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Ready to deal?

The COVID-19 merger pause may be fleeting

UBS O'Connor | Global Merger Arbitrage Outlook

The COVID-19 pandemic caused a massive wave of de-risking across asset classes in March, including the merger arbitrage space, where spreads widened dramatically and activity slowed to a near-standstill.

The economic effects of the pandemic appear to be slowly resolving, but new deal activity remains muted. We anticipate that we may see activity and announcements increase soon as stressed companies seek relief, ample private equity capital gets put to work at more attractive valuations and strategic buyers pursue both friendly and hostile acquisitions. We continue to explore the major themes reverberating through the merger arbitrage opportunity set with weigh-in from industry experts.

Ample opportunities exist despite fewer deals

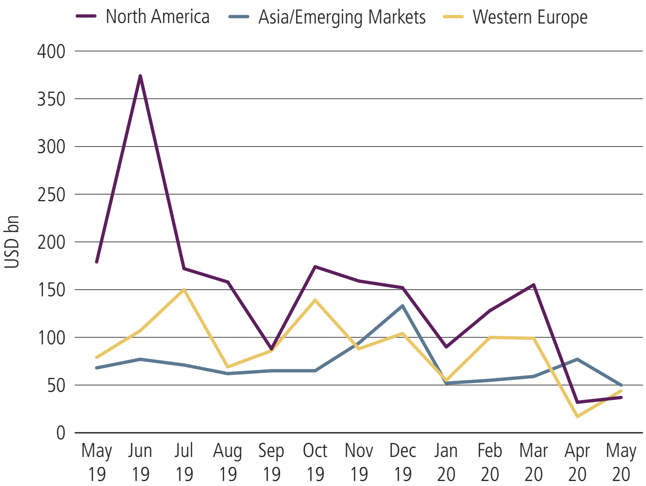
While the March decline in M&A activity approached the magnitude of the 2008 / 2009 Global Financial Crisis (GFC), both the nature of the crisis and the merger arbitrage space are different today.

Bank proprietary desks were regulated away after the GFC, however banks are now quite healthy and the pandemic has had less impact on supply and credit lines.

Despite the market turmoil, transactions still closed and some new deals were announced. While mergers have extended due to COVID-19-related slowdowns, the great majority of deals in the space are proceeding. In times of crisis, it has been our experience that merger arbitrage has been among the fastest arbitrage strategies to revert to the mean after spreads widen sharply. This is due to the definitive nature of mergers. The fact that there is a contract in place helps to stabilize the deal, allowing it to migrate back to the appropriate spread level.

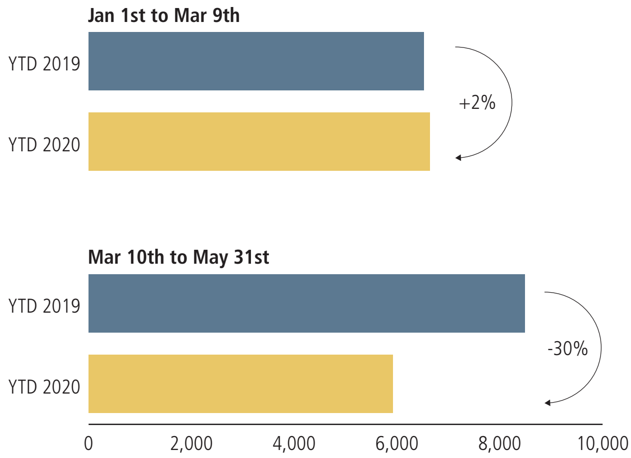
We have seen a few deals break, in particular Sycamore Partners negotiating a release from acquiring apparel retailer LB, but in general management teams have made clear their intention to close transactions despite economic uncertainty —this has been most apparent in large strategic transactions that may transform the acquirer's businesses, such as the Allergan/Abbvie deal which closed in May. We have also seen transactions close despite rumors of potential deal breaks, particularly Cypress/Infineon and Mellanox/nVidia, which both hinged on approval from the Chinese antitrust regulator.

Figure 1a: Down but not out–M&A volume by month



Source: Dealogic, Citi, Citi MA Snapshot, as of May 2020.
Note: (1) Region / nation is based on the geography of the target, acquiror or divestor, which means some deals will be included in multiple geographies. Asia/Emerging Markets includes all countries outside of North America and Western Europe.

Figure 1b: Global number of M&A deals '19 vs '20



Source: Citi, Dealogic, Citi M&A Snapshot. As of 31 May 2020.

On the supply front we have seen a lower volume of new deal announcements (Figures 1a and 1b), but this doesn't mean the opportunity set is dead—in fact, companies may use the unsettled markets to be increasingly opportunistic. As noted by Anu Aiyengar, Co-Head of Global Mergers and Acquisitions at JPMorgan Chase, "There was almost a time when you saw the mood shift. If you think things are about to resolve, you wait. But if you think things are going to be murky for a period of time, and you are a well-capitalized company, this dislocation may give you an opportunity to be strategic."[1] Indeed the past few weeks have seen a number of announcements of strategic combinations, including Just Eat Takeaway's trans-Atlantic expansion in the meal delivery space with its announcement of a USD 6.4bn acquisition of GrubHub, and Chevron's USD 5bn deal for E&P company Noble Energy.

From an investment strategy standpoint, deal activity can act as a helpful tailwind, but a robust supply of new deals isn't a requirement for attractive returns. Deal activity declined meaningfully after the GFC in 2009 – 2011, but at the same time O'Connor's merger arbitrage strategy performed well, thanks to generally wider spreads, lower risk appetite in the space and low competitive capital as bank proprietary trading desks were shuttered.[2] Today we again see reduced competition in the space as some hedge funds have decreased exposure and average spreads have widened after the market drawdown in March. We continue to actively monitor the merger arbitrage space and are well positioned to take advantage of attractive opportunities.

