Water Island Capital

The ArbCast – Episode #3: Market Update

Eric Casadei: Hello and welcome to a special episode of The ArbCast. My name is Eric Casadei, Director of Investor Relations at Water Island Capital. Joining me today are John Orrico, Founder and CIO of Water Island, as well as Portfolio Manager Roger Foltynowicz. Our primary goal today is to keep our clients apprised of what we're seeing in the marketplace amidst these historic levels of volatility. But let's start with a brief discussion of past volatility events. John, you've lived through other crises. Are you seeing any parallels to your prior experiences here?

John Orrico: Sure, thank you, Eric. When we think about what's happening today in terms of the pandemic, the health crisis this country is facing, and its impact on the financial markets, we try to come at it with some perspective. How has this country maneuvered through prior crises? How have our portfolios reacted? What have we learned from those experiences in the past? While the crisis that we face today is as different from the Financial Crisis in '07, the 9/11 crisis, the internet bubble bursting, and going all the way back to the '87 stock market crash. They're all very different. They're all very unexpected. But the parallels in terms of the market implications are striking in some sense. And what we see and what we saw back then and what we see today is a rush for liquidity, and investors are looking to go to cash. They're looking to de-risk. Some investors, beyond just looking for cash, they're looking to de-lever their portfolios. Large institutions across this globe have taken on extraordinary levels of leverage in their portfolios to try to extend their return opportunities, and we saw that back in 2008 as well. Many funds have shut down. Quant funds, hedge funds, here and in Europe, and we're seeing the impact of that on the marketplace because as those counterparties or prime brokers look to de-risk from that exposure that they have, they're going to the market and they're looking for liquidity. So those dislocations are taking place not just in the equity markets but across all asset classes. So these are the types of crises where correlations among asset classes all go to one. So bonds are down. Precious metals, commodities, equities, you name it. The asset classes are all facing severe pressure. And we, in our strategies, we're utilizing equity securities to deliver non-correlated returns. So there's a moment when we too face the impact of those severe dislocations. And as we target in our portfolios the shares of companies that are involved in mergers and acquisitions, the dislocations can be severe there as well. And when we look back at '08, because that was probably the most recent crisis that parallels what we're seeing in the marketplace today, what did we learn from that crisis? The funds that survived and thrived didn't employ leverage in their strategies, and that's something that we embrace and have always embraced in our firm today. We don't employ leverage. We keep dry powder available, because we know there's going to be an opportunistic entry point for us across any of our strategies, and we want to be prepared to take advantage of that. We don't want to be forced sellers. We want to be on the other side of that panicked selling, taking advantage of that. The arbitrage community, the event-driven community of investors, is too small to absorb all of the selling, and just like in ‘08, the arb community can step in, but we’re minuscule in terms of our ability to catch the falling knife or to put some money to work into those situations that we think are optimal from a return standpoint. So we’ve got to pace ourselves. In ‘08 the crisis lasted more than a year. It began in late ‘07 and ran all the way through the end of ‘08 into early ‘09. Pacing yourself, making sure you have dry powder, is important, and without knowing the extent or duration of this crisis, we’ve got to make some assumptions about how quickly this may resolve – or not – and when we can put cash to work and how quickly we can do that. And that’s something that, you know, Roger and the rest of the investment team focus on very closely day to day. Another difference between now and 2008 is, there are no prop trading desks at the major banks that are engaged in merger arb. While many of them were responsible for the liquidations and panic selling back in 2007-8, there are clearly no market makers, no capital being committed by banks into these strategies. So the arb community is quite small today, and as we think about who the big players in merger arb were on the prop desk side back in ‘08 – Lehman, Bear Stearns, Citibank – all those desks have been shut down and most of those firms aren’t even here today. So what did we learn from coming out of 2008 – which deals closed and which didn’t? How do we distinguish the stronger deals from the weaker deals? Where do we have more risk than not? We focus on the merger agreements. We focus on the strategic rationale that underpins these deals. We take the time to speak to the parties, to model the economics of these combinations, to ensure that what the companies are telling us is indeed true. We’re looking for those parties that are thinking beyond the current crisis and the current market meltdown and the current economic recession that’s underway, and looking to the next decade or two to position their business in a stronger, competitive way as a result of the acquisition or the merger that they are involved in. And it was the strategic deals from 2008 that survived, and that’s really just as important today because most of the deals in which we invest that populate our portfolio today are strategic deals. A big difference again from 2008 to today is the lessons learned by merging parties back in ‘08 versus today. Back in ‘08 and ‘07, many of those merger agreements allowed the acquirers to slip out or walk away when they had buyer’s remorse, because financing commitments weren’t secure, because the material adverse change clauses in those merger agreements weren’t tough enough. So today’s merger agreements are a reflection of the changes that we’ve seen over the last 10 and 12 years as companies that are the targets of mergers have constructed stronger merger agreements to protect their shareholders. So we do examine the material adverse change clauses to make sure that pandemics and health crises cannot allow the buyer to walk away. And the deals we’re involved in today involve financing arrangements that have either already been secured by the banks or already been funded in the markets, and that’s a big difference between today and 2008.

