Water Island Capital

The ArbCast – Episode #23:

Merger Arbitrage: Could a Regulatory Sea Change Lead to Smoother Sailing Ahead?

Karen Feeney: 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, Karen Feeney, and joining us today is John Orrico, Founder and CIO of Water Island Capital, and a Portfolio Manager on the Arbitrage Fund, ticker ARBNX. Also joining us is Matt Osowiecki, who serves as a Portfolio Manager on the Arbitrage Fund. Matt and John, thank you for joining us today.

John Orrico: Good morning, Karen.

Karen Feeney: John, you're coming off a very strong year in 2023, having delivered performance north of 6%. When you last joined us in June, you discussed regulatory pushback and how it was creating attractive investment opportunities. Fast forward to today - could you give us a brief review of what happened and share the details of your success?

John Orrico: Sure, Karen. As I mentioned in the last podcast, dislocations and volatility in the market present opportunities that we look for and take advantage of because as unlevered investors, they give us the opportunity to put dry powder to work in our high conviction ideas. The concerns we saw last year on inflation, the economy, interest rates, and the regulatory and political environment all contributed to the volatility that we saw. And this often impacts spreads, and that creates real opportunities for us to put capital to work at what we think are very attractive rates of return. That's what we saw in 2023, and that was really the key to the Arbitrage Fund’s solid performance last year.

Our job as arbitrageurs is to parse the facts from fiction. For example, we often see share prices react to statements from politicians or regulators, and if we understand the facts, the strategic rationale underpinning each transaction in which we invest, we can react and take advantage of those price moves and profit from them.

Let me touch on the regulatory environment quickly, as it was such an important piece of the puzzle in 2023 and really since the Biden administration took office. It's not unusual to see regulatory bodies headed by individuals appointed by the administration to pursue an agenda that reflects the political priorities of the party that occupies the White House. However, in the case of the Biden administration, we've seen the various regulatory bodies, whether it be the Federal Trade Commission, or the Department of Justice, or the Federal Communications Commission, pursue regulatory actions that were not supported by the antitrust laws that are on the books. They pursued actions that had no legal basis and in fact were entirely at odds with decades of precedence under both Republican and Democratic administrations. So, these appointees have attempted to achieve through regulatory action what their party has been unable to achieve through legislative action.

Fortunately, the courts have repeatedly weighed in against these regulators over the past year. And I think that maybe they'd finally seen the writing on the walls, so to speak. Corporations, for their part, are willing to move forward on acquisitions that are pro-competitive, and they're going to challenge any pushback that they come up against from the regulatory bodies.

So, for this reason, I think 2024 will continue to see a more pragmatic approach from the regulators, very different than what we've seen over the past two years, and I think that's going to benefit the strategy and also benefit returns.

Our team is focused on definitive deals, parsing fact from fiction, and delivering on expectations for our clients. We did that in 2023 and I just want to give a shout out to our clients that stayed the course with us.

Karen Feeney: Thank you, John. Matt, could you please unpack your approach to positioning the portfolio amid the aforementioned volatility, and how were you able to capitalize on the dislocations and deliver such positive performance on both an absolute and relative basis?

Matt Osowiecki: Thank you for the question, Karen. Our team is focused on constructing a merger arbitrage portfolio that allows us to either maintain or increase exposure during bouts of volatility. Our clients trust us to provide them with merger arbitrage exposure and navigate that space successfully. We define that as (1) capital preservation and (2) consistent positive returns. What we don't want to do is to find ourselves in a position where we're cutting gross exposure when the risk reward dynamics are improving during these bouts of volatility. What gives us confidence to add exposure when our peers may either be sitting on the sidelines or reducing risk is our tenure, our fundamental evaluation work, and our risk management.

Our team has decades of combined knowledge and together we've experienced a financial crisis, a flash crash, a pandemic, peak oil, negative oil, a zero rate environment, and now a rapidly rising rate environment. Throughout all those periods, we've stayed invested in our core strategy and sharpened our skills and processes along the way.

One of the bigger keys for us in particular this past year has been to know what you own, in terms of really understanding the target asset and the strategic rationale behind the deal. We achieve this through extensive fundamental research at both position initiation and during the life of the transaction. One of the obvious benefits of this is an accurate downside that allows for appropriate sizing in terms of risk. But more importantly, that initial and continued fundamental work provides us insight into the buyer's commitment or potential buyer's remorse around a particular transaction.

Karen Feeney: Matt, can you explain what you mean by buyer's commitment and buyer's remorse?

Matt Osowiecki: Absolutely. So, today where the antitrust reviews seem to be protracted more frequently, these merger agreements have out-dates, typically 12 to 18 months from announcement date, at which point if we get to that date and the transaction still has not closed the parties need to agree to extend the merger agreement to continue to pursue regulatory approvals.

At that point, the parties need to agree to do it. So, is the strategic rationale still in place? Is the financing still available? And if so, at what terms? If both parties do want to extend the merger agreement, do the terms need to be adjusted and can that be agreed upon?

A recent example of this is the Activision-Microsoft transaction that was originally announced back in January of ‘22. Prior to that deal being announced, Activision had struggled with some corporate governance and culture issues in addition to some underwhelming game releases. So, at the time, the $95 per share deal price looked very attractive. As the deal progressed, it was clear that while most antitrust authorities were going to clear the deal unconditionally, some authorities intended to do everything they could to prevent the transaction from closing.

As Microsoft was navigating these pitfalls, the spread continued to widen, making it a more attractive risk-reward.

