MANAGER Q&A

The Environment for Event-Driven Investing: Q&A with Water Island Capital

We recently spoke with several members of Water Island Capital's investment team about the environment for event-driven investing. John Orrico formed Water Island in 2000 and now serves as chief investment officer and portfolio manager leading the investment team. Portfolio manager Gregg Loprete manages the firm's credit investments. Portfolio manager Ted Chen is responsible for the firm's investments in equity event-driven and special situations. Rob Ryon joined the Water Island team in March 2014 as a trader on the credit team. Ryon has over 20 years of investing experience, and most recently managed and traded convertible and capital structure investments at Southpaw Asset Management. Our conversation covered merger arbitrage, credit, and equity special situations, as well as a handful of specific illustrative examples.

Can you give us an update on what the merger arbitrage landscape looks like? It seems like we may be seeing some pickup in activity.

John Orrico: I'd say it's more of the same—more than anything else. We haven't seen any real fundamental shifts in terms of the way deals are being structured today. Overall, some slight upticks in terms of deals, as far as dollar value—as well as number of transactions. I still do think there's a lot of tentativeness out there on the part of CEOs and boards pulling the trigger in an environment where there's a lot of concern about how the end of QE [quantitative easing] is going to play out.

I think that in general, the transactions that we're witnessing are being driven out of strategic need or necessity. They're smart transactions that are being fueled by a company's desire to grow their bottom line, as well as to serve their clients better. That could be through a geographic extension or product-niche extension around their current businesses.

We've talked with clients in our letters about what we consider the continuing recent phenomena associated with tax-inversion strategies. It's really an impetus for a number of transactions in both technology and health care, where we see companies making acquisitions or buying their assets that are domiciled in low-tax jurisdictions. Or making acquisitions and redomiciling their businesses in lower tax domiciles, in order to take advantage of lower tax rates.

Of course that's been significant insofar as it's offered the opportunity for investors to watch how the acquirers' stock prices are moving substantially higher on the announcements of these deals. There's been some discussion amongst regulators—amongst the politicians in this country—about trying to slow that momentum down around these types of transactions. It leads to some really detrimental impact on revenue flows to the Treasury Department when we see these companies move offshore.

But nevertheless, it's been a trend that has become more popular in the last 18 months. At this point . . . we're probably closer to not the end, but we're in the later innings in terms of the number of transactions that we're going to see driven by that strategy.

I think I can say that because I see lower quality transactions being inked today. Meaning companies making that decision to redomicile offshore where the tax savings are driving the transaction . . . not [the] strategic benefit nor the strategic rationale.

Any change in activity on the international side?

Orrico: There's been a little bit of a flurry of activity that stood out in this environment, different from years past.

We've seen an uptick in transactions in Europe. We're seeing some hostile deals, as well as transactions that are, I think for the first time, indicating to us that there is a little more confidence in terms of the corporate sector there. Maybe some light at the end of the tunnel, as these economies stabilize, and even begin to grow in some instances.

Asia's been relatively slow; again, in the commodity-related sectors, given the slowdown in China, as well as the new government in China. I think that has also led to a little bit of a pullback in the number of outward-bound transactions; meaning Chinese entities—government-owned and private—making acquisitions, particularly in the commodity sectors outside of their borders in Australia, Asia, Africa, and South America. We've seen a little bit of a slowdown there. That's been the trend for the last two years, so there's nothing new there.

What about deal spreads?

Orrico: I think that, again, it's more of the same. We're seeing . . . amongst the higher-quality deals where we have go-shop provisions (giving acquirers time to shop for a better price). During those go-shop periods, spreads are extremely tight, probably anywhere from 2% to 3% annualized, to negative. We find a little bit of froth around investor appetite to take on that negative-return bias in order to have that "free call option" associated with a better bid coming along. Those negative spreads quickly widen out to positive spreads following the termination or the end of the go-shop period.

Away from that, I think in the more traditional merger-arb deals—whether cross-border or otherwise—we're still looking at that 3% to 5% gross rate-of-return kind of environment. That's not really going to change a whole lot.

We think that more deal flow, of course, will give us better selectivity across the deal landscape globally. We're starting to see some signs of more deal flow, but I think it's really going to take a pullback in the market—deleveraging or derisking taking place—to find better entry points around these transactions. Or we're going to have to continue to wade, treading water and accepting what the market gives us while we wait for rates to rise.