EC: So John, I’m going to follow up on something you said – correlations are going to one, we’re seeing a severe dislocation in deal spreads, and there’s extreme volatility, not just in the broader markets, but also within our event-driven strategies – and it’s really, it is a level of volatility that’s atypical for event-driven strategies. Roger, what’s going on with spreads? Are the fundamentals of any of these deals changing, or are deals still getting done?

Roger Foltynowicz: Well, just to kind of overlap with what John was saying, when people are in need of liquidity, they ignore the fact that some of the names that they’re selling have a binding merger agreement between them. So we are seeing almost panic selling to a point where many of the names that we’re invested in, they’re trading at levels below where the premium was before the deal was announced. So it’s almost like we’re in special situations land in regards to transactions, and the reason being is everyone’s hitting the exits. We also have the ETF space as a major player in just passive investing, and so that’s something different than in 2008 where many of these ETF funds – they could be pharmaceuticals, it could be financials – and they do have, in these baskets, the targets of the companies that we're invested in, that are in binding merger agreements. But, when the sell button hits, our names are part of that sell basket and, once again, like John was saying, our community is too small to absorb the massive, passive investments that are taking place to unwind. I can go down many situations where we have binding agreements that carve out pandemics, epidemics, national emergencies, and yet they're still trading at 20% gross. I mean, on average, since February 20th, where our community basically hit an inflection point, to where, you know, a 1%, 1½% gross return has now gone into the 15, 20, 25% universe. And as we go through this panic day by day, it was irrational selling, and we go back to the merger agreements, we go back to the clauses and we say, okay, this was all carved out – but yet, why is the selling pressure taking place? Is it because we have leveraged players and we just needed a cleanse out? And so what you've seen this week and a little bit at the end of last week, is now all of a sudden you're starting to see our NAVs start to reposition back to, not complete normality, but at least we're getting some rational thought in regards to our community. And so as we work through this, from our experiences in '08, what we learned is that we have to have cash balance for these opportunities. Overall markets are liquidating, while we get to step in and take advantage of these moments. And that's what's been probably the best experience we've had, is that for the past two weeks we've been a net buyer every day. And we do have deals that are closing during this turmoil, which no one is highlighting, because in our community these are big wins because it still tells you that these companies are still wanting to close a deal in the midst of this turmoil without the transparency of what's going to eventually happen, three weeks, four weeks from now, it doesn't matter to them. They just want to close the deal – they made a commitment – and we roll that cash into the current universe. As the days progress, just to kind of get back to your question, as the days progress, you start to see that two weeks ago was irrational. The last four days, some sense has been coming into our space. And then at some point, it's going to be greed, right? And then everybody's going to rush and say, "Okay, we saw four deals close. This was a missed opportunity for me. So now I need to step in and buy stock." And then we start to see 15% gross, or you know, 20% gross, start to come back to 10, 5, 4, and then we're kind of back to our normal universe.

