Water Island Capital

The ArbCast - Episode #19:

Merger Arbitrage - Taking Advantage of Market Dislocations

Karen Feeney: 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. I'm your host, Karen Feeney, and joining me today is John Orrico, the Founder and CIO of Water Island Capital, and Roger Foltynowicz, Lead Portfolio Manager.

John and Roger, thank you both for joining today.

John Orrico: Hi, Karen. It's nice to be here.

Roger Foltynowicz: Hi Karen, thank you.

Karen Feeney: Volatility has been top of mind for a lot of investors. Year-to-date, as of May 13th, the S&P (500) is down 17.1% and the Bloomberg Agg is down at 9.4%. Despite global markets selling off, the Arbitrage Fund is only down about 2.8%. Can you talk about why the strategy has been able to hold up well despite the volatility?

John Orrico: Sure Karen, this is John. Let me address that question.

Volatility around our returns is to be expected when the underlying markets are volatile, as the securities that we purchase to deliver our defined return framework are the equities and bonds of those entities that have entered into definitive merger contracts.

So typically, if you think about the periods between which a merger is announced and the date of that deal closing, it can be from 45 to 145 days. As companies work towards that successful deal close, their share prices can be volatile as their underlying investor base changes. Arbitrageurs are only a small part of the investor base in a merger deal. But the

institutional and retail holders - during periods of market volatility - may decide to go home, raise cash, de-risk, de-lever, and that can send spreads wider. By spread, (I mean) the difference between where that security trades today and what we expect to receive when the deal closes. When it does widen, it presents an opportunity for us to deliver higher returns for our shareholders if that deal does close successfully.

So, while volatility in the short term can impact our day-to-day NAVs, our returns are going to be driven by capturing the returns or the spreads that are associated with each of those announced merger deals.

And if we take it a step further, if we've done our work and continue to believe that the transaction will ultimately close, then we're going to take advantage of those bouts of market volatility by putting capital to work at attractive rates of return. And remember, the deal terms are defined. We know what we'll be receiving when the deal closes. So, a wider discount today to the ultimate consideration - versus what that discount might've been yesterday or last week - can be an attractive opportunity for us. Two requirements though: we need to have dry powder, or cash available to put to work during bouts of volatility in the marketplace, and two, we need to have the capacity to invest that incremental capital in each of those transactions so that we can still maintain our risk framework for the portfolio.

So, our returns are tied to the successful close of a definitive merger transaction and market volatility can enhance those returns for us if we can take advantage of them. And we typically will see that volatility as having a short-term impact on our portfolio returns. Because, as I said earlier, the arbitrage community is quite small relative to the aggregate value of all the deals that are outstanding. So, we can’t influence security prices day-to-day, but if we can stay the course, put incremental capital to work, we can still meet our return targets and possibly even generate returns in excess of those original targets if we put capital to work at the right times.

Karen Feeney: Roger, I have a question for you. How has the current market environment impacted your investment landscape?

Roger Foltynowicz: Nothing has changed. From where we're sitting in regards to our strategy, I would say, if anything, it’s probably become incrementally more positive.

The breakdown of the current market environment is rising rates, which for us, that's the baseline return profile of our return universe that’s getting better. Volatility is great for us

because volatility creates an expansion of the return profile for merger arbitrage. Why that volatility is occurring is and has always been the need for liquidity, which is what we've seen in 2008 and the same thing in March 2020 through COVID.

Deal risks are the same. Nothing has changed from that standpoint. We still need regulatory; we still need shareholder approval; we still are heavily relying on the contract and valuation. So that has not changed. The strategic rationale, has that changed? It has not. I would say deal flow is always something we look at very heavily.

I would say acquirers that have been patient for the past six or seven months (are now) being rewarded, and they're stepping in and putting that cash to work at valuations that they feel as though are reasonable. And what's nice about these types of acquisitions in moments of dislocation, it could showcase some sort of opportunistic bidding. When things look the ugliest they then step up and put money to work and announce a deal. But what happens if things get better? What happens if we bottom out? So, all of a sudden that's a nice recipe for competitive bidding situations.

And then just liquidity. Liquidity in dislocations always comes to the fact that you have margin players who were way ahead of their skis and they need to unwind. And they're insensitive of the bids in which they sell to. They need the capital and so we're there, as John expressed earlier. These are the moments in which we thrive. We want to take advantage of these situations and there’s nothing wrong with the transaction, it’s just the players who are involved.

And so, I would say in summary, it's incrementally more positive in this type of dislocation than we've seen in a while.

Karen Feeney: That's an interesting point, Roger. How is it that you have the capacity to allocate more capital to spreads widening when others may not?

Roger Foltynowicz: I think from previous podcasts and conversations we've had publicly, we've always expressed a framework on how we handle market dislocations. And it usually falls within three or four ways of handling the madness.

One to start with, we definitely like to position the overall portfolio to shorter duration transactions. And so, those are your 30, 60, 90-day vehicles. And the reason why we like those is because the window is very tight in regards to the deal closing. So, during times of

dislocations deals are still closing, and the short-term ones are probably closing even faster because they want to get it out of the public markets. And so, that's one vehicle. We keep things short, and we'll get deals rolling off and we get to reinvest that capital back into the dislocated market.

