Water Island Capital

The ArbCast – Episode #2: Trade Wars vs. M&A

Lindsay Fitzpatrick: [00:00:00] Welcome to the ArbCast, Water Island Capital's podcast series where we hope to provide our investors with concise and timely insights into the world of event-driven investing. Today we'll be speaking with Sanjay Pall, a senior portfolio analyst based in London who works closely with our evaluation of cross-border deal flow. Hi Sanjay, how are you?

Sanjay Pall: [00:00:21] Hi Lindsay, I'm fine, thanks.

Lindsay: [00:00:22] Thanks so much for joining us. Today in our podcast, we're going to discuss with you how trade war has impacted merger arb spreads, how it's impacted deal flow and how we at Water Island Capital are managing this evolving risk.

Sanjay: [00:00:36] There's certainly been a negative impact on M&A deal volume since the trade war began, but equally there has been some interesting surprises. For instance whilst we have seen the volume of cross-border deals naturally decline, we have seen a striking increase in deal-making within the US as we potentially head into a more protectionist world and companies look to bolster their local supply chains. Having said that, the level of global deal-making in the first half of 2019 was still the third highest on record. Although, that's clearly partly a function of continued cheap financing we've been seeing and record high stock market valuations. But where we've seen the real impact is that companies are steering well away from the large high-profile cross-border deals, that will be subject to significant government scrutiny. Companies and senior management are just wishing to embark on such deals often have to stomach long transaction timelines, which can cause internal disruption and deal fatigue. So it's no surprise that those deals often get priced with significantly wide spreads at the outset of deal announcement.

Lindsay: [00:01:45] Well, can you explain then what causes deal spreads to widen or contract during a trade war and how we're working to manage this dynamic in our portfolio?

Sanjay: [00:01:54] I would say that there are in effect two key causes of deal spreads to widen or contract during a trade war. The first is the trade war’s impact on fundamental valuations of companies that we invest in, and the second is the trade war’s impact on the probability of deal completion.

Lindsay: [00:02:13] Well, let's start with the impact on fundamental valuations.

Sanjay: [00:02:18] So in a trade war the fundamental downsides of companies exposed to tariffs are very sensitive to the trade rhetoric. So it's crucial for us to keep a close eye on both the supply chain and sales base for the company we invest in. Tariffs can hit both costs and sales in different magnitudes as well as direction, which can lead to significant margin disruption. This effectively leads to a lower downside in the event of a failed deal. This can also lead to disruption or volatility in the way companies are valued in the public markets, and this can create a double whammy effect on how shares trade. For instance, when a deal gets announced, long-only investors have a larger incentive to cash out at that takeover premium, whilst event-driven investors like us can tend to be a little bit cautious to buy in size, which can often lead to an oversupply of stock in the market. This typically leads to spreads widening significantly when trade rhetoric sours and on the flip side can tighten significantly when trade rhetoric improves. For stock deals, however, the sensitivity is slightly less exaggerated, albeit even stock deals aren't completely immune since the acquirer hedge typically acts as a cushion in any widening spread environment.

Lindsay: [00:03:30] Now, you also made reference to the probability of deal completion?

Sanjay: [00:03:35] Yeah, so in a trade war the probability of deals completing is sensitive and correlated to the trade war rhetoric – especially where sensitive antitrust approvals underpin deal completion. Whilst it occurs rarely, politics and the trade war can interfere with the antitrust process and therefore the probability of a deal being granted antitrust approval can be correlated directly with the trade war. As the trade rhetoric sours, investors tend to lower their probability of deal completion, which causes spreads to widen. And again on the flipside, investors tend to improve their probability of deal completion when trade rhetoric improves, which causes spreads to tighten.

Lindsay: [00:04:13] You touched a little on politics. Tell me a little bit about how the political environment right now may have an impact overall?

Sanjay: [00:04:21] Politics is at the heart of any deal-making that occurs, whether it's within US borders or cross-border deals. As we know in the US, we've got the November 2020 elections coming up next year and companies and management are looking to see if the current president serves in a second term. We're also seeing Brexit and politics in Europe affecting deal-making as well as deal spreads.

Lindsay: [00:04:45] My takeaway overall from what you've said thus far is that trade war can make it incredibly difficult for you to build positions in target companies that are directly affected by any of these factors. How are you managing this? What's the approach?

Sanjay: [00:05:03] Well, to put it simply, it ultimately comes down to investing in transactions that have strong strategic rationale with or without the trade war, where the impact to government stakeholders are limited, and those that have strong merger agreement protections for shareholders. This allows us to gain high conviction on the probability of a deal completing and we often supplement this by looking into the options market to create downside protection.

Lindsay: [00:05:27] So it sounds like you're really working to handicap the risks. Tell me a little bit about how you're managing other risks as it relates to the portfolio.

Sanjay: [00:05:35] Well, we try to be cautious. Anticipating and expecting that volatility will pick up throughout the duration of a deal allows ample opportunity to size positions appropriately. The market seems to arbitrarily price all deals needing cross-border approval similarly, yet certain sectors are more sensitive to national security concerns than others. Understanding the nuances of the deals and the specific risk factors can help an investor find safer sectors that are being priced at unsafe levels and proper diversification can help ensure that no singular risk is overly pronounced within the portfolio. We work closely with our risk management team to ensure that our risk exposures are not overly concentrated.

Lindsay: [00:06:17] Sanjay, thanks so much for taking the time today to share your insights with us and to help us better understand the impact of the global trade war.

Sanjay: [00:06:24] Thanks very much, Lindsay.

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