Water Island Capital

The ArbCast – Episode #22:

Merger Arbitrage – Regulatory Turbulence Creating Rare Investment Opportunities

Jordan Hoerl: Hello and 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, Jordan Hoerl, and joining us today to provide an update on the merger arbitrage strategy is John Orrico, the founder and CIO of Water Island Capital, and a portfolio manager on the Arbitrage Fund, ticker ARBNX, as well as the firm's broader event-driven and credit strategies.

John, thank you so much for joining us today.

John Orrico: Hi, Jordan. I'm happy to be here.

Jordan Hoerl: So, let's jump into it. 2023 has been a year fraught with uncertainties. Most recently, it's been dysfunction out of Washington, the Fed's interest rate policy, and uncertainties associated with a recession. Meanwhile, the merger arbitrage strategy overall has had a somewhat difficult start to the year. How would you characterize what has happened year-to-date, and where do things stand today?

John Orrico: Well, Jordan, modest recent performance isn't ideal, but I think we can attribute that to two primary issues that we're dealing with as merger arbitrageurs. Number one being what I think is an overzealous regulatory environment and some of the fear that has been brought into a number of transactions across the merger arbitrage universe, some of which may be unfounded.

And then we've seen a rise in interest rates with a velocity that has been disruptive to existing spreads or return opportunities within our portfolios, and that's a temporary phenomenon. And as those spreads widen out, then we'll begin to see those spreads collapse again and close again as we move towards those specific transactions closing.

Jordan Hoerl: Regarding the regulatory pushback, is that broad sweeping across the merger arbitrage landscape, and how would you say it's impacted the strategy's return prospects?

John Orrico: I think when we talk about the regulatory environment, let's be clear, those companies in concentrated sectors where there's been a lessening of competition will attract the attention of the regulatory bodies both in the US and in Europe and overseas.

However, it's important to note that these deals comprise a relatively small part of the merger arbitrage universe. And while the regulatory pushback on some of those deals can send a chill over the bulk of the merger arbitrage universe and send spreads wider, it's likely that the vast majority of transactions that we invest in will stay under the radar of the regulatory bodies.

From a bigger picture standpoint, volatility in the markets and volatility in the merger arbitrage space has created significant opportunities for us. These dislocations that we see, whether it be a regulatory challenge announced or whether we see volatility in the overall marketplace, has really created an opportunity to invest at attractive rates of return that we haven't seen in over 15 years.

So, today's environment is reminiscent of periods that we went through in 2001 and 2002 as the markets dislocated following the internet bubble bursting; in 2008 and 2009 when we were in the midst of a great financial crisis; in 2011, the last time the debt ceiling debate took place and the US suffered a downgrade, taking the equity markets and credit markets down with it; and again in periods such as early 2020 following the impact of COVID. The dislocations in the market environment are the opportunities that we look for because, as unlevered investors, it gives us the opportunity to put dry powder to work in our high conviction ideas. And when we think about the return environment in the context of the risks we face, we think we can capture or meet our targeted returns while absorbing some of the pushback or delays associated with some of these heightened risks.

Jordan Hoerl: So John, given some of the things that you've mentioned, have you seen a material impact to the merger arbitrage investment community or the amount of capital dedicated to the strategy?

John Orrico: Well, that's a great question because I think that clearly event-driven investors, merger arbitrage investors, typically comprise just a minority of the outstanding shares of a target company. So, we really can't control the spreads or the return opportunities. So as

levered capital from hedge funds and institutional capital moves in and out of the space and out of the strategy, that will impact the returns that we're able to achieve in various transactions. And I think over the last year with the rise in interest rates that we've seen, those investors that utilize leverage in the strategy have been unable to really achieve their targeted returns given their cost of capital, and they've left the space.

And likewise, in the institutional community there's been a lot of volatility in the marketplace over the last 12 months, and I think when deals are announced that institutions tend to be more aggressive today in exiting the positions or selling out. So, it just leaves a lot of room for those of us who are left, who are dedicated to the strategy, to put capital to work at what we think are probably wider than expected spreads or higher than expected rates of return than we would typically see.

Jordan Hoerl: You mentioned the rise in interest rates and how it's impacted the levered players in this space in regards to their cost of capital, but could you briefly unpack how interest rates impact return opportunities for the strategy in general?

John Orrico: Well sure, just take it back to basics for a moment. The interest rate environment really dictates the return environment for merger arbitrage, meaning we are going to look at the risk-free rate that exists at any time and we're going to try to deliver to our clients, our shareholders, some multiple of the risk-free rate because our job is to assess all of the incremental risks associated with the transaction and to be paid or compensated for those incremental risks above and beyond the risk-free rate.

So, with interest rates having gone from zero to close to 5% today, that's a tailwind for the strategy, and it's unlike a tailwind we have seen for over two decades. So we're pretty excited about what we face or what we have to expect over the quarters and years ahead as we're back to a normalized rate environment. That's going to allow this strategy, the merger arbitrage strategy, to deliver relative rates of return that are very competitive with both fixed income and equity markets.