We continued to do our fundamental work, and during this time what we saw in Activision was an asset whose underlining earnings were dramatically improving. During the second half of '22 and the first half of '23, three of Activision's new titles were among the top 10 in terms of global gaming sales. What we determined was that Microsoft would be highly incentivized to complete the transaction at what was now a very inexpensive price of $95 per share. So, using that information, we continued to add to our Activision position as the risk-reward dynamics continued to improve. That volatility continued to increase as we neared the termination out-date which was in July of '23, and at that point we were rewarded with our additional allocation of capital as the parties agreed to extend the merger agreement to the point where they actually improved the terms slightly by allowing Activision to pay a $1 special dividend on top of the $95 deal value. And then the transaction successfully closed in October leading it to be one of our top contributors for '23.

Karen Feeney: With all the deals in the portfolio, how do you monitor all of the variables, risks and opportunities?

Matt Osowiecki: Well, as you hinted, there are a lot of variables to consider during our capital allocation process. Over the last decade, we've put a lot of resources into building out our own proprietary technology and capabilities to help us monitor all these different variables. These systems make us more efficient and really work as safety nets to ensure we don't overlook any particular risk or opportunity.

In terms of position sizing, these systems track our current risk versus our maximum risk target, but we set maximum risk targets for each individual name depending on the quality of the transaction. Then, the systems allow us to compare our maximum target position in terms of risk versus where we are today, and that drives a conversation as to where we want to be based on the remaining conditions and potential volatility we anticipate around a transaction.

The systems also give us the ability to track relative values of peers of our target companies. It's a second set of eyes on valuation - a sanity check for the fundamental work we're already doing, and it's nice to have.

And we track and monitor diversification of the portfolio. Obviously, diversification is key in terms of risk mitigation, and we track diversification across sector, acquirers, geographic exposure, and we're also able to aggregate all the idiosyncratic deal risk, such as the regulatory approvals and financing conditions that our portfolio is facing in real time.

So, overall, our investment in technology pays great dividends, particularly during periods of volatility. And then finally, in addition to our tools and experience and expertise and the fundamental work that we do, we don't use leverage. This allows us to add exposure when levered market participants might be forced to cut risk and miss out on the opportunities that dislocations may present.

Karen Feeney: John, obviously every year is different, but would you characterize 2023 as more of an anomaly or norm for the strategy?

John Orrico: Good question, Karen. I think about 2023 as typical in many respects, really in terms of the work that we do day in and day out to vet transactions and understand the risks we face. But the year was also a transition year for investors and for ourselves as well.

The year was typical in the sense that as we employ this strategy, we're focused on preserving capital. We're focused on delivering that differentiated return stream, but we utilize stocks and bonds to deliver that. And those are two very volatile asset classes. So, the volatility associated in the stock market, in the bond market, those can have an impact on the volatility of returns in our strategy as well. But the majority of the returns, or the prime driver of returns in the merger arbitrage strategy, are driven by the outcomes of each of those mergers in which we invest. Those are all idiosyncratic events, hundreds of them over the course of the year, each with a distinct risk profile and timeline.

In terms of a transition year, it was watching the effects of the Fed tightening beginning to yield some success and bringing inflation down, and the economy stabilizing and demonstrating some real resilience and surprising a lot of people.

So, we entered 2024 with many of those headwinds that we saw in 2023 behind us. And some of those headwinds have turned into tailwinds for the merger arbitrage strategy and particularly in terms of the increase in deal flow and the stabilization of interest rates and how that benefits our strategy.

Other factors that are going to contribute to returns and are typical in any given year will be volatility around rates and stock prices, but also deal flow and the regulatory climate. And I mentioned the regulatory climate earlier. I do believe what we're seeing is a more pragmatic approach from regulators, which will really alleviate some of the fear that was in the marketplace during the first two years of the Biden administration while those regulatory agencies put their imprint on how they were going to move forward on antitrust reviews.

So again, we're back to focusing on delivering positive returns with a focus on capital preservation, and we expect those returns to be achieved with low volatility and low correlation to stocks and bonds. So, looking ahead, I think the challenges - or many of the challenges - that we saw in 2023 are clearly behind us and we're expecting a positive year in 2024 as well.

Karen Feeney: Great, thank you, John. Matt, given what you know today, what are your expectations for the strategy moving forward?

Matt Osowiecki: So, our clients expect us to generate consistent returns with low volatility, and we fully anticipate doing so in 2024. We see the drivers in place that are needed to do so. We have a more normalized rate environment, which should be a tailwind for merger arbitrage as a strategy, as short term rates are a key building block in the overall return profile. And we also anticipate deal flow to recover. We've already seen signs of recovery in Q4 in 2023, as deal flow surpassed the previous five quarters. And as John mentioned, in 2023 it was a transition year, and as inflation and interest rates stabilize further in '24, we anticipate deal flow would continue to rebound as confidence returns to the corporate boardroom.

We also believe the regulators will be more pragmatic when it comes to antitrust challenges, and that's going to bode well for the transactions that don't fit the mold of any traditional antitrust theories of harm.

Our team is focused on our fundamental approach still. The processes and tools we've built over the last decade are going to continue to aid us in regards to allocating capital effectively. So again, we're anticipating a very solid 2024. And I just want to thank all of our clients who stayed with us, stayed the course, and entrusted us with their capital.

Thank you very much.

Karen Feeney: Gentlemen, thank you both very much. We've been speaking with John Orrico, Founder and CIO of Water Island Capital, and a Portfolio Manager on the Arbitrage Fund, ticker ARBNX, and Matt Osowiecki, Portfolio Manager on the Arbitrage Fund. 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 ETFs, allowing clients to choose the best format for their exposure.

For more information on us or our funds, please visit our website arbitragefunds.com or call our resource desk at 800-560-8210. To our listeners, thank you for your time and have a great day.

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As of January 10, 2024.

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