Can you give us an example of one of the deals involving the tax-inversion strategy you were talking about?

Orrico: Yes. I don't necessarily paint all of these transactions with the same brush, and I think that's important.

We had **Endo Pharmaceuticals** here in the [United States] make an acquisition of a small Canadian company that had some operations in Ireland. They were able to redomicile [in Ireland]. I'll tell you, I found it kind of unbelievable, but while they felt that their tax rate may come down from the low 30s into the high teens . . . I think that investors bid those Endo shares up from somewhere in the low $40s to $65 a share in a matter of a couple of days.

But some of the enthusiasm associated with that type of activity, I think is twofold. It's not only the tax issue, which could lead to a better earnings profile, but it's also the fact that companies that are seen to be aggressive in terms of balance sheet management—meaning putting cash to work and making acquisitions—they're gaining investor support. Because investors are looking at those opportunities or looking at the acquisitions as being very opportunistic, underpinning the long-term growth prospects for these companies.

So, Endo, while they got the benefit of the tax-inversion strategy, they also got a number of analysts to move. All of a sudden, they began to look at the company from a much different perspective in terms of a pipeline that seemed to be flattish, as well as having some potential legal problems associated with some of the drugs, to looking at this company as a growth company. All of a sudden, being able to say: Could the new management team position them to be an acquirer with a much stronger growth profile over the years ahead? That's really the rerating.

I think in a frothy market, of course, some of these stocks overshoot. I think Endo, after trading up to the mid-$60s from the mid-$40s . . . over the following month or two, it hit $75 a share before backing off down to $60.

We've seen some froth come out of the marketplace, too. It's interesting to see the marketplace psychology come into play here.

How do the opportunities in credit look to you?

Gregg Loprete: We're looking at the credit markets right now as not [having] a great deal of interesting [opportunities]. I shouldn't say things aren't interesting. I should say that there aren't the screaming buy opportunities there that you might see when there's a dislocation in the market or when we get a selloff in one part of the market.

We've really taken that view, and just spread our risks out as widely as possible by having relatively smaller position sizes in the portfolio. Trying to, where we do have larger positions, really look at shorter opportunities and harder catalyst types of situations [merger-related situations and refinancing opportunities]. Really, that's been the story probably for the last three to four quarters.

That's really been the bulk of what we've seen. But we also realize that the credit markets are—I guess we could call them—stretched. Our basic view is that we're at these very tight yields now. Spreads may be grinding even tighter. So we just don't feel there's a great amount of yield there to compensate you for the risk.

Can you elaborate on what kind of return profile you're seeing for different opportunities?

LOPRETE: When we look at refinancings—we'll call them yield-to-call situations—for something that has a merger-arb [type] timeline of three months to six months…That yield-to-call paper, depending on the credit, could be as tight as 1.5% to as high as 3.5%. So some of it is very merger-arb-like in the sense of return. Very, very tight.

What we like to invest in [are] situations that are short-dated and kind of idiosyncratic, and offer us a little bit of optionality. For these short-term trades, that optionality really comes in the terms of being redeemed early.

I guess the most recent example we have of that is NRF 3% bonds. This is **NorthStar Realty Finance**. NorthStar had a large convertible redemption due, but they didn't want to redeem it because they were in the middle of a spinoff. They felt that if they could keep this convertible outstanding until they finished this spinoff, then they would have a better shot at refinancing it at a better rate when there was more transparency into the equity in the split of the company.

About a month ago, the company underwent an exchange offer where the convertibles were exchanged for essentially a six-month note. That's still due in September. That note effectively at the time that we bought it gave us a 3.5% to 3.75% rate of return. That means if nothing happened. So to us, that would be a six-month piece of paper that had [a] very, very similar reward to what you'd see in a merger-arb deal over that time period.

What's interesting about the security is if the company ends up completing the spinoff prior to September, then through a special provision that they have, they will redeem the security early. So the optionality that I'm talking about is we could turn that September maturity at 3.5% into something closer to a 7% or 7.5%. So those are the types of names that we like. They're conservative and short dated where we can have a little bit of optionality.

ROB RYON: We know our defined return profile, with the expectation that there's a better than 50-50 chance that we're going to get the upside optionality in these positions.

Rob, you have a lot of experience in convertible arbitrage. Is that something that's looking interesting at all?

