Water Island Capital

The ArbCast – Episode #17: Merger Arbitrage Strategy Update

Jenifer Bloodsworth: Welcome to Arbcast, Water Island Capital's podcast series where we strive to provide investors with concise and timely insights into the world of event-driven investing.

Hi, I'm your host, Jenifer Bloodsworth, and joining us today is Matt Osowiecki, Portfolio Manager of the Arbitrage Fund, ticker ARBNX. Matt, thanks so much for joining us.

Matt Osowiecki: It's my pleasure to be here.

Jenifer Bloodsworth: Matt, it seems like mergers and acquisitions (M&A) made the headlines frequently in 2021, and some have referred to it as a tale of two tapes. From record-setting M&A activity to competitive bidding situations to regulatory and antitrust issues, could you walk our listeners through some of the ups and downs that signified 2020?

Matt Osowiecki: Happy to. So it certainly was a tale of two tapes. To the upside, there were several improved offers in competitive bidding situations. We anticipated this would be the case coming out of the pandemic as there's often opportunistic shopping taking place. We saw something very similar in 2009 coming out of the Financial Crisis. But away from opportunistic bids, we also saw competitive bids arise really from a changing world. One example of that would be the three strategic parties – II-VI Inc., MKS Instruments (MKSI), Lumentum Holdings (LITE) - all competing for Coherent Inc. The level of competition for this asset validated Coherent's position along the semiconductor manufacturing chain.

Another really good example of this was Hellman & Friedman's €3.90 euro bid for Zooplus which was topped by another private equity (PE) firm, EQT, at €4.70 per share. Zooplus is the Chewy of Europe, so during the pandemic we saw quite a bit of growth pulled forward and really what was determined at that point was that delivery of pet food supplies was here to stay. And in the end, the two private equity firms ended up teaming up in bidding €4.80 to take the company private, which was a 23% increase over the original terms.

So, that was really to the upside. We saw different reasons for higher bids or higher outcomes for merger arbitrage names. To the downside, it was a difficult year regarding antitrust reviews and continued U.S.-China hostilities.

The Justice Department sued to block the Willis Towers Watson-AON transaction, the Surface Transportation Board rejected Canadian National's use of the voting trust in their pursuit of Kansas City Southern Railway, we're still waiting on U.S. Hart-Scott-Rodino (HSR) rulings on Change Healthcare and Aerojet Rocketdyne, and the other aspect is that poor U.S.-China relations have led to significant delays for deals that have State Administration for Market Regulation (SAMR) reviews. An example of that would be Xilinx-Advanced Micro Devices (AMD) and Coherent with II-VI. We also saw the Committee on Foreign Investment in the United States (CFIUS) block the Magnachip transaction, which was due to take place with the Chinese private equity firm Wise Road.

So again, the tail of two tapes did ring very true for 2021 in the competitive bidding and higher bid situations, and then drawn-out regulatory reviews and outright blocks of transactions.

Jenifer Bloodsworth: Well, that certainly sounds like an eventful year. What would you say you and the team have learned from some of the challenges you faced in 2021?

Matt Osowiecki: In my 15 years here and the thousands of transactions we've looked at, I would say we're constantly learning and evaluating a changing landscape. But the big experience from 2021 was the anticipation that the Biden administration would help thaw the U.S.-China hostilities. We never saw the de-escalation of tensions, and - coming out of 2021 - my belief is the anti-China rhetoric is here for the near to medium-term, as it's a political win on either side right now. So, that's something we have to keep in mind when evaluating deals going forward.

Jenifer Bloodsworth: So that's a great segue moving into the current environment. Matt, have you seen the themes that dominated the last year impact the types of deals that are being announced today?

Matt Osowiecki: Absolutely. So when the Biden administration first came into power, the thinking was the Federal Trade Commission (FTC) and the Department of Justice (DOJ) would be more stringent in regards to pharmaceutical deals and try to put a dampening on the rising prices of drugs. In July, Lina Khan's FTC finally approved Alexion's AstraZeneca transaction. After that transaction was approved, we saw a wave of pharmaceutical deals announced. Pfizer, agreed to acquire both Trillium Therapeutics and Arena Pharmaceuticals; Merck, Novo Nordisk, and Sanofi all announced transactions of their own. So, once that fear of a nuanced antitrust theory used to prevent pharmaceutical deals was eliminated, we saw kind of a wave of pharma deals come through.

Away from pharma, the deals we saw announced in the second half of the year were really deals that would not draw any antitrust concerns. And the easiest way to do that is not only to avoid harm or perceived harm, but to make something that's pro-competitive. A good example of that was the Kansas City Southern-Canadian Pacific transaction. Kansas City Southern’s northernmost asset was in Kansas City. Canadian Pacific's southernmost asset was in Kansas City. So, this was a zero overlap, creating a rail that can service all of North America, and really provide efficiencies without job losses and create a more competitive landscape for the rail industry. So, this was a deal that was easily digestible and actually appeared to be ushered through by the Biden administration.

Another example of this pro-competitive type of transaction was Blue Prism being aquired by SS&C. Now, obviously SS&C is the largest fund administrator of hedge funds and private equity firms. Blue Prism is really one of the founding fathers of AI and programmable software for process automation. The thinking is they'll be able to apply Blue Prism’s technology into all the manual, intense processes for know your customer and other administration jobs. So again, another pro-competitive deal that was really ushered through by the regulators.

Jenifer Bloodsworth: Matt, I know it's early in the year, but what are some of the things you'll be looking out for in the year ahead that could impact your strategy.