Jordan Hoerl: So, from the sound of it, and even in light of the regulatory environment you mentioned earlier, and the fact that some capital has left the space, would you still consider this an opportune time for the strategy?

John Orrico: Well, yes. I think whenever we find ourselves in an environment where equity market volatility is elevated, with interest rates that have risen substantially but are starting

to level out, with less capital invested in the strategy than we've seen in prior years, and fears that are embedded throughout the merger arbitrage universe due to a more aggressive regulatory posture by regulators around the world, those are all embedded in spreads or the return opportunities, and we're seeing across the merger arbitrage universe returns in the low double digits. That's something we haven't seen, or it has existed only for short periods of time during severe equity market dislocations, and typically when we go through periods like that it's followed by periods of outperformance by the strategy on both an absolute and relative basis.

Jordan Hoerl: Thanks, John. Another question that comes up is are new deals being announced? Do you have enough opportunities to put capital to work in? What if we were to enter a recession, would deal flow dry up?

John Orrico: You know, we have managed the merger arbitrage strategy for well over two decades with varying degrees of deal flow, whether it be from quarter to quarter or year to year. We've never been without sufficient deal flow to maintain that risk framework with regards to diversification, dry powder, and really constructing a balanced portfolio that represents what we believe is an optimized return outcome.

2023 is no different. In each of the past couple months, March and April, we had over $145 billion in investible deals announced and I think that was probably the highest monthly total since spring of 2022. That trend has continued into May. We've seen over $35 or $40 billion in deal transactions announced in the last two Mondays alone. So, deal flow is ample, and I think if we think about a dynamic economy both here and in Europe and in Asia, and the factors that drive deal flow, we're going to see deals driven or that come about out of both necessity, as sectors that are undergoing some pressure or stress look to combinations to help strengthen their businesses, and we'll also see opportunistic transactions take place throughout the cycle.

Jordan Hoerl: So it sounds like deal flow is helpful. In fact, preferable is probably a more accurate way to describe it. But it also sounds like you'd anticipate being able to still put capital to work even if there was a lull in deals being announced. Are there periods in the past where you've had to manage through a significant decline in deal making?

John Orrico: Well, while deal flow is important because we want to have the widest selection of transactions from which we can choose to populate our portfolios, it's also important to think about the economic backdrop during which we're investing, as well as

investor psychology in the marketplace. Because if we take the period following the end of the great financial recession in 2007-2008, we came into 2009 and it was a relatively quiet period at first for deal making. But as corporate boards gained confidence, we then began to witness a flurry of deal making across numerous sectors of the economy, and much of that led to overbidding and hostile bidding as companies competed for assets in the marketplace, sending prices higher and higher, which really contributed to returns in that period.

If we go back to the early part of 2020 following the outbreak of COVID, we had a chill in deal activity for a couple of months until companies were able to look through the pandemic in terms of understanding how their businesses were going to be affected, and they were able to proceed forward in terms of deal making. But that chill and the uncertainty and the fear in the marketplace created enormous return opportunities for the strategy where we were able to put money to work in the context of a difficult investment environment. And even with regulatory delays or delays in deals closing, and even in the context of a few deals not moving to close, we were able to absorb those hits to the portfolio and still exceed our targeted returns for that year.

So, I think when we think about the merger arbitrage landscape today, we're looking to take advantage of the dislocations, the wide spreads, and the fear in the marketplace, and we know within the context of the current environment we will see some pushbacks, some delays, and some deals that may not close, but our portfolio is constructed such that we should be able to absorb those hits and still deliver our targeted returns because the return environment overall is so attractive.

Jordan Hoerl: Well, John, as we bring things to a close here, is there anything else that comes to mind or that we haven't discussed that you'd like to leave with the listeners?

John Orrico: Well, it's important and most of our shareholders and clients understand this, as arbitrageurs we spend our days thinking about where things can go wrong and worrying about any issue that might be disruptive to a successful deal close. And I think while returns reflect some of that widening spreads due to interest rates and some of the pushback on the regulatory environment, those are temporal factors. And like any investment strategy that investors contemplate, some of the best times to invest are when the strategy is facing some of its biggest headwinds. And as the headwinds we face turn to tailwinds, we think that will be reflected in better returns over the months and quarters ahead.

So, it's just about doing what we do day-to-day: fundamental work, diversification, maintaining dry powder, and trying to optimize that portfolio construction so that we can diversify risks and deliver to our investors what they expect from the strategy.

Jordan Hoerl: John, thank you so much for your time and for your insight. It's been very helpful.

John Orrico: Thank you, Jordan. I've enjoyed speaking with you. Thank you for the time today.

Jordan Hoerl: As a reminder, we've been speaking with John Orrico, founder and CIO of Water Island Capital, and a portfolio manager on the Arbitrage Fund, ticker ARBNX, as well as the firm's broader event-driven and credit strategies.

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Thank you for joining us.

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