Merger Arbitrage

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The substantial equity market selloff in the past quarter has led to significant weakening in merger arbitrage spreads as investors have become more cautious. We have witnessed these periods of selling and deleveraging on several occasions over the past seven years of managing the portfolio. In many arbitrage situations, the standalone value of the target has declined, so the downside potential in the event of a deal break has increased. Even if the breakeven probability of a deal remains unchanged, the spread will widen to reflect the greater downside risk.

In this current environment, there is substantial fear that deals could either reprice or break, similar to the start of the coronavirus pandemic in March 2020. We think this level of risk aversion is overstated and provides opportunities to add or initiate in certain positions. Why do we believe deals will close? Unlike March 2020, the possibility of invoking a Material Adverse Event is lacking. Events such as the coronavirus pandemic, war (Russia-Ukraine), and recessions are often carved out of a MAE clause, meaning the buyer cannot abandon the deal simply because those events have occurred. It is also important to recognize that in the wake of the coronavirus pandemic, the courts still did not find that the pandemic was a MAE during lawsuits. In certain situations, the parties agreed to settle with a nominal price cut rather than continue litigation.

In many private equity deals, the arbitrage spreads have widened over fears that the buyers will not be able to obtain debt financing. We believe those concerns are inaccurate. In most merger agreements, the debt financing is contractually committed by the investment banks or more recently, private credit funds. In past situations where the credit markets froze, the banks still provided financing, and at a later point when the markets improved, the banks then syndicated the debt. Year to date, while high yield issuance has been light and challenging, the leveraged loan market has been fairly open. Additionally, private credit funds have substantial dry powder and have agreed to fund certain announced deals such Thoma Bravo's acquisition of Anaplan and SailPoint. As financing terms have become more favorable to lenders, we have seen private credit funds opportunistically step up to invest in several recent situations such as CDK, Nielsen, and Carvana

While private credit funds have substantial dry powder, private equity firms do as well, given record fundraising levels over the past two years. If a deal encounters difficulty, we have seen instances where the sponsor is willing to increase the equity component and reduce the debt in order to close the deal. Furthermore, if a private equity buyer abandons an agreed upon deal, we believe that will sully their reputation and harm their ability to compete in future deals.

Sellers will rightly view that buyer as less credible. Private equity firms want to deploy their capital in attractive situations and walking away from current deals will disadvantage their future deal sourcing abilities.

Earlier this year, there were certain pending merger arbitrage deals that were trading too tight in our opinion. Given the recent selloff, we have found opportunities to initiate or modestly add to existing positions in situations where we believe there is a path to successful deal closure.

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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Important Disclosures: