

Merger Arbitrage: Core Strategy, Risk and Market Variables

I. Introduction

In June 2013, a group of hedge fund managers and analysts gathered in a courthouse in Georgetown, Delaware, ready to trade. Cooper Tire & Rubber Company had agreed to be acquired by Apollo Tyres Ltd. for \$35 per share in cash, a 43% premium to the stock's pre-announcement price¹. Within a day of the announcement, Cooper Tire's shares had already moved to \$33.82, leaving a \$1.18 spread between the prevailing market price and the deal price. Such a small spread would typically indicate a secure and near-certain completion of the deal. This time, however, the deal did not take place.

The reason was not so straightforward. A labour dispute at a Chinese joint venture, a domestic union conflict, and deteriorating trust in the deal's timeline caused the spread to widen dramatically. By the time the deal collapsed, the stock was down to \$22.34. Arbitrageurs who had entered at \$33.82 and misread the risks lost far more than the \$1.18 spread they'd aimed to pocket.

This is merger arbitrage: investing in securities of companies involved in announced corporate transactions, with the goal of turning the spread between the current market price and deal price into profit. To that end, arbitrageurs must also bear the risk that the deal never closes. The Cooper Tire case clearly illustrates both sides of that equation.

II. Core Strategies

The word "arbitrage" is a classic finance term describing the simultaneous purchase and sale of the same security² in two different markets to profit from a temporary price discrepancy. If, for example, Rio Tinto shares can be bought in London at the sterling equivalent of \$43.45 and simultaneously be sold in New York at \$43.66, the \$0.21 per share profit is effectively guaranteed. Merger arbitrage involves a similar concept, though it differs from the theoretical "pure" arbitrage in that there is no guarantee of profit. M&A deals are inherently uncertain, and multiple factors can affect the pricing of involved companies' stocks, which is why merger arbitrage is also referred to as "risk arbitrage."

When an acquisition is announced, the target's stock typically jumps toward the announced deal price but stops short of it. The gap between the two is the spread. It reflects two things: firstly, the time value of money. Capital is tied up for the duration of the deal process, often months. Secondly, and more importantly, the spread reflects the risk premium: the market's collective assessment of the likelihood that the deal falls through.

There are three classic core strategies in merger arbitrage which all demand different approaches in analysis, each carrying different risks, hence, all having different payoffs.

¹ Keith M. Moore (2018). *Risk Arbitrage: An Investor's Guide* (2nd ed.).

² DePamphilis, D. (2019). *Mergers, acquisitions, and other restructuring activities* (10th ed.). Academic Press.

Cash Deals are the simplest. Company A offers \$20 cash per share for Company B, currently trading at \$19.85. Investors buy at \$19.85, wait until the deal is closed and then collect \$20, pocketing the \$0.15 per share spread. The only question is whether the deal will close.

Stock-for-Stock Deals are trickier, as instead of cash, the target's shareholders receive shares of the acquirer³. For example, let's say Company A's shareholders get 0.444 of Company B's shares per Company A's shares. The problem is, if Company B's shares fall between the announcement and closing of the deal for any reason, Company A shareholders receive less value than expected. In this case, hedge by shorting the acquirer in proportion to the exchange ratio, locking in the spread regardless of how Company B's stock moves. The math nets out to the same profit if the deal closes on its original terms. Once again, the risk is that it does not.

Hostile Deals are the most volatile, but also potentially the most lucrative. Sometimes an acquirer makes an offer directly to shareholders without the target Board's approval. The target Board fights back, maybe finds a friendlier buyer (a "white knight"), and a bidding war erupts. Here, the spread can move violently in either direction. For that reason, these situations move very fast and require immediate, precise analysis. Hostile bids carry the highest potential upside, but also the greatest risk.

III. Risk Assessment

The spread is not free money. It compensates for the risk that the deal falls apart⁴. The question for any arbitrageur is: what can go wrong, how likely is it, and how severe would the damage be?

The Cooper Tire case failed on financing and operational grounds. As problems at the target accumulated, Apollo's ability and willingness to close simply deteriorated. This illustrates the broadest category of deal risk: a buyer who can no longer or no longer wants to complete the transaction. Whether a merger agreement includes a financing contingency, and how firm the committed capital actually is, are among the first things worth examining.

More commonly, deals fail on regulatory grounds. In the US, large mergers require Hart-Scott-Rodino filings⁷. This implies a standard 30-day review period, which can escalate to a "second request" that adds six months or more. Cross-border deals face parallel scrutiny from the European Commission, the CMA, and other national authorities in the relevant jurisdictions. Healthcare, technology, and media transactions are particularly exposed, given sustained antitrust attention across all three sectors.

Material Adverse Change (MAC) clauses⁵ allow acquirers to walk if the target's business deteriorates materially between signing and closing. Courts set a high bar for what qualifies as "material" deterioration, but the threat of a MAC dispute alone is enough to widen spreads, because it introduces legal uncertainty that resists clean probability assessment. Shareholder approval is a further variable, particularly in deals with modest premiums where activist investors or proxy advisors can shift the outcome.

³ Keith M. Moore (2018). *Risk Arbitrage: An Investor's Guide* (2nd ed.).

⁵ DePamphilis, D. (2019). *Mergers, acquisitions, and other restructuring activities* (10th ed.). Academic Press.

