The Arbitrage Funds

ADVISED BY WATER ISLAND CAPITAL

Notes from the Desk: AT&T/Time Warner

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DEAL BACKGROUND:

On October 22, 2016, AT&T Inc announced a definitive agreement to acquire Time Warner Inc for $108 billion in cash and stock. The deal would combine one of the nation's largest telecommunications providers, with business segments in mobile, wireline, and satellite service, with a content giant that owns valuable properties such as HBO, CNN, and Warner Bros.

WHAT HAPPENED?

Heading into November 2017, this merger was on track for completion by year-end. The deal had cleared multiple hurdles in the approval process (including successful shareholder votes and European Commission approval, amongst others), with the final outstanding step being approval from the US Department of Justice (DOJ). On November 8, however, news media reports (in the Financial Times, New York Times, and other publications) emerged that AT&T had reached a stumbling block in its negotiations with the DOJ.

The DOJ can take the following actions in reviewing a deal: it can approve a deal – either as-is or after negotiating remedies (which may be either structural or behavioral), or it can sue to block a deal. A structural remedy requires some sort of structural change to the combined entity, such as the divestment of assets. A behavioral remedy is designed to regulate the future conduct of the combined entity (for example, by regulating prices or requiring open access to assets for a period of time).

According to reports, the DOJ requested structural remedies from AT&T, with suggested asset divestitures ranging from Turner Broadcasting (which owns CNN) to DirecTV. News of the DOJ's opposition to the transaction, and its request for structural remedies in particular, caught investors off guard, as AT&T/Time Warner is a vertical merger – meaning it is a combination of two companies across different industries – as opposed to a horizontal merger, which combines competitors within the same industry. Traditionally, structural remedies are more commonly negotiated in horizontal mergers, in order to ensure continued competition within a consolidated industry, whereas behavioral remedies are more appropriate for vertical mergers. That said, the newly-appointed head of the DOJ's Antitrust Division, Makan Delrahim – who publicly stated he didn't see "a major antitrust problem" in the AT&T/Time Warner transaction before he ascended to his current post – has voiced a preference for structural remedies in addressing antitrust issues. Lastly, we should note, the government has not blocked a vertical transaction in more than 40 years. The concern here seems to be that there will be a conglomerate effect, and a combined AT&T-Time Warner will have too much power (though a similar Comcast/NBC Universal transaction was approved in 2011, albeit under a different presidential administration).

AT&T CEO Randall Stephenson is on record stating he has no intention of selling CNN, and a DirecTV divestiture seems unrealistic given how critical its DirecTV Now streaming service would be to the success of a combined AT&T-Time Warner entity. At the time of this writing, none of the reports that have been made public are based on official statements from the DOJ – so there is the potential that this is just a negotiating tactic. (We would be remiss not to mention that President Trump has publicly stated his opposition to the deal numerous times, and he is known to have a particular distaste for CNN.)

WHAT DO WE THINK?

There are a few ways this situation could unfold. Should AT&T and the DOJ fail to reach an agreement, litigation would be the next step for the DOJ. AT&T, however, appears to have the stronger case – there is no overlap between the two companies, and antitrust precedent is not on the DOJ's side. As such, we think there is a smaller likelihood this will end up in court. Regarding potential remedies, none of the rumored structural options seem appealing to AT&T, but there is still potential for the company to reach an agreement with the DOJ on some other small divestiture. (And if CNN actually is on the table, CBS has already stated it would be a willing buyer.) More likely, we believe negotiations with the DOJ could lead to behavioral remedies, such as a requirement to open access to Time Warner's content catalog to competitors, or restrictions on bundling Time Warner properties with AT&T services for a period of time.

In terms of the definitive merger agreement (DMA), Time Warner is well protected. The agreement contains a specific performance clause, which requires AT&T and Time Warner to make a "reasonable best efforts" attempt to complete the transaction as long as they abide by the representations therein, which includes a willingness to make divestitures as long as said divestitures would not represent a material adverse change (MAC) to the deal. In other words, if the DOJ proposes a specific divestiture that AT&T is simply unwilling to make, as long as that divestiture could be deemed a reasonable option, Time Warner could then sue AT&T to force the company to complete the transaction. Should this occur (to be clear, we think this is a low probability), we believe the DMA is strong enough that Time Warner would easily win in the Delaware courts.

WHAT ARE WE DOING?

Coming into Q4, AT&T/Time Warner was one of Arbitrage Fund's largest holdings (5.3% of assets as of 9/30/17), as we had a high degree of conviction in likelihood of completion. After the news broke on November 8, panic selling drove the deal spread from approximately $6 to the $13-$14 range. We still maintain our conviction in the deal. In our opinion, AT&T has a strong case against the DOJ, and Time Warner has a strong case to force AT&T to complete the acquisition. We traded around the November 8 volatility, and added a small amount to our total position by the end of the day. Given the spread widening, the deal detracted approximately 60 basis points from performance on the day, which is approximately -35 basis points from inception of the position. This is well within our risk limits for a single position, and even on a full deal break – which, again, we believe is unlikely – we are still within our 1% maximum downside guideline.

Outside the AT&T/Time Warner transaction, the news also led to spread volatility in a handful of other transactions. Two additional deals in the media/broadcasting space (Tribune/Sinclair and Scripps/Discovery) reacted negatively. We took the opportunity to add to our positions there at favorable rates of return. In addition, based on fears that the DOJ's position has been driven by the influence of President Trump and political posturing, spreads widened on transactions requiring approval from the Committee on Foreign Investment in the United States. We believe the spread movements in the aforementioned situations have been overreactions, and anticipate they will recover before the end of the year.

Regarding the future for AT&T/Time Warner, the termination date of the merger agreement (i.e., the date at which AT&T's offer expires and the two companies can abandon the deal without penalty) is April 22, 2018. If this leads to litigation between AT&T and the DOJ, we expect a court date sometime in March. Yet as we've said, since AT&T has a good case and we believe the DOJ will have difficulty blocking this deal, we believe the DOJ will reach an agreement with AT&T before it gets that far. Until then, we anticipate the deal spread will recover somewhat from current levels until it is trading around 50% probability of close, at which point it will likely be somewhat volatile and trade between 40%-60% probability of close until we have more clarity. From our perspective, if AT&T cannot reach an agreement with the DOJ for whatever reason, the sooner we get to litigation the better – as we believe the company will easily emerge victorious.

GLOSSARY: A *deal spread* is the difference between the price at which a target company's shares currently trade, and the price an acquiring company has agreed to pay. A *basis point* is an amount equal to 1/100 of 1%.