Water Island Capital

Market Update from the Trading Desk:
Hedge Funds, Crowded Trades, and Opportunities in Merger Arb

June 2016

There has been an uptick in headlines proclaiming the “end of the merger boom,” often citing the outsized number of deals recently falling apart at the hands of the regulators. However, by stepping back and taking a look at what’s happening beneath the surface of these troubled deals, we can see that reality is slightly more nuanced. What we’re witnessing is not a wholesale change in the merger landscape but a manifestation of what many investors (including us) predicted many months ago – namely, that **mega-cap deals in highly concentrated industries would begin to face pushback from regulators after years of comparatively lax enforcement**. Now, many months after the deals were first announced, those transactions have begun to wind their way through the regulatory pipeline and the pushbacks have come hard and fast.

Almost $5 trillion in transactions were announced in 2015, in what proved to be a record year. Among these deals (as well as a few announced in the closing months of 2014), the $38.7 billion deal by Halliburton to buy Baker Hughes (announced late 2014), the $160.0 billion deal between Pfizer and Allergan (announced November 2015), and the $6.9 billion deal combining Office Depot and Staples (announced February 2015) have been terminated in 2016. In addition to these three high profile transactions, market watchers point to the European Commission (EC) blocking Hutchison’s bid to buy Telefonica’s O2 unit ($15.5 billion) in Europe, and some large private transactions such as General Electric’s attempt to sell its appliance division to Electrolux ($3.3 billion) as further evidence of the current difficulties facing deal-making (with the implied premise that these difficulties will continue).

Recent Deal Breaks

- **Office Supplies** – When Office Depot successfully completed its acquisition of Office Max in November 2013, the industry consolidated from three major players to two. A Staples / Office Depot merger (announced February 2015, terminated May 2016) would have further consolidated the industry from two major national players to one. (Staples and Office Depot argued – to no avail – that Amazon was also a significant competitor in the industry and would provide suitable competition. It’s unlikely that the companies believed that they could create a monopoly under the Justice Department’s nose.)

- **Oil Services** – Another industry that has undergone massive consolidation over the past 25 years. There are currently three large players: Schlumberger, Haliburton, and Baker Hughes. A Haliburton / Baker Hughes merger (announced November 2014, terminated May 2016) would have further consolidated the industry from three major players to two.

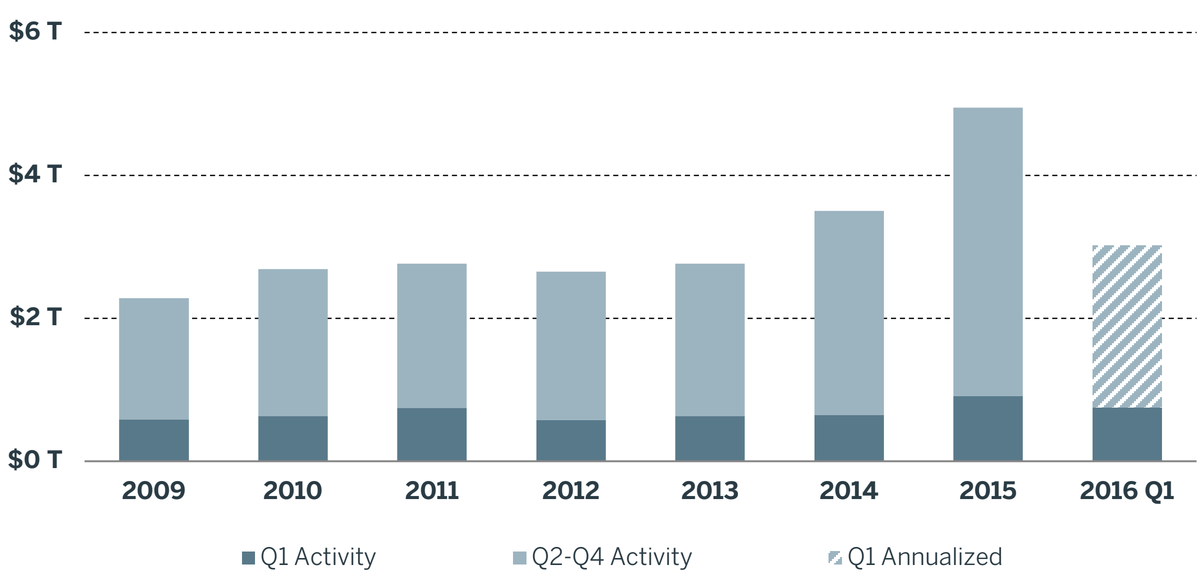
- **Health Care** – Tax inversions have been facing massive headwinds from the US Treasury – recall the $54 billion AbbVie / Shire deal which was terminated in October 2014. In an effort to make inversions less attractive, Treasury undertook policy action specifically targeted at the Allergan / Pfizer transaction in April 2016. While a surprise to the market, Treasury’s desire to clamp down on these types of mergers has been clearly broadcast for over two years now.

In addition, there is likely to be more negative news for those mergers taking place among the HMOs – Aetna, Cigna, Humana, and Anthem – another highly concentrated industry where consolidation has been gaining momentum over the past three decades. Concern from regulators and consumer groups regarding more limited consumer options and/or rising prices could cause significant problems for any proposed tie-ups.

The Current Environment

These past two years have seen hedge funds crowd into the M&A space, lured by ample, headline-grabbing deal flow and attractive profit potential. However, they have ignored the risks, inadequately hedged, and have paid dearly for it. While their performance – coupled with the recent press reports describing the demise of these high profile deals – may paint a dire picture of the space, we at Water Island feel that merger arbitrage still has much to offer for the following reasons:

1. The deal flow environment is healthy.



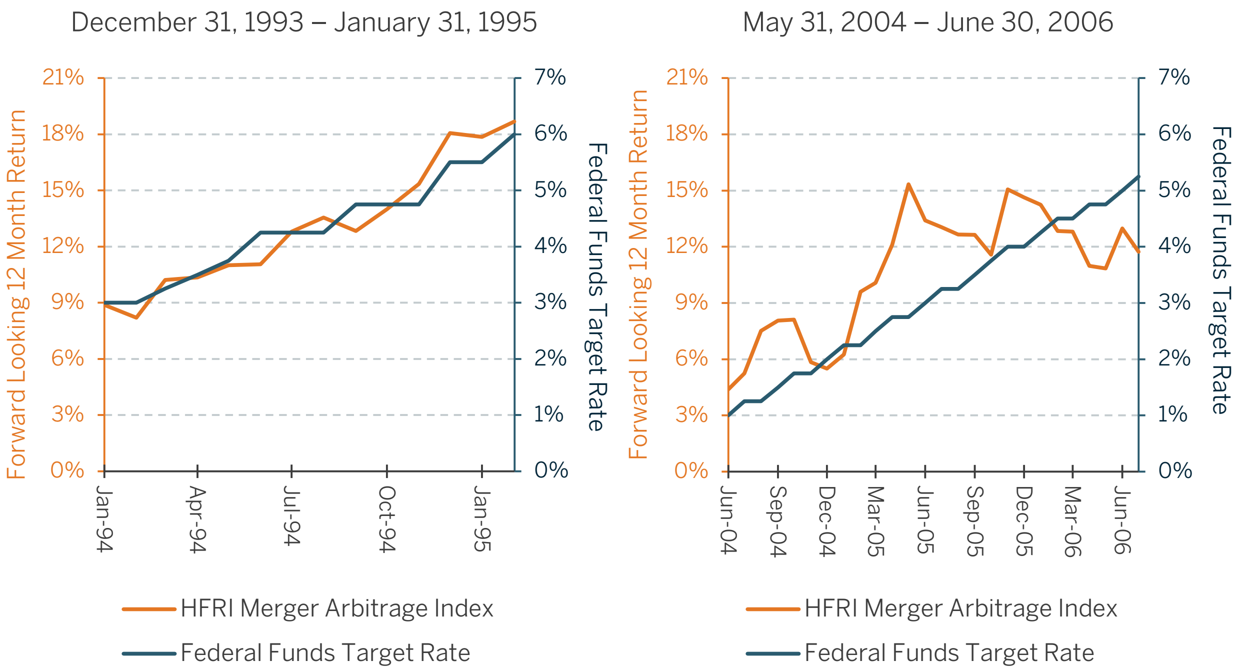
Source: Dealogic. As of 3/31/16. Past performance is not a guarantee of future results.

While 2015 was a record year for M&A volume that 2016 is unlikely to surpass, the year still started at a rate that would outpace most of the post-2008 period. Deal breaks aside, overall deal flow remains healthy and attractive opportunities continue to present themselves.

2. Interest Rates may be poised to rise…finally.

Merger arbitrage has historically benefited from the tailwind generated by a rising interest rate environment. In the last two periods of significant increases in the Federal Funds Target Rate, merger arbitrage returns moved in a similar direction. While, thus far, the Fed's approach has been slow and steady, any uptick in interest rates could see a commensurate increase in merger arbitrage returns.

Merger Arbitrage Returns in Periods of Rising Interest Rates



Source: Morningstar.

Index returns are for illustrative purposes only and do not represent actual performance. **Past performance does not guarantee future results.** Index listed is the HFRI ED Merger Arbitrage Index ("HFRI Merger Arb"). Index returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

3. The risks are identifiable.

The deals experiencing problems today generally have one or more of the following attributes: they 1) involve companies with large market shares in heavily concentrated industries; 2) are tax inversions; 3) involve a Chinese acquirer; or 4) involve companies with poor underlying economics. The previously mentioned deal breaks have all had well-known risks upon announcement, and what we are seeing today is those deals from 2014 and 2015 finally coming to their untimely end.

Additionally, in assessing the regulatory risks companies face in highly concentrated industries, there are established guidelines that arbitrageurs can reference. In evaluating proposed mergers and acquisitions, the Department of Justice (DOJ) typically uses the Herfindahl-Hirschman Index (HHI), which measures industry concentration on a scale of 0-10,000 by squaring the market share of each firm competing in a market, and then summing the resulting numbers. Historically, the DOJ has considered a market with a result of less than 1,000 to be a competitive marketplace; a result of 1,000-1,800 to be a moderately concentrated marketplace; and a result of 1,800 or greater to be a highly concentrated marketplace. While still an imperfect instrument in accurately assessing the final regulatory outcomes, it does provide a starting point for arbitrageurs to begin their own analysis (and is a stark contrast to suggestions that the current regulatory environment is indecipherable).

Looking Forward

While deal breaks – especially ones as large and as public as those previously outlined – are never pleasant, they are unlikely to herald an end to the increasing pace of deal-making activity of the past few years. They may, however, cause a general de-risking that could clear out the non-specialists that were hoping for an easy buck. As such, skilled arbitrageurs with experience navigating the nuances of regulatory review, and a strict focus on downside protection and risk management, should be well-positioned to take advantage of future opportunities in the space.

Glossary

Deal flow: The volume of announced mergers and acquisitions activity.

HFRI ED Merger Arb Index: The HFRI Event-Driven Merger Arbitrage Index includes funds which employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies which are currently engaged in a corporate merger or acquisition transaction. Indexes are unmanaged and one cannot invest directly in an index.

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