Sculptor

Q&A: Merger Arbitrage Revisited

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A CONVERSATION BETWEEN:

Jeff Lin
Global Head of Equities

Jeff Lin is the Global Head of Equities and oversees public equity investments globally within Sculptor's Fundamental Equities and Merger Arbitrage strategies. Within both Fundamental Equities and Merger Arbitrage, he works closely with investment professionals across geographies and asset classes to maximize the Firm's research capabilities in the investment process. Mr. Lin has over 19 years of investment experience, specializing in arbitrage and event-driven investing.

Michael Gubenko, CFA
Global Head of Portfolio Specialist Group

Michael Gubenko is Global Head of Portfolio Specialist Group and is primarily responsible for partnering with the Firm's clients to deliver investment insights on Sculptor's investment businesses. In addition, he oversees certain strategic relationships of the Firm and partners with those clients to provide investment solutions that meet their needs.

MICHAEL GUBENKO

In our last discussion in the summer of 2023, you spoke about the hostile regulatory environment and why Merger Arbitrage was a small allocation within Sculptor's multi-strategy fund. Fill us in on what transpired in the back half of 2023?

JEFF LIN

We knew at that time that the rules of M&A antitrust enforcement had changed following the 2020 presidential election. However, we have seen these shifts before over the course of the last two decades of investing in merger arbitrage. In the middle of 2023, there were several large-cap transactions announced in 2022 that we believed would receive acute antitrust scrutiny and could have extended reviews. The combination of a hawkish regulatory environment, coupled with a volatile macroeconomic backdrop, resulted in our smaller sizing of positions to manage these risks. Our modest exposure reflected our view that we had to be patient and act opportunistically.

What ultimately played out affirmed those concerns as regulators attempted to block several high-profile transactions. This included one of the most noteworthy transactions of last year, Microsoft's acquisition of Activision.

Consequently, these regulatory challenges entailed lengthy multi-jurisdictional reviews and resulted in a material widening of merger spreads. I think the market was a little bit surprised to see the FTC and the CMA take such an aggressive stance in a few high-profile cases. However it was these actions from regulators that affirmed our approach to how we invested our client's capital in this asset class.

MICHAEL GUBENKO

How do you navigate and find opportunities during this time of regulatory uncertainty?

JEFF LIN

Our philosophy, for as long as I have been at Sculptor, is that it is always better to have a fundamental view when investing in merger arbitrage. Developing a view of the target company provides an edge and is critical for weathering the unpredictable twists and turns that can occur during the pendency of a merger. Having conviction in a stand-alone valuation sometimes allows you to price the risk/reward differently than the market. It is extremely difficult to have an edge on the outcome of a merger review, but we find that we can often have an edge on the fundamental value of a target company.

For this reason, the prevailing regulatory uncertainty ultimately created an opportunity over the course of 2023. We ramped up our exposure, most notably during the third quarter in two deals where we had a fundamental view of the target that underpinned our investment thesis. In both cases, at the height of regulatory uncertainty, we were able to invest in the target company at what we viewed as an attractive stand-alone valuation. The merger spread was pure upside.

In addition, because we were conservatively positioned in the strategy, we had the firepower to allocate significant capital while others were de-risking. We went from Merger Arbitrage being a small percentage of the multi-strategy fund to nearly 25% in the span of a few weeks. Those deals ultimately closed in Q4.

MICHAEL GUBENKO

Were there any other types of arbitrage opportunities that arose from this volatility?

JEFF LIN

There's a large universe of non-merger related arbitrage situations that we explore for investment. Often, it's a function of what's going on in capital markets. When there is stress and a lack of capital chasing these kinds of investments, it can create interesting opportunities. Historically, we have been active in split-offs, exchange offers, and different forms of share-class or holding company arbitrage. These investments involve creative solutions where we can lean on our expertise on proration, on equity finance, on stock loan, and the size of our presence in the market to execute these complex trades.

Last year we allocated to several non-merger event-driven investments; one was a split-off of a consumer health company, a stock loan arbitrage in a media company, and a share-class arbitrage in a separate media company. The resources that we have at the firm proved again to be a huge advantage in identifying and setting up these convergence-oriented opportunities. In addition, as fundamental investors, we had the risk appetite to be short certain volatile securities while traditional arbitrageurs typically either don't have the mandate, the leeway, or the tolerance to take those risks.

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>
> —JEFF LIN

MICHAEL GUBENKO

One major difference between now and when we last spoke is that interest rates have been sustained at elevated levels. Does that impact the opportunity set in any way?

JEFF LIN

Merger arbitrage spreads are generally fixed income investments. Part of the strategy is assessing the probability that the deal closes, and another element is evaluating the time it takes for it to close. Short term risk-free rates significantly impact the net annualized returns of cash deals. Unlike in all-stock transactions where the merger spread has a short component that earns a rebate, cash deals are now much more sensitive to how long a deal takes to close. For example, when short term rates are north of 5% and a deal trades at 9% IRR to a 6-month timeline, adding an additional 6 months from a lengthy regulatory review changes the return from 400bps over risk free to being 100bps less than risk free. As a result, we have to factor this into our analysis when we think about the risk reward to different scenarios in the timeline and typically, we find that we are more conservative than the market.

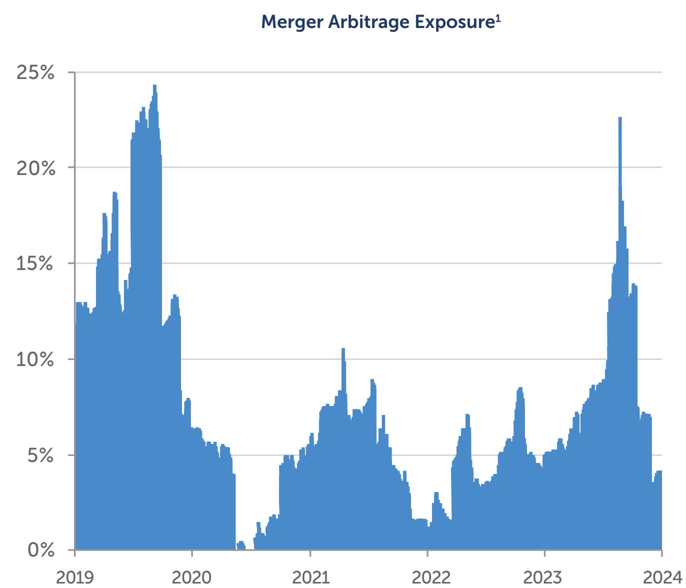
MICHAEL GUBENKO

Given the strong rebound across risk assets, many market participants are calling for a resurgence in capital markets appetite and deal activity. Is this beneficial for the merger arbitrage strategy?

JEFF LIN

Overall, more capital markets and deal activity is beneficial across our multi-strategy business. More IPOs, and more secondary offerings create opportunities to profit in arbitrage. And so yes, absolutely, this rally is a tailwind for M&A because there is more risk appetite in corporate boardrooms.

However, we have a presidential election this fall, which could bring a potential change in administration, and in turn antitrust policy. There is also the anticipation of lower short term rates from the Fed easing later this year. And so, there are a few reasons to wait on M&A. With that said, tight credit spreads, general availability of financing, and an improving global economic outlook may outweigh some of those reasons to wait. On balance, the current market provides a conducive environment for being opportunistic investors in the kinds of complex situations that we have historically favored.



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