RYON: I lived through the 2008 debacle of Lehman. Specifically, the impact it had on the convert[ible] market. Coming out of that, I don't think there is a true convert-arb strategy as it existed in the early 2000s.

So the way we are looking at convertible investments is keeping duration short, trying to find favorable risk-reward trades where the credit is solid and it's trading maybe at a slight premium or around par with the strike, or converts in price pretty near to where the stock is trading.

We're thinking that it's a defined downside of maybe a ratio of one to a four to five upside, if things happen where we can define a catalyst and it comes to fruition in that time frame.

I don't think we're looking at it from a true convert-arb standpoint, as it's been known in the past. We're using convertibles to express a credit investment with some optionality.

You guys also look further out on the risk/return spectrum. Can you talk about the potential pickup in returns you get by doing that?

LOPRETE: Where we get interested in deleveraging candidates is really when we're talking about 1,000 over. So right now, we're talking about a 10% yield is where we start to get interested.

With that 10% yield, we're going to have situations where there's the potential to have increased volatility. If you look at a definitive merger arb or a definitive spinoff that's going to occur and they're going to [refinance] the bonds, that could be anywhere from—on an annualized basis—4% to 7% or 8%.

But on these other types of situations, we're really looking at more equity-like returns for a deleveraging candidate. There's certainly a difference in yield there. It's really a question of volatility tolerance.

We really look for the one-off situations. We're looking at names that have traded down well off of their highs, for some reason. It could just be that the high-yield investors sold a lot of bonds and now it's into crossover types of investors. Crossover in this case being more stressed types of investors.

The reason we think these can be attractive is the individual stories work out. The markets don't necessarily have to cooperate. There really has to be some execution there. What we like to have [is] a real pulse on management's conviction and ability to push through these changes. Then we try to quantify those and find out what it is that we really need to increase EBITDA [earnings before and including taxes, depreciation, and amortization]…to generate cash flow to get deleveraging there.

Can you give a high-level view of the equity and special situations landscape?

Ted Chen: Sure. It might be helpful just to take a step back and look where we came from.

At the end of December, the equity market was at a complete high. It was almost a euphoria. If you looked at where volatility was, we had a couple of periods in 2013 where you had the spike in volatility. You had it in the May/June time frame. You had it in October. But for the most part, volatility was low.

When we got to the end of last year and started this year, my view began to be more concerned about how low volatility was. When we saw January occur, where there were emerging-market fears and whatnot and the market selloff, we actually took that as an opportunity to get back involved in a lot of positions that we liked.

Now anecdotally, a lot of the stuff that we saw, and the reason that we felt confident in buying, was because all of the explanations out there in terms of why the equity market was down…all of that stuff was out there already. People were talking about a harder landing in China. People were talking about some of the emerging markets having difficulties. Greece became a headline again. It gave us confidence that this was another one of those moments where people were effectively "freaking out." Generally, that's a good opportunity to step in. That's what we saw in January.

What happened in the last two weeks of March was a big rotation out of growth and momentum into value. So when we saw this, we recognized that yes, Janet Yellen had effectively—one— decided to introduce volatility into the market (we actually think that's a good thing), but—two—had talked about a rising interest-rate environment. People began to talk about…we need to be paid more for staying invested in growth stocks.

As we saw the dislocation in a lot of the names we owned, we thought that was too much. It's really not about people not wanting to pay up for growth anymore. This has gone down the road of funds that are trying to mitigate their losses and reduce their risk positions. Really kind of [trampling] each other as they try to get out of these names that are considered momentum names.

So, we've continued to take the opportunity to own these assets as they drift lower, knowing that it will take some time for them to play out. I don't expect growth names to be trading at the multiples that they were at the beginning of the year.

Some of these valuation multiples recently were clearly frothy. But again, we're not in the business of investing in growth or in value names. We're looking at investments that have a good risk-reward profile, as long as the catalyst occurs. As long as that catalyst does occur, I think we're in good shape.

Can you talk about a specific example?

Chen: SiriusXM Holdings has been a name that I believe is very misunderstood, but for good reason. It's a very high free-cash-flow-generating business. The problem with that business, when you just look at the numbers, is the capex spend. Not only on just the hardware that they have to have, but also the operations of the satellites and putting the satellites up into space.

They've historically had this huge capex spend. Accordingly, they also have a huge depreciation and amortization expense every year they had their income statement put out. So when you look at GAAP [generally accepted accounting principals] numbers, their earnings number is depressed, because of the non-cash depreciation expense that they're factoring into the GAAP numbers.