Matt Osowiecki: In the very near-term it's going to be the outcome from some key antitrust reviews that are still outstanding, and we expect them to be resolved in Q1. Those include Aerojet Rocketdyne’s acquisition by Lockheed Martin, Change Healthcare by UnitedHealthcare, and Sanderson Farms by Continental. We need to have some idea where the regulators land on these deals that aren't perceived to be anti-competitive but are in consolidated industries. And that seems to be a big red flag for the regulators at this point.

Away from where the regulators land on those outstanding deals, we're also keeping an eye on the Fed rate increases. We need to be cognizant of how these rate increases impact our return in the portfolio, but we also need to be cognizant of how they impact the companies themselves. For example, a utility deal versus a banking deal. Obviously, banking would benefit much more from a rising rate environment than a utility asset. And we also need to know what those rate rises mean for growth assets, that standalone value, and the conviction of the acquirer to go through with the transaction, especially for the longer dated deals.

Away from that, we're focused on the drivers of M&A activity and want to make sure they remain supportive. That's the corporate balance sheets; that's the general health of companies; PE firms remain flush with cash and are being active; that financing is still available and near historical lows for private equity firms and strategics as long as the Fed rate rises remain modest.

Jenifer Bloodsworth: So speaking of rising rates, interestingly, many investors view the merger arbitrage strategy as a fixed income alternative due to its similar risk-reward profile and its low correlation. The prospects of rising rates coupled with extremely low yield has alarmed many of those investors. Could you talk about why rising rates can actually be a tailwind for your strategy?

Matt Osowiecki: Absolutely. So the main reason is the duration of our portfolio. Typically, a tender offer can be as short as 40 days, a cash merger can be as short as 90 days, and at any given moment our weighted capital duration can be 40 to 50 days. So with that ultra-short duration in a steady rising rate environment, there's no threat to the current positions. And then as deals close and that cash rolls off the books, we can redeploy that cash at the new higher return environment.

A merger arbitrage spread has two components: one is short-term rates and the second component is deal risk premium - the risk for underwriting the likelihood the transaction will close. The merger arbitrage community has been operating in a near zero-rate environment since the Financial Crisis. So, any potential short-term rate increase would be welcomed by the merger arbitrage community as it would be reflecting a higher return environment for the strategy.

Jenifer Bloodsworth: Again, we've been speaking with Matt Osowiecki, Portfolio Manager of the Arbitrage Fund, ticker ARBNX. Matt, thanks so much for your time today.

Matt Osowiecki: My pleasure.

Jenifer Bloodsworth: For those listening who may not be familiar with Water Island Capital, we are an asset management firm with a proven 20-year track record in event-driven strategies across public mutual funds, private investment vehicles, and recently our line of ETFs, allowing clients to choose the best format for their exposure.

For more information on us or our funds, please visit our website at arbitragefunds.com or call our resource desk at (800) 560-8210.

--

As of January 20, 2021.

The discussion of market trends and companies throughout this podcast are not intended as advice to any person regarding the advisability of investing in any particular security or strategy. Any securities mentioned are selected for discussion purposes only and may not represent current holdings of Water Island Capital, LLC ("Water Island") or The Arbitrage Funds. Our views, opinions, and estimates – including any forward-looking statements – are a reflection of our best judgment at the time of recording and are subject to change based on market and other conditions. Water Island is under no obligation to update or revise any such views or statements, except as required by law. Past performance is no guarantee of future results. Additional information about Water Island can be obtained from our Form ADV, which is available at https://adviserinfo.sec.gov. Please visit https://arbitragefunds.com/glossary for definitions of terms.

ARBNX has limited availability and may not be accessible to all investors. The fund is also available in other share classes. Please see the fund's prospectus for more details.

Performance through 12/31/21: ARBNX (I class), 1.05% (one year), 3.15% (five year), 2.34% (ten year). 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 lower or higher than the performance quoted. For performance data current to the most recent month end, visit http://arbitragefunds.com or call (800) 295-4485. Returns shown above include the reinvestment of all dividends and capital gains. Returns greater than one year are annualized. Total Annual Fund Operating Expense for ARBNX is 1.49%. Total Annual Fund Operating Expense excluding the effects of taxes, interest, dividends on short positions, brokerage commissions, acquired fund fees and expenses, and other costs incurred in connection with the purchase or sale of portfolio securities is 1.28%.

FUND RISKS: Investments are subject to risk, including possible loss of principal. There can be no assurance that the fund will achieve its investment objectives. The fund uses investment techniques and strategies with risks that are different from the risks ordinarily associated with equity investments. Such risks include merger arbitrage risk (in that the proposed reorganizations in which the fund invests may be renegotiated or terminated, in which case the fund may realize losses); short sale risk (in that the fund will suffer a loss if it sells a security short and the value of the security rises rather than falls); concentration risk; high portfolio turnover risk (which may increase the fund's brokerage costs, which would reduce performance); foreign securities risk (in that the securities of foreign issuers may be less liquid and more volatile than securities of comparable US issuers, and may be subject to political uncertainty and currency fluctuations); market risk; sector risk; derivatives risk; LIBOR rate risk; hedging transaction risk; counterparty risk; swap risk; options risk; liquidity risk; active management risk; investment company and ETF risk; leverage risk; small and medium capitalization securities risk; currency risk; and temporary investment/cash management risk. Risks may increase volatility and may increase costs and lower performance.

Arbitrage Fund top ten holdings as of December 31, 2021: Change Healthcare Inc; Coherent Inc; CyrusOne Inc; IHS Markit Ltd; Nuance Communications Inc; Rogers Corp; Water Island Event-Driven Fund; Welbilt Inc; Willis Towers Watson PLC; Xilinx Inc. Top ten holdings represent 40.4% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

The Arbitrage Funds are distributed by ALPS Distributors Inc., which is not affiliated with Water Island Capital or any of its affiliates. [ARB001962 2022-07-31]