EC: So John, just to put this in context for the listeners, are there any specific examples that you can give – concrete examples – of deals where you're seeing dislocations this year relative to 2008?

JO: Oh, yeah, sure. So let's start with 2008 and then we'll fast forward to 2020. We were involved in hundreds of deals during that period, from late '07 to early '09, involving companies in all sectors across the globe – large cap, mid cap, small cap. And I'll just highlight a couple of them and just talk about the dislocations that took place in '08 versus some examples today. We were involved in a merger in late 2007, as the economy went into a recession as the housing crisis really began to explode across this country, and new home building and new starts and construction industry went into a pretty severe downturn. Two of the merging parties in our portfolio were a company called Florida Rock Industries, and they were being bought by Vulcan Materials, both companies operating in the cement industry. So here you had a stock-for-stock deal – they gave you a cash option for those shareholders that wanted to choose cash, but that was only limited – so you're really looking at a, at a stock-for-stock deal where the acquirer shares now, is now taking a dive, over a period of months, shareholders are nervous. The spread began to really, really blow out. The difference between what Florida Rock shareholders were going to receive in the deal and where those shares were trading went out substantially, and it looked like the deal was in jeopardy if you just looked at the share prices. But as these companies stated multiple times to us, this deal was structured not for the next year or two, or the next five years. They were coming together in order to increase the reserve life of their aggregate inventory, and the aggregate is what they use to make cement, and they have these mines across the country that is the source of those aggregates that go into the cement production. And this deal was going to allow Vulcan to extend that reserve life by close to three decades, so we're talking 25 to 30 year outlook. They've been through a number of recessions. They've come out of all of those recessions well, and they weren't going to let another one – as severe as it was in '07 – stop them from closing this deal, and they did close that deal. Another example – and this one involves a private equity company taking a home health care respiratory company private in a billion-and-a-half dollar transaction. Over the course of October of '08, the shares of that target company traded down from approximately $20 a share and hit a low of around $12 or $11 a share the day before the deal closed at $21. Looking back, three months later, we realized that the largest holder of the target company had been liquidating all of their shares over a period of 20 days in October to meet margin calls as well as to de-risk and de-lever. So that was another case where the actual spread between the deal terms and where the shares were trading was over 50% the day before the deal closed. Again, when we think about the commitments that the parties make to these transactions and their long-term vision for how the transaction will improve their competitive positioning, they know they're going to get through some tough times, so we want to make sure that the financing is in place if they require financing, that the balance sheet strength is there. But it's rare to see committed parties to a deal that has strong strategic rationale even attempt to reprice or back out. There was one other large deal that everyone probably remembers back from 2008, and that was Anheuser Busch, the country's largest brewer, being bought by InBev, and that was a $60 billion transaction. InBev raised the money – they sold bonds and raised that money, but over the course of October '08 as Lehman Brothers failed, the spread on that transaction went out – on a, on a $70 deal – the shares traded close to 50. And if you think about that return opportunity over that month, again, the large desks deleveraging, the firms being shut down, the funds being liquidated across the globe…this was a high profile deal. There were a lot of investors in this. It was a crowded trade. It was our opportunity to put some money to work in what was a really fantastic spread, and that deal closed in early November. So again, when we fast forward 12 years and we're in 2020, and we woke up last week and we have one of the premier global luxury goods companies – LVMH – buying Tiffany's, a crown jewel in the jewelry industry. They've coveted Tiffany's for decades, and they inked a deal last year to buy them for $135 a share. Well, we walked in last week and the shares hit a low of 103. There's panic in the street, but I know Roger and his team didn't have a full position, they had cash available, they had dry powder. One of the opportunities we see today, one other one is in the tech space, which has been severely hit, involves a company called Tech Data. Tech Data is being bought by a private equity firm that competed against Berkshire Hathaway for this asset. And the price is $145 per share, but last week those shares hit 95. They traded down over 40 points. There aren't enough arbitrageurs to narrow that gap and your plain institutional investors are probably still de-risking. It's a fascinating time we're in, but again, it's all about being able to take advantage of these opportunities and not being forced out, which we've seen many investors on what we think is the wrong side of these trades.

