The Arbitrage Funds

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US/China Relations, a New Regulatory Paradigm, and Volatility in Merger Arbitrage

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In 2014, details regarding China's thirteenth Five-Year Plan (covering 2016-2021) emerged, with one of the core tenets being a focus on the nurturing and growth of the local semiconductor industry and a stated goal of building local-brand CPUs. While China had been attempting to expand its influence in this area since the early 2000s, an actual, stated, policy goal coupled with the backing of the government led to – and is still driving – an elevated level of outbound mergers and acquisitions (M&A) activity amongst state-owned investment vehicles (which control a majority of the China-based semiconductor companies) as well as announcements of new partnerships with some of their largest global competitors.

Against this backdrop, however, a few issues related to US/China relations have bubbled to the forefront – and the trends that began in the waning days of the Obama administration have only picked up steam during the first year-and-a-half of the Trump administration.

Increased Regulatory Focus on M&A Involving the US and China

The trend of US regulatory agencies stringently investigating China-based M&A (via the extension of review timelines, stricter behavioral/divestiture requirements in relation to deals that don't involve China, or outright blocks) was not unheard of under Obama, but the Trump administration has taken it to another level. For the Obama administration, the focus seemed to be curtailing China's influence – e.g., using trade as a means to punish China for its expansion into the South China Sea; preventing military or military-tangential technology (such as semiconductors) from falling into Chinese hands; or punishing China-based companies trying to circumvent US foreign policy (such as ZTE, which was caught selling US technology to Iran and North Korea in spite of US sanctions). The Trump administration, on the other hand, seems more focused on nationalist and protectionist goals that will create a "fair" trade environment – e.g., by eliminating "unfair" trade deficits with China; hobbling Chinese efforts to build out 5G wireless networks; or punishing China for "stealing" American jobs, manipulating currency, flooding the US market with cheap products (such as steel and aluminum), and imposing onerous conditions on US companies to access Chinese markets. A condensed list of the deals these two administrations have hobbled include:

- In April 2015, Tokyo Electron and Applied Materials terminated their merger after regulators in both the US and China attempted to enact politically-motivated concessions from the companies.
- In February 2016, Unisplendour Corp (a subsidiary of a China-based holding company) abandoned its plan to buy a stake in Western Digital after the Committee on Foreign Investment in the United States (CFIUS) – which is responsible for reviewing M&A involving US targets from a national security perspective – announced it would investigate the transaction.
- In October 2016, semiconductor companies KLA-Tencor and Lam Research abandoned their transaction after the Department of Justice raised concerns that the tie-up would unfairly harm competitors.
- In September 2017, President Trump (via CFIUS review) blocked China-backed private equity firm Canyon Bridge from purchasing US semiconductor manufacturer Lattice citing national security concerns.
- In January 2018, Ant Financial (owned by China-based internet conglomerate Alibaba Group Holding Ltd) abandoned its deal to acquire MoneyGram after CFIUS rejected its proposal to mitigate concerns over the safety of data that can be used to identify US citizens.

- In February 2018, China-backed private equity firm Hubei Xinyan Equity Investment Partnership abandoned its deal with US semiconductor company Xcerra. The companies stated they abandoned the transaction as it was clear that CFIUS would not approve the deal.
- In March 2018, President Trump (via CFIUS review) blocked Singapore-based Broadcom's hostile takeover of Qualcomm again citing national security concerns.
- In March 2016, the US weighed the option of barring US companies from doing business with ZTE (China's largest smartphone manufacturer) after the company illegally exported US technology to Iran and North Korea. Ultimately a fine and additional behavioral conditions were imposed on ZTE in 2017. However, when ZTE was found to have violated these conditions, the US officially enacted a seven-year ban on sales of US goods to ZTE on April 16, 2018.
- On April 19, 2018, the NXP Semiconductors/Qualcomm merger hit a snag with its sole remaining regulatory approval when a spokesman from China's Ministry of Commerce (MOFCOM) was quoted as saying Qualcomm's proposed remedies had "issues that are hard to resolve, making it difficult to eliminate the negative impact." The news sent shares of both companies down nearly 5%.

Interestingly, while there is plenty of precedent in US regulators officially blocking China-based M&A, China has been reluctant to retaliate by using MOFCOM to block deals outright. Rather, MOFCOM has a history of trying to extract concessions that will be favorable to China in exchange for approving a deal, and if the regulators encounter a deal they absolutely will not approve, the agency prefers to delay rulings indefinitely (and wait for the companies to walk away) or ask for concessions it knows the companies will not be able to deliver.

