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UPSURGE IN COMPLEX MERGERS AND ACQUISITIONS BODES WELL FOR MERGER ARBITRAGE

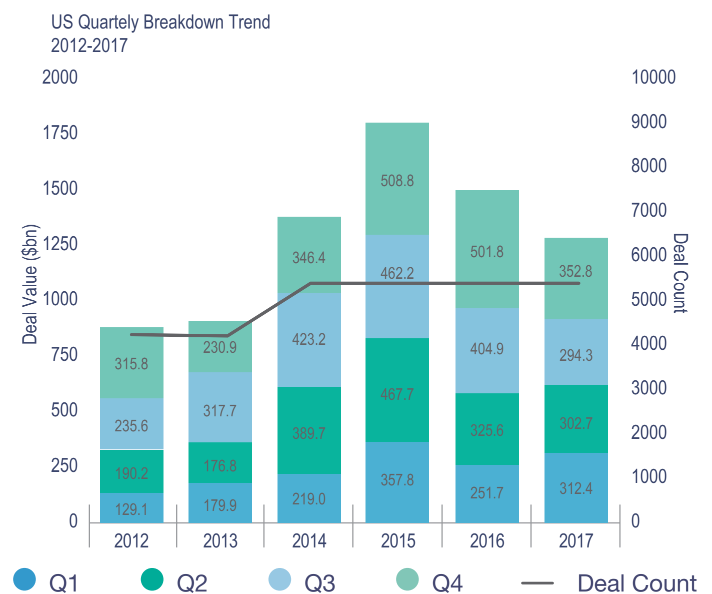
Drew Figdor
Portofolio Manager
TIG Advisors, LLC

The new US tax code has triggered an upsurge in complex mergers and acquisitions («M&A») creating a strong outlook for research-intensive merger arbitrage strategies, explains TIG Advisors, LLC's («TIG») Drew Figdor.

When President Donald Trump introduced the biggest overhaul to the US tax code in a generation at the end of 2017, he unleashed a flurry of M&A, including the multi-billion-dollar tie-ups announced by Walt Disney Company and 21st Century Fox, and CVS Health Corporation and Aetna. Not only were these the biggest deals of the year, they were also among the most complex.

At $68.4bn and $67.8bn respectively, the Walt Disney and CVS Health transactions helped to lift the value of US deals in 2017's fourth quarter to $352.8bn, making it the most active quarter in a year when transactions totalled $1.3trn[1]. Early 2018 saw similarly frenetic, yet complex, deal making. Indeed, February's correction in equity markets even encouraged deal flow as target companies became 10-20% cheaper.

President Trump's package of tax reforms made a big difference. The centrepiece was a big cut in corporations' income tax rate, from 35% to 21%, which cleared up uncertainty about how to price deals, as well as freeing up corporate cash to help finance them. Against a backdrop of low interest rates, open credit markets and a clear direction in government policy, the tax reform gave CEOs the confidence and cash that they needed to make plan opportunistic deals.



Source: Mergermarket.com

[1] Source: Mergermarket.com; Global & Regional M&A Report, Q4, 2017

COMPLEX DEALS CAN OFFER BETTER PRICING

This upsurge in deal activity and regulatory reform in tax and health care bode well for merger arbitrage strategies that do intensive research on complex deals, rather than those that focus on simpler transactions. Many of the current wave of M&A transactions have convoluted structures and are cross-border or hostile. Arbitraging them can be a research-intensive process, requiring skill and experience – consequently they offer greater rewards to those investors equipped to analyse them.

"One of the things that is significant is that when you have big regulatory change the companies need to adapt quickly", explains Drew Figdor, Portfolio Manager at TIG Advisors, LLC the New York-based global merger arbitrage specialist. "So, we are seeing opportunistic bidding, hostile bids, companies in discussion, offer prices as a starting point. Deals are being done on an aggressive basis, which fits into our strategy because we are looking for where the market prices risk and opportunity inefficiently".

"In many of these deals there is a significant amount of uncertainty as to whether they will be completed. This is true of a hostile deal, versus a friendly announced deal. In this low interest rate environment, the market prices certainty very efficiently – it prices uncertainty very inefficiently".

A growing amount of capital has been allocated to mutual funds and even ETFs that focus on simpler, agreed mergers where they arbitrage the spread between the acquiring company and target company's stock prices from the deal's announcement to completion. Such is the weight of money directed at agreed deals that the reward, in terms of the deal spread, has shrunk. By contrast, the more complex and uncertain deals, many of which are hostile, cannot be commoditised in this magnitude and offer far higher rewards.

"One of the key points is that uncertainty is where you get much better pricing", asserts Mr. Figdor. "So, a friendly announced deal trades at a 0-2% gross spread; you earn that over a 3-6-month period. An uncertain deal is anything from a 7-20% gross spread and you can earn that over a shorter or longer period. We focus on where our research and other tools give us the opportunity to create value that is not correlated to the market".