EC: Risk management is always one of our core focuses at the firm, but in an environment like this where there's so much uncertainty, and even really before the crisis started**,** we were in the longest bull market that we've ever had. How do you go about managing risk in the portfolios?

RF: Yeah, that's a good question, Eric. As you expressed, we've been in a very long bull market, and so in the back of our minds, it seems like every day we would walk in thinking that this might be the day we, we see the market actually stop going up. You know, not in this kind of manner, but that's the kind of way we prepared our portfolio in regards to percentages of our max position. We just said, you know what, there's going to be a day, or a week, or a month where we might get some volatility – this volatility is more than we imagined, but it was that thought process that led us to say, you know what, there's no need for us to be 90% of our max positions. Let's be comfortable between 60 and 70%. So, we did that, and as you start to be at 60-70% of your max positions, you start to now have somewhat of a cash cushion. And that's what we wanted going into any type of volatility learning from fourth quarter of 2018 and then also from 2008 – we wanted to be strong hands during these types of periods. And so that was the setup. But then when chaos happens, you have to go into triage mode. And so when we look at downsides during these bouts of volatility, we now have to look at it in three different types of scenarios. We have to look at, okay, maybe what we're seeing now is going to lead us to a recession, and so we need to put a downside on a recession price. And then we have to look at live, if this is kind of, let's just say for example, where the market is, this is where it's going to be for the next three, four months. And then we look at, let's say we get out of this period and we start to see some stability in the overall environment from business strategy to, you know, just business as usual. And so what we try to do is we take those three scenarios and we tried to develop how much risk we want to take versus that spectrum. And so we're just managing our position sizes as we build them during these volatile moments just to fit within that band. And then as we progress through the turbulence, we start to say, hey, you know what, the recession case is not going to happen, so then we can now go to the more of the live, what we're seeing currently in the market. And then as we prevail through that, then we'll go to the stable downsides to see what our impacts would be. But as we navigate through this, we have to see all spectrums, just to see if we need to trim some risk or if we're, we're fine within a, you know, kind of our mandate of, of looking at risk.

EC: John, anything else you'd like to add?

JO: You know, I think we, I think we've tried to give our, our clients who take the time to listen to this podcast a lot of color and how we think and what our focus is on. I'll just add some closing thoughts. You know, our team today is such a deeper bench than we had in '08. All the same folks that were there in '08 are here today, but we've got a strong special situations team that does a lot of deep dive, fundamental valuations and stress testing around the economic models for all the companies we own in our portfolios, and we've got a deep risk team in place with a number of quantitative tools at our disposal that keep us real-time focused on risk and portfolio drawdowns, and really, technology has served us well over the last decade and we've invested a lot in it. That really allows us to have some transparency into the portfolios in a way we didn't 10 or 12 years ago. We've got a team in London today that is focused on the rest of Europe, which is, which is really helpful, particularly since they're up so much earlier than we are here to focus on those transactions. And our clients should know we've got a tested team here. We're comfortable and confident about what we're doing in what's been an uncertain and really horrible environment for many of us and many of our families, but our one goal here is to focus on capital preservation, to do our job for our clients, which is focus on capturing those spread opportunities without trying to call a bottom, without taking undue risk, and put money to work, because when we go through periods of dislocation like this, the capital we put to work today yields that benefit as we get through the other side of the turmoil as the markets calm down, as things normalize. So, I'm really proud of the team we have here today and I want our clients to reach out if they want to speak to us directly, we would be more than happy to take the time to explain to them any aspect of what's happening with regards to portfolio construction.

EC: That's great, John. To our listeners, if you have any questions, please feel free to reach out to us through our website or through your regional product specialist. Keep an eye out for additional special episodes of The ArbCast as we attempt to keep you all updated through this volatility. Thank you for listening, be well, and stay safe.

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As of March 24, 2020.

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