Now, the reality is, they're not putting any more satellites [up]. They have more than enough. On top of that, they already have the entire new-car market installing their hardware in there. They're not necessarily trying to build market share anymore. The fact that you have the cars that had existing radio systems in there being sold on the used-car market—providing supplemental potential subscribers—you can think of it as the capex spend for the entire business as coming off dramatically. Yet the depreciation and amortization on an annual basis is still going to be the same, given the historical capex spend.

If you look at the business on a cash-EPS basis, it's significantly higher. It doesn't look rich, by any means, especially given the stability of the business. But again, when people just look at the face value of the numbers, they say: Wow, this business is trading at high multiples, why are we owning this here?

What we saw in SiriusXM is that there's been a flush in this stock—people [putting it] in the same bucket as a high-growth[or] momentum type of stock. But when we look under the hood, it is far and away not a growth story. This is a cash-cow business. It's harvesting the cash now. So it's not a growth story, although the earnings number and the free-cash-flow growth will be high. People misunderstand that.

What are you seeing in terms of the level of activity? Has the dramatic growth-to-value rotation and the minor increase in volatility scared people away from doing transactions? And where are you seeing opportunities now?

Chen: No. In fact, you've actually seen a couple of spinoffs get announced recently. You look at where the S&P is trading and where the Russell is trading and where Dow Jones has been trading. The impact to the broader equity market hasn't really been felt until the last week or two.

We don't see a slowdown at all, in terms of corporate transactions happening. We have a whole backlog of spinoffs from 2013. But we have a number of them that have been announced this year as well, and that hasn't changed the outlook.

Where I think we have seen a slowdown is... [the] tax-advantaged strategies that had been taking place in 2013 that have been in vogue as strategies for a lot of event-driven investors. They've taken a backseat this year. The first would be the REIT [real estate investment trust] conversions. After Iron Mountain had their PLR [private-letter ruling] delayed, the IRS put a working group together to figure that out.

There's been a step back in terms of any company trying to figure out whether they can convert a portion of their business into a REIT, or convert their whole business into a REIT. Definitely, the whole concept of REIT conversions has taken a back seat. I think that's going to come back pretty quickly. The working group at the IRS is going to come out with a result [soon]. Once that happens, you're going to begin to see this strategy get back in vogue.

One of the fears for us, back in the summer of last year... people were assigning valuation multiples assuming that the PLR was a done deal. If anyone should learn anything about what happened, it's that PLRs are definitely being scrutinized now. Not everyone is going to get it. We're going to be selective, but I think that will be interesting in the next six months.

Any final thoughts on the environment for event-driven investing?

Orrico: I don't want to leave you with a pessimistic outlook. I'm probably looking forward to the market pullbacks with a sense of opportunity. We really haven't had that opportunistic entry point around a lot of our merger-arb spreads since 2011. Even with a pullback, we don't really see spreads blowing out. We don't see that panic, yet. We've got lots of things on the radar screen and, for the first time, many of them are getting to a price level that we think makes sense for us to begin to dip our toes in the water.

We have a portfolio of singular stories that are unique to their own events. It's our job to discern between the larger macro trends and the stories that underlie what we own. So I'm a little bit encouraged to see more rational activity returning to the market, in terms of valuation and pricing.

We've been in this environment, which for five years has been dictated or controlled or driven by Fed policy. I think some people forgot that we used to have an independent, healthy economy that was driven by fundamentals. I think we're going to get back there. We'll have some fits and starts along the way. I'm happy to see some of these changes taking place. Whether it's market pullback or the Fed easing starting to disappear. The less captive we are to these macro factors that are out of our control, I think, the better.

Thanks for your time.