January 2018's contest to acquire Ablynx, a Belgian biopharmaceutical company, illustrates the potential rewards. In early January, Novo Nordisk, a global pharmaceutical company, bid for Ablynx at €30.5 a share. Ablynx's management rejected the offer as under valuing the company. After meeting potential bidders at a JP Morgan healthcare conference, TIG's analysts recognized the value of Ablynx's asset platform and its late-stage drug, Caplacizumab. TIG bought a position in the low €30s, anticipating that a higher bidder would emerge. After conducting their research, TIG's analysts became more confident that the company would be sold and grew its position. On January 30, Sanofi, another global pharmaceutical company, announced an agreed deal at €45.

SPEED READ

- The US tax reform gave CEOs the confidence and cash that they needed to make plan opportunistic deals.
- Many of the current wave of M&A transactions have convoluted structures, are cross-border or hostile.
- The more complex and uncertain deals cannot be commoditised and offer higher rewards than simple, agreed mergers.
- Volatility and mild correction in equity prices, as in February 2018, can lead to better spread prices, and encourages CEOs to bid more aggressively and opportunistically.

GROWING CROSS-BORDER M&A VALUES

But it's not just the US where M&A activity is buoyant. Growing economic activity has lifted deal activity in Europe, and 2017's $1.32trn of cross-border deals accounted for 41.9% of the year's M&A by value, the second highest level since the financial crisis[2]. From a technical perspective, the stocks of the acquiring and target companies trade on different exchanges in different time zones, making it difficult to match the respective positions. More fundamentally, the shareholder in the company being acquired may not want to hold stock in an overseas company denominated in a foreign currency. Furthermore, only a few merger arbitrage specialists are prepared to put in the work, possibly including overseas travel, needed to evaluate these deals.

"These deals are mis-priced on a technical basis because they don't trade at the same time", says Mr. Figdor. "The target price in US drops a couple of percent daily because there is no way to set the hedge up. There is also a shareholder perspective. If European mutual funds, for example, don't have the desire or ability to hold US stocks, they are willing sellers. Lastly, there is the research on the deal. So, if you need to go have breakfast in London or Germany to meet the CEO, fewer competitors have the desire to make that effort. That reduces number of competitors and increases the spread opportunity".

[2]Source: Mergermarket.com; Global & Regional M&A Report, Q4, 2017.

J. B. Barthon
Strategist

M. Jamai
Fund Analyst

Lyxor Asset Management

Merger arbitrage could benefit from a unique opportunity set in 2018, driven by a shifting fiscal regime and strong sector dynamics. Times are favorable: US asset values are high, digitalization is soaring, funding costs remain low, and executive confidence is bright.

After the tax reform was voted in, companies with high tax rates and strong operational profits were re-rated. However, implications for corporate activity are only starting to unfold. Companies are yet to decide how they will put their tax savings and repatriated foreign cash to work. Alongside organic growth and distributions to shareholders M&A will have its share.

Consolidation will be another key theme. The TMT, healthcare and industrial sectors, which face structural shifts, are set to consolidate further. Creators of content, for instance, will seek to gain scale and leverage as new distribution platforms proliferate. Broadcasters might also be active as TV station ownership regulations loosen. Companies facing technological disruption or lackluster revenue growth are also acquisition candidates. As usual, the first movers tend to force competitors to follow.

Political pressures, antitrust risk, sensitive cross-border deals, elevated valuations, and more hostile acquisitions suggest 2018 will not be short of complex deals that are the true playground for merger specialists.

REGULATION AND RISK

Risk and bad outcomes can be good; and there are always perceived risks from anti-trust regulation. This risk, especially the perception of risk, can create opportunity. For example, an arbitrageur can advantageously reverse the spread of a complex antitrust transaction that is ultimately blocked by regulatory bodies such as the US Department of Justice ("DoJ"). Mr. Figdor cites the 2015 example of the merger between Applied Materials, the US semiconductor company, and its Japanese rival, Tokyo Electron. The DoJ scuppered the deal after voicing competition concerns. Mr. Figdor's TIG had been long the deal for six months, but after continuous research anticipated the difficulties and switched to a short leaving it well positioned when the deal broke.

As for the higher rates that appear likely in the US and elsewhere, gently rising rates tend to lead to greater M&A deal spreads and, therefore, higher merger arbitrage returns. If rising rates cause a mild correction in equity prices, as in February 2018, that can also benefit M&A arbitrage returns as it creates volatility, which can lead to better spread prices, and encourages CEOs to bid more aggressively and opportunistically. However, if rates spike higher and trigger a correction of 20% or more then that is negative for merger arbitrage. "Corrections of more than 20% are negative for our strategy", says Mr. Figdor. "They start to affect the confidence of CEOs. So, corrections are very helpful. Bear markets are not so helpful".

A STRONG OUTLOOK

Short of a bear market, Mr. Figdor believes that M&A activity will accelerate in 2018 from its already high levels. With complex deals "trading way too wide", he anticipates research-intensive strategies are well positioned to succeed in this current environment.

Yet, as the weight of money has compressed deal spreads to a point where they do not justify the risks, Mr. Figdor believes it will be harder to find competitive returns in agreed deals. He concludes: "Parts of this business have been commoditised and parts are unable to be commoditised".

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Asset Management
SOCIETE GENERALE GROUP

Lyxor Asset Management - Tours Société Générale
17 Cours Valmy - 92987 Paris La Défense Cedex - France
www.lyxor.com - solutions@lyxor.com