

# [General electric’s proposed acquisition of honeywell](https://assignbuster.com/general-electrics-proposed-acquisition-of-honeywell/)

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* 1. Jessica Gallinelli should hold a position in Honeywell and take a short position in General Electric Company (GE) simultaneously

The main consideration in her decision is when she heard disturbing news about the proposed bid by General Electric Company (GE) for Honeywell International Inc. This merger is obviously an arbitrage opportunity. Generally and predictably, there will be different positions for the stock price tendency. For the target company, the stock price normally will increase whereas the stock price of the merger company is likely to drop after the announcement of acquisition released. Therefore, it would be a great opportunity for Gellinelli to buy Honeywell shares and short-sell in GE in order to take advantage of this arbitrage opportunity.

* 2. What is a reasonable share value range for Honeywell?

|  |  |  |
| --- | --- | --- |
| Valuation Method  | Low Value  | High Value  |
| Recent market prices  | $30. 37  | $36. 85  |
| Peer firms (median)  | $35. 30  | $59. 03  |
| Peer transactions: Aerospace Industry and “ Jumbo” deal (median)  | $36. 70  | $50. 20  |
| Discounted cash flow (DCF)  | $31. 56  | $40. 98  |
| Stand-alone valuation  | $33. 41  | $58. 73  |
| With-synergies valuation  | $36. 32  | $48. 69  |

These valuations have given multiple ranges of reasonable price, some of them have given a larger range, and some have given a tiny range. However, DCF would be the most accurate as it really mirrors the expected future firm’s performance based on some relevant assumptions made initially. In this case, the worst scenario will have a terminal growth rate at 5% and the best scenario will have the terminal growth rate at 7%. Therefore, the reasonable share value range for Honeywell International should be $31. 56-$40. 98/share.

* 3. What is the return on investment for Gallinelli’s arbitrage position?

ARB RETURNS ESTIMATION

|  |  |
| --- | --- |
| Position and Payoff in Target Shares  |  |
| Buy Target shares at  | $41. 16  |
| Value of Target Shares at End of Holding Period  | $41. 82  |
| Gross Spread Per Share on Target shares  | $0. 66  |
| The total value of Gross spread on Target Shares (× No. of shares (million)) 100  | $66. 00  |
| Short Buyer shares at  | $47. 08  |
| Value of Buyer Shares at End of Holding Period  | $41. 60  |
| Gross Spread Per Share on Buyer shares  | $5. 48  |
| Total Value of Gross Spread on Buyer Shares  | $548. 00  |
| Total Assets of the Arbitrage Position  | $4, 116. 00  |
| Short Position in Buyer Shares  | $4, 708. 00  |
| Return on capital for holding period only  | 37%  |
| Return on capital annualized  | 105%  |

* 4. How will the market react to the news from antitrust regulators?

GE has officially announced the merge and acquisition with Honeywell on October 22, 2000 and if it has been gone through, GE will be the biggest company in the aerospace industry with more than 60% of total market share. Undoubtedly, GE will be more monopolist and may bring about unfair competition with its rivals. Hence, both the United States (represented by the Department of Justice (DOJ)) and European countries (represented by the European Commission (EC)) have an " Antitrust Law' subject to protect the merger businesses. DOJ has approved the M; A since November 15, 2000, while EC is still worried about the inelasticity and the enhancement of price will affect the consumption.

In investor’s views, the probability that EC will approve the merger is likely to be decreasing along with the increasing stand-alone values of Honeywell. For instance, in the period November 1 to November 15, the probability for merger arbitrage is gradually falling from 83% to 42% corresponding to the stand-alone value increases from $30 to $44. This news would make the share price of GE and Honeywell decrease as losing an opportunity to be the dominant player in the aerospace industry. GE’ share price has lost 15% and Honeywell has lost 13% since November 3, 2000 to March 1, 2001. The probability is likely high above 60% at the same stand-alone value if it is far fallen behind $38. However when the stand-alone value is approximate or goes beyond the market value, the probability of M; A is extremely low or even not applicable. For those investors who already hold stocks of either or both companies, it is a good signal to sell them now. For those investors who have not invested in both stocks yet, it is not a suitable time to buy them now and they should wait to see the final decision from the merger approval before making a decision.

* 5. What should Gallinelli do?

Gallinelli should close the position on 1 March 2001 in order to recognize profit that is extraordinarily high (return on capital annualized is 105%) from this arbitrage opportunity. Moreover, EC recently announced that they would open a full investigation into the proposed GE-Honeywell transaction. This news is likely to decrease the stock prices of both companies in the future. If Gallinelli’s fund waits for the merger result from EC and holds this investment position further, it would make the fund get less profit from a long position in Honeywell because of the reducing price. If the takeover were failed it would return the share price of Honeywell and GE to the original price as before the proposal of the acquisition has been announced. As the consequence, BCM will also get the rate of return on capital annualized lower than 105%. Therefore, Gallinelli should decide to close the position now on 1 March 2001 to obtain an abnormal return immediately.