Another item that we usually put in our framework is we always like to have five to ten percent in cash, just for times like this. John has experienced a lot more market corrections, (but) we experienced 2008 together and March of 2020 together. And it's always beneficial to have that type of capital earmarked for these types of dislocations. Yes, it could be a cash drag, but in these types of moments it's worth every penny to have that.

Another portion of our framework is we can always sell things in our portfolio where the alpha event has already occurred. So if there's a shareholder vote and that has already passed, then our alpha event to the upside has already gone away. So really there's just time value of money in holding that name. And so, we can sell that position pretty easily in order to reallocate that capital into the new overall landscape.

And then the other thing is there are some benchmark transactions in our universe where it could always be a funding vehicle for us. There's always going to be buyers on the other side, and the duration of that transaction might be four or five months. So in the meantime, we can exit the position near term and get back into it two months from now or three months from now and feel as though we won't miss much on the rate of return profile on that deal.

So, many ways to take advantage, and also just a significant amount of experience in handling these types of situations in the past.

Karen Feeney: What strategy specific risks are you navigating and what keeps you up at night?

John Orrico: Yeah, those are good questions, Karen. You know, the specific strategy risks really haven't changed for us and don't typically change throughout the market cycle. The emphasis we place on the various risks might, but we're still focused on the regulatory landscape and the risks associated with transactions clearing various jurisdictions around the globe and the regulatory bodies that these parties to a deal must navigate.

There's also tracking the macroeconomic fundamentals or the impact associated with the fundamentals with the parties to a deal, and whether or not we're in or moving towards an economic environment that may create some difficulties for any of the parties to a deal and how that might affect either the buyer's perspective or the target's perspective when it comes to moving forward on a transaction.

The other risks that we think about are all really driven by the fundamental analysis that we do around each transaction. Its strategic rationale; the reasons the parties are doing the deal. Those don't change. Those are a constant part of our process here because we really need to understand what the downside might be for any position that's in the portfolio, and that really guides our positioning.

And finally I'll say that while the credit markets for the last decade or so have been quite friendly to companies looking to finance transactions with leverage - I think as we move towards a different rate environment and as we see the Fed engineering rate increases (that) the credit markets already reflect to a great extent - we're going to be paying attention to those transactions that might require some financing or that might involve leverage. For instance, when private equity is involved.

So again, we go back to the basics - understanding what we own, continuing to do the fundamental analysis around each transaction throughout the duration of the deal, and staying focused on risk and risk management. And I think markets like the ones we're in are clearly ones that are opportunistic for us and really give us that opportunity to put capital to work at what might be better than expected rates of return than we see in calmer markets.

Karen Feeney: John, what would you like to say to investors today who are considering adding to the strategy or investing for the first time?

John Orrico: Well, I guess the first thing I'll say is that we're in an environment today where the return opportunities around definitive merger arbitrage are extremely attractive. Meaning spreads are wider - investors are nervous, we've seen a lot of de-risking in the market, and that leads to wider spreads. And as we put capital to work, that means we can generate those excess returns over expectations for our clients.

I think second, we're in an environment where we've seen interest rates move higher, and we've had a couple of false starts over the last decade, but we haven't been in a rising rate environment for well over a decade. And as most of you know, rising rates are a tailwind to

the strategy; and as rates rise, so do merger arbitrage returns. So that's one of the foundational motivations for investors to come into merger arbitrage, and we don't think that the Fed's move to bring rates to a neutral level for this economy to fight inflation is going to stop anytime soon.

When we analyze transactions on the desk, what we look for are those transactions that may be mispriced or underpriced because of the market environment. Today we're in an environment with a lot of fear. So, the deals we see priced today may in fact turn out to be priced too low in the hindsight of six months or a year from now when the markets stabilize or investor sentiment improves. And what we've seen happen in the past - we saw this in ’09, we saw this in the spring of 2020 - those transactions that were inked during those periods of market volatility many times attract new buyers into the fray once the markets stabilize and investors have had a chance to take a look at the bid that their boards or companies have agreed to. And that's also exciting for the strategy too.

I'd say two other points I'll make here, and we've heard this before and we've talked about this before, cash balances on corporate balance sheets and cash levels at private equity firms are at record levels and that cash is going to get put to work. So, we expect consolidation to continue, we see that in the deal flow, and we continue to see a pretty robust pipeline of deals being announced. And that will move up and down of course, over the course of the cycle, but there's plenty and ample deal flow for us to invest our client’s dollars.

So overall, it's an opportunistic environment for us and that's really what tends to be the environment that we execute the best in.

Karen Feeney: Roger and John, thank you for joining us and thank you to our listeners today. For those 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 ETFs, allowing clients to choose the best format for their exposure.

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

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Performance through 3/31/22: ARBNX (I class), -0.76% (one year), 2.87% (five year), 2.23% (ten year); S&P 500, 15.65% (one year), 15.99% (five year), 14.64% (ten year); Bloomberg Agg, -4.15% (one year), 2.14% (five year), 2.24% (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

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