DuPont Capital

EQUITY STRATEGY REVIEW
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Merger Arbitrage

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In the most recent quarter, M&A activity continued to slow due to numerous factors including weakening macroeconomic indicators, political uncertainty, and trade tensions. Corporate managements remained cautious of engaging in major deals due to substantial uncertainty across the regulatory landscape. M&A is still an option, as most corporate balance sheets are in decent health and the private equity sector has significant uncommitted capital, but the focus is on smaller, bolt-on deals and capturing cost synergies.

During the quarter, the trade hostility between the U.S. and China drifted between optimism and outright despair. From a merger arbitrage perspective, many pending deals that need Chinese regulatory approval have often traded at a wide spread, particularly in sensitive industries such as technology. The opaque and difficult process of obtaining approval in China remains a key impediment for many management teams that consider large M&A. While some market pundits point to the Phase One trade deal agreement as a positive step toward a more normalized approval landscape, we remain cautious and look for more concrete signs.

Political risk has emerged as a heightened risk in merger arb analysis. For example, the Sprint/T-Mobile merger has been approved at the federal level but is still being challenged by several states. Past merger challenges have not generally followed this path. Historically, State level approvals have been more benign than the Federal process. We await greater clarity on whether enough concessions can ameliorate competition concerns at the State level and push this merger to completion. Another point of concern in the political arena involves the upcoming U.S. presidential election. It is unknown who the Democratic candidate for president will be and there appears to be a large variation in the policy positions of potential candidates regarding M&A. For example, Elizabeth Warren has recommended revisiting past mergers and possibly unwinding them, an unprecedented step. One can easily see how this might put a damper on the M&A market. In our view, there seems to be a window in the near term where mergers with a shorter completion time frame can be completed, whereas deals with a longer time to close in multiple jurisdictions will most likely be shelved until the political environment is more certain.

Government bond yields were relatively steady throughout the quarter. In general, this has led to low volatility in arb spreads for rate of return type deals. Credit markets remain very accommodative for issuance with volume strong throughout the quarter. Both investment grade and high yield spreads have continued their march tighter for much of the quarter with CCC debt joining in later in the quarter. Market expectations are for a robust debt issuance environment in 1Q 2020, which should accommodate the issuance needs for M&A announcements. One area of concern often flagged is the larger representation of BBB debt in the investment grade market. This concentration has moved steadily higher for over a decade as corporate leverage has risen.

Merger arb continues to demonstrate its low correlation to both equity and fixed income benchmarks. Deal flow continues to be dominated by strategic mergers, with a greater emphasis on stock consideration as equity multiples have expanded during the ten-year long bull market. The ultimate success of a merger arb strategy is whether the portfolio deals will close, rather than such quantitative investment factors as style or leverage. This uncorrelated attribute is a useful diversifier in an overall investment portfolio.

About our firm:

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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