

The Art of the Deal

Spotlight on M&A in 2018

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Merger arbitrage strategies have enjoyed a plentiful opportunity set over the last several years as underlying dynamics have been favorable for deal making. We expect such conditions will remain intact during 2018; however, we are seeing political and regulatory risks surface. In this paper, we focus on how the mergers and acquisitions (M&A) landscape is evolving and the implications such change will likely have on future M&A activity and merger arbitrage portfolio management.

Economy Instills Confidence, Paints a Beautiful Backdrop for M&A

A convergence of factors has painted an attractive canvas for M&A activity over the last several years. Low interest rates, a healthy global economy, and rising levels of CEO confidence have led to robust activity. While 2015 remains the highwater mark of the current cycle, both volume and deal count are still elevated versus the last fifteen years (Figure 1).

At its core, M&A is an agreement between the executives of two companies that the consolidation of the two entities will create corporate value. Lower confidence in the outlook of a company portends a decline in M&A activity, as seen during and following the Great Financial Crisis. Confidence reached a multi-year high in 2017 as global growth synchronized across major economies, and CEOs became more optimistic about future revenues and earnings growth potential (Figure 2); consequently, deal pace has remained robust.

Beyond the optimistic outlook among CEOs, corporate M&A activity has been motivated by historically low interest rates coupled with tight corporate spreads and a more favorable US tax structure. Recently, the Tax Cut and Jobs Act of 2017 has provided further stimulus, slashing the corporate tax rate from 35% to nearly 21%. Earnings accretion is very attractive under these conditions and continues to drive deal activity. The new tax code has also spurred many companies, particularly those in technology and health care, to repatriate offshore cash. We expect deal activity to remain strong, particularly in these sectors.

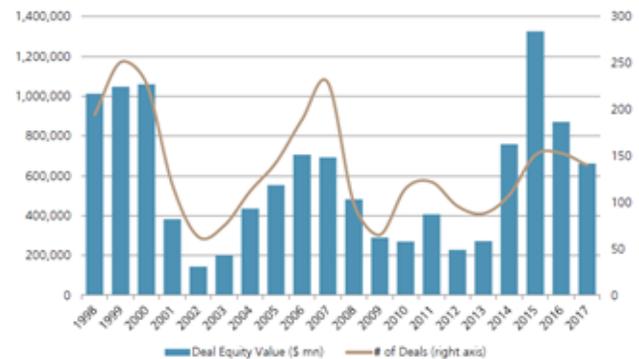
A Closer Look Reveals Some Errant Brushstrokes

Although the potential for M&A activity is bright, certain headwinds have become more pronounced in the past year. The pending AT&T acquisition of Time Warner, which many market observers expected to be approved, has raised concerns due to the opposition it has received from the Department of Justice

(DOJ). Historically, vertical mergers, such as the AT&T deal, have faced little resistance since they do not eliminate a competitor and have little overlap. The DOJ's unexpected lawsuit against AT&T has cast uncertainty over how future vertical deals will be reviewed. We believe this may be a near term deterrent for deal making while CEOs await the lawsuit outcome and the implications for antitrust policy.

We also believe the AT&T case foreshadows how cases deemed anticompetitive may be remedied by the DOJ. A new DOJ preference for structural remedies over the behavioral remedies of the past may pose a challenge for mergers if the proposed remediation damages the value of the combination.

FIGURE 1. DEAL ACTIVITY



Source: UBS Special Situations

FIGURE 2. CEO CONFIDENCE LEVELS (DECEMBER 2002 - PRESENT)



Source: Chief Executive Magazine, Bloomberg

Additionally, we have separate concerns for cross-border deals that require approval in multiple jurisdictions. As nationalism has risen globally over the past year, it is unclear whether governments will become more cautious of foreign competition, producing additional regulatory headwinds. The influence of contentious international trade situations on M&A discussions also bears monitoring.

Lastly, we are also monitoring the role of the Committee on Foreign Investment in the United States (CFIUS). CFIUS, an inter-government agency headed by the Secretary of the Treasury, has historically focused on deals that were viewed as national security risks to critical infrastructure, such as defense and sensitive technology. Recently, CFIUS has hardened its stance on foreign buyers of U.S. assets, particularly China (Figure 3), blocking a

Chinese private equity firm from purchasing US technology company Lattice Semiconductor and causing Ant Financial to withdraw their offer to buy MoneyGram following multiple unresolved reviews. The National Law Review recently wrote that the scope of what is considered “critical infrastructure” under CFIUS has expanded to include companies that have access to sensitive personal or consumer information¹, which could prevent or complicate future deal making in a wide variety of industries.

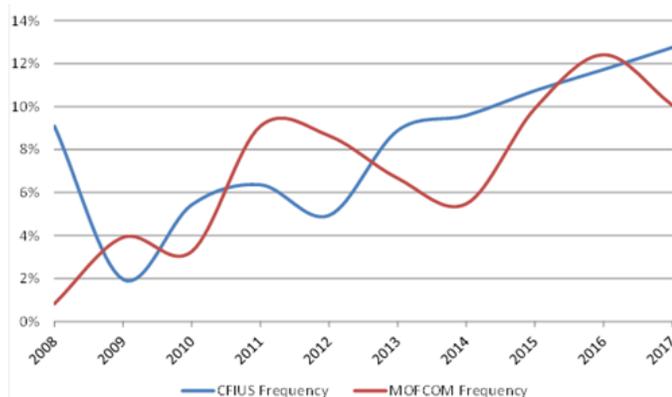
Painting a Masterpiece: Implications for Merger Arbitrage

An increase in the number of deals over the past four years has provided an ample opportunity set for selecting arbitrage positions. We believe the conditions currently in place, such as strong CEO confidence and capital market financing availability on both the credit and equity side, will continue to spur future deal making. Recent earnings commentary from investment banks during Q1 2018 confirm that the conversations among corporate clients and potential M&A backlog is optimistic.

In our merger arbitrage portfolio, we assess each deal on a variety of risk factors, such as regulatory, financing, and industry risk. The recent regulatory and political risks described earlier in this piece have raised the risk profile of assessing arbitrage deals. We ask ourselves several key questions: Will this deal win US approval? Will it obtain approval from the EU or China? When applicable, how will CFIUS view this deal? Careful consideration of these risk factors, which are specific to each deal, can help avoid potential deal breaks. While the merger arbitrage environment continues to provide attractive investment opportunities, we maintain a heightened awareness of emergent risk factors.

¹ National Law Review, January 10, 2018

FIGURE 3. FREQUENCY OF DEALS SUBJECT TO CFIUS OR MOFCOM¹ REVIEW



Source: UBS Special Situations

¹ Ministry of Finance, People’s Republic of China (MOFCOM)



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