GLOSSARY:

"free" call option: a contract which designates the right, but not the obligation, to purchase shares of a particular underlying stock at a specified strike price on the option's expiration date.
free cash flow: A measure of how much cash a business generates for shareholders after paying expenses and investing in growth, commonly used as to indicate financial performance
yield to call: The yield of a bond or note if you were to buy and hold the security until the call date. This yield is valid only if the security is called prior to maturity. The calculation of yield to call is based on the coupon rate, the length of time to the call date, and the market price.
convert-arb (convertible arbitrage): a market-neutral investment strategy that involves the simultaneous purchase of convertible securities and the short sale of the same issuer's common stock. The premise of the strategy is that the convertible is sometimes priced inefficiently relative to the underlying stock, for reasons that range from illiquidity to market psychology. In particular, the equity option embedded in the convertible bond may be a source of cheap volatility, which convertible arbitrageurs can then exploit. The number of shares sold short usually reflects a delta-neutral or market-neutral ratio. As a result, under normal market conditions, the arbitrageur expects the combined position to be insensitive to small fluctuations in the price of the underlying stock. However, maintaining a market-neutral position may require rebalancing transactions, a process called dynamic delta hedging. This rebalancing adds to the return of convertible arbitrage strategies.
Private Letter Ruling: a written statement issued to a taxpayer by an Associate Chief Counsel Office of the Office of Chief Counsel or by the Tax Exempt and Government Entities Division that interprets and applies the tax laws to a specific set of facts. A private letter ruling binds only the IRS and the requesting taxpayer. Thus, a private ruling may not be cited or relied upon as precedent by other taxpayers.

Performance through 9/30/15 for Arbitrage Event-Driven Fund: AEDNX (I class), -9.63% (1 year), 0.93% (5 year), 0.63% (since inception 10/1/10). Performance through 9/30/15: ARBNX (I class), 0.16% (1 year), 1.39% (5 year), 3.12% (10 year). Performance through 9/30/15: ACFIX (I class), -1.79% (1 year), 2.01% (3 year), 2.01% (since inception 10/1/12). Performance greater than one year is annualized. The performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. Current performance may be higher or lower than the performance quoted. For performance data current to the most recent month end, please call (800) 295-4485.

*The Arbitrage Fund and Arbitrage Event-Driven Fund assess a **2%** redemption fee on shares redeemed within 30 days of purchase. The Arbitrage Credit Opportunities Fund assesses a **2%** redemption fee on shares redeemed within 60 days of purchase. Contractual fee waivers are currently in effect. Without such waivers, performance numbers may have been reduced. The Total Annual Operating expense for ARBNX is **2.06%**; Total Annual Fund Operating Expenses Excluding the Effect of Dividend and Interest Expense on Short Positions for ARBNX is 1.20%. The Total Annual Fund Operating Expense for AEDNX is **2.27%**. The Advisor has agreed to waive fees in excess of 1.44% for AEDNX until September 31, 2016. The Total Annual Fund Operating Expense for ACFIX is **2.05%**. The Advisor has agreed to waive fees in excess of 1.25% for ACFIX until September 30, 2016.*

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RISKS: The Fund uses investment techniques that are different from the risks ordinarily associated with equity investments. Such techniques and strategies include merger arbitrage risks, high portfolio turnover risks, options risks, borrowing risks, short sale risks, and foreign investment risks, which may increase volatility and may increase costs and lower performance. The Funds may invest in debt securities which decrease in value as interest rates increase. Diversification does not eliminate risk.

Arbitrage Event-Driven Fund top ten holdings as of 9/30/15: PartnerRe Ltd, Cytec Industries Inc, Chubb Corp, Thoratec Corporation, IPC Healthcare Inc, Precision Castparts Corp, Sigma-Aldrich Corp, Symetra Financial Corp, Dealertrack Technologies Inc, KYTHERA Biopharmaceuticals Inc. Top ten holdings represent 30.5% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

Arbitrage Fund top ten holdings as of 9/30/15: PartnerRe Ltd, Precision Castparts Corp, Sigma-Aldrich Corp, Chubb Corp, Cytec Industries Inc, Thoratec Corporation, Ansaldo STS SpA, Symetra Financial Corp, HCC Insurance Holdings, World Duty Free SpA. Top 10 holdings represent 37.7% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

Arbitrage Credit Opportunities Fund top ten holdings as of 9/30/15: Capella Healthcare Inc 9.25% 7/1/17, Chiquita Brands International Inc 7.875% 2/1/21, Baxter International Inc 5.375% 6/1/18, DealerTrack Technologies Inc 1.5% 3/15/17, SunGard Data Systems Inc 6.625% 11/1/19, SRA International Inc 11% 10/1/19, SPX Corp 6.875% 9/1/17, Brightstar Corporation 9.5% 12/1/16, US Foods Inc 8.5% 6/30/19, Par Pharmaceutical Companies Inc 7.375% 10/15/20. Top ten holdings represent 23.2% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

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