of Moly Mines (iron ore) and 11.5% of Marenica Energy (uranium). They have also bid $144 million for Bannerman Resources (current market capitalisation $82m).

The mine(s) owned by SDL also require capital expenditure of $7.79 billion to develop rail and port infrastructure. Hanlong brings this capacity to the table so the board of Sundance can strongly argue the case for a tie-up between the companies.

Tragically, Sundance lost most of its board last year in a light plane crash, so the current board could be seen by some as caretakers and likely push the deal through. Indeed, they have approved it.

These factors reflect a willingness on both sides to complete the deal, but that does not always mean it will go through. On balance, the very high potential returns available reflect a high chance that the deal won't be consummated.

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