Changing Regulatory Paradigms

In 2017, the US Department of Justice (DOJ), led by Makan Delrahim, decided to upend decades of regulatory precedent by going to court to block a vertical merger (AT&T's deal to acquire Time Warner). Coupled with Delrahim's insistence that behavioral remedies (which, to the detriment of divestitures, had been gaining favor among global investment regulators recently) cannot solve regulatory concerns, this represents a US regulatory environment where established precedents regarding M&A may no longer exist. As a result, volatility in M&A names has greatly increased – since the historical precedent may no longer be a reliable indicator of future behavior, the slightest bit of good or bad news (rumor or otherwise) can impact share prices.

Uncertainty and the erosion of established norms in M&A have led investors to reply to any bit of news in a panicked manner, causing a higher degree of volatility in M&A names than has occurred in the past.

Global Tariffs

The Trump administration's decision to imposed $50 billion worth of tariffs on a litany of Chinese goods (taking special aim at metals such as steel and aluminum), as well as the response from China that it would reply to any tariffs with measures of equal strength has raised the specter of a trade war ensuing. China has already imposed retaliatory tariffs on $3 billion worth of US goods, has said it can target $50 billion more, and the Trump administration has threatened to respond by imposing tariffs on an additional $100 billion in Chinese goods. The resulting breakdown of long-established norms (such as deference to World Trade Organization rules and guidelines) has only made investors more sensitive to issues regarding US/China relations. While regulatory approvals may seem distinct from tariffs, they are just another lever countries can pull should they seek to punish one another.

The impositions of tariffs have led to an "anything is possible" attitude in the market. The US hobbling the strategic M&A goals of China-based companies, and vice versa, is always a lever that can be pulled in lieu of more serious actions such as tariffs.

In general, spreads in the merger arbitrage space have been increasing for the past few years. This is due in large part to rising interest rates and increased volatility in the overall markets – especially since the beginning of 2018. The tenuous relationship between the US and China and an increasingly challenging regulatory environment, however, are further contributing factors. Uncertainty breeds volatility – and volatility in merger arbitrage has surely increased in the past few months. That said, volatility in spreads is not entirely unwelcome. It provides opportunities to trade around deals and to increase position sizes or to implement hedges at favorable levels. Thankfully, regulatory challenges are familiar territory for merger arbitrageurs. Handicapping the regulatory approval process is one of the most critical aspects of properly analyzing the risk/reward scenario for any deal – and to be fair, gauging the likelihood of success in mergers involving the US and China may now be more difficult – but our team has decades of experience navigating similarly unpredictable situations. As we continue to recalibrate our risk tolerances around exposure to US/China-related M&A, we look forward to having more to say on these issues as in the weeks and months ahead.

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. *China's Five-Year Plans* are a series of initiatives designed to shape the social and economic development of the nation.

IMPORTANT INFORMATION

An investor should consider the Fund's investment objectives, risks, charges and expenses carefully before investing. The Fund's prospectus contains this and other important information. You may obtain a copy of the Fund's prospectus at http://arbitragefunds.com or by calling (800) 295-4485. Please read the prospectus carefully before investing.

RISKS: The Fund uses investment techniques with risks that are different from the risks ordinarily associated with equity investments. Such techniques and strategies include merger arbitrage risks (in that that the proposed reorganizations in which the Fund invests may be renegotiated or terminated, in which case the Fund may realize losses), high portfolio turnover risks (which may increase the Fund's brokerage costs, which would reduce performance), options risks, borrowing risks, short sale risks (the Fund will suffer a loss if it sells a security short and the value of the security rises rather than falls), and foreign investment risks (the securities of foreign issuers may be less liquid and more volatile than securities of comparable US issuers, may involve political uncertainty, and may incur currency fluctuations), which may increase volatility and may increase costs and lower performance.

Top 10 holdings as of 3/31/18: Blackhawk Network Holdings; Callidus Software; CSRA; DST Systems; Monsanto; NXP Semiconductors; Orbital ATK; Rockwell Collins; TDC; Tribune Media. Top 10 holdings represent 56.3% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

Material represents the manager's opinion and should not be regarded as investment advice or a recommendation of any security or strategy.