The standard evaluation framework neatly summarizes these risks in a probability-weighted expected return. Take a \$2 spread, a \$13 downside if the deal falls through, and a 90% completion estimate. The expected return is $(0.90 \times \$2)$ minus $(0.10 \times \$13) =$ just \$0.50 per share. This asymmetry between modest upside and large downside defines merger arbitrage. Being approximately right on the probability is not enough. An arbitrageur who systematically overestimates completion odds by a few percentage points will lose money over time, because the downside scenarios carry disproportionate weight. Hence, any merger arbitrage strategy demands thorough and precise analysis.

IV. An Example

The contest for Warner Bros. Discovery across late 2025 and early 2026 is the clearest recent demonstration of merger arbitrage in practice, compressing nearly every risk category into a single transaction.

In December 2025, Netflix announced an agreement to acquire Warner Bros. Discovery at an enterprise value of \$82.7 billion. The spread at announcement was large enough to reflect uncertainty about both regulatory approval and competing interest. That uncertainty was well-founded. The DOJ raised antitrust concerns about streaming concentration, weakening Netflix's position and widening the spread further. Then Paramount Skydance entered with a revised proposal that the WBD board determined constituted a superior offer. By February 2026, Warner Bros. Discovery had shifted course.

Arbitrageurs holding the Netflix-deal spread were not catastrophically exposed (WBD's stock didn't collapse the way Cooper Tire's did) but the transaction they had underwritten didn't close. Those who had separately identified Paramount as a credible competing bidder and positioned accordingly fared better. One activist investor, Pentwater Capital, publicly favored the Paramount proposal and applied direct pressure on the board, contributing to the reopening of negotiations.

The regulatory risk and bidding dynamics in the media sector were both visible, but many investors lost big attempting to arbitrage the WB deal. What separated arbitrageurs' outcomes was the precision of the probability assessment and a willingness to update that assessment as information changed.

V. Market Variables

Interest rates are the most important macro variable, mainly because the strategy ties up capital for a known period with a capped return. The risk-free rate sets the floor for what spreads need to offer. Higher rates force⁶ wider spreads; lower rates compress them. Simultaneously, higher rates raise borrowing costs for acquirers in leveraged deals, which can slow activity or make financing more fragile.

Deal flow determines the opportunity set. In boom periods, arbitrageurs build diversified portfolios and can afford to be selective. In downturns, the universe of diversification shrinks, and concentration risk rises. M&A is cyclical: 2021 was a record year, 2022-2023 saw a sharp pullback⁷, and 2024-2025 brought

⁶ Jetley, G., & Ji, X. (2010). The shrinking merger arbitrage spread: Reasons and implications. *Financial Analysts Journal*, 66(2), 54–68. <https://doi.org/10.2469/faj.v66.n2.3>

⁷ Baker, M., & Savasoglu, S. (2002). Limited arbitrage in mergers and acquisitions. *Journal of Financial Economics*, 64(1), 91–115. [https://doi.org/10.1016/S0304-405X\(02\)00072-7](https://doi.org/10.1016/S0304-405X(02)00072-7)

recovery, especially in media and technology. The Paramount Skydance-WBD mega-deal, at roughly \$111 billion⁸, is emblematic of this latest wave.

The regulatory climate shifts across administrations and geographies, directly affecting completion rates and spreads. Permissive regimes narrow spreads: aggressive enforcement widens them. Market volatility cuts both ways: in turbulent periods, the downside on a broken deal worsens because the target's unaffected trading level is harder to estimate, but moderate volatility can widen spreads without raising fundamental deal risk. The latter of these can create significant opportunities. Cross-border deals add currency exposure and multi-jurisdictional review, while sector-specific patterns (longer reviews in healthcare, commodity sensitivity in energy, specialised approvals in financial services) further shape each position's risk profile.

VI. Conclusion

In finance, reward always comes with risk. Money can never be "guaranteed", and real-life conditions and occurrences have a massive influence over the markets and what price stocks are sold for. Merger arbitrage is the science behind the risk associated with the buying and selling of stocks during times of high volatility, such as an acquisition or merger of a company.

Cooper Tire and Warner Bros. Discovery are separated by twelve years, and the details of both deals are wildly different, but they share one thing in common: both looked, at first reading, like they would close. The Cooper Tire spread was tight enough to suggest near-certainty in that fact. The Netflix-WBD deal attracted many arbitrageurs before the competing bid materialized. In both cases, the investors who came out ahead were those who had done the work rather than those who simply bought the spread and trusted the headline.

What the current environment has changed is the base rate at which things go wrong. Regulatory risk is structurally higher than it was a decade ago. Financing is more fragile. Cross-border deals face scrutiny that has expanded significantly in both scope and speed. Spreads today reflect this accurately: they are wider, on average, because completion is more difficult. With that in mind, the margin for misreading risks has further narrowed.

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⁸ Warner Bros. Discovery, Inc. (2026, March 26). *Warner Bros. Discovery sets shareholder meeting date of April 23, 2026 to approve transaction with Paramount Skydance*. <https://www.prnewswire.com/news-releases/warner-bros-discovery-sets-shareholder-meeting-date-of-april-23-2026-to-approve-transaction-with-paramount-skydance-302726244.html>