[1] Source: "M&A is showing signs of life in the healthiest and least healthy sectors," Fortune, 21 May 2020.
[2] Past performance is not indicative of future results.

Recovery will spark deal activity

We anticipate activity and announcements to increase as companies under stress seek relief, ample private equity capital gets put to work at more attractive valuations, and some strategic buyers pursue hostile acquisitions.

"What we have learned from the past is that sharp declines in the M&A market have led to sharp recoveries, so we're expecting a strong second half with higher levels of M&A," said Goldman Sachs Group Inc.'s Co-Head of Global M&A Dusty Philip.[3] Market liquidity and debt issuance have not been impaired by the recent turmoil, and over the past few weeks we have begun to see some green shoots of deal activity, with JustEat's USD 7.3bn offer for GrubHub and Volkswagen's announcement that they are in discussions to acquire Europcar—in our opinion, increased corporate confidence will be crucial to bringing strategic buyers back to the market in force.

The COVID-19 crisis may add further impetus to transactions in sectors already undergoing secular change, in particular healthcare, which has maintained a degree of activity through the downturn, "Healthcare is a sector that might have interesting opportunities as a result of this crisis and is one of the sectors that has had the least impact," said Nestor Paz-Galindo, UBS Group AG's head of M&A for EMEA.[4]

The biotechnology sector is also worth watching."Once things calm down a bit, you're going to see a number of bigger bets in the most innovative areas of biotech this summer and into the fall," according to Stuart Cable, a partner and the global chair of M&A at Goodwin Procter LLP.[5] We anticipate the decade-long trend of large pharmaceuticals acquiring biotechs for their research and compound pipelines will continue. "The large-cap pharmaceutical companies are sort of starving for innovation, starving for growth… Most of the exciting, breakthrough work that's being done in biotech is being done by companies under USD 5 or 10bn in market cap," according to John Porter, Fund Manager at Mellon Investments.[5]

[3] Source: "Dealmakers Look Beyond Virus Crisis for M&A," Bloomberg, 7 April 2020.
[4] Source: "Dealmakers Look for M&A to Pick Up in Second Half of the Year," Bloomberg, 14 May 2020.
[5] Source: "Biotech Pacts Leave Wall Street Salivating for M&A," Bloomberg, 28 May 2020.

Stressed companies may seek relief

The economic downturn has had an outsized impact on a number of industries including travel, hospitality, gaming and manufacturing.

We anticipate that we may see a surge of deal activity as acquirers seek targets at discounted valuations, and as acquisition candidates look for partners to shore up their businesses. "When the economy stabilizes after the crisis, the first wave of deals could involve companies looking to fix supply chain problems or get their operations back on track," said Citigroup Inc.'s Head of EMEA M&A, Alison Harding-Jones.[6]

Industries that have and will continue to feel a stark impact from the pandemic include travel and hospitality. Oil and gas companies will also need to act—"They suffered a double hit from the pandemic and also low oil prices and may have to look to transact as a matter of survival," according to George Casey, who leads the global M&A practice at the law firm of Shearman & Sterling LLP.[7] There may also be some shake-out in industries, causing a wider debate about the survival of smaller companies in industries that are over-crowded. Yoshihiko Yano, head of M&A in Japan at Goldman Sachs Group Inc. believes, "This could eventually become a catalyst for large-scale M&A activity."[8]

Our canvas of market participants suggests a 'reopening' for M&A could soon emerge, and we hear that sentiment from others as well. "We are seeing an uptick in inquiries and signs of an uptick in activity," said Eli Hunt, a partner at the law firm Simpson Thacher & Bartlett. "There are a lot of companies and private equity groups out there with capital, and there is potential opportunity."[9] Echoing this sentiment, Eric Schiele, a Corporate Partner with Kirkland & Ellis LLP believes, "As the current crisis abates, I expect a spike in deal activity as people feel some urgency to pursue any strategic transactions that have been kicking around in the remaining window—before the M&A cycle turns for real."[9]

Private equity flush and looking

With the lower valuation multiples post-March we anticipate that private equity firms, with > USD 1trn in available capital, may become more opportunistic in taking advantage of targets at discounted prices versus pre-COVID-19, although increased visibility into forward earnings will be key in new deal flow. Recently we've seen green shoots of renewed private equity activity, as China's 58.com agreed to a USD 8.7bn buyout offer from a consortium led by Warburg Pincus, and a separate consortium led by Providence Equity Partners acquired Spanish Telecoms provider Masmovil for USD 3.3bn.

[6] Source: "Dealmakers Look Beyond Virus Crisis for M&A," Bloomberg 7 April 2020.
[7] Source: "Dealmakers Look for M&A to Pick Up in Second Half of the Year," Bloomberg, 14 May 2020.
[8] Source: "Goldman, Mizuho Expect Thaw in Japan Dealmaking to Quicken," Bloomberg, 7 June 2020.
[9] Source: "Global dealmaking drops to lowest level in more than a decade ," Financial Times, 1 July 2020.

Conclusion: Slow, steady activity offers opportunities

Regardless of the short term direction in deal activity, our team has managed the Merger Arbitrage portfolio though similar cycles and produced attractive returns for our investors. We anticipate that we may see activity and announcements increase, but in the meantime we continue to see attractive opportunities, particularly in high quality strategic deals with short-term catalysts on the horizon, and we will continue to add new positions and increase exposure where we see attractive risk / reward.

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