



The Arbitrage Funds

ADVISED BY WATER ISLAND CAPITAL

AUGUST 16, 2017

There has been a recent bout of volatility in the merger arbitrage space. We believe the cause of this volatility has been spread dislocations in a handful of widely-held merger names, more than any general spread weakness across the landscape or capital leaving the space. In particular, a few transactions come to mind.

NXP Semiconductors / QUALCOMM

NXPI is probably the largest and most widely held name in the event-driven community. This is a tender offer that has been trading through the terms (\$113 vs. \$110 deal value) as activist Elliott Management has increased its stake and has been pushing for an increase in deal value. The semiconductor space has had a huge run over the past year, and this has helped support their argument for a higher deal price as comps have improved. That said, QCOM has held off on bumping its offer as regulatory approvals still haven't been received (the thinking being, there is no incentive to renegotiate until they have antitrust approval). Recently the SOX index has experienced a pullback on the back of some peers reporting softer earnings, and that weakness has bled into NXPI. Suddenly, the current bid on the table looks more reasonable again, and the likelihood of QCOM increasing its offer has dropped. We think a lot of investors who entered this position below \$110 have likely taken profits on this turn of events.

(Our approach: We also trimmed our position in NXPI/QCOM into strength, but it remains a core holding for us. We have our position hedged with a sector ETF, which has helped mitigate the impact of recent weakness.)

Cabela's / Bass Pro Shops

This is another widely-held deal in the merger arb space, especially following a number of announcements that on the surface appear to bode well for completion of the deal — including the successful renegotiation of a bank deal for Cabela's credit card business that was required for the Bass Pro acquisition to proceed; Hart-Scott Rodino (HSR) regulatory approval; and a shareholder vote that approved the



The Arbitrage Funds

ADVISED BY WATER ISLAND CAPITAL

transaction. That said, at the end of July two events occurred that shook investors: First, Cabela's released earnings that showed a significant decline in same store sales. On the same day, a sell side research report was released, claiming that the Office of the Comptroller of the Currency — which would have had jurisdiction over regulatory approval of Cabela's bank deal before it was renegotiated — had reached out to the Federal Reserve — which has jurisdiction to approve the newly renegotiated deal — with complaints about the transaction. Subsequently, Cabela's shares traded down more than 5% in one day. With every day that passes without approval of the bank deal, we get closer to the October 3 deadline by which CAB/Bass Pro must be completed, and Bass Pro is already on record stating they will not extend the termination date to ensure the deal gets done.

(Our approach: While we were initially long the deal at announcement, in December we changed course and implemented a reversal to express our view that the transaction would not close. We covered some of this position on the recent weakness to take profits, and continue to maintain a conservatively-sized short position, as we think the fundamentals of the deal have deteriorated and the timing on Fed approval is highly uncertain.)

Brocade / Broadcom (née Avago)

As recently as quarter-end, we were on record stating that delays in the appointment of commissioners to key seats in regulatory bodies, thanks to gridlock in Washington D.C., had not put a damper on the pace of deal approvals, and that fears over the impact of populist ideals and poor US-China relations may have been overblown. In the past few weeks, however, this has begun to change. CFIUS — the Committee on Foreign Investment in the United States — is the regulatory body charged with reviewing deals from a national security perspective. CFIUS is currently significantly understaffed, with many senior positions remaining unfilled. A record slow rate in confirmations in the Senate, combined with a record high number of applications from deals seeking CFIUS approval, has led to continued delays in the CFIUS process. Perhaps more importantly, these delays are occurring exactly when the tide of populism is ebbing toward "for," with increasing concern in D.C. over China acquiring critical US technology and intellectual property. The CFIUS approval process typically runs on a 75-day clock, so a number of the deals that have been experiencing delays



The Arbitrage Funds

ADVISED BY WATER ISLAND CAPITAL

have been required to pull their applications and refile in order to reset the clock, lest their applications expire unapproved. This is exactly what has happened with BRCD/AVGO. The companies had initially guided to a 7/31 close, and the deal was trading at a very tight spread. A week before the expected close, the companies announced they had extended their agreement to the end of October, that they have yet to receive Ministry of Commerce (MOFCOM) approval in China, and that they had chosen to pull and refile their CFIUS application. This is exacerbated by that fact that Broadcom (formerly Avago) is domiciled in Singapore, leading some investors to fear CFIUS will block the deal. The spread went from nearly zero to over 20% annualized (based on the newly extended October close) on the news.

(Our approach: We believe fears of a CFIUS block are overblown and what we are seeing is simply a delay in timing. While Brocade does manufacture some semiconductors for the US government, the company has already announced it is divesting these businesses to US buyers, and it was just last year that CFIUS approved Singapore-based Avago's acquisition of Broadcom. That said, given the tight spread and low rate of return as we neared the expected 7/31 close, we had already cut our position in order to redeploy capital to better risk/reward opportunities. We maintain a small position, and we do expect the transaction to eventually be approved. We had also initiated a short position in the acquisition of another semiconductor company, Xcerra, by Sino IC Capital. Sino IC is a Chinese private equity company that is backed by China's state-owned technology fund. As soon as we saw that Sino IC is state-owned, we realized this transaction was asymmetrically skewed toward widening out on any negative CFIUS-related headlines, and despite Xcerra claiming they have no exposure to the US government, our reversal has acted as a good hedge to our long Brocade position.)

Whole Foods / Amazon

Another widely-held merger arb name, when AMZN's acquisition of WF was announced, there were widespread expectations of topping bids from the likes of Costco, Target, and Kroger's. Alas, that thesis has largely evaporated, with a number of the aforementioned parties announcing their disinterest (and AMZN's bid being tough to beat to begin with). In addition, there has been some fear that — depending on how they construct their view of antitrust in this situation — the Department of



The Arbitrage Funds

ADVISED BY WATER ISLAND CAPITAL

Justice (DOJ) could attempt to block the deal. The spread on this transaction has widened on these developments.

(Our approach: There really is no overlap in the existing businesses of AMZN and WF, and we don't expect the DOJ to redefine how they view the marketplace for this transaction. As such, we believe any regulatory fears are just noise, and we're maintaining our position in this deal.)

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, 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. Foreign investing involves special risks such as currency fluctuations and political uncertainty.

Top 10 holdings as of 6/30/17: Allied World Assurance Co Holdings AG; Astoria Financial Corp; CR Bard Inc; Fortress Investment Group LLC; Kate Spade & Co; Mobileye NV; NXP Semiconductors NV; Panera Bread Co; PAREXEL International Corp; Time Warner Inc. Top 10 holdings represent 44.6% 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.

Distributed by ALPS Distributors Inc., which is not affiliated with the advisor or any of its affiliates.
[ARB001154 2018-03-31]